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Let's connect

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The Merry Men of Sherwood Forest

Most people would know that the Merry Men were criminal yeomen from early 13th century England who were led by the infamous Robin Hood. The feudal class was oppressed by Prince John, son of Crusading King Richard. The cruel Sherriff of Nottingham was their operational enforcer of the law in the area. It was Robin Hood's mission to steal from the rich, those being the nobles who supported the King, and give to the poor.

Today we have a new Robinhood, a discount broker by that very name in the US with a stated mission to "democratize finance for all." Robinhood targets millennials by clever marketing and offering fractional shares. Happily, for Robin Hood, there began a worldwide pandemic one year ago. Thus, began a series of events that no one could foresee.

A combination of a money flood in the system, work from home mandates, boredom and lack of entertainment lead ringleaders on a Reddit board called r/wallstreetbets to hatch an incredible gambit. They decided that hedge funds that are short specialists were the modern-day King Richard. It was the Shorts who were evil and must be destroyed. The modern Merry Men easily found where they could cause the most damage which was where the Shorts had bet most heavily. One security was GameStop, a mediocre purveyor of gaming software. Together they started buying which started the losses rolling for the Shorts. Much of the buy origination was on the Robinhood platform. In the end, the Shorts lost billions as they had to buy back the stock at 25 to 50 times what they sold it for. The Merry Men however will inevitably die in battle as a failing company cannot sustain a valuation of US$14 billion.

There are other examples of excess money causing weird behavior.

There is a US investment group, ARKK Invest, whose Cri de Coeur is that we are in an age of disruption. Their specialty is identifying companies who will cause chaos in their industries and destroy the incumbents. The theme resonated with speculators, fund prices started to advance, and money started to flood in. Underlying companies in the funds reached ridiculous valuation levels and the top was reached in mid-February this year when the funds had assets of $50 billion. The best possibility for disruptive growth is in smaller companies which is where ARKK primarily invested. The problem for the group is that their positions became too large in their investee companies, so they had to move up the scale to larger companies. Although they deny the charge, their mandate has changed. This is a familiar problem for asset managers in small ecosystems. Good luck to everyone.

At the top of the scale for weirdness is the SPAC craze. SPACs are special purpose acquisition companies. A group raises funds on a stock exchange with the mandate to buy a hot private operating company within two years that otherwise would not be public. The people who are sure to profit are the people behind the SPAC as they take a 20% Promote fee plus warrants (options to buy more equity at a low price) on the deal.
In the first two months of 2021, 160 SPACS that have raised US$48 billion were initiated. In 2020, US$76.2 billion was raised. The normal way to go public is through the traditional underwriting route. This is a slower and more rigorously vetted process that is a disadvantage to the company. For the individual investor though at least, they have had many eyes on the deal and have better assurance that the valuations are closer to some realistic benchmark. However, SPAC investors are blind. Why would you take the chance? The SPAC space may be in the process of blowing up. SPACs are required to make a deal within two years and there are 497 still looking. Expect a lot of mediocre and garbage deals done to ensure the money does not have to be returned to investors.

As you can see there is a plethora of cash sloshing around the markets. Everything is being bid up. This is not to say there is a problem in the markets. Projected real GDP growth for 2021 and 2022 in the following areas are: US: 6.3%, 4.0%; Canada: 6.2%, 4.1%; Japan: 7.8%, 4.7%; Western Europe: 5.4%, 5.1%; UK: 7.3%, 6.3%.

Put the Money to Work!

In the Spotlight: Luxury Brands

In past newsletters we discussed the evolution of developed economies into more concentration in the high-income deciles and the low-income deciles. People with money spend and they like luxury brands. Next time you are in Toronto take a walk along the Mink Mile, Bloor Street between Yonge and Avenue Road. The same shops can be found all over the world in high traffic tourist areas in major cities. Another important demand factor has been the incredible growth of the Chinese upper class. We have had Compagnie Financière Richemont in the portfolio for a couple of years. Richemont is a Swiss holding company of specialist watchmakers, jewelry houses, on-line distributors and fashion & accessories entities. The jewelry businesses include Cartier, Van Cleef & Arpels and Buccellati. Its specialist watchmakers segment includes businesses whose primary activity includes the design, manufacture and distribution of precision timepieces. The businesses in the watchmakers segment include Piaget, A. Lange & Sohne, Jaeger-LeCoultre, Vacheron Constantin, Officine Panerai, IWC Schaffhausen, Baume & Mercier and Roger Dubuis. The Company's other operating segments include Montblanc, Alfred Dunhill, Chloe, Purdey, Shanghai Tang, and Peter Millar.

Richemont, controlled through super voting shares by Johann Rupert, a reclusive South African billionaire, was founded by him in 1988. While some may think that there has been a permanent impairment to jewelry demand, Rupert noted in May 2020, “a lot of our brands have survived multiple wars and crises.” Richemont is the leading global jewelry business. Long term secular growth is 7% to 8%. Through the pandemic, Richemont’s expected Q1 21 sales are +7% vs Q1 19 and +16% in jewelry vs Q1 19. Since over 80% of global jewelry sales are in non-branded products, this allows Richemont a lot of opportunity for incremental growth. In the 2020 fiscal year sales were €14.2 billion with free cash flow of €1 billion. The market cap of the company is €46 billion.

Kering SA is a France-based luxury group. We recently added the position in the portfolio. It owns a portfolio of fashion brands, including Gucci, Saint Laurent, Bottega Veneta, Alexander McQueen, Balenciaga, Boucheron, Brioni, Pomellato, Qeelin and Ulysse Nardin, among others. The Group manufactures and sells, mostly through managed retail stores, a wide range of products, including leather goods, apparel, accessories, footwear, watches and jewelry.

Kering is a bit lopsided in that 80% of its profit derives from the Gucci brand. Recently that has been a weakness as Gucci designs became less favored compared to competition especially from Louis Vuitton and Dior, top brands of LVMH. Gucci was more negatively affected during the Pandemic as it is very reliant on physical shops and the tourist trade. Creative force Alesandro Michele has adjusted strategy to appeal to European +40 women with handbags emphasizing Gucci’s historic ties to Jackie O and Princess Diana. The Pandemic also delayed introduction of its new Cruise collection so there was a paucity of new product. Today better analysts can determine how brands are faring, prior to company news releases, by a sophisticated analysis across search engines and social media channels. Gucci is showing positive momentum.

In the last year Kering’s secondary brands outperformed Gucci. Bottega Veneta has become one of the fastest growing big luxury brands. Saint Laurent and Balenciaga are performing very well.

Kering has a market cap of €74 billion. 2021 revenues are expected to be €15.1 billion with earnings of €22.1 per share. Projected 2022 earnings are €25.28. The stock trades at about €630.

If you are weary of streaming services and want to see some fascinating videos of Kering’s brands you can do so here: www.kering.com/en/houses.

Ask Brian

Hi Brian:
I am hearing a lot of talk about the market being very overvalued. Inflation also seems to be a threat that I hear can be bad for stocks. Should I hold off investing in the market?
Tom

Dear Tom:

What you are really asking is whether you should attempt to time the market. You are hoping that there will be a correction of some magnitude and you will be able to step in at the precisely correct time. Historically that has never worked for people.
Timing is important when it comes to my job. Once I have identified a buy candidate there are better times than others to start buying. This type of consideration occurs every day as I monitor the 10 to 20 stocks on the buy list. So, let me worry about that. It is one reason why you pay a fee.

Regarding your inflation concern, it is true that the massive stimulus unleashed by government spending has the fixed income market worried. In fact, I wrote about the possibility in the MQ of October 2020. In the first quarter of the year the Canadian fixed income benchmark declined 5% and our fixed income portfolio declined 2.8%. To be more direct about it, the worry manifested by traders selling bonds so much that the price fall overwhelmed the interest payments. Thus, the overall loss. The selling somewhat stopped in March. There is a lively debate about whether this is the Big Move or merely a fake out. There is no real way of knowing. There is no question however that the traditional weighting given to fixed income in portfolios needs to be reconsidered. For trustee accounts it is uncertain how courts would interpret this change to intrinsically higher risk.

Leading analysts believe that equities can withstand higher interest rates. In the past, equity returns have not been affected by rates quite a bit higher than where we are now. This period should be no exception to previous experiences.

Sources: Financial Times, New York Times, Washington Post, BMO Capital Markets, RBC Capital Markets, J.P. Morgan, Barron's, Wall Street Journal, The Globe & Mail, National Post, Bloomberg, Richemont, Kering

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