claret Asset Management

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The Next Big Thing...

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It looks like this wall of worry is a lot taller than thought. After climbing it in 2023 (up 23.8%), the S&P 500 continued its ascent in the 1st quarter of 2024 by increasing another 10%+ (10.16% price-wise, to be exact but who's counting...).

To put things into perspective, the S&P 500 equal weight index is up only 7.4%, reflecting the importance of the "Magnificent Seven" - please refer to our last quarterly letter for the definition of this term.

Is the market too expensive?

It depends…

1. On the level of interest rates:
   Simplistically, the market's Price/Earnings (P/E) ratio (a term that is widely used in financial news) is a multiple that reflects what the market is willing to pay for future earnings. If we inverse the ratio, Earnings/Price (E/P) would imply a "market yield", which is, sort of, an interest rate. Currently, the P/E ratio stands at 23.5X based on the last 12 months' earnings, with the ratio based on 2024 earnings estimated at 21.50X. It means that the market yield is somewhere between 4.3% and 4.7%.This can be compared to the current 10-year interest rate of 4.3%.
   Alternatively, if we downplay the exaggerated weight of the "Magnificent Seven" in the S&P 500 index by analyzing the P/E ratio on the S&P Equal Weight Index instead, it actually stands at only 17.25X, reflecting a market yield of 5.8%, compared to the 4.3% on the 10-year rate.
   Therefore, we can reasonably say that the market is fairly priced.

2. On the level of economic activity:
   It seems to us that the economy in North America continues to bump along fairly steadily. There is no sign of recession in sight although most economists expect one. Sooner or later, they will be right…

3. Most importantly, on people's expectations regarding the directions of both 1/. And 2/. Here, we do not have a crystal ball that is any clearer than your own.

Fortunately, our investment philosophy is not based on macroeconomic forecasts. We generally assume that the future will resemble past norms and then, make allowance for the possibility of things being worse than normal. That way, we ensure that our investments have a "margin of safety" that would render the results acceptable even if future developments disappoint somewhat.

‘I can calculate the motion of heavenly bodies, but not the madness of people.’ - Isaac Newton.

This writing is directly related to Newton’s financial misstep during the **South Sea Bubble** in 1720. The **South Sea Company**, founded in 1711, initially aimed to manage British government debt. Newton was an early investor and profited as the company’s stock rose throughout the 1710s. However, in 1720, the company’s stock surged and then crashed spectacularly. It came to be known as the South Sea Bubble.

After having taken substantial profits in the initial surge, Newton re-entered the market as the bubble continued to inflate. A dramatic crash ensued and his losses were significant. Newton’s experience serves as a cautionary example of how misinformation and disinformation can lead even brilliant thinkers astray.

We thought we would highlight 2 stocks in the market that epitomize this “madness of crowds”:

- Trump Media and Technologies Group

    No need for us to introduce this company. Its name is self-explanatory. What needs to be said is that its revenues in 2023 were a mere US$4.1 million and its losses were US$58.2 million. Yet, its market capitalization is over US$7 Billion.

    The stock price has been following a very interesting path since becoming public. It surged from US$10.00 to over US$175 in a matter of days at the end of 2021. It then languished all the way back down to US$12-13. Then it surged again to reach a recent high of US$79.00.

    When politics, speculation and FOMO (Fear Of Missing Out) merge, there is no end to the madness of crowds.

- **Microstrategy Inc.**

This is a company in the Information Technology (IT) industry with around US$500 million in revenues. It operates in business intelligence (BI), mobile software, and cloud-based services. Somehow around 2020, the founder and CEO Mr. Michael Saylor decided to go all in on owning Bitcoins and has accumulated 215,000 since, representing approximately 1.02% of all outstanding Bitcoins.

A quick number cruncher would realize that the value of all Microstrategy's Bitcoins is around US$15 billion whereas the company's Enterprise Value (market capitalization plus debt) is US$30+ billion. Does it mean that the IT business that generates US$500 million of revenues with barely any profit is valued at US$14 billion? Of course not! This is a Bitcoin story…
Historical data shows that this company's valuation was pegged at US$1.5 billion to US$2 billion before the Bitcoin saga. By excluding the value of the IT business, this means "investors" (rather speculators) are willing to pay almost US$2.00 for every US$1.00 of Bitcoin owned.

No wonder Mr. Saylor plans to issue more shares and/or borrow more money to buy more bitcoins. By issuing more shares at such a high premium to the underlying value of its bitcoin, and then using the proceeds to buy more Bitcoins at an ever-rising price, the stock price is therefore driven even higher. As Buzz Lightyear would say: to infinity and beyond!

Until it comes to a halt…

Rest assured we won't be buying Microstrategy or anything similar with your money or ours!!!

Meanwhile, by way of conclusion:

"The market can stay irrational longer than you can stay solvent".
John Maynard Keynes

To trade or not to trade, that is the question.

With financial news being broadcast minute by minute by the likes of CNN, CNBC, BNN and a multitude of other social media channels, intra-day market volatility has increased over time. This gives the average investor the impression that it is possible to catch these short-term swings and improve their performance.

Yet very few of these so-called experts got rich by trading the market. They got rich by selling news. It reminds me of a fisherman story:

A young fisherman shows up at a fishing equipment store and looks at the infinite number of colourful lures at the counter.

“How many kinds of lures do you sell? Do the fish actually bite?” the young man inquired.

“I don’t know”, the owner of the store replied.

“Why are you selling them then?” the young man asked.

“I am not selling them to the fish. I am selling them to you.”

While a few are very successful in trading the markets, most investors - and that includes us at Claret (in principle, we are buy and hold) - are not skilled enough to do it profitably... continuously!

Our psychological flaws make us fall prey to the sometimes not-so-honest salesmanship of Wall Street and Bay Street whose sole objective is to create enough noise to generate trading activities on which they make commissions and fees.

Most of the time, your and our objectives are not aligned with the actors on Wall Street and Bay Street. Being in a state of semi-consciousness regarding trading generally helps your investment performance over the long term. We will end up paying less in taxes, less in commissions and spending less time listening to senseless stories about... **the next big thing.**

- Alain Chung, CFA, Chairman and CIO, on behalf of the Claret team.