The Wrap Up

Wake Me Up When September Ends

Summer is ending and the markets are entering a time of year historically associated with major narratives playing out. While we tabulate the remaining quarterly earnings results, we want to open a new discussion with our clients centered around private markets.

As it stands today, most of what retail (that's ordinary people as opposed to pension or investment funds) investors hold are publicly traded securities. Microsoft, one of our favorite companies, is a public company; that means its shares trade on an exchange. These shares trade constantly throughout the day, allowing for liquidity and price transparency. Comparing this to a real estate transaction, for example, we can fully appreciate the benefits of stock ownership; I do not need to hire an agent and pay a 3-4% commission to sell my shares. I also do not need to clean my portfolio up and stage photo shoots in order to entice a buyer. Lastly, I do not need to guess what my shares are worth, I have a bid and ask that is constantly updating every second of the trading day. For better or for worse, this has led to an evolution in investors' behaviours where short holding periods are the norm and a more pronounced momentum effect is evident.

Over the last couple of years, you have seen outperformers really stand out relative to the rest of the stock market, look no further than Nvidia's outsized impact on index returns this year. Over the long run, we have more money chasing fewer ideas which is why we see such inflated valuations amongst the more interesting ideas; 25% of the S&P 500 is represented by 7 companies. While we like 6 of those 7 companies, eventually, so will everyone else (if they haven't realized this already) and this will make portfolio differentiation more difficult to achieve. The question then becomes, why bother being different? Our clients give us two objectives with their money: make x return and take y level of risk which ideally comes out to close to the market return and as close to a GIC when it comes to risk. As long as we stay within the concentrated public market, it becomes harder to achieve similar returns with lower levels of risk.

Let's connect

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It is precisely for this reason that we have begun to introduce ideas such as income notes or applied strategies such as covered call writing. We wish to achieve our targeted returns while efficiently managing our clients' risk. While we are happy to continue to apply these strategies, we are always looking for ways to enhance our offering and this is where private markets make an entrance. If public markets are defined by liquidity and price transparency, private markets tend to be illiquid with less timely pricing. What exactly is a private company? It's a company that does not trade on public markets and its ownership is privately held. While private equity is hardly new, historically, private equity mandates were reserved for institutional investors who were less sensitive to the details of what they own and were also less sensitive to liquidity constraints. Over time, private assets have grown to become larger components of institutional portfolios; the Canada Pension Plan has 50% of its portfolio divided between private equity, private credit and real assets.

So if these assets are good enough for the largest investors out there, why would they not be good enough for retail investors? Again, liquidity and complexity have always been very real constraints that have limited our options. Thankfully, with time and effort, new products are coming to market allowing a little bit more flexibility as well as a few more reassurances for advisors. Recently, we have met with firms that have proposed interesting new ways to access non-market trade assets; imagine owning a privately held real estate fund where you do not need to hire an agent to sell and instead you can redeem monthly ? Imagine a private equity mandate that does not require you to lock in your money for seven years but only for three months? Before I go on, we want to acknowledge that there are liquid alternative funds available, however we have not been fully convinced by what we have seen so far. There are some promising mandates that we've seen over the last few years but our main concern with these strategies is that offering daily liquidity may still prompt the strategies to behave like public securities in times of economic volatility. One way to create daily liquidity would be for the mandate to hold a large portion of its assets in cash; while the cash rates today are at 5%, lower rates of the past usually meant that the cash component ended up being a drag on performance.

Circling back to private assets, there are some realities that we need to recognize in order to appreciate their appeal. Firstly, we like the offerings as private companies outnumber public companies by a ratio of almost four to one. This means, we have a greater selection than the concentrated equity markets of our times. Secondly, because you do not have millions of eyes on individual private companies, there are greater opportunities when it comes to finding undervalued assets. The stock market is far from perfect but it is fairly efficient; the price that you see today is the consensus of thousands of shareholders assessing all publicly available information about the company and the economy. The private company does not have thousands of bidders nor are its financials readily available which means there is the possibility of greater price discovery. Also, especially in the case of smaller companies, a deep pocketed private equity firm can have a greater impact on the performance of a smaller firm than a potentially larger company. Larger public companies can sometimes have an easier time raising capital than a smaller private one, however, a private equity firm armed with billions, can come in and allow for that expansion that was previously difficult to pursue.

Most importantly for us and our clients is the potential for less volatility in the private equity portfolio. While private companies are just as susceptible to economic downturns as are public ones, their cheaper valuations tend to make their prices less volatile relative to their public counterparts. Circling back to our beloved Microsoft, the company currently trades at 30 times the next 12 months of estimated earnings. If a recession were to occur and earnings were to take a 10% drop, the estimated impact on the share price will be close to 30%. Conversely, a private company, which may trade at 5 times earnings, would only experience a drop close to 5% in the event of a 10% drop in future earnings. We already see this dynamic play out on the stock market with value companies (those which inexpensive earnings multiples) tending to experience less volatility in a market downturn than their more expensive growth counterparts. The effect may be even more pronounced when shifting from publicly traded value firms to private held ones.

We are not here to say that we suddenly dislike public markets; these will still remain the largest component of our portfolio because of the liquidity and unique opportunities that exist only on the stock market. I picked on Microsoft earlier but I can say that my opinion is, public or private, there is no company in the world that does what they do, this is why we hold them and they deserve a premium valuation. That being said, when considering our dual mandate of producing returns while balancing risk, we will be offering access to private markets in order to help our clients achieve their financial goals in a more efficient manner.

Healthy Distraction

And so we enter the month of September. The first official day of fall is three weeks away but we're already feeling those fresh, cooler mornings. Thus far we've had a summer that brought volatility in the markets and volatility in the weather. Our thoughts go out to the people in Maui and Florida fighting these unprecedented storms, to the people in California, and parts of Quebec battling relentless forest fires. This too shall pass!

September is an opportunity for that last summer golf trip, fishing adventure, apple picking and, when unseasonably warm, a few extra pool days!

What are we at LD Wealth doing for the next few days?

- Myles will be taking advantage of the beautiful weekend to enjoy the pool with the family (thanks Mom and Dad!) and read through a book (*True Style: The History and Principles of Classic Menswear)*.

- David will be hosting his annual NFL Fantasy draft.

- Leon is headed to Tremblant with the family.

Whatever your plans are, we hope you enjoy them and have a wonderful long weekend!