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Let's connect

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Ride `em Cowboy

Once again into the breach. The latest assault by our common enemy COVID has found me immersed in streaming cowboy narratives. The Amazon series Yellowstone with Kevin Costner is a tale of a powerful Montana rancher who places "family" ahead of community. Really, it is a metaphorical representation of rapacious capitalism with no regard for community. Benedict Cumberbatch, in the film Power of the Dog, evinces a cowboy's psychological turmoil within a patriarchal rural society. Tortured psyches may well be one of the longer lasting effects of this pandemic.

An interesting commonality between the dramas is that one of the significant functions of the cowboys involved is to break wild horses. Symbolic of man defeating COVID?

2022 is shaping up to be an interesting and tumultuous year in the markets. Authorities now acknowledge Inflation as not "transitory." Quelle surprise.

The pandemic shutdowns delivered an immediate economic contraction with a GDP output gap of 2 to 3 percent. Central Banks and governments, through transfer payments and other stimuli, overfilled this hole by a factor of 5-7 times. It is a simple conclusion that the excess funds in the system were going to cause a sustained inflation. Ninety percent of CPI components are running at over 3% inflation. The overwhelming evidence is that corporations have and will continue to raise wages to attract and retain employees and have the pricing power to pass on the costs. Labor market shortages will continue to drive up prices. Housing prices have increased, and these increases are not yet in the CPI measurement.

Q4 2021 shows a market still ignoring the inflationary evidence. Bond yields are still quite low, yet off the bottom. High growth and momentum equities were still in favour. There are cracks starting to appear. No profit concept stocks chosen by Aunt Cathie Woods and ARK have taken dramatic hits. Most of “high growth” is in the NASDAQ.

In January’s first week NASDAQ fell 4.5%. As at January 19th it is down 8.3%. Looking through NASDAQ entrails reveals a strange story. The index is down 11.5% from its all time high while 38% of its stocks are down over 50% from their individual highs. The disparity bodes ill for all expensive high growth stocks.

Central Banks know the score. This year will see a quick end to monetary easing and a regular increase in the discount rate. The Bank of Canada indicates it will be the most aggressive amongst its peers. The central banks would like the market to believe that it will be a smooth seamless process. Nothing to see here folks; move along now.

Investors had best be prepared for disruption. The challenge will be to adapt and adjust as to a wild bucking bronco.

Ride 'em cowboy
Don't let 'em throw you down
You can't make no money if you hit the ground
They say, ride 'em cowboy
Don't let 'em throw you down
You're the toughest cowboy in town

Paul Davis

In the Spotlight: Stericycle Inc. (SRCL)

Every night I take out the garbage. That's the last I think about it until the next night. Good riddance. Of course, there is a massive industry that takes the next steps that I prefer not to know anything about. Today we will focus on medical, industrial and commercial waste.

Stericycle Inc., headquartered in Illinois, was founded in 1989, and grew by buying over 500 companies over the decades. This strategy worked wonderfully until the company started to falter financially in 2017. The company's stock, perhaps anticipating future problems, topped out in August 2015 at a price 135% higher than the current price. The problems were substantial. SRCL had made some poor buys, had failed to properly integrate others, and did not have management talent to right the ship. To get a flavour of the depth of the problems, SRCL had become reliant on 450 different information technology systems and 65 financial systems. This was a company without a controlling central nervous system. The stock took 3 ¼ years to finally bottom out in December 2018.

SRCL has two main business segments. Regulated Waste and Compliance Services (RWCS) provides collection and processing of regulated and specialized waste including medical, pharmaceutical and hazardous waste. Brand names include CsRX, Kiosk, and Seal/Send. Secure Information Destruction Services (SIDS) collects personal and confidential information for secure destruction and recycling. SIDS brand is Shred-it which was acquired in 2015. A much smaller competitor is Iron Mountain.

The key to the rebound is CEO Cindy Miller who started at SRCL as a C level executive in October 2018. She has been CEO since May 2019. The implementation of the Enterprise Resource Planning Software (ERP) is an ongoing project that will have many starts and stops. This step function approach to improvement has and will mean great variation in quarterly profitability. The stock has reacted greatly to the non-linear improvement function. This pattern is upsetting to some street analysts and to many classes of institutional investors. Generally, they would rather pay higher prices for the stock for less variability in the financial metrics. Those readers who know our style can deduce that SRCL is a perfect stock for us.

Stericycle has a US$5.4 billion market cap. Consensus 2022 revenues are expected to be $2.76 billion with an adjusted EBITDA of $503 million and consensus earnings per share of $2.24. RWCS dominates the North American medical waste sector with the next largest competitor, Sharps Compliance, 33 times smaller and not profitable. As the goliath, SRCL has superior operational metrics. Larger industrial solid waste companies have tried and failed to enter the space due to the difficulty in regulations, obtaining permitting and compliance. The SIDS business is more mature but there is still opportunity for growth through acquisition as the segment is fragmented. Additionally, the ERP deployment which started here will improve margins substantially.

We own the stock.

Ask Brian

Hi Brian:
How would you assess the capital markets for 2021?
Mike

Hi Mike
The term "Mindless" resonates with me. To do well required zero thinking. You could have bought the market at the beginning of January and sat on a beach, golfed, skied, or hung out at the cottage for the balance of the year. There have been stories of millennials lecturing their parents on how to invest using simple products that cost nothing. Or to get with crypto. It was all quite amusing for seasoned hands (i.e., me.)
Why do I laugh? Because we all know how this period ends. It ends in tears for the millennials.
First a review of the 2021 returns in major equity markets. All returns below are rebased to Canadian dollars.

North America total returns
TSX: 25.1%; S&P500: 27.7%; Dow: 20%; Nasdaq Comp: 20.5%; Russell 2000: 14%
Europe price returns
DJ Stoxx 50: 13.5%; UK FTSE 100: 12.3%
Asia/Pacific price returns
Japan Nikkei 225: -6.6%: China Shanghai: 6.8%; Hong Kong Hang Seng: -15.2%
Global price returns
MSCI World: 19.2%; MSCI Europe: 12.9%; MSCI Emerging Mkt: -2.0%
MSCI Global All Cap (ACWI): 15.9%
Fixed Income
NOTE: Canadian Broad Composite Index: -2.5%

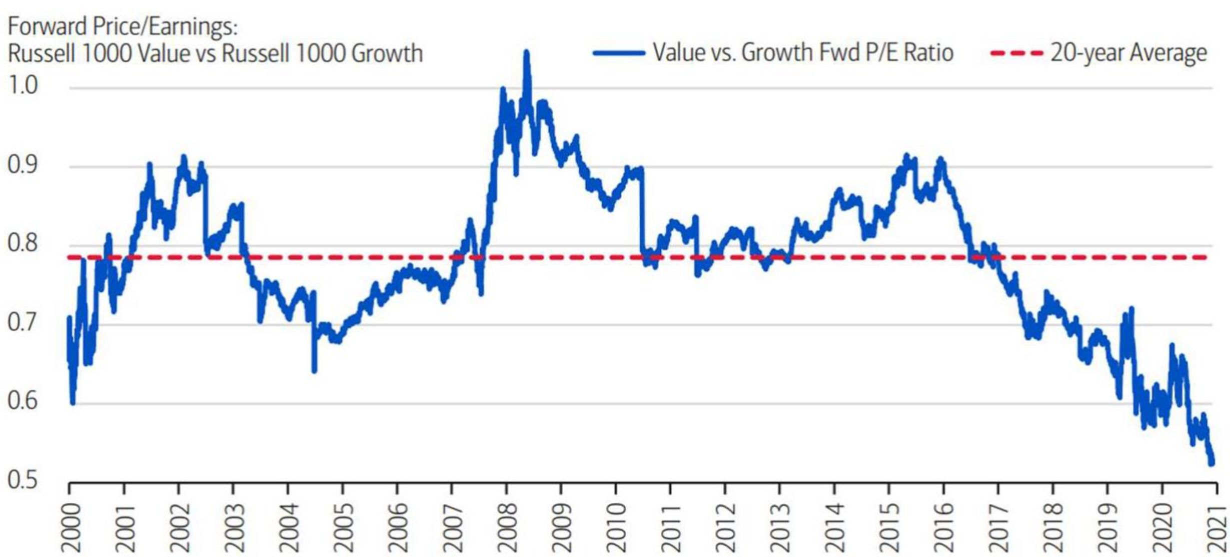
In the listing above the S&P500 is the anomaly. Although a very diverse market, it is still highly concentrated. The top seven stocks, all tech, represent 27% of the S&P500 index. Practically speaking, to exceed the 2021 US main benchmark return you would have had to have more than 26.9% allocation to the top seven names: Apple, Microsoft, Amazon, Tesla, Alphabet (Google), Meta (Facebook), and NVIDIA. I would not touch any of those stocks with a ten-foot pole. They are extremely expensive compared to future earnings expectations. You would need flawless and high earnings growth performance for 10 years to justify the current prices. As Clint Eastwood said: "Do you feel lucky, Punk?"

In the resource intense Canadian market, we had one of those years that happen every 7 years or so. It reflects the performance of the Bloomberg Commodity Index up 27% (USD), its best year in decades. Energy stocks came up from sub-basement #3 to return 48.9%. (Aren't we all going electric?). Paper/ forestry, facing incredible demand for lumber and wood products, were up 38.4%. Banks coming off a mediocre 2020 returned 38.4%. None of this is repeatable.

A key characteristic of capital markets is their long-term returns that don't vary much over time. When there are periods where returns are much higher, there follows periods when returns are lower than the long-term average. The average itself is based on real interest rates, productivity growth and risk premium required. The long-term market return is baked into current economic realities.

The chart below is the value versus growth dichotomy that will soon reverse. For those that do not know, the top seven stocks above are in the Growth camp. The reversal happens when high growth equities falter and/or value stocks go up.

Exhibit 5: Value remains historically attractive relative to Growth.



Source: Bloomberg. Data as of December 1, 2021.

There are many ways to make money in the market. Some methods work only under specific conditions. As suggested above we are about to experience a change in basic assumptions. If you have been involved on your own, you know that there are several ways to lose money.

A strategy that works consistently over time is to invest with a longer time horizon than the typical institutional investor. They are benchmark constrained, meaning they need to own those seven stocks, and they are answerable for quarterly performance.

Regards,

Brian

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, Morningstar, Bloomberg, Stericycle Inc., Lawrence Summers

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