



July 8, 2020

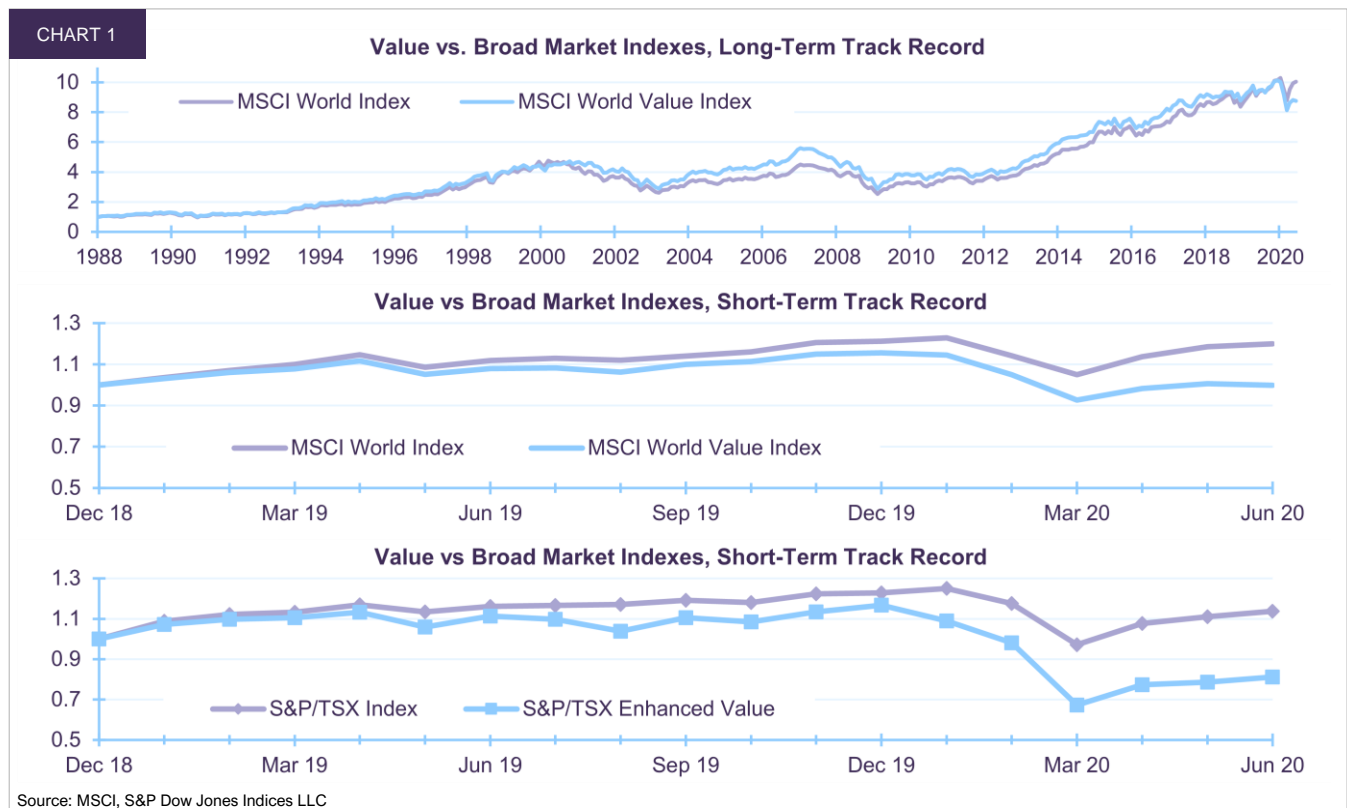
Since the emergence of the COVID-19 pandemic, and, to a lesser extent, over the past decade, stocks trading at low multiples of earnings, cash flows, sales, or book value – often called value stocks – have tended to underperform when compared to the general market. Unsurprisingly, this has led to questions as to whether value investing is still an effective philosophy for managing portfolios.

Letko Brosseau is a value manager, but not in the strict classic sense. We believe it is very important to focus on the companies, industries, and economies in which we invest. When looking at companies, we need to determine the value of the company’s business which means we pay careful attention to growth, competition, margins, tax rates, leverage, environmental impact, governance, compensation, and many other fundamental factors. Once the value of the company has been assessed, we then look at the price we need to pay for the company in the market. We are interested in the relationship between value and price and our objective is to invest at a justifiable price.

As Warren Buffet said, you should “buy stocks like you buy your groceries, not like you buy your perfume.”

We believe that the recent and temporary underperformance of value versus high earnings multiple stocks can be explained by a confluence of factors: the link of value stocks to the real economy, a decline in interest rates, and the unusual performance of a small group of large technology companies which have come to command a significant index weight. While value may have underperformed over the past eighteen to twenty-four months, their remarkable progress over the long-term still holds. Value stocks have not underperformed the broader market over time (see Chart 1).

## Value investing has been a sound investment strategy based on fundamental analysis





Value stocks have tended to be more strongly associated with the physical economy: sectors like commodities, financials, industrials, transportation, and homebuilding. Over the past 20 months, trade tensions between the U.S. and China and the COVID-19 pandemic have disproportionately impacted these industries but this is temporary, and they will recover, driven by the rebound of the global economy post-pandemic.

Interest rates have also impacted the relative performance of value stocks. The decline in interest rates has benefited companies with stable growth and high levels of leverage, such as utilities, pipelines, and real estate. The ultra-low interest rates have also led investors to give more value to far out earnings, just as they have done with long bonds, which is why some growth stocks are trading at very high multiples.



Interest rates now sit at their lowest level in the past 225 years, nearing 0% (see Chart 2). While interest rates may stay low for an extended period of time, to allow the world to recover from the pandemic, this is neither good nor bad for value versus growth stocks: it is the rate of change that matters more than the actual level. Interest rates would have to continue to decline for multiple expansions to be sustained. Investors that assume interest rates will stay at current levels for a very long time are exposing themselves to important losses when interest rates normalize, just like the holders of long bonds. When interest rates rise, the valuation effects will reverse.

We have largely immunized the portfolios from interest rate risk by focusing on companies trading at low multiples of earnings, cash flows, sales and good dividends.

Finally, the last decade has experienced historic disruptions of traditional retail, media, and enterprise IT towards internet-based business models. The so-called FAANMG (Facebook, Amazon, Apple, Microsoft, Netflix, and Google) have been the beneficiaries of these shifts and today are veritable titans of industry. This displacement of traditional industries has fueled large growth for the FAANMGs who today trade at 33x P/E on average, a significant premium to the average market multiple. In Canada, Shopify, an e-commerce enabler, now trades at over 2000x P/E.

It is tempting, with the benefit of hindsight, given the success of these companies, to believe that it was a mistake to not own these companies. However, the high valuations of the past priced almost perfect execution and monopolistic market shares in these various markets, which remarkably were achieved. That being said, there are countless examples of companies who did not deliver the promise of sustained growth and suffered as a



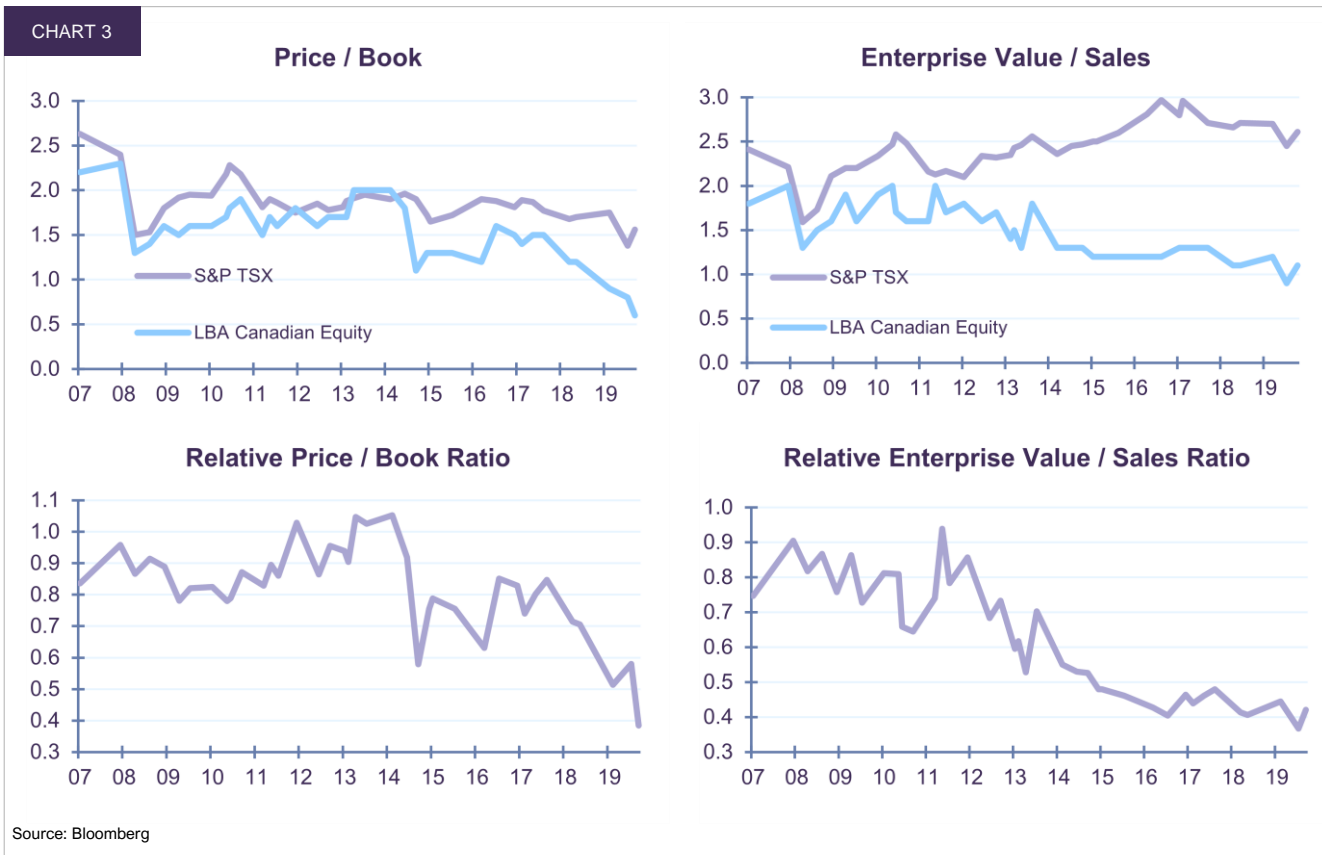
consequence. We have only to think of companies like Nortel, Yahoo!, pets.com, Palm, BlackBerry, AltaVista, Enron, or WorldCom to understand why we are committed to the discipline of buying stocks at reasonable valuations.

While the growth of the FAANMGs has contributed a large portion of the S&P 500 Index's returns over the past decade, this has been a remarkable period of time. Most decades do not feature this sort of technological displacement and skewed returns. Even today, while some of the FAANMGs have delivered earnings, some of these stocks are still pricing in huge improvement in operating results. While we are owners of Facebook, Google and multiple Apple suppliers, stocks like Amazon and Netflix are trading at 78x and 54x 2021 earnings respectively.

High multiples are common when a large following develops in a popular concept and this is where markets breed risk. Today Netflix is an example of a wonderful innovation that has attracted investor interest. As a result, its current P/E multiple is 54 times 2021 estimated earnings per share or, expressed differently, the stock price is equivalent to 54 years of profit. One might ask whether the business model is durable and how immune it is to competition. This is an interesting question today as Netflix has moved from buying content to developing its own at some cost and risk. Competition is developing from Amazon, Disney, HBO, Crave TV and several others. What will the landscape look like in the future?

Analysts that write about Netflix argue this is justified by forecasting an increase of the current subscriber base of 183 million to 350 million over the next 5 years. Much of this estimated growth is thought to take place outside of North America, as the Canadian and U.S. market, where Netflix has 70 million subscribers, has seen its growth rate slow.

One leading dealer forecasts that EBITDA (earnings before interest, taxes, depreciation, and amortization) margins will double from 20% to 40% over the next 5 years with no change in monthly pricing. The company would then trade at 18 times EBITDA (more than twice the S&P 500 average), down from today's almost 50 times EBITDA and result in a share price of \$800, a 64% improvement, giving a 10% compounded annual return. Striking are the large increases in business activity and profitability, as well as the relatively high terminal value the company needs to achieve an average 10% return over the next 5 years.





All of which has pushed us to pay more careful attention to value in the portfolios. For example, the average 4% dividend yield of our portfolios provides a good part of the Netflix return without an aggressive earnings growth forecast. The relative price to book value and total market value to sales of our Canadian equities has doubled since 2008 (see Chart 3). Back in August 2008, LBA's Canadian Equities were trading at 2.3 times book versus 2.4 times for the S&P/TSX or 95% of the market multiple. In May 2020, our equities were trading at 0.6 times book versus 1.6 times for the market, or 40% the market multiple. Similarly, the enterprise value to sales ratio went from 2.0 to 1.1 times sales for our equities while the market went from 2.2 to 2.6 times during the same period, a decline in relative valuation of 90% to 42%. Despite the decline in these multiples, our portfolio equities had a total return of 92% versus 59% for the market. Clearly, the relative decline was not because our companies grew at a slower rate than the general market but rather that they have become much cheaper.

## The importance of discipline in delivering long-term returns

Interestingly, the initial market reaction to the COVID-19 pandemic created an opportunity to add Facebook and Google to our portfolios. Growth has value and as stated earlier, we are interested in the relationship between value and price. Our objective is to invest at a justifiable price.

We remain convinced that our approach is more appropriate than ever, especially given the lofty prices we observe across many asset classes, including bonds and stocks. An emphasis on price discipline has always been instrumental in avoiding bubbles. In addition, our attention to value has generated better returns than growth investing over time, except for the past two years in most world markets and a few more years in the U.S.

Lower P/E multiple stocks are currently significantly discounted and exhibit high likelihood of appreciation as the economy normalizes. While timing remains a challenge in investing, patience has always been greatly rewarded. This is a unique historical moment and opportunity.

Benjamin Graham said, "investing isn't about beating others at their game. It's about controlling yourself at your own game."

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