MONTHLY COMMENTARY | OCTOBER 2021

"Dig deep. Own long."
– Dennis Starritt, Laurus Investment Counsel

Because stocks have rebounded so strongly despite the ongoing effects of the coronavirus, we're frequently asked about the level of valuations in the market. In response, we acknowledge the words of Wharton School professor Dr. Jeremy Siegel. Siegal notes that over 90% of a stock's worth is generally based on earnings beyond one year into the future, which is a broad generalization. However, not enough attention is paid to the only real approximation of any assets – the discounted value of the future stream of cash flow an asset can generate. This calculation requires some heroic assumptions, the most heroic being the factor at which the cash flow is discounted, or the weighted average cost of capital (WACC).

This number will affect the current value of a long-term stream of cash flow more than anything else. There are many arguments as to how best to identify the appropriate WACC, but for analytical purposes it is most important to be consistent. However, it cannot be argued that the generally accepted expectation for mid to long-term interest rates is a very important ingredient in determining an appropriate weighted average cost of capital. Interest rates are, after all, the basis for long-term investment decisions and capital allocation by corporate executives.

This highlights the importance of 10-year treasury bond rates. The primary governor of 10-year yield will be inflation since higher inflation will increase the required return on savings to compensate for purchasing power loss. Central bankers can exert considerable control over short term rates, but inflation expectations will be the key driver of 10-year, and especially 30-year, fixed income investments. Following the credit seizure of 2008/9 and lately to overcome the unprecedented havoc wreaked by the COVID-19 global shut down, central banks throughout the world have forced short term rates to historically low levels, dragging long-term rates lower as well. This certainly has impacted economic progress, although minimally.

But the impact has been significant on assumptions regarding the weighted average cost of capital. The relevance of a lower WACC assumption is definitely not understood by politicians who only focus on a strong economy and labour market for re-election purposes. And the importance is also not well understood by monetary authorities who tend to be economists and are not in the business of valuing assets. Nevertheless, the unintended consequence of a lower weighted average cost of capital (WACC) is to mark up the value of future income streams generated by any asset. So, the well-meaning policies that have been aggressively pursued by politicians and central bankers throughout the world have caused the rich to get richer since they tend to own the assets. This phenomenon is certainly evident in the prices being paid in the stock market for businesses with predictable long-term earnings expectations. And, unfortunately, the desired impact of a stronger economy helping to benefit those who do not own assets has been limited at best.

So where does all this lead? The current level of intervention would appear unlikely to be sustainable over the longer term. If inflation and interest rates should revert toward historical norms, there will be significant turmoil as financial markets make the required adjustments. Being aware of these possibilities does not enable useful predictions but we continue to adhere to our long-term beliefs. Companies that lead their sectors and have well established records of success enabling them to generate free cash flow and maintain essentially debt-free balance sheets will continue to have sound long-term prospects. Short term valuations may ebb and flow, but these businesses survive and prosper over the long term. Long duration investments have served us well in the past and we expect them to continue to do so into the future.