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Yipppeee!!

One could almost hear the cheers from investors this past quarter as the current bull market turned five years old. What a journey it has been. The extreme uncertainty and fear which gripped global markets back in 2009 offered a "crash" course on risk, but the lessons learned were only temporary and now seem long forgotten.

Human nature and the inevitable cycles of fear and greed persist. The market's emotional pendulum swings from one end to the other, it doesn't stop nor does it turn back midway. As stocks go higher, more people want to get in on the action, and those that are already in get more confident. The fear that was once prevalent is now supressed by the excitement of profits. We know this love-hate relationship is one of the primary drivers of market extremes. What we don't know is how much passion remains!

"The less prudence with which others conduct their affairs, the greater the prudence with which we must conduct our own affairs" - Warren Buffett

Great advice on managing risk from Mr. Buffett, but not many individuals really care to follow it. The irony remains that the majority of investors will tell you they want to manage risk, just as long as it's not at the expense of returns! And there lies the challenge with being prudent in the midst of a rosy stock market; you take on the risk of missed opportunity. Everyone wants to protect capital during the tough times but then seem to be willing to throw caution to the wind when enthusiasm and trailing returns are high. This improves your odds of matching the returns of a strong market in the short-term, but often at the expense of compounding your capital in the long-run.

Judging the level of enthusiasm in the markets is at best an imprecise science, but we find numerous examples of risk taking behaviour. Take for example the recent surge in initial public offerings (IPO's) in the U.S. year-to-date. The pace at which companies are making new public filings for IPOs is at levels not seen since 2000. IPO activity in and of itself is not a bad thing, but the quality of companies and the zeal with which investors are responding to them is what concerns us. Nearly 45 percent of all companies that conducted IPO's were in the biotech sector, not a single one reported positive earnings and nearly half of them had no revenue at all. Surprise surprise, their returns have far exceeded the broad market year-to-date.

The shares of social media companies have been sky-rocketing with investors willing to pay extreme valuation multiples as of late, and companies in the space have been buying others at seemingly incomprehensible valuations. We've seen these types of frenzies before. They don't end well.

Five years ago many investors vowed to never buy stocks again. Today not only are they buying them but they are using significant debt to do so. The ratio of margin debt as a percent of nominal GDP is at a record high. This statistic has historically been a red flag but can carry on for quite a while.

Equity markets are not alone in speculative activity. We are finding it in areas of the bond market as well. In the U.S. over the past 30 years, junk bonds (non-investment grade) have always offered investors a higher yield to compensate for the additional credit risk compared to their investment grade peers, until now. This bears repeating, the yield on junk bonds is equal to investment grade bonds for the first time in nearly 30 years!

Investors desire to achieve maximum profits at this point in the cycle is quite typical. But we shouldn't fool ourselves into thinking it is the right approach. You may be wondering then, what is the right approach? What is prudent?

Before we paint too negative a sentiment picture, we must balance what we consider to be excessive stock market optimism with the many fundamentally strong business franchises we remain shareholders of. At the end of the day it is these entities we are invested in rather than the biotech stocks with no earnings or the stock market as a whole. Excessive optimism presents a risk not to the business franchise we are invested in, but rather to the multiples we have to pay for them. The further the market appreciates, the more challenged we are to maintain our margin of valuation safety within our portfolios. This margin becomes extremely important when the optimistic mood of the market changes.

Our approach to prudence has always been to manage the overall valuation and compounding ability of our portfolios. Given today's backdrop, we have continued to be active in reducing positions which have been priced excessively and redeploying the funds. The short term challenge is we are often selling down companies which the market has really gotten excited about. They may be expensive in our minds, but the share price keeps rising. Our experience has been that it's better to miss some potential short term upside than it is to dilute the overall margin of safety within our portfolios. Speaking of our portfolios, the majority of our companies continue to deliver solid growth in cash flows and dividends. Their balance sheets remain sound and their return on capital steady. Our biggest challenge remains on the valuation side. We always like better values.

Don't Fight the Fed … or maybe we should?

We can list a number of positive economic developments which are supportive of markets, but the most important force to continued stock market strength remains the U.S. Federal Reserve and their accommodative policies. Investors have succumbed to the viewpoint that with bonds yielding so little, equities win by default, and so far they have. They are convinced that if the economy or markets should fall, the Fed stands ready to once again provide a helping hand. This line of reasoning we don't like but we understand, to a point. Equities win, as long as businesses are growing and are reasonably priced.

It feels to us like the most significant extreme in confidence by investors is in the Federal Reserve itself. The mantra "Don't fight the Fed" has never been more important, and at the same time never more dangerous.

Looking Forward

The majority of global stock and bond markets performed well in the first quarter, for equities a real feat considering last year's out-sized returns. The Canadian market lagged many international markets in 2013 as Canada's heavy exposure to resource sectors weighed down on the broad index. For the first quarter of 2014 the trends reversed and the Canadian market performed relatively well. Our Canadian funds, both small and large, had solid returns but did not keep up to the benchmark returns in the past quarter. The same can be said for our bond and balanced strategies. This was to be somewhat expected given last year's significant outperformance. Our global fund also posted strong results and managed to outperform its relative benchmark indices. The Canadian dollar's continued weakness was of considerable assistance.

Our balanced fund asset mix remains overweight in equities but not to the same extent it did last year at this time. Our bond strategy remains short and defensive in nature with high credit quality and our equity selection is tilted to achieving better valuations. We are trying to act prudently within the strategies rather than extrapolate the good times out into the future. If the optimism gets more excessive we will lag in the short term, but will not risk compounding your capital in the long run.