Bubbles

Todd Johnson, CFA, CIM

Chief Investment Officer & Portfolio Manager

2020 will forever be known as the year of the COVID-19 pandemic. The health crisis and the crippling economic lockdowns that followed for many countries will not be forgotten anytime soon. It will also be remembered as the year of bubbles. To contain the virus spread, we're all trying to live in bubbles of some sort while we await the broad vaccine rollout. A strange new world indeed. We have seen various sports leagues operate in a bubble format, such as the NHL and NBA, allowing them to finish their abbreviated seasons that were halted in March. However, the bubble that appears to have formed in some areas of the capital markets is more worrisome.

A "bubble" in financial markets refers to a good or fortunate situation that has inflated asset prices and is unlikely to last or be sustained. No one would call 2020 a fortunate situation, but certain sectors of North American markets have soared during the year. The Nasdaq market was up an eye popping 44.9% this year, and the S&P500 was up 18.4% in 2020. The Canadian market as reflected by the S&P/TSX rose a more modest 5.6% year over year, given it only has one exchange listed technology company that performed amazingly well - Shopify Inc. (TSX: SHOP).

As the lockdown forced everyone inside, a new investor emerged to expand the bubble. Millions of new novice online investors opened trading accounts. What else could explain why a bankrupt car rental company's stock (Hertz Global Holdings Inc.) suddenly soared in June when its true value was close to worthless given its debt levels. The value of Eastman Kodak Company (NYSE: KODK) suddenly went up immensely in July and then fell after it was temporarily approved for a loan to make drug components. Finally, the cryptocurrency Bitcoin was up 300%.

Strange things start to happen when markets are forming a bubble, especially when public psychology starts to believe that one needs to jump on board as certain stocks or even asset prices continue to rise. Investors now seem to want to 'party like it's 1999' all over again, forgetting the bust and a lost decade for many technology stocks in the early 2000's. Whether we have reached the same psychology as the internet and telecom mania of the late 1990's or the condo-flipping boom in the United States in the mid 2000's, I am not as sure. Time will tell, but the conditions are in place and warning signs of excessive speculation are on full display.

Greed and fear drive the behavioral side of financial markets and will always be present, but with unconstrained government spending and loose central bank policy, valuations may continue to expand with the bullish momentum. The good news is that there is a better option than hoping for the best with expensive technology and disruptive companies profiting from the lockdowns. With many investors and the media focussed on 'stay at home' stocks, some traditional businesses in Canada and the United States have been overlooked and appear relatively undervalued. In various sectors such as utilities, financials, insurance, industrials and even healthcare, we hold many businesses that are fairly valued and even inexpensive with attractive and modestly growing dividends. This is attractive to the conservative investor who values capital preservation as well as growth. Momentum is currently in fashion, but when looking out over a longer time horizon, owning businesses like these is a prudent way to grow one's wealth in the long term.

Yes, some technology stocks may have another great year, some will not. But what we would call 'perfectly priced' businesses can become very vulnerable when something unexpected happens. That could be a geopolitical shock such as military exchanges in Asia or Eastern Europe/Middle East. It could be inflation becoming imbedded into prices with a resulting push higher in bond yields. It could be government regulation on monopolistic business practices or even higher taxes. Investors can't predict the unexpected, but as economies unlock, some of the good and fortunate conditions that bolstered and inflated the values of companies in some sectors will wane. In our various investment strategies, one can expect reasonable returns from business in recovering industries as life returns to something resembling 'normal'. Bubbles in one's champagne as a new year begins are good, bubbles in financial markets are best to avoid. Happy New Year.

A Cautionary Look at IPOs

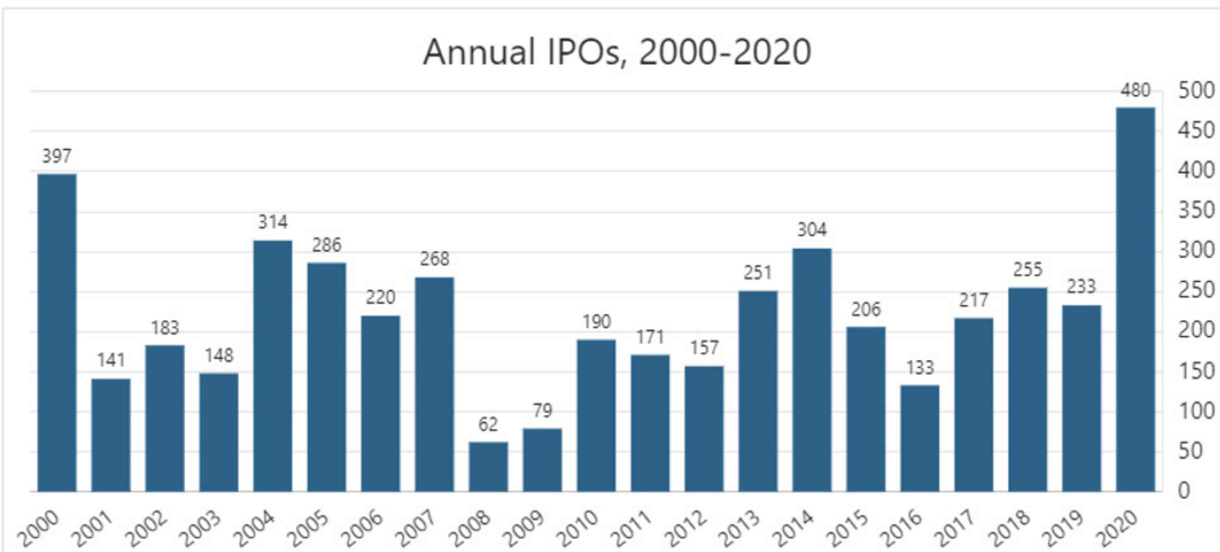
Cory Lang, CFA, CPA, CA

Portfolio Manager

With the holiday season behind us, we can take a moment to reflect on some of the brand new things we gave as gifts to our children and grandchildren, whether it was a cell phone, pair of skates or the latest gaming console. The excitement and uncertainty they faced as they awaited the big day could almost be felt as the days ticked down. A similar feeling was likely washing over many investors throughout 2020, as a series of shiny new objects appeared on the market, in the form of IPO's.

The IPO (short form for Initial Public Offering) is not a new concept. Private companies use this process to gain access to public capital markets where they can raise substantial funds compared with bank financing or private investors. Investment banks act on the company's behalf, generating interest in the deal through "road shows". These events showcase the great potential of the company's product or service, usually with PowerPoint charts presenting soaring revenues and stats on the number of daily active users, or some related metric. The greater the interest in the company's IPO, the greater the stock price when it is initially priced and begins trading on the selected exchange.

In 2019, the market appetite for IPO's was relatively strong with well-known businesses such as Uber Technologies, Inc. (NYSE: UBER) and Lyft, Inc. (NASDAQ: LYFT) competing for the attention of investors. While the early part of 2020 saw a softening as the COVID-19 pandemic took hold, there was a flurry of activity throughout the summer and into year-end as companies such as Snowflake Inc. (NYSE: SNOW) and Airbnb, Inc. (NASDAQ: ABNB) raised billions of dollars of capital on their IPOs. With record low interest rates fueling a strong stock market, the pandemic further intensified matters by putting work-from-home technologies and related software at center stage. This led to a record 480 IPO's during 2020, a number that easily surpassed the previous high of 397 during the 2001 Tech boom.



Source: Stockanalysis.com

Before we examine IPO's critically, let's look at why investors might be attracted to them in the first place. Firstly, they seem to be associated with new ideas that will disrupt existing models. Snowflake supposedly has a better way to store a company's data in the virtual cloud. Perhaps, but is it going to be able to do that forever, without competitive threats? A second reason for investor interest is the chance of getting in on the ground floor of a fabulous growth opportunity. Cue the behavioral bias of hindsight for this one, as nearly everyone wishes they had been involved in a success story from the early days, whether it's Microsoft Corporation (NASDAQ: MSFT), Apple Inc. (NASDAQ: AAPL), or Amazon.com, Inc. (NASDAQ: AMZN). Finally, the marketing hype around IPO's is just about as powerful as an iPhone release. An army of investment bankers, TV commentators, and brokers are more than eager to tell you about the wonderful opportunities occurring in data storage and work-from-home video technologies. But before we jump on the IPO bandwagon, let's do some critical thinking.

Many, but not necessarily all, companies that had an IPO during the past year are unprofitable. For example, Airbnb lost over $1 billion for the 9 months ended September 2020, on $3.6 billion in sales. Given a market value of roughly $88 billion at the time of writing, it seems preferable to have a profitable company with that valuation. Let's also consider competition. DoorDash Inc. (NYSE: DASH) is a food delivery and logistics platform that competes in a very crowded space. Significant competition means that profit margins should fall to a minimal level, creating winners and losers in the industry. The ultimate winners may be very difficult to predict, particularly with relatively nascent industries. Finally, valuations of IPO's tend to be expensive, to say the least. They are often based on a multiple of sales rather than earnings, due to persistent losses in the past. Airbnb trades at approximately 12 times 2021 estimated sales, and 188 times estimated 2021 free cash flow. Lofty indeed.

It's very easy to get caught up in the excitement of an IPO and there's no question that some of those companies will ultimately be successful. However, much of that excitement can fade quickly, as the real economics of the business take shape and speculators head for the exits. It's much wiser to place your capital in the hands of well-run businesses that have already earned their place at the top of the industry. The relative consistency of profitability, dividend payments and limited competition may not be as exciting as Christmas morning, but as a shareholder of these companies, we anticipate that investors will be better off in long run.