

# As Bad as IBM's Been, Amazon's Been Worse

About a year ago our newsletter compared the valuation of IBM and Amazon (AMZN). At the time IBM had a P/E of 10X (AMZN's was 166X), was growing Free Cash Flow (versus flat at AMZN) and seemed wholly more attractively priced than AMZN. As we noted then, we owned IBM and not AMZN, where we think that being a customer is so much better than being an owner.

A year later, IBM has so far been a disappointment. Its most recent quarterly earnings saw continued weak sales, an abandonment of their long-held 2015 forecast of \$20 in EPS, and a payment of \$1.5 billion to a firm kind enough to take their loss-making chip manufacturing business off their hands. From November 1, 2013 through today IBM has returned -7% (including dividends), substantially worse than the S&P500's +13.5% total return over the same period.

It's hard to compare the P/E they were trading at last year with their current level, because for now management isn't making a 2015 earnings forecast. However, using consensus estimates of \$16.91, it's trading at less than last year's 10X multiple that we found attractive. The critics point to the challenge of adapting their business model to cloud-based software as a service and away from their licensing model. So far events seems to agree with them. And yet, the company continues to generate \$12-14 billion of free cashflow, some of which buys back stock which helps its per share metrics. We were obviously early with IBM, but are staying the course.

Although it's hard to believe, owning AMZN for the past year would have been worse than the 20% relative underperformance delivered by IBM. AMZN CEO Jeff Bezos and his penchant for putting growth ahead of profits helped drive AMZN's most recent quarterly earnings disappointment and is behind their

-20% one year return, 33% worse than the S&P500. Bezos has always wanted to deliver profits sometime in the future. It's why they're such an exciting company to watch and why I buy all kinds of obscure items without having to set foot in a brick and mortar store. In the last several weeks I have bought beach shoes, a replacement license plate light bulb, batteries, leather luggage tags, a belt and several 1lb bags of shelled Brazil nuts. I love AMZN investors for helping keep the company's cost of capital low so that they can offer all these products and millions of others.

Some people thought long AMZN/short IBM was a great pairs trade. Well, IBM certainly has been a worse investment than the S&P500, but handily better than AMZN. If you're not leveraged, waiting for IBM to beat the benchmark as well isn't that expensive.