QV UPDATE

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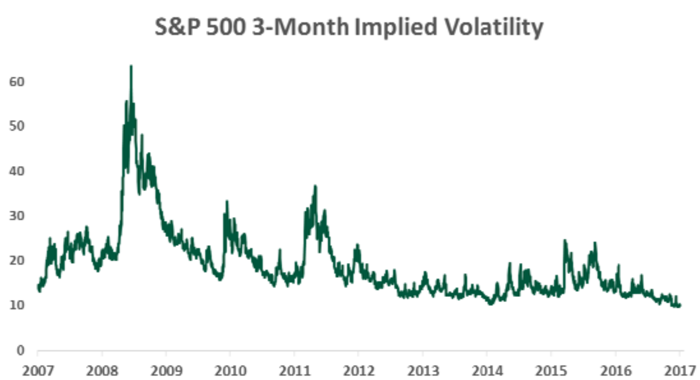
Stable Markets in an Unstable World

In reading yesterday's semi-annual Financial System Review from the Bank of Canada, I thought back to Mark Carney's adept comments from late 2010:

"An extended period of stability breeds complacency among financial participants as risk-taking adapts to the perceived new equilibrium. Indeed, risk appears to be at its greatest when measures of it are at their lowest."

– *Living with Low for Long*, December 13, 2010

Despite elevated political policy uncertainty and increasing global unrest, capital markets have been uncharacteristically stable. Implied volatility measures for the S&P 500 have reached abnormally low levels, recently dropping to new decade lows.



Source: Bloomberg

This extended period of market stability has indeed created complacency. Money is pouring into exchange traded funds. According to Financial Analyst Gary Ho at Desjardins Capital Markets, both Canadian and US ETF assets reached all-time highs in April, up 30% year-over -year. Money flowing into the market often chases assets that have been performing well. In our opinion, risk taking by short-term benchmark sensitive institutions and individuals has accelerated, with funds continuing to flow into assets exhibiting positive momentum.

Evidence of this is rampant among publicly traded growth stocks. Companies like e-commerce enabler Shopify are capturing the collective imagination of investors. Year-to-date, Shopify shares have risen over 100%, and there was ample investor appetite for a recent US$500 million equity issuance to help fund future spending plans. On a trailing enterprise value to sales (EV/S) basis, investors were willing to pay 10.4x for this business at the start of the year. Although the business model hasn't changed, investor appetite has. The already high valuation multiple has doubled to close to 21x trailing sales. For context, the NASDAQ Composite EV/S multiple peaked at approximately 6.6x at the height of the technology bubble. The company has yet to generate any income. Although we admire a number of aspects of the Shopify business, we don't have enough downside protection or conviction in the economics of the business to warrant investment.

The price action in Shopify is not unique. We are witnessing swift valuation expansion in numerous growth stocks. This has helped to propel the valuation multiple for the overall S&P 500 to a new post tech bubble high. Fund flows into capital markets are very strong and volatility measures have reached new lows. Animal spirits are alive and well.

With conditions as rosy as they are, now is the right time to be contemplating bear market scenarios. The S&P 500 has experienced eleven bear markets (defined by a 20% market decline) since World War II, with one occurring every 6.2 years or so, on average. It's been over 8 years since the end of the last bear market. The more investors unabatedly chase growth, the more vulnerable the market becomes. Bear markets are a healthy part of stock market cycles. They always feel awful, but they wash away the excesses created by prior advances.

We remind ourselves that equity is an inherently risky part of corporate capital structure. It comes with volatility and limited recourse. That is why it's important that we consistently ask ourselves: is this a business we would want to own a lot more of if the shares were caught up in a vicious downturn? If the answer is a well thought out and resounding yes, it's easier to stay calm and take advantage of the long-term opportunities when an eventual bear market occurs. In the meantime, we will stick to QV's process of investing with an emphasis on risk management.