2020 Annual Investment Letter

Striving for excellence.

"It's not where you take things from—it's where you take them to."

- Jean-Luc Godard

In past years, I began writing this letter early in December with the hope that most would be completed by the time Laurus shut down for the Christmas holidays. This year, safely ensconced in a small rental north of Huntsville, the writing begins with New Years Day quickly approaching. What an end to a decade.

This Christmas, I miss my children, a country away. I miss live music; the magnificent final verse of "Silent Night." I miss fun and merriment around the Christmas tree. Getting through December has been hard this year.

In the C.S. Lewis classic children's story, 'The Lion, the Witch, and the Wardrobe', the land of Narnia is cursed by the White Witch. "'It is winter in Narnia,' said Mr. Tumnus, "and has been for ever so long…. always winter, but never Christmas." The comment seems apt as I look out the window and watch the snow gently falling and yet have missed the delights of Christmas.

That is a resounding joy I wished to repeat but won't until next year. It's as though we have all developed benign paroxysmal positional vertigo – when we try to stand up and get off the couch, the world goes off-kilter. Always winter. Never Christmas.

Hopefully it was different for you. After all the presents are opened and all the children are in bed (if you are able to have the kids with you), to sit down with someone or group of someone's in front of the Christmas tree - a fire would help, so might something warm to drink, and so would Christmas music – and smell the remnants of an excellent meal. Reflect upon the now-opened gifts lying around. Just sit quietly and listen. Love is in the room. That's Christmas.

The year 2020 has seen a similar slowdown in intimacy. While we have all carefully managed the safekeeping of client assets, the inter-relationships between manufacturer and buyer have taken a more laissez-faire approach: changes made if required, otherwise why consider the alternatives. Of note was this year's on-line conversation with an intermediary, fully clothed thankfully,

adorned in their finest pajama's. It was also a nice touch to see the spouse wander by in her teddy - though perhaps a bit too intimate.

It has been well-proven that sociality is a dominant force that shapes thought, behavior, physiology, and neural activity. Despite possessing capacities far beyond other animals to consider others' minds, to empathize with others' needs, and to transform empathy into care and generosity, we fail to employ these abilities readily, easily, or equally. We engage in acts of loyalty, moral concern, and cooperation primarily toward our inner circles, but do so at the expense of people outside of those circles.

And yet, social interaction can also offer a new way to interpret your past experiences, discover something new, and remind us of something we already know. A good conversation updates the software in your brain. Learning more isn't simply a matter of having more conversations, but rather getting more out of each conversation that you are apart of. Deep conversations with 'people that do' offer the richest source of learning.

Despite the amazing advances in technology, Zoom calls do not replace social interaction. Which allows many to retreat into the relative safety of our home offices, secure in the knowledge that we only have to extend beyond our comfort zone when absolutely required. And winter continues.

There is an old parable that goes something like this: Two young fish swim through the ocean, passing an older fish, who says: "Hey boys, how's the water?" The two younger fish swim on, until one turns to the other and asks: "What the hell is water?" This is an apt metaphor to describe the pervasive, under-appreciated effect that passive investing is having on markets. Difficult to see and talk about, lest we are branded an imperious stock-picker that has been reduced to nothing more than a simpleton.

Perhaps lending credence to our simpleton nature, we believe passive investors have certainly won the short-term performance game by blindly pouring money into index funds and ETFs that hold many of the same stocks. As we've mentioned many times before, it would be very difficult for an active manager to outperform a passive investor that simply held the SPX (the SP500 ETF) for the past decade. And yet, we must remember the goal of investing is not only to grow capital, but also to protect it.

Whether the original 2010 Flash Crash, the 2014 bond market flash crash, the flash crash of 2015, the "tech wreck" in 2017, or the 2020 'fastest 30% drop in history', there are abundant signs that the stock market behaves differently in the age of ETFs and the rapid trading of passive investments.

Indeed, the world of passive investing is becoming an over-crowded trade. As many already know, six stocks (Microsoft, Apple, Amazon, Alphabet, Facebook, and Netflix) make up over 22% of the SP500 market capitalization. In a recent Forbes article, they reviewed the seven largest ETFs in the US market (with assets exceeding $900B USD) which ALL listed these stocks as their top holdings. Despite the suggestion of offering different "styles", investors are actually buying the same holdings.

When an index fund or ETF receives inflows, the fund essentially has no choice but to invest in stocks based on their index allocation at that moment, without any consideration of fundamentals, valuation, or anything else. To go further, while pundits continue to argue markets are 'expensive' having rallied so

hard off the March bottom, it’s prudent to consider whether broad over-valuation is simply an unintended consequence of large, uninterrupted inflows into ETFs and other passive index products.

Passive investors are playing a numbers game. By allocating capital as broadly as possible, they attempt to participate in all winners while minimizing exposure to sure-to-happen losers. Diversification is no substitute for diligence. In volatile and uncertain times like the current market, accurate fundamental analysis is of paramount importance. Stocks that don’t make up a significant portion of an index can get overlooked because less passive money is flowing blindly to them.

One of the big questions on investors minds seems to be whether the COVID low in March 2020 has initiated another long-run equity bull market. There is no definitive answer to the question, and certainly no bell rings when markets change over, but we can look at past history and glean some basic conclusions.

Since 1957, there have been eleven SP500 index bull markets (a “bull market” being defined here as one that has risen more than 20% from its previous low). Over these eleven, the average length was 57.4 months with an average gain of 159% (cumulative). These averages have been skewed by the two very long bull markets of 1987 – 2000 (154 months, +559% gain) and 2010 – 2020 (125 months, +400.5% gain). Following history’s fastest bear market (30 days, Feb-Mar 2020) where the index fell 33.7%, the recent bull market has run 8.9 months with a gain of 52.5%. Thanks to FactSet for all this data, but it still really doesn’t help answer the question.

The current economic picture paints another interesting perspective. In August 2020 at Jackson Hole, Federal Reserve Chairman Jerome Powell implied that the central bank would let inflation rise above their 2% target rate if the prior periods has been significantly below that level (as it has). As COVID sent the economy into a deep recession, interest rates were cut to zero and trillions of dollars purchased securities to shore up markets, stimulate the economy, and, with it, job creation. This past September, the Fed pledged to keep these historically low interest rates near zero through 2023.

Looking at the market through the lens of an intrinsic value model, the lower the interest rates, the higher the projected market price is; very simply, using a lower discount price increases the value of the market assets. If interest rates are to remain low for the next couple of years, higher market prices are likely supported.

Of course, not all holdings in a market will necessarily rise. As my previous comment notes, the ‘Big Six’ stocks in the SP500 have simply grown through price momentum; a continuing surge of passive capital being invested in six stocks comprising more than 22% of the SP500 market capitalization. Not one of them has any supporting fundamentals for their valuations. Momentum is an interesting thing – it works until it doesn’t.

The past year has brought us many challenges. Certainly, the market drop early in the year had us collectively holding our breath. The confusion created with the initial virus outbreak – exacerbated by extensive media coverage – which has mutated into worldwide concern, emotional pain, and, not surprisingly, division between the ‘maskers and anti-maskers’.

Emotional pain typically causes vivid and strong reactions; after a particularly trying event, the human instinct prepares for a repeat of whatever challenge they just faced. Known as 'availability bias', we succumb to the urge to get ready to fight a war we've already fought. We don't tend to generalize in the knowledge that disasters do, as a rule, tend to happen. Instead, we tend to make changes that are intended to keep us safe from a repeat of the disaster we just experienced.

When terrorists used airplanes to attack the US in 2001, security was immediately increased at airports worldwide so that planes can never be used again to do so much damage and kill so many people. Yet, despite increased measures, there have been seventeen attempted hijackings across the globe – about the same number as in the ten-year period prior to 9/11. Slower yes, but not stopped.

In the aftermath of a disaster, we want to be reassured of future safety. We lived through it, and we don't want to do so again. By focusing on the particulars of a single event, however, we miss identifying the changes that will improve our chances of better outcomes next time. Yes, we don't want any more planes to fly into buildings. But preparing for the last disaster leaves us just as underprepared for the next one.

We can find ways to benefit from disaster. Building our resilience starts with the way we process the negative events in our lives. Mental toughness is a prerequisite for personal growth and success, while adversity allows us to become better rounded, richer in experience, and to strengthen our inner resources. We can learn from the last disaster how to grow and leverage our experiences to better prepare for the next one.

The COVID-19 pandemic served as a backdrop to just about everyone. The challenges have been incredible, and the speed of change was, at times, overwhelming. After all, no one has lived through anything like this. However, though we may be ashamed to admit it, human nature is more at home in a crisis. Disasters force us to band together and often strip away our differences.

Mainly, to quote Daniel Kahneman, "the lesson we should learn from surprising events is that the world is surprising." While it may not be surprising to most of our readers, we believe the coming years will bring about a return to smaller company investing. The past ten years have been the story of large cap stocks – as the Alphabets and Amazons of the world outperformed smaller companies, they have also dominated investor attention. Small company investment has largely been overlooked.

Which means change will be slow. It's easier to continue herd mentality – safety in numbers. But portfolios constructed of investments with no underlying fundamentals are ripe for correction. We've experienced a wonderful decade of performance. But now we need to think clearly.

As the author of 'Thinking Fast and Slow', Kahneman notes what gets in the way of clear thinking is that we have intuitive views of almost everything. And we have beliefs mostly because we believe in some people and we trust them, thereby adopting their beliefs. We generally don't reach our beliefs by clear thinking; we tend to quickly form an impression then spending most of our time confirming it rather than collecting evidence.

Such has been the case in the investment market.

As we mentioned in our May white paper on small cap investing, historically, coming out of recessionary troughs, small cap markets outperform. This year has been no exception. Since March 31st, the Russell 2000 has outperformed the SP500 by over 25% (in USD). Over the same period, the MSCI EAFE small cap index has outperformed the all cap MSCI EAFE index by over 17% and the MSCI Global Small Cap Index has outperformed the MSCI World Index by almost 19% (also in USD). If history continues to prove, we expect this to continue for a while.

Large cap investing is easy, relative to small cap investing. Their size tends to make them less likely to go out of business in a slowdown, information is readily available and widely distributed (as are opinions), and most pay dividends to compensate investors for their relatively stagnant price appreciation. And many are recognized brand names, giving comfort to readers of an investment portfolio. As a portfolio manager, one is less likely to be chastened for owning TD Bank versus Canadian Western Bank if both were to pull back 25%.

Small cap investing, on the other hand, is hard. Fundamental research on smaller companies requires considerable 'face time' with management to understand their business model, use of capital, potential growth rates – their economic engine. Small cap businesses have more simple organizational structures, allowing them to make decisions faster – and they can change direction in time to take advantage of shifts in the economy.

As we move into the next couple of years, beyond the initial trauma of the pandemic but not yet past it, businesses that have great economic engines – either current high profitability or a margin structure that will grow when scaled up as costs fall – and have the ability to move fast, will grab market share from slower moving, more "corporate" businesses. We also expect takeovers and consolidation to increase, with higher quality companies able to successfully consolidate or disrupt their markets.

This is my seventh Laurus annual letter and thankfully, despite the pandemic, I remain as healthy today as I was in 2014. More grey hair perhaps. The year has had its challenges but also some amazing successes. Ranking for the second year in a row in the Global and Mail Top 400 Growing Companies. Launching our international small cap investment model on the back of the tremendous success investors have seen in the global and US small cap strategies. Finishing the year with record assets under administration.

All this due to an incredible team of folks. The investment team, led by Linda Lebrun, now has some of the most robust collective brainpower I've seen in a team over my forty-plus year career. Our client services team continues to expand its capabilities, most recently adding on MSCI alongside our FactSet group to provide clients with more accurate performance analytics in the years ahead. And the guidance provided by our various counsel continues to provide a true measure of how a business relationship should just have a wee bit of personal touch.

Of course, we also have an extraordinary group of clients without whom we would not exist. Their continued support, their confidence in our abilities, and, dare I say it, their friendship has buoyed us through some of the darker hours of our development. Personally, I remain forever grateful, and on behalf of my partners and all the employees of Laurus, we humbly thank you.

Next year begins a new era at Laurus as we begin discussions with potential clients and their advisors in the US. The market south of the border is well-versed in small cap investing and, with the able assistance of the team at Tessera Capital in New York, we look forward to the challenges that market can bring.

And so, 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