AMM

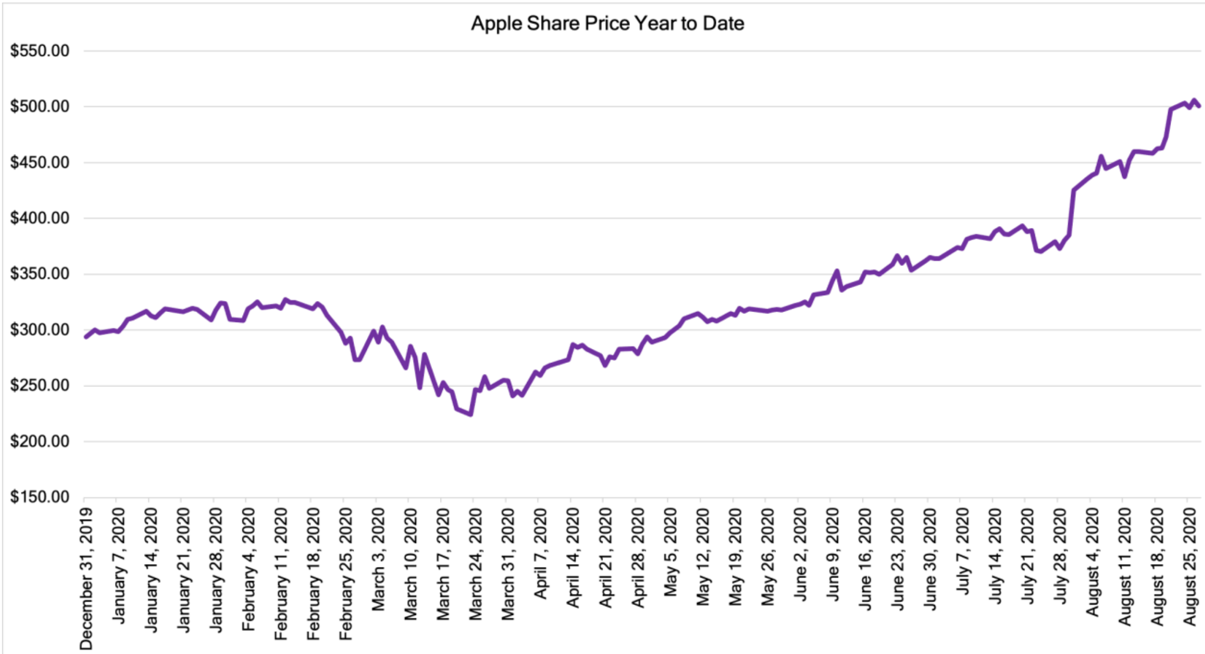
AMERICAN MONEY MANAGEMENT, LLC

SEC Registered Investment Advisor

Trimming Apple Again

At the start of June Apple's market capitalization was $1.4 trillion. **In 3 months, Apple added another $744 billion in market cap**. And the bulk of that increase came within the last month.

By July 28, Apple's stock was up around 27% year to date. Already impressive, given that this includes the coronavirus market sell-off. But from July 28 to August 27, Apple is now up over 70% year to date.



At the time of this writing, **Apple's market cap is now equivalent to the combined market cap of the smallest 382 companies in the S&P 500!**

As of August 24, 2020, Apple's market cap was 30% bigger than the number two company, Amazon.

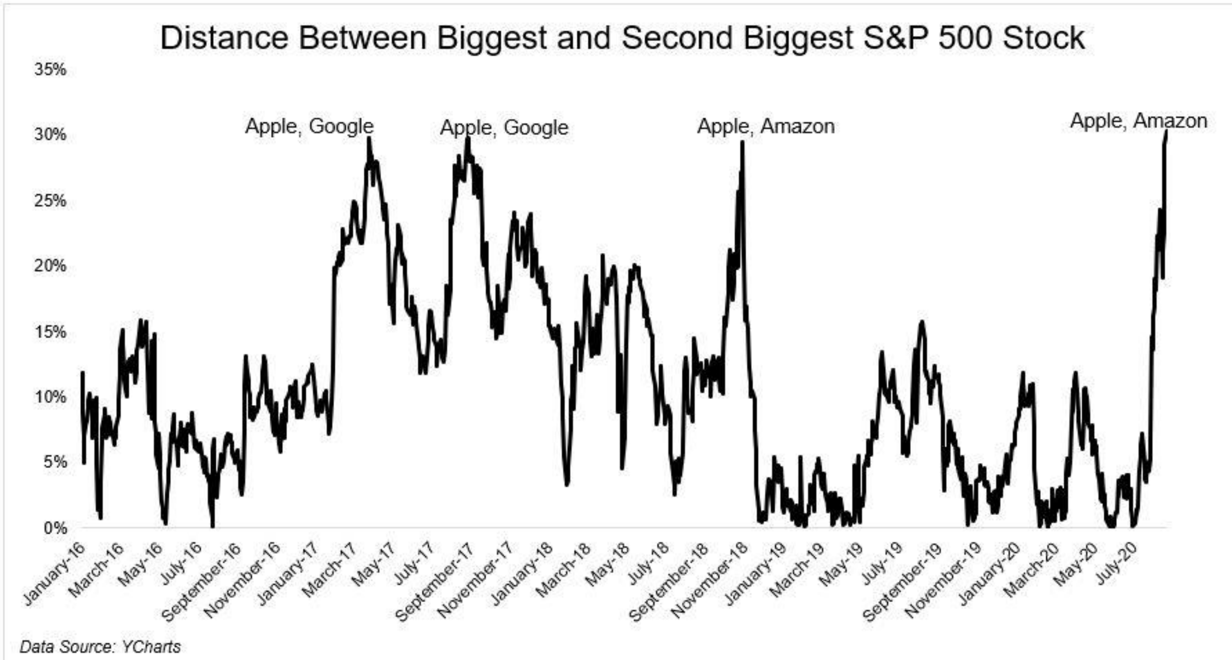


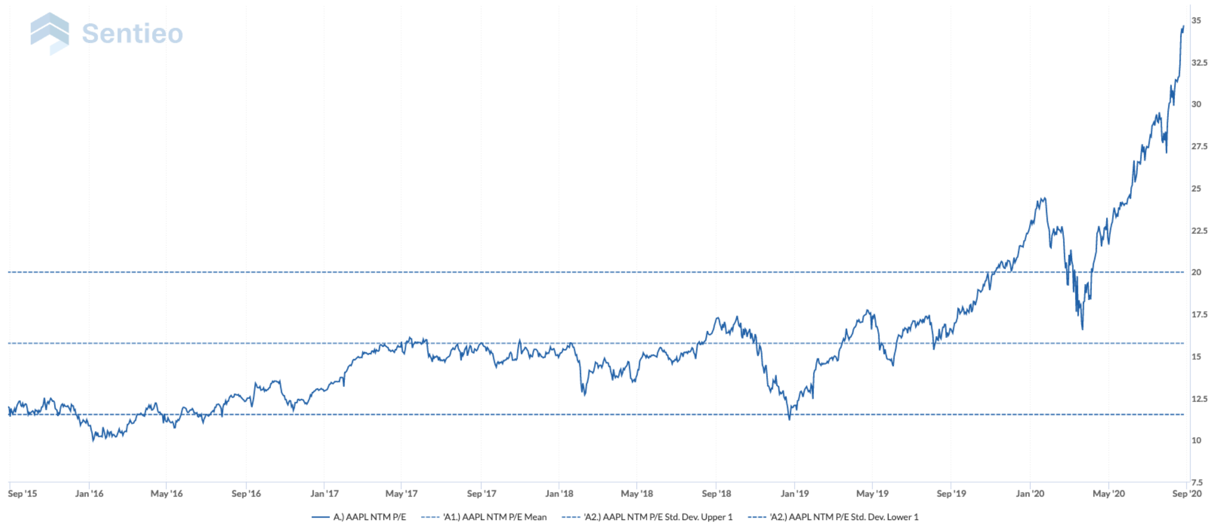
Chart from [The Irrelevant Investor]

As Michael Batnick points out in his post [King Apple], this discrepancy usually self-corrects but it's not a trading signal. Apple's share price could underperform from here or Amazon and the other top S&P 500 holdings could outperform Apple. Most likely a combination of them both. What it does signal is the short-term exuberance in Apple's stock.

Trimming Apple

After this impressive run we are trimming Apple. As we've stated in the past, we have maximum position size rules for positions in the portfolio. The guardrails allow positions to grow along with the portfolio without triggering a trade. But sometimes a position grows faster than the portfolio and exceeds our maximum position size rules. When a position gets too big in a portfolio then the portfolio is too dependent on one position and this increases the risk in the portfolio. Risk is further increased if the stock has moved too far ahead of its fundamentals.

Nothing has changed in our view regarding Apple's fundamental business over the last 3 months. What has changed is the market's perception of its business. The P/E ratio, in part, is a sentiment metric. How much are investors willing to pay today for the company's current and future earnings power. During the last 3-months, the price investors are willing to pay for Apple's earnings power has risen alongside its stock price.



The argument could be made that the market had persistently underpriced Apple's earnings power. We thought so and that's why we made our first investment back in 2013. The market may also be finally recognizing the value in its Services business which generates recurring revenue and is highly profitable.

	3 Months Ended		9 Months Ended	
Gross margin percentage:	**June 27, 2020**	**June 29, 2019**	**June 27, 2020**	**June 29, 2020**
Products	29.70%	30.40%	32.00%	32.40%
Services	67.20%	64.10%	65.70%	63.60%
Total gross margin percentage	38.00%	37.60%	38.30%	37.80%

What is the Right Price to Pay?

We like companies with consistent high returns on invested capital (ROIC). It is a sign that the company has a strong competitive advantage. We can also use ROIC and the Gordon Growth Model to determine the P/E ratio we're willing to pay.

The Gordon Growth Model is:

$$p = \frac{D_1}{r - g}$$

P = Price

D_1= Next year's expected annual dividend

r = Discount rate or required return

g = Growth

For D_1 we're going to change the definition to all cash that can be distributed to shareholders not just the dividend.

If a company has $1 of distributable cash, is growing at 6%, and we require a 10% return on our investment, then the stock is worth $25 per share.

$$25 = \frac{1}{10\% - 6\%}$$

And a company with the same $1 in cash, growing at 3%, with a 10% required return is worth $14.30.

$$14.3 = \frac{1}{10\% - 3\%}$$

We need to bring ROIC into the equation. If we have two companies that both want to grow at 6% per year, we need to figure out how much each company needs to reinvest in their business to achieve a 6% growth rate. How much additional profit is created for each dollar of capital it invests?

A company with a ROIC of 30% needs to only reinvest 20% of its profit to achieve a 6% rate of growth. 80% of the profit can be distributed to shareholders.

$$6\% = 30\% \times 20\%$$

The second company has a ROIC of 10%. To reach a 6% growth rate it needs to reinvest 60% of its profits. Only 40% can be distributed to shareholders.

$$6\% = 10\% \times 60\%$$

And all else being equal, we're willing to pay more for the high ROIC company that can distribute more cash to shareholders.

High ROIC company value

$$20 = \frac{.8}{10\% - 6\%}$$

Low ROIC company value

$$10 = \frac{.4}{10\% - 6\%}$$

If we keep D_1 constant at $1 and our required return at 10%, we can create a table of the prices we're willing to pay for that $1 in distributable cash based on the expected growth rate and a company's ROIC.

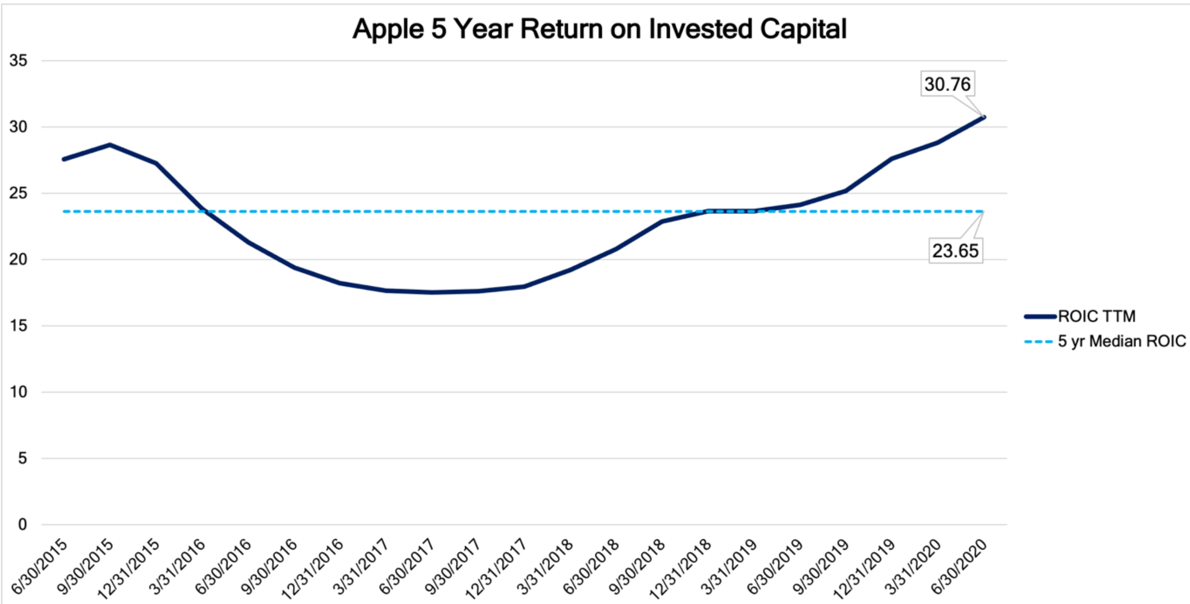
Remember the P/E ratio is simply price divided earnings. By holding D_1 constant at $1 we're creating a table of P/E ratios.

	Return on Invested Capital									
Expected Growth Rate	22.0%	23.0%	24.0%	25.0%	26.0%	27.0%	28.0%	29.0%	30.0%	31.0%
9%	59.09	60.87	62.50	64.00	65.38	66.67	67.86	68.97	70.00	70.97
8%	31.82	32.61	33.33	34.00	34.62	35.19	35.71	36.21	36.67	37.10
7%	22.73	23.19	23.61	24.00	24.36	24.69	25.00	25.29	25.56	25.81
6%	18.18	18.48	18.75	19.00	19.23	19.44	19.64	19.83	20.00	20.16
5%	15.45	15.65	15.83	16.00	16.15	16.30	16.43	16.55	16.67	16.77
4%	13.64	13.77	13.89	14.00	14.10	14.20	14.29	14.37	14.44	14.52
3%	12.34	12.42	12.50	12.57	12.64	12.70	12.76	12.81	12.86	12.90
2%	11.36	11.41	11.46	11.50	11.54	11.57	11.61	11.64	11.67	11.69
1%	10.61	10.63	10.65	10.67	10.68	10.70	10.71	10.73	10.74	10.75
0%	10.00	10.00	10.00	10.00	10.00	10.00	10.00	10.00	10.00	10.00

*Required Return = 10.0%

Apple is expected to grow its earnings at 6% per year over the next 5 years. That might not seem like a lot, but it is for a $2 trillion company. It is still higher than the expected U.S. GDP growth.

The chart below is Apple's 5-year ROIC for the trailing twelve months and its median ROIC over those same 5 years.



Using Apple's current 31% ROIC, a 10% required rate of return, it's 6% expected growth rate, we arrive at a **P/E ratio of 20x**.

If we use Apple's median ROIC of 24%, the same 10% required return, 6% growth, we arrive at a **P/E ratio of 18.75**.

Currently, Apple's **P/E ratio is 39.15**.

Investing is an expectations game. Market participants are expecting Apple's earnings to grow much faster than 6% per year and they're willing to pay a premium multiple for it. But what if Apple's earnings don't grow faster than 6%? What if effective competition cause Apple's ROIC to fall? Then market participants are overpaying for the rosy future that does not materialize.

When the market is willing to overpay for the rosiest of futures, we're willing to sell a little bit of our position to them. Then when sentiment shifts and they're willing to sell us the stock at a discount, we will seek to buy it back.

Trading Rules

We're not selling our entire position in Apple. We're selling a small portion of it in accounts that meet the following rules. The following rules apply to accounts 100% in the AMM Dividend Growth Strategy. The rules will flow through to all accounts in the AMM Dividend Growth Strategy depending on how much of your account is invested in the strategy. Accounts that have specific trading restrictions on their position in Apple will not be affected by these trades.

We're only trading accounts that have greater than 5% of their AMM Dividend Strategy portfolio in Apple. Instead of trimming

Apple back to our target weight of 3.5%, we'll trim it back down to the upper range of 5%.

In the case where a client is invested in one of our asset allocation strategies that includes bonds, international stocks and/or other assets, *we will trim positions that are greater than 5% of the amount invested specifically in the AMM Dividend Strategy*. For example, an account with a 50% allocation to the AMM Dividend Strategy will have their position trimmed if it is above 2.5% (5% * 50% = 2.5%).

To minimize taxable gains, we're only trimming a maximum of 2% of a portfolio value. If your position in Apple is 7% of your account, then we will bring it back down to 5%. If your Apple position is larger, like 8%, then we will bring your position down to 6%.

If you have any questions, would like to discuss this further, or want to double check restrictions on your Apple position, please give us a call as soon as possible.

Sincerely,

Your Portfolio Management Team