



2021 annual investment LETTER

STRIVING FOR EXCELLENCE.

“You’ll be on your way up! You’ll be seeing great sights! You’ll join the high fliers who soar to high heights.”

- Dr. Seuss

It has been a joyous year to be in the equity markets. With central banks worldwide keeping interest rates low and markets awash in cash, values have soared over the past twelve month’s spreading good cheer to all who participated. In fact, for a third year in a row, the S&P 500 posted strong double-digit gains – something that last occurred more than two decades ago, from 1997 through 1999. If we were to step back in time to 2018, could we have been prescient and foreseen this extraordinary market rise?

Unlikely.

Early in 2018, then-President Trump appointed Jerome Powell to replace Janet Yellen and lead the Federal Reserve. Market volatility, largely absent during Yellen’s reign, spiked with Powell’s appointment as there was an understanding that Yellen was supportive of bailing out the markets whereas Powell was more inclined to leave them alone. In his first week on the job, the S&P 500 fell over 272 points – about a 10% correction.

After settling down, the market recovered to its pre-appointment level by the end of September. Then, in an early October interview, Powell seemed to indicate a potential rise in interest rates, noting “Interest rates are still accommodative, but we’re gradually moving to a place where they will be neutral.” The results?... the S&P 500 fell about 20%, from 2925.51 on October 3rd to 2351.10 at Christmas. Bah humbug.

Then, like now, market participants worried about the effect of rising interest rates on the equity market valuation. Many might suggest the resulting negative market reaction was simply “confirmation bias”, whereby we see what we want to see, accept these postulations as truth, and act accordingly. What we “find” is most often what we wanted or expected to find all along.

C.S. Lewis wrote in *The Magician’s Nephew*, a children’s book that is so much more, that, “What you see and what you hear depends a great deal on where you are standing. It also depends on what sort of person you are.” For all of us, all too often, believing is seeing.



Yet, while behavioral finance may have played a large part, we prefer to think of this simply as cause and effect.

The laws of cause and effect are relentless. Every action has a consequence, and each consequence has another consequence. Thus, every change made to a complex system will have second-order effects, which may affect the system's functionality in unknown and unexpected ways.

Simple example – according to the World Health Organization, a large portion of the world population over consumes too much food without corresponding exercise (cause). As a result, world obesity has doubled since 1980 (effect). And obesity has become the fifth-leading risk for global death (secondary consequence).

American chewing gum sales fell 15% over the decade commencing in 2007. That happened just as 220 million American adults bought their first smartphones. It wasn't a coincidence. When people wait in line at a store, they would once have spent the time looking at the goodies for sale at the counter – “impulse” items – and gum was a frequent purchase. Suddenly, customers were responding to a different impulse. They were surfing the internet. Gum sales plummeted.

Unintentional consequences.

Almost exactly 50 years ago, on July 1, 1971, John McQuown and his team of academics created the first-ever index fund. An index fund tracks the performance of an underlying index of securities, like the S&P 500 – also known as passive investing. It employs broad diversification without stock picking, active trading, or high fees. It was instantly derided by competitors as being “un-American.” Fidelity Chairman Edward Johnson spoke for most of the investment world when he said that he couldn't “believe that the great mass of investors are going to be satisfied with receiving just average returns.”

Some \$11 trillion is now invested in index funds, up from \$2 trillion just a decade ago. And by 2019, more money was invested in passive equity funds than in active funds in the United States. Clearly, during the longest bull market run in history, the “index mindset” has clearly won the debate over active management.

Of course, the index mindset does create unintended consequences.

In the USA in 1960, 13% of Americans lived alone. According to this year's statistics, that number has risen to over 28% – the most ever. Until recently, marriage was common, with partners committed until death did them part. Today, Tinder and other dating apps allow people to diversify their relationships across an index of partners while avoiding marriage commitment. Even though it's proven that spouses in a good marriage are happier, healthier, and live longer, we are increasingly delaying, avoiding, and escaping the bonds of holy matrimony. In a 2021 report by Harvard researchers, loneliness in America is leading to increased early mortality along with a wide variety of physical and emotional problems.

In 2009, the top movies were predominately original screenplays — films like Titanic, Saving Private Ryan, The Matrix, Star Wars, Shakespeare in Love, Good Will Hunting, The Truman Show, and There's Something About Mary. In 2019, of the top ten grossing movies, nine were sequels or live-action remakes of Disney



animated movies. This lack of originality, or indexing, is clearly damaging the arts – though it does seem patrons are content watching a movie with a numeral in its title.

Even in science – a field of study that is famed for its “eureka!” moments – results are becoming indexed. A study by economists Jay Bhattacharya and Mikko Packalen entitled “Stagnation and Scientific Incentives” contends that scientists are increasingly producing research and papers that lead to citations and career advancement rather than risking focus on research that might trigger a major advancement, since it might also lead to a dead end. The contention in the study that new ideas are simply harder to find (more risk) and has caused a stagnation of scientific discovery, resulting in new ideas no longer fueling economic growth.

Returning to the use of passive investing, with investors pouring money into index funds (cause), the largest companies have become bigger (effect). For example, Apple, Alphabet, Microsoft, Amazon, and Tesla have, together, gained \$6.5 trillion in value since their March 2020 lows. Apple alone has gained an astonishing \$1.85 trillion in value over this period — an average increase of well over \$4 billion per trading day.

In turn, these companies now make up over 29.9% of the S&P 500 index \$40.1 trillion market value. Therefore, an index participant has an unintended concentration risk in high multiple stocks because of the massive flow of funds into index funds.

On March 9, 2009 the S&P 500 index closed at 676.53 - as I write this, the index has gained almost 500% in the bull market since that trough set by the last recession. With very few exceptions – brief pullbacks in 2011, 2015, 2018, and 2020 – the chart is an upwards forty-five-degree line left to right.

“To the moon, Alice.”

The S&P 500 has averaged roughly 10% per annum returns since its inception, including dividends. But very few years have been close to average (annual S&P 500 returns have been between 8% and 12% only four times since 1928) and very few component companies within the index provide “average” returns.

When market prices accelerate – also known as a momentum or “high beta” market – active management has little chance of outperformance. The constant refrain by active managers is that “long-term performance is made in down markets.”

But what if there are no more long-term down markets?

In September 2000, the S&P 500 closed at 1484.91 – it did not hit that closing value again until seven years later, in December 2007, just prior to the recessionary collapse that took the market down to 676.53 in early 2009. The late ‘90s market was driven by the performance of technology companies, with considerable underperformance of non-tech stocks during the period. The subsequent market – from 2000 to 2007 – was driven by the correction in pricing by technology. Similarly, with big tech (Amazon, Apple, Microsoft, Google, Netflix) now making up over 25% of the S&P 500 market capitalization, there are plenty of prognostications pointing to the similarities to the late 1990’s.



The difference between then and now, as noted earlier, is the massive use of passive investing. Index investing has no perspective on valuation or market concentration – it’s simply buying the average. The market correction in 2020 was exacerbated by the retail investor selling of index products as prices began to slide. It makes one wonder what might happen if we had several years of flat or down markets, as experienced previously.

It has been a wonderful twelve-year bull market, but storm clouds loom.

Inflation is the main investment concern for 2022, and its expected transiency is perhaps the most debated topic in the investment community. Historically, equities have shown an ability to manage inflationary periods; the focus should be on which equities to own rather than whether to own equities. Equities (in aggregate) have an ability to pass through input cost escalation.

Rising inflation in periods of economic weakness, however, could negatively disrupt the market. Stagflation would nullify much of equities’ “inflation resistance” as corporate margins contract amidst minimal or negative earnings growth.

One of the curses of being old (and there are many) is that all your cultural references become irrelevant; no one knows what you’re referring to. Like bell bottoms. Or The Hustle. Or a Walkman. Or double-digit inflation.

Inflation has been so low for so long that most people can’t conceive of 16% mortgages (which were a thing in the early ‘80s). According to The Economist magazine, a third of the people currently living in the world had not been born when average inflation last exceeded 5%. But while inflation had been hovering at a near-decade low, it has recently risen above 2%, a key level that could eventually cause the central banks to raise short-term interest rates if inflation were to persist above this level for some time. And should interest rates begin to creep up, there will be increasing pressure on markets.

The pandemic-induced recession dominated our thoughts when market prices corrected in early 2020. As central banks continued to infuse the economy with cash to support low interest rates, labour shortages and supply bottlenecks rose, and the past year has seen prices elevate. Fueling the elevation in prices, vaccines have become widely distributed, social restrictions have loosened, and people who have been storing cash and going nuts from being stuck in the house have begun to open the spigots on a torrent of spending.

More and more, the subject of high inflation becoming an economic reality in the coming years has made the front pages in the economic press.

The reason inflation is a concern now starts with the enormous economic stimulus packages from the federal government over the past ten years, together with what are considered to be artificially low short-term interest rates. Yet central bank chatter has turned somewhat chilly, as policymakers signal the days of stimulus are coming to an end. As economist David Rosenberg recently wrote, “It simply is not well appreciated as to how government stimulus, both fiscal and monetary, juiced up the Canadian and U.S. economies and financial assets this past year.”



An article in the March 27, 2021 edition of *The Economist* breaks the inflation “worst-case scenario” into three stages. The first stage, in which inflation rises mechanically as the economy and commodity prices picked up after the spring of 2020, has already happened (as we noted earlier). The second phase occurs as “spending by newly vaccinated consumers rebounds from the pandemic faster than production can keep up” – something we are currently seeing in the retail sales numbers of public companies and hearing in discussions with various management teams. In the third stage, which is also the most controversial, “..temporary inflation turns permanent as the public’s inflation expectations rise and become self-fulfilling. Workers, anticipating a higher cost of living, demand higher pay; forward-thinking firms raise prices. This could result in a “return to the 5% plus inflation of the late 1960s, or perhaps even the 10%-plus rates of the 1970s.”

Worse still is the prospect of “stagflation,” which results from a combination of a slow economy, high unemployment and rising prices. The effects of stagflation in the United States in the 1970s and early ‘80s was so drastic that the Fed had to intentionally induce a recession by dramatically raising short-term interest rates to stop it. There are certainly some signs of stagflation - supply chain shocks, ongoing elevated inflation, rising energy prices and lower economic growth forecasts – but, at best, most seem transitory.

As government policy moves from market tailwind to headwind, one must consider whether the current inflationary forces are sustainable or transitory. This should guide how quickly central banks like the Federal Reserve exit their quantitative easing. Unfortunately, just as they have continued the current stimulus policy well beyond its usefulness, their tightening policy in months and years to come may overshoot as well. Risk assets may be clearly in the gunights.

Yet, as long-time readers are aware, we approach any macro forecast with a high degree of skepticism. Frankly, one cannot accurately predict the future or, to quote Howard Marks of Oaktree Capital, “I can count on one hand the investors who successfully base their decisions on macro forecasts. The rest invest from the bottom up, one investment at a time.”

Macro forecasting is, once again, in its ascendancy. Debates on whether current inflationary trends are permanent or transitory wage on – there are very intelligent people on both sides of the debate, but the long-term result is, frankly, unknowable. What we do know is that markets absorb events and react, either positively or negatively. That short-term reactions tend toward excess (again, positively or negatively) does not preclude the fact they should be ignored entirely. To quote Howard Marks again, “No one can confidently predict whether we’re entering an inflationary era, but the consequences of doing so would be significant.”

Which is why we prefer our Quality investing style.

Quality-based investing is not the only route to investing success. However, in our view, it is a methodology that provides a certain peace – for our analysts, who have taken great pains to understand the fundamental attributes of the companies we invest in, to our clients, who gain confidence over time in the long-term stability and investment gains high quality businesses generate.



Many struggle to understand the “quality style”. The definition of value investing is widely understood – one might simply define it as purchasing securities that are trading at a discount to their intrinsic or book value. Many also understand growth investing is a method of seeking out businesses that have above-average future profit potential.

Definitions of quality investing, however, will differ significantly. Many will define it as a search for strong management or company competitive advantages which are certainly elements of the style, but not a fulsome description. Readers will know what quality is, as it is part of their everyday judgements. Compare a Mercedes to a Chevrolet to a Kia – all meet the same functional needs, but there are enormous differences in the construct.

In our view, the three dominant characteristics of a quality investment are: strong and predictable cash flow generation, sustainably high returns on capital, and attractive growth opportunities. There are, of course, subsets to each of these, including strong management teams (strong capital allocation capability) and market leadership (competitive edge) and low debt leverage (a function of cash usage).

So why is this important now?

As we look toward future market and economic growth, we believe quality companies will have the best capability to ride out the volatility and uncertainty generated by the central bank extraction from their long-term quantitative easing program. A simple illustration might be helpful. Assume a company generates \$10 million dollars of free cash flow in a given year and has a return on invested capital of 15%. Over the next ten years, that \$10 million will grow to \$40 million – a four-fold increase in the business’s capability for reinvestment in expansion but also providing additional cash resources to withstand market and economic pressures.

And the true joy of a quality-type investment? Once owned, there is little impending need to sell. Which allows for very long holding periods, providing plenty of time to search for the next high-quality company while reducing trading costs to clients.

In so many ways 2021 was a continuation of the challenges of 2020. Yet through it all, we’ve learned not to focus on the destination, but rather to make the most of the journey that is leading us there. Many of us continue to be puzzled at the sizeable numbers refusing to vaccinate, even though it has been proven that we humans are prone to bad ideas, ideas that escalate to terrible decisions, and then metastasize into actions that undermine, damage, or even ruin our lives and futures. We choose poorly, far too often, on matters big and small, vital and prosaic, important and ordinary.

And once we reach a conclusion, we aren’t likely to change our minds, even when new information shows our initial belief is likely wrong and clinging to that belief has real costs. “When we know something, we stop thinking about it, don’t we?” a character in the Miriam Toews novel, *Women Talking*, recognizes, as she tries to develop the ability and willingness to change her mind. And once we start seeing confirmation bias, it’s hard not to see it everywhere.

At year end we released the second white paper in the firm’s history, discussing the benefits of international small cap investing. We were pleased with reactions by our readers and have scheduled



another discussing our unique approach to ESG (Environmental, Social, Governance) issues. Just like the garment industry, when it comes to ESG no one size fits all. Having interviewed management teams for over four decades, my experience has been that each management team has their own moral code that drives actions and culture within the business. This is distinctly separate from wonderful marketing literature touting social causes, environmental awareness, or corporate governance. Investment analysts are now awash in this corporate hype.

Ray Lam and Louis Chan are working on an ESG white paper – to be released later next quarter – that will more fully explain our approach to this complicated topic.

Our US efforts continue to soldier on. With the extraordinary talent of the folks from Tessera Capital, we are now beginning to develop relationships with key people in the US. Donna Dimaria and Greg Huston have worked tirelessly to introduce our Toronto-based firm to their long list of contacts. With their guidance, I have no doubt we will see success in the coming year.

Having just completed our second COVID-Christmas, I'm reminded of the refrain quoted in my letter last year, "...always winter, never Christmas." The past year has been tremendously difficult for my family, yet they have successfully navigated the turmoil and stresses, steadfastly triumphant in small glories. At year end, my family remains safe and happy – perhaps it's age, but having watched them traverse their difficult lives in 2021, I now get a lump in my throat each time I speak with them.

And our incredible team has been tremendously supportive through my difficult year, and, for that, I am deeply grateful. It has been an awkward twenty months or so through this pandemic, with a combination of working at home and occasional office visits, constant Teams and Zoom calls, and a variety of challenges that would test anyone's mettle. I thank all of you for your patience and counsel.

This letter would not be complete without a heartfelt thanks to our extraordinary group of clients. I have said it before, we appreciate your continued support, your confidence in our abilities, and dare I say it, friendship. Personally, I remain forever grateful, and on behalf of my partners, we humbly thank you.

I will conclude this year's letter with my fondest wish, echoed by everyone at Laurus, that you have the courage, faith, and strength of spirit to walk the difficult road ahead, along with the tenacity and patience to achieve everything you desire.

Christopher Page