Quiet Counsel

Summer 2020
Investment Outlook

Quiet Money.®

Finding Value in Unexpected Places

This is a two-part series written for private clients as a companion piece to "Has Value Had Its Last Dance?," a more technical article we wrote recently for our institutional clients. In part one of this series, we provide a straightforward explanation of what makes a stock "Value" or "Growth," explore what it means to invest with a Value style, and provide live examples of our process at work. In part two of the series (Finding Value in Unexpected Places: Is Value Dead?), we examine the recent performance of Value portfolios relative to Growth, and provide compelling evidence of the historic opportunity that has emerged for Value investors.

Many obituaries have been drafted lately for the Value investing style. Capitulating prognosticators suggest Growth's ties to the New Economy and its inevitable success spells dooms for Value, a waste-bin of washed-up companies on life support. While it is tempting to try to categorize companies into convenient buckets, the reality is that investing is not as obvious, or as easy, as that.

Stock prices oscillate over cycles, driven largely by investor psychology. For example, the late 1990s favoured Technology companies prior to their millennial bust, and they are hot again today. Similarly, Energy, which

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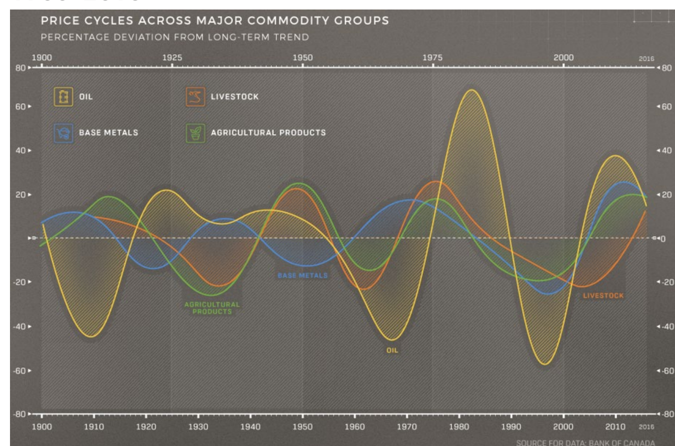
is unloved today, was a leader through the mid 1970s and again in the early 2000s. Figure 1 illustrates how commodity prices go through cycles and thus companies in those sectors can oscillate between being "unloved and inexpensive" (Value) and "popular and expensive" (Growth).

Figure 1: Price Cycles Across Major Commodity Groups, 1900-2016



Source: Visual Capitalist.

So companies that may find themselves in the Value bucket today may have been in the Growth bucket in the past (and may be again in the future?). Easy, right? Let's simplify by ignoring sectors and labels and instead say great businesses may be lousy investments, and overlooked (but good) businesses may be outstanding investments.

Good Businesses versus Good Investments

A **good business** is identified by qualities such as product, service, management, balance sheet strength, market share, profitability, sales growth, brand, and intellectual property. A **good *investment*** is determined by the difference between **price paid** and **price sold**.

At Leith Wheeler we seek both: quality businesses with engaged, aligned management whose stock prices trade below our estimate of future value (or "intrinsic value"). Often, this can be due to short-term company-specific issues that attract excess investor pessimism – and so creates an opening for us to buy. By repeating this

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process, we're able to create a portfolio of stocks that are cheap relative to the broad market. To us, the opposite of "Value" is "Over-valued" (not Growth).

In our history we have invested in underpriced, out-of-favour companies in all sectors at various times. We have owned Apple, and currently own Google, Samsung, and Constellation Software. We are overweight Technology in Canada and internationally, and overweight the Technology sector compared to the Value index in the USA. We understand Amazon well and admire the company but at over 100x P/E, recognize that – like Microsoft in 2000 (see below) – everything has to keep going perfectly for it to provide a good return through the *next* cycle.

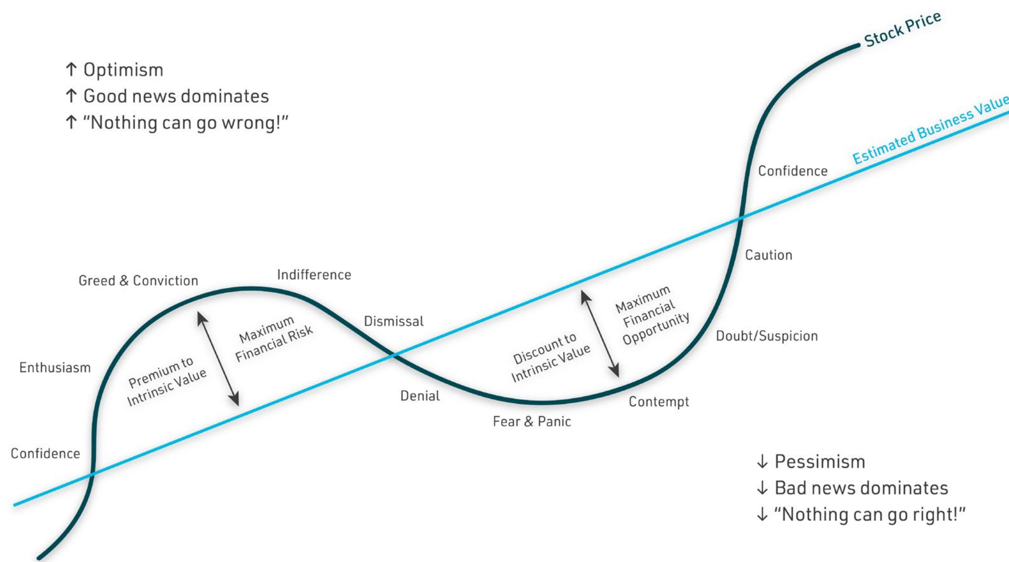
So how do we try to "tilt" the odds in our favour?

Look for Unloved or Underappreciated Assets

It's human nature to over-react to both good and bad news and this tendency yields price points that allow contrarians like us to take advantage. The graphic below illustrates the valuation of a hypothetical company (or sector) over a long period of time, and the impact of the "feelings" of investors.

While this is a stylized representation (as Figure 1 showed, industries can and do go through similarly shaped cycles – impacting the share prices of the companies in it), it captures the essence of investor psychology as these cycles play out. The opportunities of interest to us occur when pessimism reigns and we are able to buy at prices below intrinsic value from other investors who allow the short-term "noise" to obscure the long-term value that's still there. These entry points lay below the light blue line where stock prices reflect market sentiment of contempt, fear, and doubt. Conversely, we are less likely to find good

Figure 2: The Emotional Lifecyle of a Stock Valuation



Source: Leith Wheeler

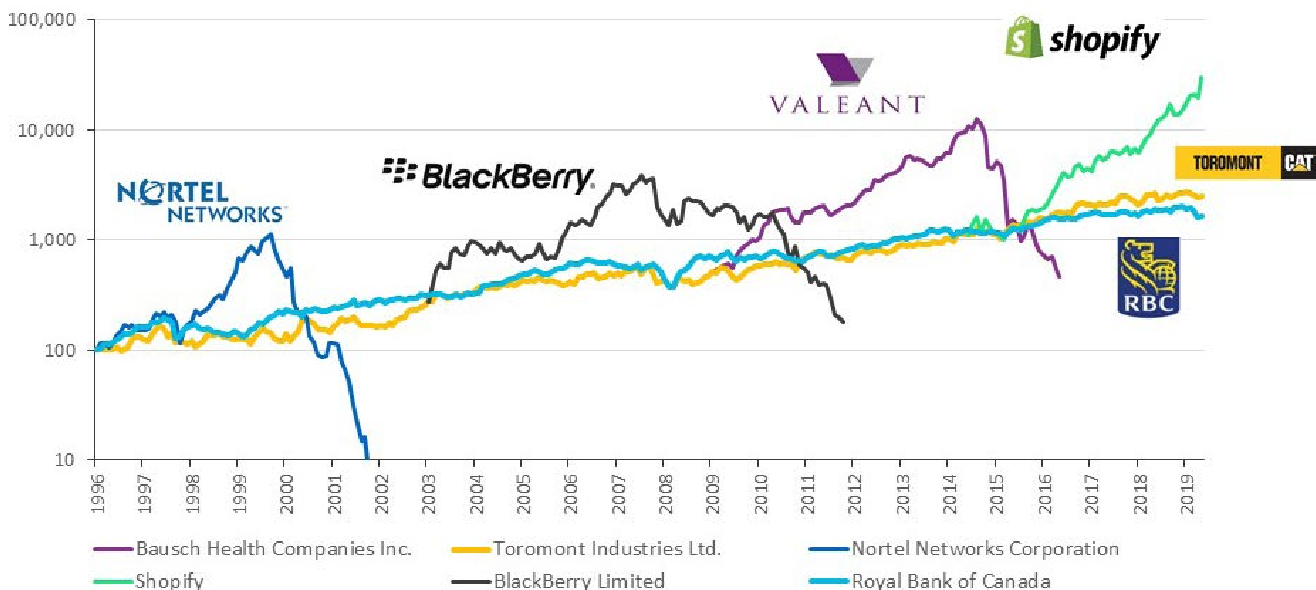
investment opportunities in areas of the markets driven by enthusiasm and conviction, where "surprises" are more likely to be negative than positive.

Pay Attention to Price Paid

Price discipline is one of the main risk controls of our management style. If we buy a good business at a great price, all we need to do is wait. While we monitor progress along the way for changes to our thesis, time will eventually price the business properly. We view time and patience as significant assets within our control in a world that is unknowable and increasingly focused on immediate satisfaction.

In some cases, a stock might *look* cheap but it is cheap for good reason (i.e., a "value trap."). Perhaps its business is in permanent decline, it has a poor management team, an overleveraged operating model, or is losing market share. Similarly, we believe that overpaying for popular investment trends or excessive growth optimism (i.e., a "growth trap") can leave an investment flat or down for years even if the underlying business is growing

Figure 3: Canada's Troubled History with Growth Traps



Source: Bloomberg, Leith Wheeler estimates.

and improving. **Avoiding both traps requires insight, judgment and humility as the future is a wide funnel of doubt.**

Figure 3 shows examples of Canada's troubled history with growth traps, many of which ranked as the TSX's largest weight for their time in the limelight. We have preferred to own stable growers like Toromont and Royal Bank, two companies that have delivered superior returns without the drama.

Case Study: Microsoft

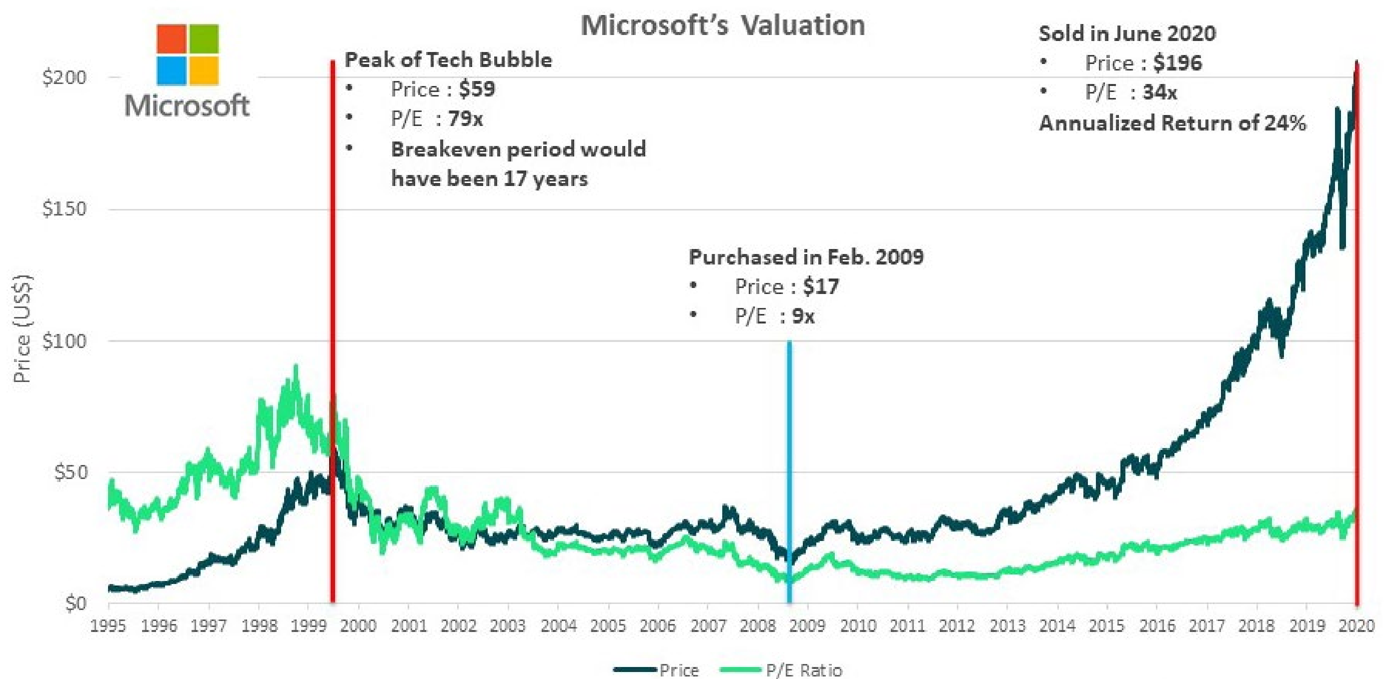
While Microsoft is a tech darling today, investors may recall that it led the investment landscape 20 years ago, too. Then, as now, it was a wonderful example of a well-managed company with leading-edge technology, solid earnings growth potential, and a very strong balance sheet. (Today, it benefits further from a more diversified business.) In 1999 the company was perceived by many as a "no-brainer money-maker," a "New Economy" company destined to change the world... But, at 1999 valuations, was it a good *investment?*

Recall that a great business does not necessarily equate to a great investment. Sadly, those who bought in 1999 based on the popular narrative had to wait **17 years to break even on their initial investment (until January 2017)!**

The chart in Figure 4 illustrates that in 1999, investors in Microsoft were paying $59 per share, which represented a Price/Earnings (P/E) multiple of 79x at the time. This means that for every dollar of profit that Microsoft earned, investors were paying $79.

This is a company of a quality and with a competitive advantage that has rarely come into question, and indeed when it traded down to a P/E multiple of 9x during the Great Financial Crisis, Barrow Hanley (sub-advisor to our US Equity strategy) **established a position at $17.** Microsoft has been a long-term holding in the strategy and an excellent investment, rising eleven-fold before we sold it in June 2020 for $196 – a price return of 24% per annum over the past 11 years! It was a disciplined assessment of intrinsic value combined with an opportunistic purchase price that made this a successful investment.

Figure 4: Price and Valuation of Microsoft, 1995-2020



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IMPORTANT NOTE: This article is not intended to provide advice, recommendations or offers to buy or sell any product or service. The information provided is compiled from our own research that we believe to be reasonable and accurate at the time of writing, but is subject to change without notice. Forward looking statements are based on our assumptions, results could differ materially.

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Author: Mike Baker, CFA, FEA
Vice President, Portfolio Manager

Editor: Mike Wallberg, CFA MJ
VP, Marketing & Communications

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leithwheeler.com

Vancouver Office
Suite 1500 – 400 Burrard Street
Vancouver, BC V6C 3A6
Tel: 604.683.3391
Fax: 604.683.0323

Calgary Office
Suite 570 – 1100 1st Street SE
Calgary, Alberta T2G 1B1
Tel: 403.648.4846
Fax: 403.648.4862

Toronto Office
Suite 1801 – 145 King Street W
Toronto, Ontario M5H 1J8
Tel: 416.646.8240
Fax: 416.646.8249

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INVESTMENT COUNSEL LTD.

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