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Warning of Warming

I recently escaped this seemingly never-ending winter to attend the 35th Annual Raymond James Institutional Investor Conference in Orlando, Florida. It is one of my favourite conferences because of the vast number of companies (around 350) with broad industry representation. Over the years that I have attended, no matter how cold it was in Calgary, (or how warm it was in Orlando) the conference has always provided a good proxy for measuring the temperature of the investment climate.

This year's event had record attendance. After sitting in on 36 company presentations, it was clear to me that corporate optimism has not been this positive since before the financial crisis. Many companies demonstrated healthy growth last year and forecasted further growth in the year ahead. Most were also generating near record levels of cash flow, and using excess cash to reinvest and buy-back stock. Some of the proposed buy-backs are enormous, with the largest from Home Depot. They are targeting a $5 billion share buy-back this year, and expect to repurchase between $17-23 billion between 2013 and 2015. This equates to nearly 20% of the company's entire market capitalization.

I do not have the statistics to back this up, but I get the sense that if corporations achieve their earnings forecasts and follow through on their proposed share repurchases, 2014 will be a record year for both S&P 500 earnings and share buy-backs. When it came to gauging the health of US based corporations, the temperature is running fairly hot.

Investors have taken notice, and not just the institutions. After taking a near five-year hiatus, retail investors are actively participating in equity markets again. One presentation I sat in on was TD Ameritrade. TD Ameritrade is one of the world's largest discount brokerage firms with over six million funded client accounts. The company has seen average daily trading volume rapidly increase over the past six months. Last month, the company averaged over 500,000 client trades per day for the first time in history, up 30% compared to a year ago. With the improved corporate outlook, investor interest is back in a big way. I am seeing other statistics on a daily basis that also corroborates this. Large Initial Public Offering (IPO) announcements are starting to become near daily affairs. Earlier this week, King Digital Entertainment, maker of the mobile phone game "Candy Crush" announced an IPO estimated to be worth up to $7.6 billion. New York based high-frequency trading firm Virtu Financial also announced IPO plans earlier this week, targeting a $3 billion IPO valuation. In last Friday's Wall Street Journal, Telis Demos cites that in the first two months of this year, 42 companies went public in the US, tying 2007 for the busiest start to a year for IPO's since 2000. According to the article, 75% of companies that have gone public are unprofitable and two thirds have annual sales of less than $50 million. Both of these measures are also at the highest annual level since 2000. So far, participating in this risk seeking behaviour has paid off. The average IPO return in the first two months of the year equated to approximately 19% according to market analytics firm Dealogic.

Today's increased animal spirits are not reserved for equity markets. On Wednesday, junk rated Puerto Rico, which only a few months ago was a major financial concern, raised $3.5 billion in debt. The banks involved received over $16 billion in orders, and in its first day of trading (which started late in the day), accounted for one-third of municipal bond market trading. More than the entire offering traded hands, with approximately $5.1 billion in volume-more than 100% turnover in a day!

Warmth is a blessing for most Canadians during a winter when the words "polar vortex" have become commonplace. However, when applied to stocks, a market that is heating up can be very uncomfortable for a value investor. The investment pendulum has swung from risk aversion to risk taking. This trend can go on for longer than we would like, but throwing caution to the wind is not how we earn our keep. As the market's temperature reaches its warmest level in five years, QV is focused squarely on managing risk.