



2022 annual investment LETTER

STRIVING FOR EXCELLENCE.

"...if you grant that the environment is, and may continue to be, very different that it was over the last thirteen years - and most of the last forty years - it should follow that the investment strategies that worked best over those periods may not be the ones that outperform in the years ahead."

Howard Marks

When I began last year's letter, it noted how joyous the year had been in the equity markets. With central banks worldwide keeping interest rates low and markets awash in cash, equity values soared over the prior twelve month's spreading good cheer to all who participated.

My how the world has changed.

When we began the Laurus journey roughly nine years ago, our initial goal was to reach a billion dollars in assets under management. In June 2021, we were a breath away. With a strong team evolving a disciplined process, our performance was strong and our clients happy. Eighteen months later, the euphoria has faded.

We had watched over the prior few years as the Canadian investment market changed from traditional value/growth investing to escalating valuations of a few winners in the internet space and a lot of pure momentum investing. There was growing interest in commodity-based companies, particularly energy, but the overall exit of investment capital from an already depleted market left trading volumes down and investment interest more so. Speculation was rampant and interest waned in traditional stock and bond investing in favour of alternative asset structured product commitments.

As a result, many local investment firms experienced healthy withdrawals from their Canadian equity base as institutional investors reallocated asset mix to global markets or to alternative assets like real estate, private equity, and infrastructure. Unfortunately, like our competitors, we also experienced some healthy withdrawals.

And then the market corrected.

Sometimes it just sucks to be an entrepreneur. We always worry about the abyss. What if there are no sales next year? What if the economy suddenly tanks? What if a key employee leaves? Endless worries, most of which come true in the longer term. We lost two great people this year simply



because they were fearful of the impact of current markets to our long-term business prospects. Yet, while their loss saddened me, it has also hardened my resolve.

Nobel laureate Daniel Kahneman says that if you rationally weighed the odds of success, you'd never start a business. Many people believe that ego plays a large part in establishing a new enterprise; in fact, it is often more about a belief that a product or service can be improved compared to current suppliers.

Such is the case in small cap investing. While there are a few excellent small cap strategies in the US and Europe, here at home the list is limited. Firms like Mawer, QV, and Van Berkom had strong reputations as high-quality small cap investors but even they have succumbed to investor's penchant for larger capitalization stocks. That predilection is a result of a strong equity market – with everything rising, investors prefer the stability and recognition of larger businesses.

Of course, as we work our way through the end of the last investment cycle, small cap investing will likely make a comeback. Businesses that have been chased over the past ten years ending in 2021 reached excessive valuations, while the smaller, less watched, businesses with better growth opportunities languished. As has been typical throughout history, these businesses will provide investment leadership in the coming months and, perhaps, years as attitudes around valuation change.

Our goal is to provide investors with a trusted partner in small cap investing, utilizing high-quality investments to dampen volatility and improve return. While successful in some parts of the globe, areas like Europe impacted by the Russia/Ukraine crisis actually experienced higher volatility and lower returns – even with the same investment style.

The reality is that, at times, luck plays an enormous role – both good and bad – in many specific endeavors, from baseball to investing to poker to winning a Nobel Prize.

Kahneman made the point that you can rely on your skill and your expertise and your intuition much more in a predictable environment. But, as evidenced by the past twelve months, is the investment market ever a very predictable environment? In his most successful song, Frank Sinatra crooned: “Regrets? I’ve had a few. But then again, too few to mention.” Obviously, he wasn’t talking about investing in the markets.

Michael Mauboussin loves to make the distinction between experience and expertise; the two are synonymous in a predictive environment but experience will hold sway when the environment is unstable.

As we look to write to clients about market performance in 2022, we struggle for the right verbiage. Words like “challenging” and “difficult” are sure to get heavy play. That’s because, in language as plain as I can make it, pretty much every market and sector has had a very bad 2022. Both equity and bond markets worldwide have been crushed this year.

In the aggregate, this news is no fun at all. Still, it’s not a problem for long-term investors. As we’ve written in previous comments, over the past 50 years (1972-2021), the S&P 500 has provided an excellent annualized total return of 9.4 percent, but the results are heavily skewed. In 19 of those years, the index gained more than 20 percent. Returns were 10-20 percent 13 times and 0-10 percent nine times. Losses



of up to ten percent were suffered four times, losses of 10-20 percent two times, and more than 20 percent three times. The current year will add to those latter averages.

The clearest lesson here is that stocks are vital for long-term investors. Willie Sutton is said to have claimed that he robbed banks because that's where the money is. Good long-term investors buy stocks because that's where the best returns are. Using very rough long-term return numbers (9.5% for stocks; 5% for bonds; 8 percent for real estate; and 6% for hedge funds), \$10,000 invested for 30 years in stocks turns into about \$173,000 while bonds yield \$45,000, real estate \$110,000, and hedge funds \$60,000.

That's an enormous disparity. And yet institutional investors continue to employ short-term allocation thinking to long-term liability return objectives.

One of my mentors, years ago, was fond of studying and discussing Kondratieff waves. Nikolai Kondratieff was a Russian economist, early in the twentieth century, famous for being a proponent of the New Economic Policy, best known for its business cycle theory. His theory centred on the belief that Western capitalist economies had cycles of boom and bust. These economic super cycles lasted 40-60 years; the first ran from 1780 through 1830 with the invention of the steam engine, and the most recent fifth cycle began in 1970 through to the present with the invention and adoption of information technology.

Similarly, we have experienced a bond super cycle that saw ten-year US Treasury yields fall from around 16% in the early eighties to the lows in 2021 at almost zero. Hugely bullish for bond investors and a distinct tailwind for equity valuations. What is less known, is that bull market was preceded by a forty-year bear market in bonds, as rates rose from below two percent in the early 1940's.

In one of his more brilliant commentaries, Howard Marks recently opined on his fifty-year history in the investment markets, concluding we are witnessing a transformation in market direction.

He notes his intent is not to get caught up in economic theory but, rather, to explore how investors will change their thinking. Yes, there were micro cycles where bond yields spiked – the 1994 bond crash and the 2013 taper tantrum come to mind. But forty year falling rates adjusts one's mindset to achieving returns without forethought as optimism (or luck, as noted above), rather than skill, produced four decades of incredible returns in bonds and stocks.

Beyond the investment markets, there have been other benefits to falling interest rates. Economic growth accelerates as consumers can buy greater quantity on credit. Business cost of capital lowers thereby increasing profitability. Rising asset prices create a wealth effect, making people feel richer and wanting to spend more. And many others.

Then, at the very tail end of this extended cycle, along came the COVID-19 pandemic. Governments kicked in capital to businesses and provided relief payments to individuals. Like deficit spending, governments juiced the economy with cash and the markets and economy reacted accordingly. From the March 2020 low of 2,237 as COVID set in, two years later the S&P500 finished 2021 at 4,796 – up 114% in less than two years!



Marks concludes that, coming out of the Great Financial Crisis of 2008/2009, it's been a wonderful time for investors. But times of highly stimulative, declining interest rates are over. We have returned to a “historical” interest rate environment – though young investors who came into the business world in the past fifteen years may see rates as elevated.

Further, as investors can now get solid returns from credit instruments, they will no longer have to rely on riskier investments to achieve their income goals.

As it relates to our world – the equity markets – declining interest rates have allowed valuations to rise without impediment lessening the role of “active management” and increasing the use of simple exchange-traded funds. If Marks’ contention is correct, a) the stimulative practices of central governments will abate, b) there will be a continued reduction in globalization and its deflationary influence, and c) credit conditions for new financings will be more restrictive in the coming years, then we are, indeed, in for a “sea change”.

All of which would lead to a more difficult investing environment. And more nervous investors as volatility increases. Risk will resume its rightful place in the investing landscape and speculation will no longer offer widespread rewards.

If we could only have a sure thing.

Dr. Wes Gray, one of the founders of Alpha Architect, studied under Nobel Prize Winner Eugene Fama. Dr. Gray created a hypothetical stock portfolio constructed with perfect foresight, invested entirely in the top decile of stocks based on their performance over the upcoming five years. In other words, making sure to own the stocks he knew would perform best over the next five years. He called it the God portfolio. After five years, Dr. Gray rebalanced the portfolio to invest only in the top performers for the next five years, and so on. He ran this exercise from 1927 to 2016 covering the 500 largest publicly listed stocks in the United States.

Over that 90-year investment horizon, the God portfolio compounded at almost 30 percent per year. Such an investment – were it possible – would have turned just \$1 into almost \$18 billion over the entire period. By way of comparison, the S&P 500 returned, on average, almost 10 percent annually during that time (which is very good, obviously), meaning a \$1 investment would have grown to just over \$5,000.

Yet, while the theoretical value created by the God portfolio is obviously staggering, the drawdown profile is even more astonishing. Instead of protecting against large reversals, the portfolio endured the pain of drawdowns that exceeded 20 percent ten separate times, including a 76 percent drawdown that lasted for three years. As Dr. Gray points out, given that drawdown profile, if God were a money manager, most investors would have fired Him.

The sad fact is that when market volatility seems oppressive, many investors bail. With (always 20:20) hindsight, our loss aversion and our impulsive performance-chasing weigh strongly against our being able to hold on when investments inevitably suffer losses. Especially big losses.

That’s why the “behavior gap” between investment returns and investor returns is so significant and so potentially damaging. Many – probably most – investors who cash out when negative volatility rears its



ugly head will see their chances of investment and retirement success decrease significantly. Negative volatility hurts. Ofttimes, it hurts a lot. However, such volatility is the necessary price to be paid for the much higher returns provided by stocks as compared with other investment choices. Investors would be wise willingly to commit and hold on for the ride.

As with the markets, our psychological make-up tends to push us to “buy high” and “sell low” — to act against our own interests. We are all prone to innumeracy, which is “the mathematical counterpart of illiteracy,” according to Douglas Hofstadter. It describes “a person’s inability to make sense of the numbers that run their lives.” While illiteracy mostly strikes the uneducated, we are all prone to innumeracy.

In the investment world, we intuitively tend to think that if we start with \$1,000 and suffer a 50 percent loss on Day 1 but make 50 percent back on Day 2 (day-to-day volatility being exceptionally high), we’re back to even. However, were that to happen, our initial \$1,000 would actually be reduced to \$750. Similarly, a sum of money growing at eight percent simple interest for ten years is the same as roughly six percent compounded over that same period. Most of us have trouble thinking in those terms.

The inherent biases we suffer make matters worse. For example, we’re all prone to the *gambler’s fallacy* – we tend to think that randomness is somehow self-correcting: the idea that if a coin is fairly tossed nine times in a row and it comes up heads each time, tails is more likely on the tenth toss. However, as the investment firms take pains to point out, past performance is not indicative of future results. On the tenth toss, the probability of heads turning up still remains 50 percent.

Similarly, there is much hue and cry about diversity and inclusion in the investment world at the moment. Unfortunately, without mean statistics, much of the discourse suffers from *base-rate fallacy*. For example, suppose that Company X has a workforce that is only 20 percent female. The base-rate fallacy would suggest that the company is discriminatory. However, if the applicant pool was only 10 percent female, Company X might actually have an exemplary record of hiring women.

It’s easy to fool ourselves, especially when we want to be fooled. We all really like to be right and have a vested interest in our supposed rightness. So, let’s check our work and our biases very carefully all the time, as best we can. And ask for help. And question our assumptions. And doublecheck our work.

Those would make some pretty good New Year’s resolutions.

We like to think that we see the world as it truly is. The difficult and dangerous reality is that we tend to see the world as we truly are. As C.S. Lewis wrote in *The Magician’s Nephew*, “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.

In the weeks leading up to Christmas, Hallmark regularly ranks as cable television’s most-watched entertainment network in primetime. Over 50 million people watch Hallmark Christmas movies each year, and they aren’t all women. It shouldn’t be hard to figure out why. Hallmark movies offer tidings of comfort and joy by providing a delivery mechanism for one of the more powerful themes in literature – the longing for home.



Which leads me full circle to being an entrepreneur. True, a business has to make money to be successful and survive. But to be successful in the long term, the goal must be to develop a supportive, emotionally healthy environment in which our “family” can grow into tomorrow’s leaders. Security, a sense of belonging, open communication; making each person feel important, valued, respected, and esteemed are truly the objectives of a well-balanced business environment.

To that end, I thank our incredible team for their kindness, support, patience, and counsel over what has been a difficult year. I truly hope the coming year rewards our hard work.

And, of course, a heartfelt thanks to our extraordinary group of clients. We truly 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 once again 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