July 26, 2020

Flashback

The Value Fund was up +6.1% in Q2 and is down -7.0% year-to-date through June 30. The strengthening of the Canadian dollar (the Value Fund's reporting currency) lowered our Q2 returns by approximately -3.4%. A more detailed explanation of our view on currency hedging (and our bias for not doing so) can be found here.

As at June 30, the major North-American indices are largely in negative territory for the year: TSX -7.5%, DJIA(CAD) -4.3%, S&P500(CAD) +1.3%. Markets have largely rebounded from the steep Q1 selloff. Meanwhile COVID-19 is still reproducing at alarming rates in the US and much of the global economy is operating at partial speed.

Market Commentary

Say say two-thousand-zero-zero party over
oops out of time
So tonight I'm gonna party like it's 1999

Prince. "1999". Warner Bros. Records, 1982

Written in 1982, Prince's lyrics to his hit-song "1999" proved to be prophetic. But instead of correctly predicting nuclear Armageddon, he nailed the bursting of the dot-com bubble and the stock-market hangover that followed in 2000.

As Mark Twain so aptly put it, history doesn't repeat itself, but it often rhymes. The current market environment — especially in certain tech stocks — reminds us a little of the late '90s stock market. Back then, a tech-related business plan and not much else could lead to mind-boggling valuations and access to capital markets. Valuations were deemed irrelevant — all that mattered then were eyeballs and a dot-com name. Many entrepreneurs took advantage of the market's folly by raising vast sums of capital and proceeded to recklessly spend these "businesses" into oblivion.

Today's market is different in that many high-flyers are actual businesses that do have a future. For example, Canada's **Shopify** (SHOP) is growing rapidly and provides small and medium-sized businesses with an easy way to set up an online presence. With revenues of US$1.7 billion and a leading market position, it certainly has a promising future. Its stock is another story.

Sporting a market capitalization of C$146 billion, the company is currently being valued at 63x revenue. We would give you the P/E multiple but are unable to as the company has yet to turn a profit. Let's assume that Shopify can grow revenues at 40% a year for the next five years and eventually earn a 20% profit margin. Hardly conservative. On those numbers the stock trades at 75x projected earnings for 2025. By comparison, **Royal Bank of Canada** (RY) earns about $11.2 billion in profits a year and its market capitalization of C$133 billion implies a P/E of 12x. We like companies that grow fast — we just aren't inclined to overpay for that growth. We have a sneaking suspicion that investors in Shopify at current valuations will eventually experience an unpleasant outcome.

There are other signs of market froth. For example:

- By our count, there are dozens of software-as-a-service (SaaS) companies with market capitalizations over $10 billion that are trading at more than 25x revenues. Almost all of them are unprofitable.

- Account openings at online brokers is surging and there are credible reports that trading stocks was among the most common uses of government stimulus cheques.

- Day traders like Dave Portnoy are becoming celebrities to his legion of day-trading followers. He may be entertaining to watch, but we remain skeptical of his views that "stocks only go up" and Warren Buffett is "washed up".

- Rental-car company **Hertz** (HTZ) filed for bankruptcy protection and yet the stock rallied from $0.56 to $5.53 within a week. As a result, the company tried to issue new equity that it described as "worthless" until the regulators stepped in.

Asset-price inflation is a direct consequence of easy money. Yields on 10-year government bonds — the "risk-free" rate — currently stand at 0.6%. The idea of lending someone our money for a decade at these fixed returns strike us as highly unattractive especially given the risk of future inflation.

Government stimulus related to COVID-19 is paying many people more to stay at home than they were making at work. Idle consumers locked in their houses with extra pocket change is contributing to this folly.

Given the environment, our experience tells us that today remains a time to be cautiously positioned with the portfolio. We prefer the risk of looking stupid for missing out than the risk of losing your money (and ours) by making bets with poor odds.

Our focus remains on what we can control. We know that the companies that we own in the portfolio can weather the COVID-19 storm, even if it lasts for several years. We also know that there are some attractive opportunities out there. We believe that owning high-quality equities that are trading at reasonable prices will lead to better returns than the other alternatives currently on offer.

The Economy vs. The Stock Market

The major North-American indices have quickly rebounded from the March lows and are nearing all time highs despite the pandemic's ongoing drag on economic activity. While this has been a surprise to many – myself included – it reinforces our belief that short-term market movements are entirely unpredictable.

In addition, despite widespread belief that the stock market and the economy are closely correlated, they are not.

> *The trouble with picking stock markets on the basis of expectations of GDP growth is not that GDP growth is hard to predict (although it is harder than many people assume), it's that even if you could predict it with perfect accuracy, it wouldn't do you any good picking stock markets.*

Ben Inker, Grantham, Mayo, & van Otterloo (GMO) [1]

The economy is still a mess and the full economic-impact of COVID-19 on many businesses has been temporarily delayed due to government stimulus. Some businesses will draw down their reserves and then ultimately fail. Stronger competitors will gain market share and many businesses will reemerge with new equity owners via the bankruptcy process. Eventually the economy will improve, Schumpeter's creative destruction will have worked its magic and we will move forward.

The survival of our ingenious species is in our ability to continually adapt to changing conditions. We remain of the view that the scientific community will find a solution to COVID-19 and that the world will return to normal in a year or two. Society will adjust and successfully adapt as we have for millennia. So will businesses.

[1] *GMO White Paper: Reports of the Death of Equities Have Been Greatly Exaggerated: Explaining Equity Returns. Ben Inker, August 2012.*

Our approach in this difficult economic environment is to focus on valuations and how the pandemic will impact the earnings of our investee companies in the coming years. We stick to investments in quality companies with strong balance sheets and attractive long-term outlooks. We avoid speculative equities and even good companies that are trading at valuations that will likely lead to poor long-term returns. We think about risk.

The Value Fund Portfolio

The Value Fund finished Q2 up +6.1% with the biggest contributors largely coming from our technology holdings: **Facebook** (FB) +36.1%, **S&P Global** (SPGI) +34.5%, **Alphabet** (GOOG) +21.6% and **Visa** (V) +19.9%. Our worst performer was **Berkshire Hathaway** (BRK.A/B) -2.4%.

The sharp selloff earlier in the year allowed us to add several high-quality stocks to the portfolio: pharmaceutical giants **Merck** (MRK) and **Pfizer** (PFE) and UK-based spirits producer **Diageo** (DEO). We also uncovered a gem in Israeli-based cybersecurity company **Check Point Software** (CHKP). Cybersecurity is an industry with long-term tailwinds and the shift to working from home increases the importance of network security.

Check Point earns operating margins in excess of 40% and astronomical returns on capital. The business is a cashflow machine. We also like the fact that the CEO/Founder takes stock options in lieu of salary and owns about 20% of the business. At our average purchase price of $102 we acquired the stock at 14x earnings after adjusting for the $4 billion of cash on its books (no debt). If the company can improve on its sales execution and increase its already respectable revenue growth, we believe that a multiple expansion on the stock will follow.

We took advantage of the Q2 market rally by selling out of our positions in **Nike** (NKE) and **United Postal Service** (UPS) once they traded at prices in excess of our estimates of their intrinsic values. We also fully exited our position in **Wells Fargo** (WFC). The company's operational and regulatory challenges continue, and COVID-19 was the icing on the cake. Given the state of the economy, the low-interest-rate environment and their company-specific challenges, we decided to exit.

Berkshire Hathaway has been a laggard this year and there is plenty of talk of the Oracle being washed up. Perhaps. But with $140 billion of cash on hand and a stock trading at approximately 1.1x our estimate of the company's current book value, we like our odds. Historically the stock has traded at about 1.4-1.6x book value. The company has also been buying back some shares recently which is another sign that the Oracle views the stock as undervalued. People have written him off before and to date, they have been mistaken.

We wouldn't be surprised to see Buffett get an opportunity to put a large portion of that cash to work via major acquisitions and/or share repurchases. We believe that COVID-19's impact on many businesses is still in the early innings and the nascent recovery quite fragile.

Despite being 89, we think that the Oracle may yet have another card to play before walking away from the table and dealing in his successor (Canada's own Greg Abel is the likely pick). The $2 billion of cash flowing into Omaha each month will eventually pressure the company to start paying a regular dividend. Berkshire Hathaway is much more than just Buffett and Munger. It is a collection of wonderful and diverse businesses trading at an attractive price. In addition to the likely prospect of growing earnings for years to come, a future stock rerating is also probable. We view the stock as a core holding.

We finished Q2 with a cash position of approximately 23% and own quality names that we believe are undervalued. We would caution people not to mistake our cash position for a bearish near-term call on the market. We are neither short-term bearish nor bullish. No one knows what the market will do short-term, including us. Instead, we focus on valuations and opportunities available in any market environment. When we don't find compelling value, we are prepared to hold cash.

Our team of summer research analysts and yours truly are evaluating stocks at a furious pace. Just because there is some froth and the market generally overvalued, that doesn't mean that *every* security is expensive. Our daily efforts are focused on uncovering pockets of the market where we are finding value. We are willing to put our cash to work immediately if we find a compelling risk-reward. In fact we put some of that idle cash to work just this past week into a new position. When we find compelling valuations, we will act.

We are also updating our watch lists of great companies that we would like to own at a certain price. In other words, we are putting in the work and preparing for whenever opportunity happens to knock.

Business as Usual

COVID-19 may have prevented us from putting on our annual client gathering this summer but otherwise it's business as usual at GreensKeeper. Our entire team is working hard (and remotely) and we are finding video conferencing to be very efficient. Technology is a real blessing.

The firm's assets under management (AUM) has continued to grow as several of our clients sent more capital our way during the market selloff. They have been rewarded for their conviction by the swift market recovery. We are thankful that our client base shares our long-term approach to investing.

To all our clients, thank you for the privilege of managing your capital alongside our own.

Michael P. McCloskey

President, Founder &
Chief Investment Officer