Markets In One Lesson

"Progress is cumulative in science and engineering, but cyclical in finance."
— Jim Grant, *Grant's Interest Rate Observer*

Dear Investors,

Cyclical. That's probably the right word to describe not only knowledge, but 2020 in its totality. And much like human behavior, this year's market certainly had its cycles. In fact, 2020 felt like a complete market cycle compressed into 12 months. The year started with a strong rally that was suddenly followed by one of the fastest and most significant market declines in history as the pandemic led to deteriorating economic data and lack of clarity on future earnings. Fast forward a few months and we saw a strong rebound, then broad-based strength for the rest of the year post-US election and on the back of better than expected vaccine news.

Adaptability and humility were crucial in navigating these cycles, as always. That means there were times we acted swiftly and aggressively in the midst of tremendous uncertainty, and other times when we felt we needed to be patient and wait for new data points before making additional changes to our portfolios. It's what we call *driving based on the road conditions*.

This year also made it even more clear to us what we have long said: sticking to any one-size-fits-all approach — including being constrained by artificial boundaries and labels — could pose a long-term threat to the survival of many managers. There is a fine line between discipline and dogmatism, as many managers have found out to their detriment over the years. We will address that in the second half of this letter as we dive into valuations.

WHEN THE WORLD STOPPED AND MARKETS TANKED

First, let's quickly revisit what was by far one of the most volatile and uncertain periods of not only the year, but also of recent history: the weeks leading up to the beginning of the pandemic, which you may recall led the S&P 500® to decline 30 per cent in 22 days starting at the beginning of March.

In hindsight, it's always easier to distinguish the right moves from the wrong ones. But as I reflect upon how our portfolios were positioned in March when the markets hit the panic button, we were rather calm at the time. That's because we had started reacting early enough to the data points coming out of China on Covid-19, which allowed us to reposition the portfolios to weather what might have been a catastrophic and more prolonged downturn.

"This is worse than SARS or anything we have seen before," I recall one of our non-traditional analysts, a native of China, saying before there were any known cases of Covid outside of China as she sounded the alarm on what was ahead of us.

Armed with this insight, we started reacting and began to cut back on names we felt would be more directly impacted. One of the areas of concern was about the impact on the financial sector; namely around a slowdown of loan growth and the potential for an increase in non-performing loans.

This is a classic case of what we call *a macro switch-off*. Because of this deterioration in our earnings views for these companies, we reduced our financial exposure and redeployed it in areas where we felt we had better visibility from an earnings and moat perspective. There were some companies, in our opinion, that actually could benefit from what might be structural changes in how we live on a daily basis.

The portfolio changes generally benefited areas such as technology, consumer discretionary and communication services. Our portfolios benefitted almost immediately from those changes as we saw strong relative returns in March 2020 during a period when global equity markets posted one of their worst monthly returns in recent memory. In our view, we avoided the classic "bad returns in bad times," and that's something we believe is integral to long-term compounding.

When we lose confidence in our estimation of the depth of the valley ahead — it may be 10 feet or 1,000 feet — we think it's better to sidestep, because if the valley is 1,000 feet deep, the fall may be fatal. One might recall a number of managers who tried to predict the future during crucial inflection points, whether trying to time the market in the early days of the dot-com bubble or by being contrarian in owning financials during the Global Financial Crisis. Some of those shops are no longer around.

Following this strong survival instinct is a key part of our investing style and it is at the core of what we have pledged to our clients: to focus on long-term compounding while aiming for better downside protection.

THE EARLY STAGES OF THE REBOUND

Our strong commitment to protecting our client's assets during these inflection points often means we may underperform on a relative basis during the early stages of a rebound. Generally speaking, if deep cyclicals are up, which they typically are in early stages of an upturn, we're going to underperform on a relative basis. That pattern has been fairly consistent over the last two decades of my career. That's what happened in November when areas of the market that were most negatively impacted by Covid-19 suddenly leapt in price on the news of strong data on the efficacy of the vaccines and US election results.

Maybe the most dramatic example of this was Carnival Cruise Lines (CCL), which jumped nearly 40 per cent on Monday, November 9, 2020. As you can imagine, our exposure to this part of the market — those most negatively impacted by Covid — was nil, because we feel we have very little visibility on the earnings potential of these companies over the next three to five years. Many energy companies would fit in this speculative bucket as well. In November, two of the top five best-performing asset classes were Brent Crude and WTI.

Looking at the patterns of the market, what actually surprised us during this period was that several of the most expensive companies, whether on a price-to-earnings basis or more egregiously on a price-to-sales basis, also appreciated (more on that in a moment). Quality growth at sensible prices — what we call *motherhood and apple pie investing* — underperformed and basically didn't participate in the rally.

SHORT- AND LONG-TERM PERFORMANCE

On net, portfolio returns across the firm have been quite strong for the full year of 2020 on an absolute basis. However, we're acutely aware of the path-dependent nature of things in this business.

Last quarter was tough as we gave back a meaningful part of our relative outperformance across our products. These results are not surprising in light of our historical return patterns. But we recognize that many of our investors who hired us earlier in 2020 have experienced relative underperformance in this period. Be assured we do not take this lightly.

As you'll see below, we are positioned for where we think markets are going, but always with downside protection front of mind. We believe that investing isn't about being proven right or wrong; it's about *surviving*. That could be the answer of why most managers don't have a very long-term record.

LOFTY VALUATIONS

With that in mind, let's dive into the current and prospective environment, and discuss one of the current hot topics: value versus growth in a world where lofty valuations that are making the art of investing more interesting — or more dangerous, depending on how you look at it. First, a quick review of some history for context. Since the world is a non-linear place, we won't quite proceed in a linear fashion here either.

If we look back at our 2019 CIO letter, we highlighted the valuations for quintiles of revenue growth. Keeping with our cycles theme, we will revisit this same statistic despite reservations on beating a dead horse. Similar to last year, we looked at the MSCI USA Index back to 2004 and segmented constituents into buckets based on revenue growth. As highlighted in Exhibit 1, the fastest cohort of revenue growth is the most expensive basket — but look how much *more expensive* it became in 2020.

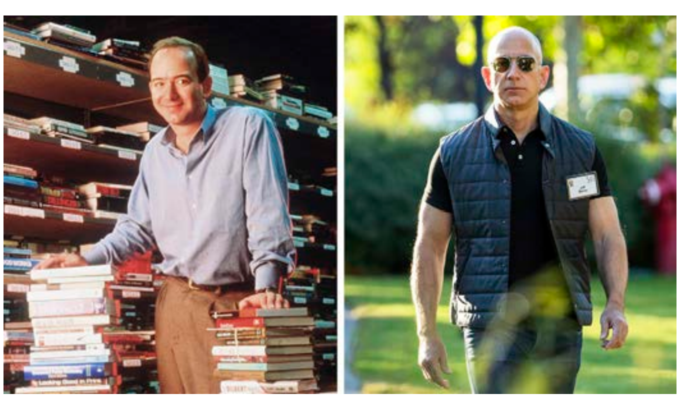
EXHIBIT 1: THIN AIR AT ALTITUDE

MSCI USA INDEX: P/E MULTIPLE EXPANSION IN HIGHEST VERSUS LOWEST REVENUE GROWTH QUINTILES (2004 TO 2020)

Source: Bloomberg and GQG analysis as of November 30, 2020.

HOW MANY WILL BECOME THE NEXT AMAZON?

EXHIBIT 2: JEFF IN HIS 30s... JEFF IN HIS 50s



Source: Alina Selyukh, "Bigger And Brawnier: Clout Of Amazon And CEO Jeff Bezos Under Scrutiny," NPR, July 28, 2020, https://www.npr.org/2020/07/28/895135423/bigger-and-brawnier-clout-of-amazon-and-ceo-jeff-bezos-under-scrutiny. Photo credit: Paul Souders and Drew Angerer (both for Getty Images). Reproduced under Fair Use.

Throughout the year, I've heard phrases such as "growth at an unreasonable price" and "the next Amazon." We think these types of phrases require a level of suspension of disbelief with which we can't quite get onboard. For example, take a look at Exhibit 2. How many people get *better* with age? (Unlike wine, we usually weaken with age.) While Jeff Bezos looks buff in his fifties compared to his nerdy thirties self, his maturation, like that of his great company, is clearly an outlier!

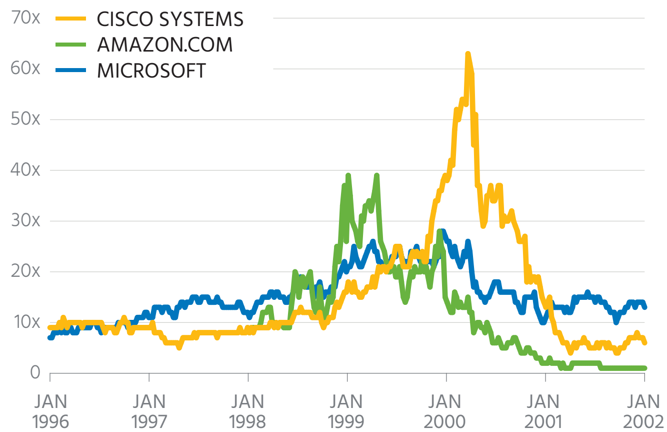
By the sheer quantity of comparisons to Amazon, it's probably unlikely that the next *x, y and z* can become Amazon. This matters quite a bit if an investor is buying growth at any price, including unreasonable ones, because the margin for error gets lower and lower.

If we look at Exhibit 3, we notice that even during the dot-com era, very few names got to these valuations on a price/sales basis — and these were the survivors of that era. We are confident when we say that not all those who appear to be growth darlings will be winners over the long run.

To be clear, we do own some names which are priced at 15-20x revenue. However, these represent a small portion of our overall portfolios and are companies that we feel are dominant and have a long runway for growth. To have a few higher-multiple names is very different than having a weighted average price/sales of 6x or even higher at the whole *portfolio* level. The air begins to get thin at those altitudes!

EXHIBIT 3: SKY-HIGH VALUATIONS

TECH BOOM PRICE/SALES RATIOS (1996 THROUGH 2001)



Source: Bloomberg as of December 31, 2020 for price/sales ratios January 1, 1996 to December 31, 2001.

WHAT'S REALLY OUR STYLE?

For those concerned that we sound like a value investor, lamenting growth and sitting around waiting for mean reversion, we're not changing our stripes. We do believe in growth. However, where we break with some of our growth peers is that we still believe in fundamentals and that the price one has to pay for an asset still matters. We also believe that history doesn't repeat itself, but people do. We have no reservations that the issues around valuation that we have laid out will at some point manifest themselves in a similar, but not exactly the same, fashion as they have in past.

For anyone struggling to understand our out-of-the-box style on valuations and growth, here is a quick way to frame our approach: with a mission to take less risk as we try to compound our clients' assets, we believe that **valuation** sensitivity matters, **growth** is very valuable, but **quality** keeps you afloat even in bad times. These are our three pillars. As a former value manager who is now described as a growth manager myself, I know that combination is possible.

DOES THE *B* WORD APPLY THIS TIME?

So, what's driving current valuations? What's behind the recent mania? While we're hesitant to use the dreaded *B* word, it's hard to argue that pockets of assets aren't in "bubble" territory, as evidenced by the valuations in Exhibit 1. We know hope springs eternal, but even the price of hope still matters when it comes to the hope of investment returns. Let's provide a few more examples to set the backdrop for what we're describing:

— THE SOUTH SEA COMPANY
In 1720, a speculative frenzy was set off in London on the back of loads of liquidity. The South Sea Company, which was created to finance Britain's war with France, saw its initial shares explode in value, setting off a wave of new companies (like modern-day SPACs) investing in things from Irish bogland to square cannon balls, as well as the famous anecdote of "an undertaking of great advantage, but nobody to know what it is!" This latter scheme purportedly raised £2,000 in 1720 terms. Truly extraordinary.[1]

— THE NIFTY FIFTY

In the 1960s' United States, the Nifty Fifty were large, blue chip stocks that carried the moniker of *one-decision stocks* according to Morgan Guaranty Trust, so named because one simply bought them and watched their money compound at 2 per cent… *per month*. These companies, from IBM to Coke to Procter & Gamble, were the growth darlings of their day. Their growth was so strong and their prospects so bright, that this growth could be bought at any price, regardless of how unreasonable. By the early '70s, when the S&P 500 traded at just under 20x earnings at the time, the Nifty Fifty traded at more than 40x earnings. This was a "bargain" given their assumed perpetual growth.[2,3] It just turns out that as the decade ended, multiples had compressed by, well, multiples and ended up in the single digits.

— CISCO THE DOT-COM

When commenting last year on the Tech Bubble, we highlighted the book *Dow 36,000*, which was published in October 1999. Despite Dow 31,000 finally being reached in 2020, the book really encapsulated the fervor from the late 90s. To discuss the late 90s this year, we will look at the late Benoît Mandelbrot's *The (Mis)Behavior of Markets* where he notes that at Cisco Systems' peak

> the P/E reached a stratospheric 127x. Put that into perspective. Any investor who actually believed that to be the company's intrinsic value would have had to assume its earnings would keep up the same torrid pace for at least another decade — by which point Cisco's market value would have exceed the annual production of the entire US economy.[4]

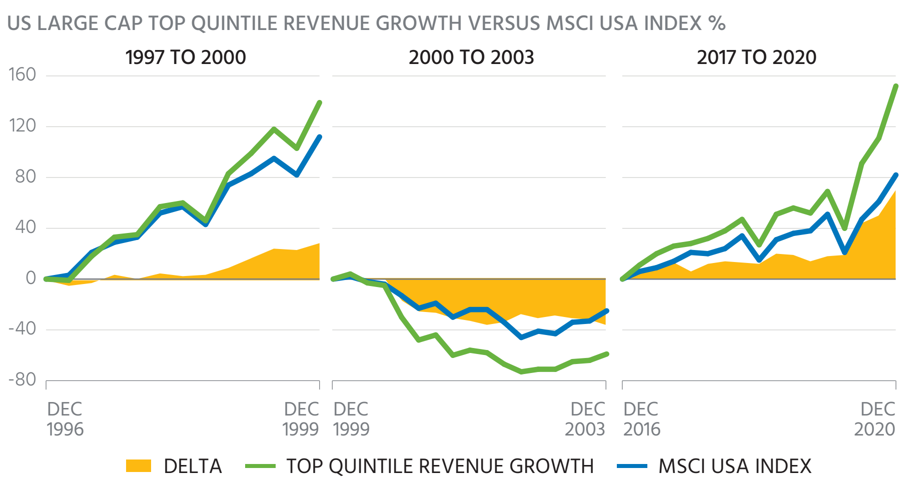
Interestingly enough, Cisco was trading at the "bargain" P/E of 26x in 2003, but its *realized* growth was 35 per cent per annum. A truly extraordinary change in sentiment.

TURNOVER AND RETURNS

Since we are addressing controversial topics, let's turn up the heat a bit and talk about the importance of turnover in risk management.

Like a lot of things in the investing world, conventional wisdom is "long on convention and short of wisdom." Conventional wisdom is that lower turnover is *always* better. Our view is that low turnover is mostly good but not always. In our annual letter a few years ago, we stated that our turnover can go up during times of higher volatility as we try to adjust our portfolios to a changing environment. That could be us admitting our mistakes, upgrading the portfolio or a combination of both.

EXHIBIT 4: TOP QUINTILE REVENUE GROWTH BY REGIME



Source: Bloomberg as of December 31, 2020.

While we acknowledge that is not conventional wisdom, it is a key part of our risk management in crisis periods and has added value for our clients over time. If we look at the top quintile of revenue growth over the last three years (2017 to 2020) in Exhibit 4, buying the highest revenue growth *irrespective* of valuations has been one of the best ways to outperform indices, much like 1997 to 2000. Unless one was dynamic enough (read: higher turnover), that same approach would have cost you dearly from 2000 to 2003. What has recently worked remarkably well for many growth managers could also possibly kill them. We cannot and will not guarantee that we would do well if the tide turns. We do think, however, that our approach of adjusting to what the market is offering increases our chances of surviving over the long run. Nothing is permanent in this world and that is doubly true in the investment world!!

WHEN THE AIR GETS THIN

In December 2020 alone, ARK Investment Management, on the back of its ARK Innovation ETF (ARKK), ranked #3 in total monthly flows behind only Vanguard and BlackRock, ***the two largest asset managers on the planet*** (those two have been in business for decades and manage assets in the trillions; ARK, founded in 2014, manages just north of US$36 billion). Taking nothing away from the firm's success and strong 2020 performance, our whole theme for this letter is built around historical behavior and valuations, which are cyclical by definition. Therefore, we'd be remiss not to highlight such data points. As of November 30, 2020, the top 5 holdings of the ARKK ETF, representing more than 35 per cent of the portfolio, trade at a price/sales ratio in the range of **14x to 137x!** Again, kudos on the strong performance but, in our view, incredible flows with high prices tend to yield a margin of danger rather than a margin of safety. The air is almost certainly quite thin at those sky-high prices.

LOOKING FORWARD HOPEFULLY TO A LESS EVENTFUL YEAR

So, what are we doing for the next year and beyond? We feel some perfectly reasonable businesses that may have slightly slower growth (but we think will still grow) can be found at very reasonable prices. Health care in developed markets and a few select financials are the two areas that have found some more room in our portfolio at the expense of some more expensive technology/consumer discretionary names. Harvesting what has done well may seem quaint in this era, but it's all about long-term compounding for us.

With a majority of Tim's and my wealth invested in GQG Partners and our strategies, and most of the rest of our GQG associates also invested right alongside our clients, we think a lot about risk. We feel a lot of aggressive growth managers currently have too much risk embedded in their portfolios. When we look at what the market is offering currently, we see an attractive path of buying companies with great moats at sensible prices at slightly lower earnings growth. Looking at what has been rewarded in the market over the past three years, it is easy to get complacent in this environment. In our view, complacency is seldom rewarded by the markets over the long term.

Thank you again for your trust and support.

Rajiv Jain
Chairman & Chief Investment Officer
GQG Partners LLC

END NOTES

1. Ellen Castelow, "The South Sea Bubble," History of England, Historic UK Ltd. (website), accessed December 31, 2020, https://www.historic-uk.com/HistoryUK/HistoryofEngland/South-Sea-Bubble/.

2. EquitySchool (@equityschool), "Nifty Fifty Stock Bubble of the Seventies — Is There a Similarity with Today's Market," Medium, October 24, 2015, https://medium.com/@equityschool/nifty-fifty-stock-bubble-of-the-seventies-is-there-a-similarity-with-today-s-market-34b19d7a4cff.

3. Martin Sosnoff, "Where's The New Nifty Fifty?," *Forbes*, August 10, 2016, https://www.forbes.com/sites/martinsosnoff/2016/08/10/wheres-the-new-nifty-fifty/?sh=144bfd2b5330.

4. Benoît B. Mandelbrot and Richard L. Hudson, *The (Mis)Behavior of Markets* (New York: Basic Books, 2004), 250.

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