QV UPDATE

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Bravado and the Fear of Missing Out

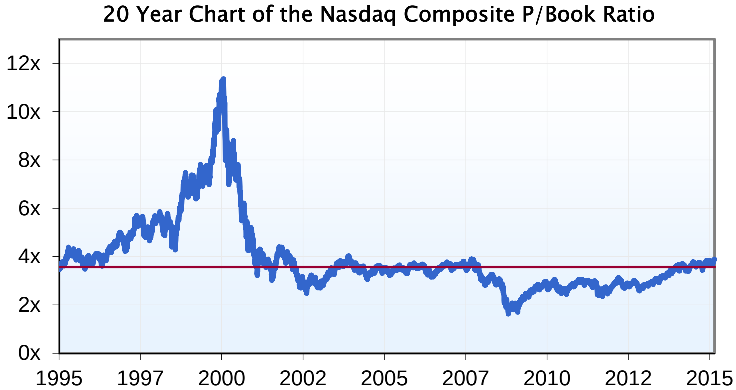
The Nasdaq Composite Index is a highly followed performance gauge for technology and growth companies consisting of over 3,000 equities. After rallying nearly 300% over the past six years, it is now within striking distance of its March 2000, internet-bubble high.

20 Year Chart of the Nasdaq Composite Index

Source: www.stockcharts.com

Although price levels today are similar to 15 years ago, current valuation levels are not suggesting we are back in another bubble. Below is another chart, also of the Nasdaq Composite Index, measuring price-to-book value, rather than just price. This time around, there is a fair amount more underlying equity and earnings support than during the prior all-time high.

20 Year Chart of the Nasdaq Composite P/Book Ratio



Source: S&P Capital IQ — Median

15 years ago, at the bubble's climax, the Nasdaq's P/Book ratio peaked out at nearly 11.0x book value. Today it is less than 4.0x book value. We are not suggesting that the current valuation is a bargain, it is near the upper end of its range of the past 15 years absent the bubble. It is also now above its long term median multiple, but it is certainly not remotely close to the excessive valuation characteristics exhibited during the internet craze. Although the market as a whole is not demonstrating bubble like characteristics, we are concerned that investors are increasingly going on the offensive; losing sight of our belief that defense is paramount if you want to win the long term investing game.

Laws of Motion

There are physical laws of motion and emotional laws of motion. For every action, there is a reaction. When it comes to the action of US markets and many Canadian stocks outside of the resource sector hitting new all-time highs, a natural emotional reaction can be full of bravado or the fear of missing-out on future gains. We are witnessing increased hints of risk. Take for example, the February 1st edition of Fortune. There is an article titled "The Age of Unicorns". The article highlights 80 private technology companies, each with valuations now in excess of $1 billion. In the article, one institutional investor and board member of the private ride sharing company Uber (currently carrying a US$40 billion valuation) highlights heightened investor confidence even when a company may not have good uses for additional capital:

"You can't choose not to play….If your competitors are raising $150 million at high valuations and pouring it into sales, you either can do something similar or be conservative and no longer matter".

For us, whether risk taking is in vogue or not, we need to have an underlying investment thesis for every cent we invest. Chasing market returns with emotion is not an option. We consistently strive to construct portfolios with valuations lower than the market, with profitability higher than the market and balance sheets that carry less debt. We are at a point in the market cycle where investors are less concerned about valuation and balance sheet strength. That is exactly why these considerations are more important today than at any other point in the past five years.