Market Update

August 2020

Important Topic: Valuation Matters ... Eventually

Valuations matter. Overpaying for anything is never wise. Overpaying for an investment can be particularly dangerous to one's financial health. But there are reasons why people do it.

Allow me to consider these reasons in the context of a real life example: Tesla

Tesla – the electric car and energy storage (battery) company – has taken the world by storm and is led by an unusual, but visionary leader, Elon Musk.

Tesla is now worth USD $442 billion. This exceeds all US and European listed car companies combined. Volkswagen (USD $52bn), Daimler (USD $51bn), GM (USD $42bn) plus BMW, Ferrari, Ford, Fiat, Peugeot and Renault have a combined market valuation of "only" USD $280 billion. Looking at Sales figures, Tesla has revenue of just over USD $25bn while the sales of all of the other companies combined totals USD $1.8 trillion or USD $1,180 bn – 47x greater. Looking at Capital Expenditures (amount being spend on research and growing the company), Tesla is spending USD $2.5bn while the capital expenditure of all of the other companies combined totals USD $75bn – 30x greater.

It is safe to say that by any traditional metric Tesla's stock is expensive.

So why buy it? Why "overpay"? and what does one hope for when doing this?

1. Human Nature

Human nature is such that many (some say all) decisions are made emotionally. The intellect is then used, after the fact, to justify the decision made.

(There is less interest for companies that are trading at rock bottom valuations as this requires contrarian confidence and a fair amount of patience.)

Second, human beings instinctively extrapolate. This is a strength in almost all parts of lives. Seeing patterns, managing expectations based on past experiences, expecting people to act somewhat consistently, all help us lead our lives, help us make important decisions and provide some stability in a chaotic world. As a result, investors are comfortable buying investments that are going up and they expect such investments to continue this path.

Other human traits, such as instinct, greed, and arrogance may also come into play.

However, "Valuation" is rarely a factor in the decision and by that measure the decision may be questionable and fraught with risk.

2. Greater Fool Theory

According to this theory, once bought, an investor can (rightly) expect to sell the investment at a higher price to someone just like them. There are others who have not yet bought, not yet capitulated to the crowd and want to get "a piece of the action" before they miss out. The value of Tesla was already stretched on July 1 (2 months ago) when the company was worth USD $221bn. Yet anyone buying then could sell today at twice the price.

There are undoubtably those who are buying Tesla today on the expectation of selling these shares to someone else. Needless to say, this works until it does not.

3. Company grows into its Valuation

The one saving grace, the one possible scenario, where over paying for an investment can be profitable and will justify the purchase (certainly in the mind of the buyer), is if the company grows sufficiently and quickly to justify the price paid.

Taking Tesla as the example, it is possible that one day Elon Musk announces a breakthrough in battery technology that changes the world. Imagine if he could build a battery that is large enough, and maintains its charge long enough, so that this battery could be charged by solar panels spread across the deserts of the world and then shipped to cities all over the world to power them. Such batteries would change the world and make solar (and wind) much more viable and economical.

If this were the case we could look back at Tesla's USD $442bn valuation and decide that it was cheap. But what are the odds?

Conclusion

Tesla may represent the future. It is commonly thought that the combustion engine is doomed and that electric cars are the future. Tesla got a jump on designing and producing electric cars that are excellent and desirable in my opinion. Elon is a visionary who has built successful businesses in the past and is currently spearheading several innovative movements across the globe. It is all quite impressive. But everything has its price and everything has a value. How much is Tesla really worth?

Volkswagen is worth less than 1/8th of Tesla, has sales 12x larger than Tesla and is spending more than 8x the amount of money on capital expenditures. There are many who believe that Volkswagen may soon introduce electric cars that are as good if not better than Tesla (they are working with Apple). Currently Volkswagen (and Renault) sell more electric cars than Tesla in Europe. Volkswagen's USD $20.0bn being spent annually on developing the future, far exceeds Tesla's USD $2.5bn. Is it so obvious that Tesla will announce the next breakthrough, and not Volkswagen? It is so obvious that Tesla will be able to build factories and produce the millions of needed electric cars and not Volkswagen who already has the factories, assembly lines and workers in place? Is it so obvious that Volkswagen won't be able to at least match whatever Tesla does? Is Tesla worth 8 times the value of Volkswagen?

These are questions that should be asked.

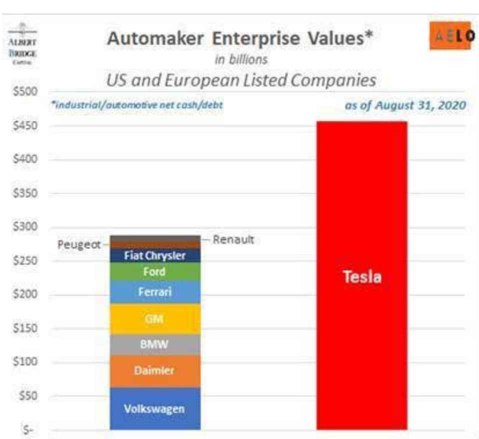
Valuation matters .... and eventually either Tesla justifies its stretched valuations or it falters and its price falls to more realistic levels.

Market Update: August 2020 - The Rally Continues ..

The market has continued its rally, now in its 23rd week.

The underpinnings of the rally remain – government stimulus, low interest rates and better economic data than expected.

As long as these remain in place, we expect that the rally will continue ... however some valuations have become stretched (see above) and this must be constantly monitored.



Dollar amounts specified are expressed in USD.

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CAPEX refers to Capital Expenditure.

Economically the data has supported much of the market's increase. The housing market in the US is very strong. The Canadian housing market has emerged from the lows under the impact of Covid with significant increases. Mortgage rates are near record lows and spurring on much of this activity. The auto sector is particularly strong as it too benefits from low interest rates. Many vehicles are being sold with 0% financing. Much of the economy is tied to interest rates.

Separately many companies have learnt from the past few months and have adjusted to the new reality. Expectations for company earnings in the third quarter are increasing.

Manufacturing activity has also recovered and is now above the level at the beginning of the year.

Looking Forward

The markets are likely to remain quite volatile. The future remains quite unclear and we wait to see what effect opening schools and businesses will have.

As for our investments, we like the positions we hold – quite a bit – and we are continuing to buy, though very selectively.

While US Growth Large Cap stocks continues to lead the way higher (NASDAQ setting a new all-time high), other asset class have shown signs of recovery. This is important and we look for it to continue. As always we remain convinced that superior companies and investments trading at attractive valuations will rebound in time, providing attractive long-term returns. We remain focused, selective and patient.

For the month, the bond market was down 1.4%, the Canadian market was up 1.7%, the US market was up 5.0%, International markets were up 4.8%, the Emerging markets were up 0.6%, the Real Estate market was up 2.4% and the preferred market was up 4.6%. (Reuters 8/31/20)

Year-to-date, the bond market was up 7.3%, the Canadian market was down 0.6%, the US market was up 6.5%, International markets were down 5.6%, the Emerging markets were up 2.4%, the Real Estate market was down 18.0% and the preferred market was down 5.1%. (Reuters 8/31/20)

Have a great month and let us know if there is anything we can do for you,

- Meir

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