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The Love Letter

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Growth at a reasonable price

For the past several months, we've been concerned about speculative activity and overvaluation in certain pockets of the marketplace. Evidence of this has been widely available: elevated retail investor participation, increased number and size of initial public offerings, heightened usage of leverage, and detachment between fundamentals and prices resulting in high valuation multiples. During this period when momentum, Reddit forums, and meme investing has been in vogue, staying rational has been challenging but ultimately the right course of action for our clients.

In the post-pandemic world, capital markets have been reacting to a series of sudden societal changes including lockdowns, working-from-home, travel restrictions, coupled with massive injections of fiscal and monetary stimulus. In the early days of the pandemic, technology companies legitimately outperformed as demand for their products and services accelerated. Valuation of these companies got an additional boost from a drop in short- and long-term interest rates. At the same time, industries negatively impacted by the pandemic suffered a drop in earnings and investor sentiment. After the initial market reaction, some investors began to extrapolate short-term trends and were willing to pay larger and larger premiums for businesses that were experiencing high rates of growth. And therein lies the challenge for portfolio managers like us: what's a reasonable price to pay for future growth?

Despite our conviction that markets are generally efficient in discounting fundamentals over the long-term, they are nevertheless susceptible to short-term episodes of irrational behaviour. During these episodes, myriad justifications are presented for high valuations as some investors pursue growth at any price. As part of our valuation-centric investment analysis, we compare valuation metrics of individual companies with the overall market and try to approximate how many years of growth are already embedded in the current share price. Ideally, we would prefer to pay as little as possible for future growth. In practice, however, we settle on paying for growth at a reasonable price.

As an example, at its peak share price e-commerce company Shopify (SHOP-TSX) was trading at 356x forward 12-month price/earnings versus the market at 22x. At this valuation, it would take 10 years of 32% annual compound growth in earnings for Shopify to trade at the same multiple as the current market. By comparison, Alphabet (GOOG-Nasdaq, the parent company of Google) recently traded at a peak valuation of 28x, requiring only 2-3 years of 10% annual earnings growth to trade at the same multiple as the market. Knowing that uncertainty rises as the time horizon expands, paying up for two years of modest growth is much more reasonable than paying full price for 10 years of high growth. In our experience, lofty growth expectations are either rarely achieved or investors eventually lose enthusiasm for paying such high premiums for anticipated growth. It should come as no surprise that we own Alphabet and not Shopify. Amidst the current correction underway in the technology sector, Alphabet has declined 8% from its all-time high set on April 28, while Shopify has dropped 32% from its Feb 10 high. Even at current prices, we think the former trades at a reasonable valuation, while the latter continues to trade at an uncomfortably large premium.

Canadian dollar strength has been a headwind

As of May 12, the Canadian dollar has gained 5.2% against the U.S. dollar so far this year and is trading close to a four-year high. This is great for Canadians thinking of travelling abroad later this year (assuming restrictions are lifted), but a strong Canadian dollar has been restraining performance of portfolios that contain non-Canadian holdings.

Movements in currencies are typically driven by relative differences in growth expectations and monetary policy of respective central banks. All else equal, countries with faster growth and tighter monetary policy (i.e. expectations of higher interest rates) experience currency appreciation relative to countries with weaker growth and looser monetary policy.

Much of the strength in the Canadian dollar has come in the past three weeks and can be attributed to a hawkish change in tone by the Bank of Canada. At its April 21 rate decision announcement, the Bank of Canada announced a tapering in its bond buying policy, signaling to the market that it is gradually withdrawing emergency support measures it enacted when the pandemic began. It also hinted that it could start raising short-term interest rates in the 2nd half of 2022, which was earlier than the consensus expectation. Last week, the Bank of England followed the same playbook, causing the British Pound to appreciate 2% versus the U.S. dollar.

Meanwhile, the U.S. Federal Reserve continues to resist tapering its emergency measures until it sees "substantial further progress" in economic conditions. Whether the Banks of Canada and England were too early or the Federal Reserve too late is debatable, but we view the divergence in policy as short-term in nature. As the pandemic recedes and employment and inflation trend higher, we expect the Federal Reserve will also announce tapering plans over the next 2-4 months. Depending on the pace of economic recovery in coming months (likely faster in the U.S. than Canada), we think the Canadian dollar's advance should slow and eventually settle back in the US$0.80-US$0.82 range.