

OPINION

A costly sentence for investors: ‘I just don’t want to miss this one’

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I got a call from a friend last week asking if he should invest in the upcoming Anthropic IPO. I am a value investor, so this is like asking a vegetarian to choose a steak.

I said I had no idea. He launched into the merits: the growth rate, the growth of artificial intelligence and its leading position. He then added that his brother-in-law, who got into Google early and has never let anyone forget it, was putting money in. He ended with “I just don’t want to miss this one.” I thought to myself that might be the most expensive sentence in investing.

Nevertheless, I said, let’s walk through the numbers. Anthropic is expected to come public with a US\$2-trillion valuation. Revenue’s annualized run rate (not audited revenue) is about US\$65-billion per year. This suggests an IPO valuation of 30x revenue, not earnings or cash flow.

Of course, my friend knew that already. Revenue is expected to double this year and perhaps again by 2028. Even then, it wouldn’t be cheap in my mind, but he was on a roll.

I suggested we go back to basics and count how many things have to go right for this to be a great investment. He laughed and said only one matters: Anthropic has to grow.

Sure, I said, but for you to make money, revenue has to grow, profits have to follow, the share count has to behave and the multiple you’re paying can’t fall too far. Think of them as links in a chain. At this price, you need an awful lot of the links to hold.

He pushed back. Those aren’t independent coin flips, he said. If the revenue arrives, the margins should follow, and the multiple probably comes with them.

Fair enough, I said. But that's also my worry. He needs the business to deliver and the market to be in much the same mood on the day he wants to sell. That last part is something I think investors often overlook.

If he pays 30 times revenue and Anthropic grows as expected, but the market eventually decides it's worth only 10 times revenue, he may have little to show for all that growth. He could be completely right about Anthropic and still make a lousy investment.

I reminded him of Cisco. Its revenue more than doubled between 2000 and 2010, yet its stock fell by more than two-thirds.

That's why my protection has always been in the price I pay. I prefer buying when the mood around a company is foul. Then the market has less room to mark me down and plenty of room to change its mind.

At this point, he had heard enough of my value-investing sermon and rightly turned it around on me: So, what have you been buying in the McElvaine Value Fund?

"Diageo," I said. I could hear his groan over the phone.

"Johnnie Walker, Guinness, Smirnoff," I added, as if that might help.

"I know, I know," I said. Volumes are soft, the dividend was trimmed, people are drinking less and GLP-1 adoption is further reducing U.S. volumes. There is nothing fashionable about Diageo, a multinational alcoholic beverage company. But that's the point. Most of the bad news is well known and reflected in the share price.

What I think isn't in the price is that Diageo is roughly twice the size of its nearest spirits competitor, and scale matters in a business built on distribution. Even with U.S. volumes going the wrong way, it produces more than US\$2-billion a year in free cash flow. It also owns a shelf full of non-core brands that could be sold over time. And Dave Lewis, who turned around Tesco in Britain, took over as CEO just under a year ago. He's a cost-focused operator.

In other words, Diageo is an ugly duckling and I buy ugly ducklings. To me, the trick isn't spotting the swan. It's buying the duckling for less than a duck is worth. If it grows into a swan, wonderful. If it stays a duck, I still do all right. My friend, in contrast, is paying swan prices for a swan. He laughed and hung up, satisfied I'd missed his point entirely.

Thinking about it afterward, neither of us knows the first thing about the future. The difference is what we do about it. He's investing in a future he believes will happen. I've gone hunting for a price that works even when I'm wrong.

He may well be right, and if so, I hope he does beautifully. I trust he'll remind me.

I've missed plenty of swans over the years. That's okay. I've learned I'm much better at buying cheap ducks.

Tim McElvaine worked with value investor Peter Cundill before founding the McElvaine Value Fund, which he has managed since 1996. McElvaine Value Fund owns shares of Diageo.

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