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Irrational Exuberance?
2021 Review & Outlook

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Chris provides financial planning, investment planning and full implementation services to about 100 families.

We are pleased to welcome new clients. New clients should have $1 million or more of investable assets.

A quick look at the 2021 investment returns shows that 2021 was a third spectacular year, with returns of 26% and 28% in Canada and the US respectively. Most of your portfolios returned between 15% and 20% depending on the mix, while many more equity-oriented portfolios were up by well over 20%. We don't get many years like this.

My goal today is a quick review of 2021, followed by a separate but related look at some of the things going on behind the scenes, and my fearless forecast for the future. There is much worth thinking about: there are bubbles, yes, and also pockets of investment value and good opportunity. Against a disturbing social/political background…

2021

The table below shows the returns from the major asset classes for 2021.

Even the TSX and Canadian Small Cap index did well, powered by banks and resources. International stocks (EAFE Europe Australia Far East) returned 11%, while emerging markets languished at -3%; both were dragged down by a roughly 25% decline in Chinese stocks (iShares China Index) and a tepid European market.

Returns from bonds was negative, as the post-covid economic boom brought us closer to the long-expected increase in interest rates off the artificially low rates engineered by central banks worldwide. The exception was high-yield bonds, formerly known as 'junk'. High yield rose in price because they tend to trade more like stocks, on the fortunes of the underlying companies, rather than interest rates in general.

What's really interesting is the individual subcomponents of the market indexes. We have discussed how the US market has been driven these last few years by the mega-cap FAANGs, (Facebook, Apple, Amazon, Netflix and Google) plus Microsoft and Tesla. As shown in the chart below, technology didn't disappoint with a return of 34%.

2021Asset Class Returns

Bonds	
Canada Gov't	-3.0%
Canada Corporate	-1.3%
US Corporate	-1.9%
US High Yield (Junk)	4.4%
Equities	
Canadian	25.8%
Small Cap	22.5%
US (S&P500)	28.7%
US Small Cap	18.5%
EAFE	10.8%
Emerging Markets	-3.1%
US Sectors	
Energy	54.6%
Mining & Metals	45.0%
Technology	34.5%
Financials	30.0%
Materials	27.3%
Consumer Discretionary	24.4%
Industrials	21.1%
Consumer Staples	18.6%
Gold	7.4%

Source: YCharts, Tacita

Mighty tech was eclipsed by the old-school banking sector at 35%, and the mining and metals sector at 45% (Morningstar), as both reflect the post-covid surge in economic activity. Gold stocks were at the bottom, their 7% sector return signaling the gold market's belief that inflation is not a threat.

But the surprise for most people, and a shocker for the ESG crowd, is the 54% return from the energy sector. No, it wasn't from windmills and solar. It was oil, gas, and coal. More on this in a moment.

Manager performance

Another pleasant surprise from 2021 was how well your managers performed. The broadening out of the market from the Flying Five FAANGs (I just made that up) allowed portfolio managers to participate, since professionally managed portfolios like yours are diversified across more than 5 stocks.

The managers also did very well in absolute terms and against their benchmarks. Keep in mind the managers' returns are after fees and expenses where the index is before the fees or expenses incurred to invest in them. If you would like to investigate your managers' performance more closely, please let me know and we'll schedule a detailed review.

Investment Manager Returns to December 31, 2021

		1 Year	3 Year	5 Year	10 Year
Canadian Equity:	CI Canadian Investment	19.0%	15.4%	8.9%	9.1%
	CI Canadian Small Cap	19.6%	18.0%	8.4%	8.5%
	Mackenzie Canadian Growth	24.3%	19.9%	14.5%	15.5%
	Mackenzie Canadian Small Cap	32.4%	23.1%	11.7%	11.2%
Indexes:	Canadian Equity	26.8%	17.0%	9.7%	9.2%
	Canadian Small Cap	22.5%	21.1%	10.6%	7.2%
US Equity:	CI American Small Companies	31.1%	20.0%	11.1%	15.1%
	CI US Stock Selection (1)	31.2%	19.9%	12.9%	14.7%
	Mackenzie US Growth	30.9%	26.1%	19.5%	17.0%
	Mackenzie US S/Mid Cap Growth (CN)	19.4%	18.4%	15.1%	14.0%
Indexes:	US Equity (S&P 500) (Tacita)	25.9%	23.3%	17.3%	19.2%
	US Small Cap (Tacita)	18.5%	18.8%	12.5%	17.0%
International Equity:	CI Global Leaders (2)	14.9%	16.3%	12.4%	15.7%
	Cundill Value	14.2%	7.7%	2.3%	7.1%
	Mackenzie Global Dividend	16.7%	18.0%	12.5%	13.2%
	Mackenzie Global Growth	24.9%	23.6%	18.2%	16.1%
Indexes:	International Equity (EAFE)	10.8%	11.1%	8.8%	10.9%
	Emerging Markets	-3.1%	8.5%	9.0%	8.2%

Source: Morningstar

1) Formerly CI American Value 2) Formerly Black Creek Global Leaders

Portfolio Performance: Most Important, Least Understood

One of the most important – and difficult – lessons of investing is that investment success does not depend on the 'outperformance' of a particular investment, or manager. Clients will recall that some 90% of the difference between portfolios' returns over time is attributable to the asset mix (stocks, bonds, cash, and real estate) that the portfolio had over the period. Very little difference is attributable to the performance of the manager within the asset class.[1]

This is one of the most important concepts in investment management, although it is not well-understood because you never read about it in news media. It's boring: much more exciting to watch the spectacular daily fireworks of Gamestop and market gyrations.

Asset mix is so much more important than the performance within the asset class because the difference between the top and bottom within an asset class is often less than the difference between the returns of stocks and bonds. Statistically speaking, the dispersion of returns within an asset class is lower than the difference between the returns of the asset classes over time. In other words, a top quartile bond manager doesn't have a hope of outperforming even a third quartile equity manager because equities do so much better than bonds.

So it's much more important to get the asset mix halfway right than it is to shoot the lights out within the asset class.

The last several years have been very good for US equities and I am very grateful to have experienced them as we have. We have been very fortunate to have - by far - our highest portfolio weighting in US equities - the top-performing asset class - and the lowest weighting in the poorest-performing asset classes: bonds, cash, and emerging markets, for the past 7 or 8 years.

We'll look to the future in the last section below. First, a closer look at what's going on now.

Irrational Exuberance?

In 2021 we saw a distinct detachment from reality. From the Gamestop phenomenon, where day-traders coordinated by social media ganged up on professional traders, to people throwing billions into SPACS – empty shell companies that promise to go buy another company soon, thereby avoiding regulatory scrutiny – to people paying $50 million for NFTs – digital pictures. The more detached from the reality of a business producing profits and dividends by selling services or products that people pay for, the higher the prices seemed to fly.

It is reminiscent of the famous question asked 25 years ago by the then-Chair of the Federal Reserve Alan Greenspan: "How do we know when irrational exuberance has unduly exalted asset values, which then become subject to prolonged contractions as they have in Japan over the past decade?"

Markets continued to rise for three more years, the S&P500 doubling from about 750 at the time of the speech to about 1525 three years later. The tech-heavy NASDAQ went up much more.

But Greenspan wasn't wrong. It was just a matter of timing. The music did eventually stop, when the tech stock bubble's spectacular blow-off top in March of 2000 ended one of the greatest bull markets of all time, and vaporized many of the icons of that bubble, such as Canada's Nortel Networks.

The bursting of that bubble took the tech-heavy NASDAQ Index down 80% in three years, from which it has only recently recovered. Now, 21 years later, driven by the new generation of flyers, it has just caught up with the S&P500. A year ago it was more than 20% behind. (YCharts)

Are we headed for another tech bubble? Let's have a look around the markets today.

1 The famous Brinson Hood and Beebower study, Financial Analysts Journal, 1986.

Mega Company Concern

There are some concerning similarities. Markets have been driven these last few years by the Flying Five FAANGS (Facebook Apple Amaxon Netflix and Google). The 10 largest companies by market cap now make up a larger weighting of the US and global indexes than the top 10 did at that previous peak in early 2000 just discussed. This alone should give one pause.

The difference today is that the top 10 companies are producing monster profits. The top 10 stocks in 2000 accounted for about 27% of the total market capitalization but only about 18% of total market profit; today the top 10 account for 29% of market cap and 28% of profit (J P Morgan).

A spectacular implosion of the entire tech sector isn't likely this time, because the top 10 are so well supported by profit. This time it will be different. Maybe the Flying Five reach their natural limits, possibly aided by antitrust initiatives and customer pushback against manipulative and monopolistic behavior, and their share prices just run out of steam.

While the downside to the mega-caps isn't the same as March 2000 it is still considerable: if they were to revert from their lofty P/E of 29 to their 25-year average of 20, their share prices would drop by 31%. Individual companies, like Tesla, are much more precarious.

ARK's Hot Hand – End of a Bubble?

One of the hottest of the hot funds in 2021 was Cathie Wood's ARK Fund, an ETF investing in 'disruptive technologies'. ARK was up a spectacular 7-fold in 4 short years from 2017 to April 2021 when it peaked at $156/unit (data from YCharts unless noted). Assets under management were $27 billion, an astounding $25 billion of which flowed in in just the 12 months before the peak of April 2021. Wood was pictured wearing a T-shirt 'Queen of the bull market' (FT 12/21). Stuff like that is the kiss of Death.

The fund was hitting all the right buttons for new-age investing. ARK's top holdings are a who's who of haute-couture investment fashion: Tesla, Zoom, Teladoc, Coinbase, Shopify, Twitter, and Robinhood among others. Tesla was making hundreds of millions flipping Bitcoin, of all things, and from carbon credits in the US cap and trade system. That's as crazy as it sounds.

(I love Robinhood: it offers investors zero fees and no commissions – but it does so by directing its investor trades to rapid-trading brokers, who make so much money front-running investor trades that the brokers write Robinhood massive cheques, called 'payments for order flow' in the jargon, according to the FT, Economist, and others. It used to be called 'front running', but now it is called 'rapid trading' and 'price discovery'.)

The bloom is coming off the rose as I write. From its peak of $156/share in April 2021 ARK is now about $87, a loss of about 45%. In seven months. (Compare that to your portfolio). All 44 holdings in the ARK Fund are off their peaks, only six are down less than 20%, about half have fallen 50% and five are down more than 70% (FPost). Without Tesla's 44% gain, fundholders would be much worse off.

Green and cleantech investments are fast becoming yesterday's darlings, disruptive now to their investors, not so much as intended. Ballard Technology, a Vancouver battery company, had more than doubled from $21 to $53 in five months to February 2021; as I write in January 2022 is under $12, a decline of almost 80%.

Other snowballs flying across the River Styx are Lion Electric, a Montreal electric bus manufacturer and recipient of hundreds of millions of federal taxpayers' money, fallen from over $28 in June to under $14 in December, as reported in the Post. Nano One materials, also of Vancouver, designs lithium-ion battery parts and has fallen by half; Loop Energy, which designs hydrogen fuel cells has fallen from almost $17 in March to under $4 in December.

Tesla

Tesla is the darling of the electric car universe and can do no wrong. Its stock is up ten-fold in 2 years, making the company worth about a trillion dollars - more than the rest of the worldwide auto industry combined. But the chance of it being a good investment now is low. Nil, in my estimation.

Tesla is up 10-fold in 2 years because it has gone from zero to producing 800,000 cars and generating about $50 billion revenue. An amazing achievement. But it is now trading at an Earth-orbital 342 times earnings, while running into serious competition from the likes of VW, which produces about 6 million cars a year. Audi, a division of VW, produces about a million cars a year.

I'll spare you the math[2], but to justify today's trillion-dollar valuation Tesla needs to be ten times its current size. Growing a $50 billion dollar company 10-fold is a different matter from a fashionable startup where customers are super-enthusiastic about buying your cars and there is no competition.

If Tesla only manages to double twice from here (i.e. is 4x bigger), which would be another amazing achievement, and if the stock were valued at a premium P/E twice that of Toyota and VW, its stock price would fall by more than 60%. If the P/E were merely that of Toyota the stock would fall by 80%. (YCharts)

Competition has arrived. Car and Driver says Audi and Porsche are both building EVs of similar or better quality, performance, styling, and range. Tesla DNF'd a recent cross-country comparison test because of a motor failure requiring complete motor replacement. As C&D said, total motor failure is an inexcusable fault in today's market.

I'm not being bold or using a lot of IQ here. I only remember writing the same piece in April 1999 that for the price of Yahoo you could buy a fistful of established companies such as Boeing, Colgate, or Kellogg. As famous investor Yogi Berra reputedly said, 'It's déjà vu all over again'.

EV Craze

Another example of how crazy the EV sector is Rivian Automotive, a US electric pickup truck company just delivering its first vehicles. Rivian went public in November at $78. In an incredible example of investment hysteria, the stock shot to $123 November 18. This values the company at about $150 billion, which places it in the league of Honeywell, Union Pacific, Bristol-Meyers and Boeing. Currently the shares are back around $75 per share, valuing it at around $100 billion, ranking it with Ford Motor, General Electric, and Caterpillar. (figures US$)

I'm sure I don't need to spell this out for clients, but I will anyway: either Rivian is wildly overpriced at $87 and might be worth 1/20th of that, or Ford, GM, Caterpillar and GE are all mispriced and should be worth at least ten times what they are. We will see.

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2 Here's the math: T esla will sell about 800,000 cars in 2021. If Tesla remains a very profitable car company and earns profits of 10% of sales, and its shares are valued at a P/E ratio of 17 – twice that of VW (7x) and Toyota (10x), your calculator will tell you that Tesla would need sales of about $670 billion. To grow from its current $50 bn to $670 bn would require revenue growth of 50% per year for 7 years. That's just to get to its current valuation. For the stock to appreciate from here would require additional growth.

This opinion is based, not on the ethical or scientific merits behind the headlong rush to net zero or so-called ethical investing. It is because good ideas don't necessarily make good investments. To put a finer point on it, the most popular ideas are almost always the worst investments. (The ESG craze is another essay; if you are interested in ESG investing let me know and I'll forward you a draft.)

Good Ideas vs Good Investments

Be aware: the US indexes have been driven by these mega-cap Flying Five. Billions are flowing into index funds, and the more they go up, the more of them the index-followers have to buy. It's a dangerous game of musical chairs.

They aren't necessarily all bad investments: some of them will actually meet your managers' criteria for investing and may be in your portfolios now. Companies that hold promise for a far-off future may still do very well – if that future materializes.

But the danger lies in things that are not supported by value – old-school value like actual cash flow and dividends. The farther into the future the hoped-for value is, the more susceptible it is to revaluation, either by rising interest rates, or the future not materializing.

If that far-off future doesn't materialize, there is precious little value to support the stock price, and the investment will go the way of Wile E Coyote, the cartoon character who runs off the cliff, and freezes in mid-air until he looks down…

There is also the danger of regime change: the Economist commented recently that the mobile internet may be reaching the end of its golden age of growth and profitability. Already the big tech firms are being circled by wary regulators and political leaders whose publics sense the firms' monopolistic and manipulative behaviors, from video game addiction and manipulated search results, dating, and newsfeeds.

Parents, educators and psychologists are recognizing the negative aspects of screen time on people's socialization, brain development, attention spans, and ironically, ability to follow lines of logic.

Value Today

Where is value to be found today?

Your portfolios are full of companies that are well-managed, sell at reasonable prices, and have good prospects for growth.

Banks are one sector with good value. Banks do well in rising interest rate environments because their loan defaults are low, and because the 'spread' between what they pay on deposits and what they receive on loans goes up. Watch for dividends and share buybacks to increase significantly on Canadian and US banks.

Companies such as Makita (power tools) BAE Systems (aircraft flight simulators) and Advanced Micro (computer chips) are positioned to do well in the post-Covid global expansion.

The most reviled sector today is oil and gas. Popular political wisdom is that oil and gas is finished, although it is Canada's largest generator of foreign exchange and a major industry. Traditional energy is so loaded with political and ideological militancy that it is almost an untouchable third rail of discussion.

But it's my newsletter, so here goes. Oil and gas producers represent very good investment value. Suncor, for instance, has a very long-life asset in the oil sands property, and a large and efficient plant with low operating costs. Suncor and the other oilsands producers don't have to drill expensive deepsea wells or build costly production platforms. Compare Suncor's P/E of 21 to Tesla's 342. And it pays a dividend of 5%.

Chevron and Exxon sell at dirt-cheap P/Es of 13 and 12 and pay dividends of 4% and 5% respectively. Canadian pipelines are also excellent value. TransCanada, Pembina, Enbridge, Superior, and AltaGas are all well-run companies selling at reasonable prices and pay dividends of 5%-6% except AltaGas which is only 4%.

Turns out that fossil fuels aren't going away just yet: the EIA (Energy Information Administration) a nonpartisan US government agency, projects global fossil fuel consumption to increase for at least the next 30 years (although a declining percentage of the total mix). It also seems that the underinvestment in energy production of the last few years is running into the persistent demand for reliable and inexpensive energy, which is driving the price up sharply and making life profitable for energy producers. The irony, of course, is the more you restrict something that has persistent demand, the more profitable it becomes.

Glencore, a major global mining company, spun off its south African coal assets into a separate company, Thungela Resources. The goal, of activists such as Bluebell Capital anyway, was to starve coal and shut it down. Unfortunately, the coal business is alive and well, driven by poor countries where modernization is more important than political correctness, and Thungela's share price promptly quadrupled (now merely tripled).

Looking Forward

The idea of looking forward into an unknowable future deserves its own essay. In the meantime, clients know that I do not pretend to make a forecast. Our investment strategy is not dependent on a particular market view materializing. But I do believe it is worthwhile to have a weather-eye open. Flying blind is no smarter than pretending to know the future. The wise navigator is somewhere in between.

My theme in the last several newsletters is that the global big picture is good. Very good, although there are dangerous currents behind the scenes.

The world economy is set to boom: consumers are in very strong financial condition thanks to government transfers, the pent-up demand jamming short-staffed production and supply lines. People are itching to get back to normal lives.

The US market is around the high end of its valuation range, but several factors mitigate the risk. High valuations are an indicator of risk, but they tell us nothing about timing. As we saw with the Greenspan 'Irrational Exuberance' story, high valuations can persist for years. Valuations are high today because the outlook is good. And strong earnings growth is bringing valuations down quickly. (JP Morgan)

Secondly, market valuations today are distorted by some companies, such as Tesla, that have sky-high valuations. Your managers are avoiding these high-risk situations, and are concentrated in the more modestly valued firms.

Inflation

Inflation, the panic du jour currently dominating headlines ('highest inflation in 40 years!!'), is a hazard of central banks printing money. The recent price spikes give the risk credibility. But it is important to distinguish between price shocks, which are temporary, and underlying inflation, which is a longer-term thing caused by debasing the currency.

Inflation today is wrestling with deflationary forces driven by aging demographics that have dominated world economies for the past two decades. At the moment it appears the price spikes are the result of strong consumer demand hitting supply constraints as pandemic restrictions are lifted.

A great example is the car market. Production shortages of the microchips used in cars to control everything from power windows to fuel flow have constrained car production, leading to very strong prices in both new and used cars, and driving (sorry) a 9% increase in the CPI automobile subcategory.

The microchip shortages are temporary, caused by covid-related slowdowns, says Drummond Brodeur of CI Global Investment. Watch for the big inflation numbers to fall out of the year-over-year CPI as these shortages are resolved. This will lead to a sharp drop in inflation, and possibly a reversal as prices normalize. A year from now, the fear will be recession and deflation.

Normally, inflation getting traction would be signaled by rising longer term interest rates in the bond market and by the price of gold. Gold is showing no concern about inflation. Unfortunately, the bond market has been artificially distorted by central bank quantitative easing (QE). As the US Federal Reserve cuts back its QE program in the next few months, the bond market will give a clearer signal on inflation.

Rising Interest Rates

Rising rates are not necessarily a threat to stocks. Rising rates are normal in strong economic conditions, and corporate earnings do well in a strong economy.

Today, interest rates have been suppressed by central banks and are below inflation in most modern economies. This is the economic equivalent of putting the gas pedal to the floor. The central banks will be raising short term rates (the only ones they can control) just to take their foot off the gas.

The first 2 or 3 or even 4 small interest rate hikes won't be the issue. The danger - of hitting the economic brakes - will be the 5th or 6th hikes, says Drummond. As long as rates don't rise too far too fast, stocks can continue to post strong earnings growth. The Fed is very sensitive to the fact that the danger of a policy error – raising rates too far too fast – is his to make. Chair Powell is going slowly on rate increases because he is well-aware of all this.

Bigger Picture

There is much good news to brighten the coming years. We are winding down a global pandemic. It wasn't nearly as bad as it could have been: it wasn't smallpox, or Bubonic Plague. There is no permanent damage to the global economy or political order. There are no major wars.

The really good news is that two and a half billion people – almost half the population of the world – are under governments that are actively improving the lot of their people. Never before in history have so many people made so much progress.

India and China are trying to move forward by adopting liberal market principles, if not fully functional democracy. The Chinese have a very strong merit-based system for public administration, and are making tremendous progress educating their people in math and sciences, which are fundamental to progress.

This is totally different from the Marxist Maoist Leninist Stalinist regimes of the past, which consciously destroyed their societies' brightest lights. Mao and Stalin and Pol Pot murdered tens of millions of their own people, cynically killing off their countries' chances of economic progress. Only North Korea, with no hope of escaping poverty, remains of that cadre today. (The destructive revolutionaries today are the authoritarian and radical racists, cancel culture wokists and environmentalists in our own country, but that's another essay).

The potential exists for a golden age of advancement in global standard of living, if we let it. Regardless of what you might think of such as world, it is highly likely that the fortunes of the world's top 500 companies will participate in a share of that growth, and prosper.