

Facebook and the Challenges of Investing in an Expensive Market

This article is excerpted from a letter by Zeke Ashton, managing partner of Centaur Capital Partners, based in Southlake, Texas.

We view Facebook's ~20% stock price decline in late July as sort of a "sequel" to its initial decline earlier this year when the stock suffered a similar fall. We had taken the Fund's position in Facebook to as high as 20,000 shares back in March as the data usage controversy reached its most intense level. As the stock rallied into the summer and the world's attention moved to other subjects, we trimmed the position at incrementally higher prices such that we had reduced the Fund's position to 13,000 shares going into the late July Q2 earnings report.

We believe that Facebook's management has elected the path of absorbing some short term pain in order to protect the longer term value of the business. Facebook's biggest risk factors appear to be reputational and regulatory in nature, and the company needs to show that it takes responsibility for the potential negative societal impacts introduced by its products in order to mitigate these risks.

If Facebook is successful in its efforts to the extent that both users and advertisers perceive that its services are less prone to societal harm, then the business will likely be far healthier and better insulated from these hard-to-quantify risk factors in the future.

However, it is also apparent that Facebook will be investing heavily to better monitor the 2.5 billion users and many millions of advertisers across its platform. As a result, the company's near term financial outlook seems somewhat less attractive than it did prior to the recent controversies, and our estimated value range for the stock is also somewhat lower today than it was six months ago.

Importantly, in our view Facebook's business remains immensely strong and user behavior has largely been unchanged by the recent negative events and corresponding media coverage. Now that expectations for the business have been re-set, we hope that the company can move forward with less drama and the stock price will move higher as the market regains comfort with the company's strategic direction. As of this writing the Fund's position of 15,000 shares is roughly a 4% portfolio weighting with the stock trading at around \$175 per share.

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While the Fund has made money on its Facebook investment so far in 2018, we feel somewhat fortunate to have done so because the stock itself has not produced a gain. Our experience has been somewhat better only because we bought shares on weakness and sold shares on strength.

However, I think Facebook is a good case study in the difficulties of investing in a market in which nearly all high quality businesses trade at extremely full valuations, and in most cases one can really only hope to find relative (not absolute) value. The problem is that when prices are full, stocks are vulnerable to sudden changes in future expectations.

In the case of Facebook, we can make a strong argument for relative value at prices we paid, but we know that the margin of safety in the event we are too optimistic in our estimates is much lower than we'd like.

While most of the Fund's investments aren't in high growth companies like Facebook and therefore

aren't quite as sensitive to changes in expected future growth rates and profit margins, we still have less room for error than we'd like on the valuation side across the portfolio.

This means we have to be very diligent with respect to watching for emerging risk factors that could affect our portfolio companies. It also means we need to be aware of how the potential risk/reward pay-offs for our securities change as prices move around, and take reasonable action to increase or decrease exposure when opportunities present themselves.