Brent Sheather's RESEARCH

Private Asset Management Ltd

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CAR STUFF : PART 3 – WINNERS AND LOSERS IN THE EARLY YEARS

Today, in Part 3 of the four-part story on the car industry we will kick off with a brief discussion as to why the industry is so important to big economies like those of the USA and Europe. We will try to put the current crisis facing western auto manufacturers, and in particular those in Germany, into some historical perspective by looking at the highs and lows of the US car companies back when they started. First off though, why is car manufacturing important? Forrest Henslee, an analyst at Research Affiliates posed that question to ChatGPT and its answer was as follows:

> *The auto industry—especially the EV transition—is no longer just about transportation; it's about economic power, energy control, national security, and technological leadership. As the world moves away from oil and toward electricity, the battle over who controls the future of mobility will shape the next era of global geopolitics.*
>
> *Whoever dominates EV production, battery technology, and raw material supply chains will hold outsized influence over the 21st-century economy—just as oil-producing nations did in the past.*
>
> *The U.S. and EU worry that China's EV dominance could translate into military advantages.*

By email, he added "*this feels like the next technological arms race, where nations compete for industrial capacity and strategic know-how. Using the arms build-up to WWI and the Cold War as reference points, the appeal of self-reliance will only intensify—something we've seen unfold since Trump's first term in the U.S. Meanwhile, Europe has taken a different path, which you highlight well in your first article. Where this all leads is anyone's guess. The U.S. has a technological edge in chips and software, but China is far ahead in industrial capacity and supply chains.*"

The age of the automobile started more than 100 years ago so data is hard to come by but fortunately a number of academics have looked closely at the topic. Back in 2008 the Federal Reserve Bank of Atlanta produced a working paper entitled "Returns to Investors in Stocks in New Industries" where they examined the returns to equity investors in companies which developed various outstanding technological developments like personal computers, airlines, railroads and cars. They concluded that "*a relatively small number of companies generate outstanding returns and many firms fail. Firms in new industries typically have high volatility of individual stock returns.*" Looking at the automobile industry in the US they noted that investors in two companies in particular did particularly well: General Motors' shares returned an average of 17.2% per annum in the 16 year period 1912 to 1928. This compares with 11.9% per annum for the US stockmarket in the same period. Packard shares did even better – delivering a phenomenal 50.7% per annum in the seven years ended December 1928. Those were the winners but there were lots of losers. In the period 1902 to 1926 there were almost 200 car manufacturers but only 44 remained in 1926. The average return for the automobile index in the 1912 to 1928 period was 8% pa, with the median return just 4% pa, vs 11.9% pa for the broad stock market. Of the 22 car makers for which the study has data only seven did as well as the stockmarket average and about 67% underperformed the index. The authors warned that their data was limited and advised that many companies were omitted from their analysis because they were not listed on the US stockmarket. Because those that were listed

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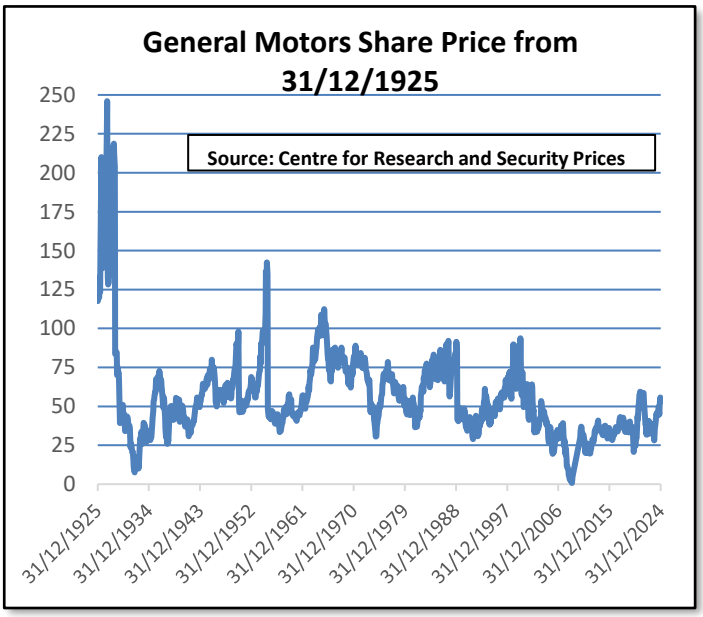
were generally amongst the most prominent, with the exception of Ford which was a major player but not publicly listed at that time, their analysis might actually overstate the returns accruing to early investors in the car industry. In any case the big difference between the mean and median returns for car investors suggests wide dispersion and not a "normal distribution".

The reason for the 1912 start date is because there was little information available prior to that date and it ends in 1928 to avoid the impact of the stockmarket crash and the subsequent Great Depression. Not surprisingly that period was a very dark one for car manufacturers and the picture below gives some perspective on that time.

I contacted the Center for Research in Security Prices at the University of Chicago which has a database of US share prices back to 1925 and they kindly provided the graph adjacent of the General Motors' share price. Whilst the data is just the share price, ie it excludes dividends, it illustrates the fact that an investment in GM hasn't been particularly attractive, to put it mildly. The stock hit a high of US$250 per share in August 1927, when GM dominated the US market. It then dropped significantly to hit a low of $7.62 in June 1932, at the depths of the depression, when buying a new car didn't feature particularly highly in the plans of anyone lucky enough to have a job. GM hit an all-time low of US$0.75 in May 2009, having been US$100 per share just eight years previously, due to the impact of the financial crisis and its subsequent bankruptcy. These two incidences thus illustrate the level of volatility in car company profits - due to the industry's high operational leverage and the fact that consumers invariably have the ability to postpone their purchases if they perceive that their financial circumstances will deteriorate.

What could explain the poor performance of GM shares, despite it being, initially anyway, such a big player in the US car business? Salient factors probably include a highly competitive market which constrained returns, as outlined in the previous story Big Market Delusions, competition from Japan, poor management decisions and, as a result of these various factors, a sharply declining market share – falling from around 50% in the 1950s to 17% today which adversely impacted economies of scale, with the latter being a vital component of competitiveness in a business with little in the way of barriers to entry. Professor Aswath Damodaran of the Stern School of Business, New York University, alluded to these issues in a recent post on X when he made the point that a good business inevitably has "strong barriers to entry that allow it to sustain its excess returns in perpetuity, and those could include anything from a superlative brand name to patent protection to exclusive access to a natural resource. In the absence of these competitive advantages, these excess returns would fade very quickly over time."



Brent Sheather is a Financial Advice Provider. A disclosure statement is available upon request. Brent Sheather may have an interest in the companies discussed.