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"The individual investor should act consistently as an investor and not as a speculator" ~ Ben Graham

Equity markets continued their upward trend in the fourth quarter of 2023. Optimism was largely based on the expectation that Central Bankers have concluded their interest rate hikes and that inflation was on its way to the two percent target rate. Investors drove equity prices up as they anticipate several interest rate cuts in 2024.

Artificial Intelligence (AI) was a significant driver of market sentiment. The shares of companies that had direct or indirect exposure to AI increased in value dramatically. The perceived benefits of AI along with the expected decline in interest rates propelled several large technology companies to extremely high valuations. Indeed, a significant percentage of the increase in the S&P 500 and MSCI World Index was due to substantial price increases by just a few high technology companies; Amazon, Apple, Alphabet, Meta, Microsoft, Nvidia and Tesla. These seven companies, dubbed the "Magnificent Seven" accounted for approximately 77% of S&P 500's advance in 2023.

The optimism reflected in the Magnificent Seven's fundamental growth prospects and market valuations brings us to a pivotal juncture where the distinction between investing and speculating becomes paramount. Investing in companies with rapid revenue and earnings increases at extremely high valuations often blurs the line between investing and speculating. Below we discuss why we make such a bold statement.

There are two components to growth investing. First is the belief that the underlying business will grow at extraordinary rates for a prolonged period. The other component is the extremely high valuation that these businesses command and investors willingly pay. Both convictions require a leap of faith.

Growth stocks, characterized by their potential for significant future earnings, often come from sectors like technology, green energy, and biotechnology. Investors are drawn to these stocks for their promise of above-average growth, not just in the present but well into the future. However, this anticipation of growth embeds an intrinsic speculative element, as it relies heavily on forecasting future success, which is inherently uncertain.

Investing in growth stocks requires an optimistic outlook on a company's future performance. Predicting the future is speculative by nature. Unlike value investing, where decisions are grounded in a business's current intrinsic value, growth investing looks to future potential earnings. This forward-looking approach is speculative by nature, as it depends on numerous unpredictable factors, including market trends, technological advancements, and shifts in consumer preferences. No matter how thorough the analysis, predicting a company's future growth is perilous at best. In addition, the pace of change in the business and competitive environment is accelerating making the future even more difficult to forecast.

Growth stocks typically trade at valuations that reflect not just current performance but their future potential. However, when these valuations reach excessively elevated levels, they may signal over-optimism about the company's future growth. If a company does not meet these expectations, even if it is still growing at a decent rate, the stock price can suffer significantly.

Stocks with high valuations are more sensitive to changes in market sentiment. Shifts in investor confidence resulting from changes in macroeconomic factors such as rising rates, economic slowdowns and geopolitical events can lead to substantial price fluctuations.

The tables below illustrate how changes in expected growth rates and discount rates dramatically affect the intrinsic value of growth companies. These extreme changes in valuation and the volatility that goes with them clearly highlight the speculative nature of these businesses trading at exceedingly high multiples.

Table 1

	Scenario A	Scenario B
Discount Rate	10%	10%
Growth rate / Terminal	20% 6%	10% 3%
Intrinsic Value	$97	$32

As Table 1 above indicates, dropping the growth rate from 20% to a still very respectable 10% and reducing the terminal growth rate to a reasonable 3% decreases the intrinsic value by approximately 65%.

Table 2 below, holds the growth rates constant but increases the discount rate from 5% to 10%.

Table 2

	Scenario A	Scenario B
Discount Rate	5%	10%
Growth rate / Terminal	10% 3%	10% 3%
Intrinsic Value	$125	$32

Once again, we see a dramatic drop in the intrinsic value. In this example, the value falls from $125 to $32 or 74%!

Reducing growth rates and increasing discount rates to normalized levels is prudent. Assuming that growth rates will permanently stay at abnormally elevated figures and discount rates at historically low levels introduces a speculative element into the investment process.

Real-world examples, such as Microsoft and Tesla, illustrate the potential disconnects between market valuations and sustainable growth rates. These reality checks offer a sobering perspective on just how unrealistic the implicit assumptions embedded are in some growth company valuations.

Microsoft's (MSFT) sales in 2022 were $212 billion. Currently MSFT's P/E multiple is @33X. This P/E multiple implies a perpetual growth rate of 8%. The Gross Domestic Product (GDP) of the United States was $25.7 trillion in 2022. Using the implied eight per cent growth rate for MSFT's sales and a normalized three per cent growth rate for US GDP, Microsoft's sales will be equal to that of the entire American economy in 102 years!

Tesla is another example where an objective look at the numbers brings out the speculative nature of investing in high growth companies.

Table 3 below shows that the market value of Tesla is greater than the entire value of its global competitors. This valuation persists even though Tesla's sales and EBITDA are only 7.7% and 10.5%, respectively, of the industry's totals. Tesla's valuation implicitly assumes that its profitability will increase tenfold in relatively short order. Given the competitive challenges that Tesla faces, this outcome is highly unlikely!

Table 3

Company Name	Market Capitalization Latest	LTM Total Revenue	LTM EBITDA
Ford Motor Company (NYSE:F)	45,113.3	174,228.0	16,908.0
General Motors Company (NYSE:GM)	47,945.5	171,971.0	16,681.0
BYD Company Limited (SEHK:1211)	74,481.0	80,661.2	7,549.9
Rivian Automotive, Inc. (NasdaqGS:RIVN)	16,051.3	3,782.0	(5,087.0)
Mercedes-Benz Group AG (XTRA:MBG)	67,233.6	167,148.0	24,349.1
Honda Motor Co., Ltd. (TSE:7267)	51,644.0	124,185.2	16,071.8
Hyundai Motor Company (KOSE:A005380)	29,154.7	118,520.6	13,632.2
Renault SA (ENXTPA:RNO)	9,912.5	56,618.2	5,787.6
Kia Corporation (KOSE:A000270)	25,796.5	73,275.2	10,516.9
Toyota Motor Corporation (TSE:7203)	259,546.0	279,113.4	39,245.9
Total	626,878.4	1,249,502.8	145,655.4
Tesla, Inc. (NasdaqGS:TSLA)	685,216.5	95,924.0	15,152.0

Presenting the above examples in the context of mathematical realities highlights the sustainability of growth, valuation, and market sentiment as speculative components in the evaluation of growth companies.

In contrast our philosophy and investment process are rooted in absolute value. Our focus is on the pursuit of businesses with long operating histories, predictable models. Our strategy focuses on acquiring businesses at a significant discount to intrinsic value, ensuring a margin of safety and aiming for consistent, repeatable success. We favour conservatism over exuberance and attempt to mitigate speculation in all its forms.

Your portfolios continue to be well positioned for current market conditions. As of December 31st, 2023, our total portfolio yield was approximately 5.5%. In addition, the portfolio's overall characteristics compare favourably to major benchmarks such as the S&P 500 and S&P/TSX Composite. While our equities performed better than the TSX the overall return relative to our benchmarks was held back by the large cash balances during the year. Also, we were underrepresented in the high performing technology sector.

Thank you for your confidence and continued support.

We wish all of you and your families much health and happiness in 2024.

Vito Maida