Winter 2021

What a year!

2020 has been a year like no other; both from a market perspective and the pandemic that struck mid-March. While we were celebrating the start of a new decade, little did we know that the world was about to change dramatically. After the initial shock of a pandemic declaration in March, to a relatively more normal summer, and to the current second “surge” we find ourselves amid frustrating times. But the frustration is tempered by the hope that newly approved vaccines bring.

The equity markets had a decline in March but since then have been on an unparalleled rise. Equity markets have continued to rise despite the concerns brought on by the pandemic. The NASDAQ Composite Index returned over thirty per cent last year. The S&P 500 returned approximately eighteen per cent during 2020. What is more surprising is that while equity markets declined in March of 2020, they did so from extremely high levels and even at their 2020 lows the valuations were in our opinion at best “fair value”.

Notable investors such as Warren Buffett and Seth Klarman seem to agree with our view. They did not appear to increase their equity exposure in a material way during the market decline in March nor throughout the year.

Leading the charge are technology companies. Many of these businesses were perceived to be immune and/or benefiting from a post-pandemic world. As people were forced to stay and work at home, companies that facilitated the "new normal" were bid up to extraordinary levels.

Businesses that benefited from online shopping, video conferencing, networking and in-home exercising to name a few, all have been driven up dramatically in value. Many of these businesses were never truly undervalued and in some cases these businesses are not nearly profitable enough to justify their current valuation nor any semblance of realistic long-term growth.

Below are a few examples of these excessive valuations:

• Shopify is valued at USD 146 billion. The company has $2.5B in revenues and $200M in net income. The Royal Bank of Canada has a market value of USD 121 billion, the Royal's net income is fifty times higher than Shopify's revenue!

• Tesla, the electronic car maker, is valued at an astounding USD 834 billion despite having only $550M in profits. By some measures, Tesla is worth more than all the leading global car manufacturers combined.

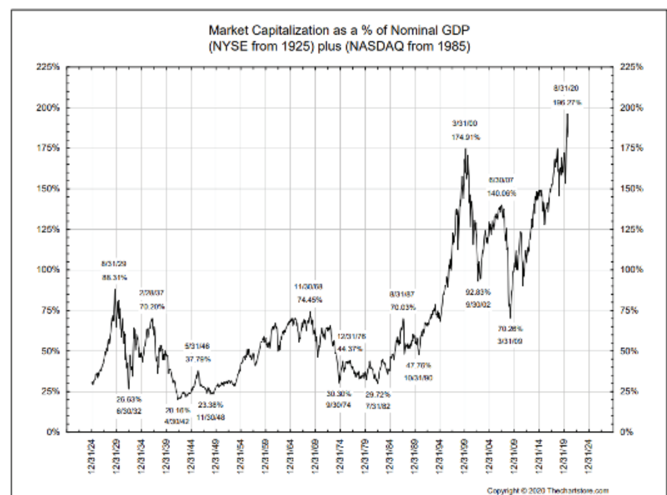
• Amazon is trading at approximately 100x earnings and is valued at almost USD 1.5 trillion.

These are just a few of the many examples of extreme market valuation. Other indicators such as record numbers of Initial Public Offerings, increasing retail investor participation in the equity markets and phrases such as "it is different this time" or "new paradigm" are all signs of exuberant markets.

These market valuations have been driven by a dramatic drop in interest rates and a flood of liquidity directed at the financial markets by global central banks in response to the economic damage caused by the pandemic.

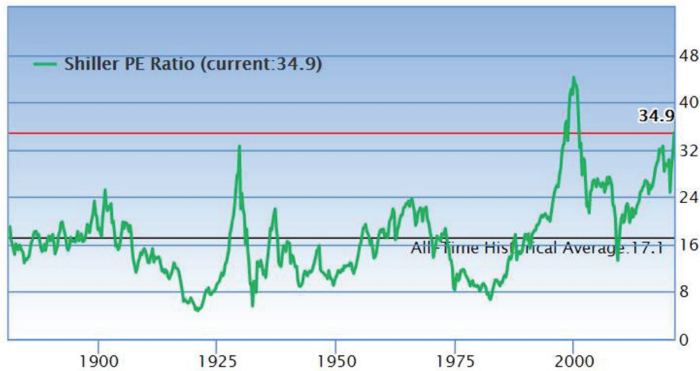
As the Charts below indicate, equity market valuations are at all time highs. These levels are now higher than at any time in history; surpassing the 2000 tech bubble and the 2007 housing market led bubble.

Graph 1
Market Capitalization to GDP



Source: the Charstore.com

Graph 2
Shiller P/E Ratio



Source: gurufocus.com

One glaring difference between today's market bubble and previous ones is that the state of the economy and its prospects were in relatively good shape. Today the economic environment is much different; the pandemic has caused a substantial increase in unemployment and a recession. Despite the unprecedented government stimulus, economic recovery is not expected to reach pre-pandemic levels soon and there is a high degree of uncertainty. In addition, the governments around the world have taken on debt as never before and the impact on both the markets and economy of this globally historical debt load is unknown.

Amid a pandemic that is causing substantial uncertainty about the direction of the economy and the prospects for individual businesses, these returns are extraordinary! Investors appear to have given way to the belief that near zero interest rates, substantial government liquidity and record-breaking debt fueled spending will support current markets and propel them higher. Investors have also forgotten the damage that these bubbles can cause. Market declines in previous bubbles such as Japan in 1989, the tech bubble in 2000 and the housing mania in 2007 were sixty per cent or more from their peaks.

On the other hand, traditional businesses such as banks and manufacturers were beaten down dramatically in the belief that the strain on consumers was going to create a wave of substantial credit losses and decline in demand for many products. Today, these "traditional" value stock investments have lagged the market for some time and value investing has trailed growth investing for the longest time period ever and by the widest margin historically. The graph below illustrates this huge gap in performance.

Graph 3
Value Index vs. Growth Index

Source: MotleyFool.com

Historically, value stocks have performed better than growth stocks over long periods of time. If "mean reversion" occurs as it has in the past, then value investors should have several years of strong performance going forward.

We may be at the beginning of a resurgence in value stocks. In the last quarter and

continuing into the start of 2021 they have outperformed growth stocks. As vaccines become widely distributed and the economy recovers, businesses that we own should start to see a material improvement in share prices. As a result, we are starting to see improved performance in our portfolios. The share prices are now starting to catch up with the fundamentals and the quality of the underlying businesses.

We recognize that the past twelve months have tested the patience and conviction of many who have adhered to our investment philosophy. To make matters more challenging, value investors' long term performance has dropped off dramatically. The confluence of substantial volatility in value stocks and the aforementioned outperformance of growth companies, culminating in the current bubble has had a dramatic impact on value managers' performance relative to indexes and growth managers, over both shorter term and longer-term time periods.

Despite the challenge we remain confident in our time-tested approach. We believe that performance in both absolute and relative terms has the potential to increase dramatically. More fundamentally we are confident that our portfolios will provide positive returns since we purchased businesses that are:

- Well positioned in their industry;
- Have generated strong returns in the past;
- Generate cash flow.

Just as importantly we have purchased these businesses at a substantial discount to their "intrinsic value". The combination of purchasing attractive businesses below fair market value will ultimately stand us in good stead.

We thank you for your continued support in what has undoubtedly been a challenging year. As we approach the end of our twenty first year of operation, we look forward to continuing to serve you.

We wish you and yours a safe and healthy 2021!