Quiet Counsel

Fall 2018
Investment Outlook

Leith Wheeler
INVESTMENT COUNSEL LTD.
Quiet Money.®

Bubble, Bubble, Toil and Trouble

Visit our new website, **LeithWheeler.com**, to download previous Newsletters and read our latest Insights.

The market decline in October got us thinking. Thinking about the "big picture" of the market's direction, as we spend some small portion of our time doing, and about the "smaller pictures" – the collection of little stories and themes that capture our attention (or not) and ultimately feed into newspaper headlines. We spend our time in the weeds, but once in a while it's worth popping our heads up to see if there's a lawnmower rolling by.

Speaking of weeds, the dramatic declines of until-recently high-flying cannabis stocks also reminded us of the danger of bubbles – those beautiful but hollow and ultimately fragile distractions that can entice investors en masse into the path of the whirling blades. It's on this topic that we'd like to spend most of this quarter's Quiet Counsel, reflecting not only on the year of pot stocks, but on the rich history and psychological roots of the bubbles that came before. Because it's only by understanding and remembering bubble history that we and our clients can continue to avoid them when they inevitably form in the future.

"History may not repeat itself, but it rhymes a lot"

While it's a line often attributed to Mark Twain, the American humourist wouldn't have had the benefit of knowing about the dot-com bubble, the credit crisis, or the cryptocurrency or marijuana stock manias to come when writing that line over 100 years ago. But even in the 19th century there was already plenty of fodder for this astute observation on the short-term memory of men and markets - and there have been plenty of examples since.

Tulipmania | 1630s

One of the first documented episodes of an investment bubble occurred in Holland in the 1630s. After their introduction to Europe in the late 16th century, tulip bulbs gained such popularity that their value soared to the point where in 1636, a single bulb could be traded for "a carriage, two grey horses, and a complete harness." (1) The inevitable and sudden collapse of this bubble then ushered in significant economic hardship in the region for many years thereafter.

The 1929 Stock Market Crash | 1924 - 1929

After the Great War, the euphoria of the 1920s spawned the can-can, the Jazz age and, perhaps surprisingly , considerable financial innovation. As US wealth doubled between 1920 and 1929 (2), closed-end investment trusts and liberal use of leverage – with investors buying stock with 90% borrowed funds - were widespread. When the music stopped on October 21, 1929, however, the dance was over. The Dow Jones Index subsequently shed 89% of its value before 1931 was over, propelling the world into an economic depression that would drag on for a record 10 years.

The Dot-Com Bubble | 1997-2001

Believing (rightly, if a bit early) that internet-based commerce would initiate a sea-change in the economic order, web-based businesses were flooded through the late 1990s with eager cash. Investors relaxed requirements for profitability or even revenues in "new tech" companies, which sent traditional valuation metrics such as price-to-earnings ratios into the stratosphere, if they could be measured at all. At one point in Canada, Nortel Networks grew to represent an astounding 35% of the TSE 300 Index before the bubble peaked and popped on March 10, 2000. In the following 30 months, the tech-centric NASDAQ Index fell 78%. Nortel shares collapsed and ultimately de-listed in 2009.

The Financial Crisis | 2007-2009

The financial crisis that birthed the Great Recession of 2007-2009 could be described as the result of one part hubris and one part (willful) ignorance (3). At the root of these factors was a belief amongst investors that what goes up cannot possibly come down – in this case, home prices (4). This belief proved a powerful motivator for individuals to borrow heavily against their homes, banks to underwrite those mortgages, investment banks to create and sell products based on those mortgages, and investors to buy those mortgage products.

AIG executive Joseph Cassano went so far as to say, "It is hard for us, with and without being flippant, to even see a scenario within any kind of realm of reason that would see us losing one dollar in any of those transactions," but when mortgage defaults starting rolling in and first Bear Stearns and later Lehman Brothers failed, the house of cards was toppled. One of the biggest culprits of the financial crisis, AIG would go on to lose nearly $100 billion in 2008 alone – including $28 million *per hour* for the last three months of the year (5) – and avoid collapse only through massive government intervention. The S&P/TSX Composite Index fell 50% and the S&P 500 Index fell 56% from their peaks to their simultaneous troughs on March 6, 2009

How can you recognize a bubble forming?

A consistent theme of bubble formation is that its promoters tout it as **something that is "new" in the world** that will **change the way we do things**, and that **valuations are irrelevant** because somehow **"it is different this time."**

There is always a **sense of pride** amongst participants that they have **discovered or understand this new opportunity and others do not,** and in many cases **new financial instruments** are created and hailed by the investment industry for their novel application. **Leverage** also often plays a role in accentuating the problem.

Let's apply the bubble test to two recent examples.

Bitcoin as Protest Platform

As incredible as these prior bubbles proved, last year's Bitcoin bubble would dwarf them. The peak prices paid in the dot-com and tulip manias "only" amounted to four and 35 times the price of three years prior, respectively. When Bitcoin hit its peak at over US $19,000 in December 2017, however, investors were paying **60 times** the 2014 levels (6)! Through the boom of 2017, an estimated $1 billion of new capital was raised for 1,000 cryptocurrencies that had already failed in the first six months of 2018 (7). After a brief bounce in January, the cryptocurrency ultimately lost over two-thirds of its value. At the time of writing, it trades in the mid US$5,000s.

The most fervent of Bitcoin adherents believe that the cryptocurrency represents a form of social revolution because it is an anonymous, independent and fiat currency. Due to its security, Bitcoin is also considered a store of value, similar to gold and given the finite nature of it (it has been designed to eventually "max out" in coin volume), its supporters believe(d) its value can only increase over time. In response, thousands of "initial coin offerings" floated in 2017-2018 in efforts to catch the hype. So we had an investment vehicle underpinned by belief in a "new" world order, promoted by zealous believers, and carried to stratospheric heights by credulous followers.

Cannabis in the Clouds

In the lead-up to the October 2018 legalization of recreational cannabis in Canada, businesses promising to participate in the growing, distribution, and retailing of the product enjoyed significant commensurate "growth." The Canadian Marijuana Index, which tracks the performance of publicly traded companies in the sector (8), peaked on January 27, 2018 after spiking more than 1,000% over the previous 18 months. After falling 39% in subsequent months to today's levels, the 18 largest Canadian players still enjoy market capitalizations of over $43 billion – despite their industry being technically only a month old and earning little to no profits.

The legalization of cannabis marks both a historic pivot in drug policy in this country, and the creation of what will undoubtedly be a massive agricultural market. On this, we and pot stock advocates can agree.

Our long-term value investor roots have kept us out of the cannabis bubble, however, because the infant industry lacks clear visibility into its overall supply-demand balance (we believe a supply glut is looming) and even the key players remain largely in loss-making positions.

Good industries don't always have good companies in which to invest, and good companies are not always good investments. It takes a solid management team, working in alignment with shareholder interests to build a competitive advantage and sustainable earnings - trading at an attractive price – for a prospective investment to make it into a Leith Wheeler portfolio.

By way of example, Nutrien, the world's largest fertilizer company with a leading retail distribution network across North America, is expected to realize $600 million in synergies over the next two years from the merger that created it. It trades at 15x next year's earnings. The largest cannabis stock, Canopy Growth, is also a leader in its industry with over 500,000 square feet of production capacity and a head start on its Canadian peers in seeking international growth opportunities. It lost money last year, and is currently trading at 298x its 2020 expected earnings.

Put bluntly, from where we sit the cannabis bubble has reflected a simplified and overly optimistic understanding of the industry, along with likely many of the elements discussed above: hubris-fueled speculation, with advocates heralding the unlimited riches available only to those with the vision to set aside valuations and invest in the dream. Unfortunately, a sizable chunk of those dreams has gone up in smoke, at least for now.

There may be room yet for cannabis stocks in value portfolios, but even with the correction, valuations remain firmly outside of what our price discipline would allow. We also don't rule out the possibility that the pot bubble may re-inflate several more times before rational prices prevail. For now, it seems this bubble still has some air to release.

(1) Galbraith, John Kenneth. "A Short History of Financial Euphoria."
(2) History.com. "The Roaring Twenties."
(3) And arguably, one part fraud. For an account of the complicity of investment banks and rating agencies in the crisis, see Lewis, Michael. "The Big Short."
(4) Astoundingly, an assumption that house prices would only increase was coded directly into many of the financial models underpinning complex mortgage products of the day.
(5) McDonald, Robert. KelloggInsight. "What went wrong at AIG?" and The Guardian. "AIG's $61.7bn crash sends markets plunging."
(6) Bloomberg; International Center for Finance at Yale School of Management; Garber, Peter.
(7) Biggs, John. TechCrunch. "Thousands of cryptocurrency projects are already dead." 30 June 2018.
(8) The Marijuana Index uses an equal-weighted methodology, rebalanced quarterly.

Author: Michael Job, CFA
VP, Portfolio Manager
Leith Wheeler

Author: Mike Wallberg, CFA
VP, Marketing & Communications
Leith Wheeler

FALL **2018** EDITION

Vancouver Office
Suite 1500 – 400 Burrard Street
Vancouver, British Columbia 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