WARATAH

Brad's Musings

Stand-To!

For 30 minutes before dawn and 30 minutes before dusk, it is standard operating procedure for soldiers in a defensive position, such as a trench, to take up ready positions and prepare for an enemy attack. The order that is called out is "Stand-To". It is also called out at any time by any soldier who sees or hears something during the night. It is quickly passed down the lines with each "Stand-To" getting fainter as the words travel. It doesn't matter how tired the soldiers are or how many false alarms have previously been called out; a "Stand-To" is always treated the same way - with a seriousness that your life depends on. If there is such a thing as a financial equivalent of a Stand-To, I am shouting it now. Something is coming, I don't know what or when, but it feels close at hand. I may be wrong or early and we could be heading to a blow-off top in the equity markets. Regardless, I'm not buying into it.

I served for six years in the Canadian Army as a reservist. Fortunately, I was never deployed and I was never exposed to the risks and hardships that so many of our soldiers face. I am grateful for what these exceptional men and women, and their families, do for us. Without exception, my time in the military was the single best learning environment I have ever experienced. As a civilian it is easy to ignore risks, avoid thinking about infrequent events and to casually dismiss the idea of our own mortality. Have you ever ignored a fire alarm at work or at least delayed leaving the building hoping that a voice would come on the speaker to announce it was just a drill? I know I have and I suspect most people can relate to this experience. Now, if you're old enough, can you remember how you felt and acted during that first fire drill after the September 11th attacks? I remember walking down 46 stories to the ground and the whole time my thoughts were with those who perished and I wondered why this was the first time I had ever actually gone down the stairs during a drill. I wanted to get out of that building as fast as I could and I promised myself I would always take these drills seriously henceforth. That feeling, that level of action, purpose and seriousness is what the army teaches. We poor ~~investors~~ civilians are probability weighing machines and we just can't help ourselves. After 18 years and 50 or so fire alarms we become complacent and numb. Not in the army. Soldiers train for the worst possible and most unlikely events and situations you could ever imagine because that's their job. If you have any friends who are firefighters, police officers or soldiers, notice how they park their vehicles. Almost without exception you will find they back into their driveways. This is the only logical way to park. In the event of an emergency you need to get somewhere fast and you don't want to waste time backing out when every second counts. The principle of efficiency shows up everywhere in army training. It's the reason why soldiers set a routine at bed time that minimizes the time needed to get to a fighting position in the field or into uniform and ready for inspection while in the barracks. Every army in the world and throughout all of human history adheres to these principles of efficiency and preparedness. The best way to describe this philosophy is as an "abhorrence of complacency". Soldiers think and act this way because they are conscious of what is at stake – their lives and the lives of their best friends depend on it.

With that sobering context, let's now turn to the job you have hired me to do and why I am calling a Stand-To. I have never seen more complacency in the financial markets in my entire career. There is a long list of incredible, sometimes contradictory and outright "weird" stuff going on; negative interest rates all over Europe going out as far as 50 years; a flip-flopping Federal Reserve eager to cut interest rates ever closer to zero despite equity markets at all-time highs; the lowest unemployment rate in over 50 years yet no signs of inflation; an uncertain but inevitable divorce between Britain and Europe; a realignment of the post-war system and an emerging Cold War between the world's two superpowers; our "allies" murder a Washington Post journalist, get caught red-handed, and we collectively pretend it didn't happen; China kidnaps multiple Canadian citizens and locks them up in rooms where the lights are never turned off and we yawn; asset bubbles have formed in technology, cannabis, veggie burgers and boring old utility and real estate stocks; large government deficits in the US and Canada despite the longest un-interrupted economic expansion in history; and an obvious lack of strong political leadership everywhere. Just to emphasize the absurdity, consider that the 10 year Greek Government Bond recently traded at a yield of only 1.99%, which is lower than even the "safe haven" US Government 10 year bond yield. It was in 2012 that these same Greek bonds traded at 25% yields and as recently as 2016 they were still yielding as high as 15%.

Throughout the post-2008 recovery, investors questioned how long interest rates could stay near zero. Lower interest rates make all future cash flow streams more valuable but investors were never fully willing to put zero into their risk-free rate assumptions when valuing stocks. The expectation was that interest rates would eventually normalize and this was the stated goal of the US Federal Reserve as recently as December. All it took was a 20% drawdown in the US equity markets (and constant badgering from Trump) to cause Jerome Powell to completely reverse his position. Since then the stock market has been on a rip roaring rise. Investors have finally capitulated and are tripping over themselves to put near zero interest rate assumptions into their valuation models. It has been interest sensitive sectors (real estate, utilities) and growth stocks with high terminal values dependent on interest rate assumptions that have led this market rally. The asset bubble is inflating as you read this. You can see for yourself in the Appendix attached to this musing and keep in mind that those are the stocks I own (you wouldn't believe the valuations on the ones I am short).

The bottom-line is that I see rising risks, an irrational market and a hubristic attitude of complacency. Practically speaking, this means I will continue to buy put options to protect against a major drawdown. It's hard to accurately measure the cost of this put protection because some of the cost is offset by gains in our long positions that are bigger than they otherwise would be without the protection. At this point, I am happily willing to invest a few hundred basis points per year to maintain this protection. The trick is to do so efficiently, which means buying protection when it is cheap and when it is most needed. The former is easy to identify but the latter has always been more art than science.

I have never considered myself to be a 'gold bug' and there have only been a few instances in my career where I've paid much attention to the commodity or the stocks that produce it. However, gold does tend to perform well during periods of uncertainty. Two great unanswerable questions at the moment are: when will the next recession happen and what will central banks do to stimulate a recovery when cutting interest rates is no longer an option? Ultimately, I worry that central banks will or have already started to engineer a competitive devaluation of their currencies. My fears may be unfounded but it's a scenario that seems plausible, and it is for this reason that I am long gold and own a few gold stocks in multiple portfolios as an insurance policy.

I am on watch and I am not leaving my post. However, there is a meaningful risk that "it is different this time". Perhaps I am too old fashioned or simply too stubborn to see the new ways of the investing world and the untold riches that await equity investors once all bonds go to negative yields. If you believe we are heading for the ultimate blow-off market top that will finally entice all the non-believers to join the party, then you probably should have your money invested in a passive equity fund or an active manager who is a believer. If you want someone on Stand-To, whose mission is to survive and prosper from whatever is coming, I am your man.

Brad Dunkley

29 July 2019

Appendix A

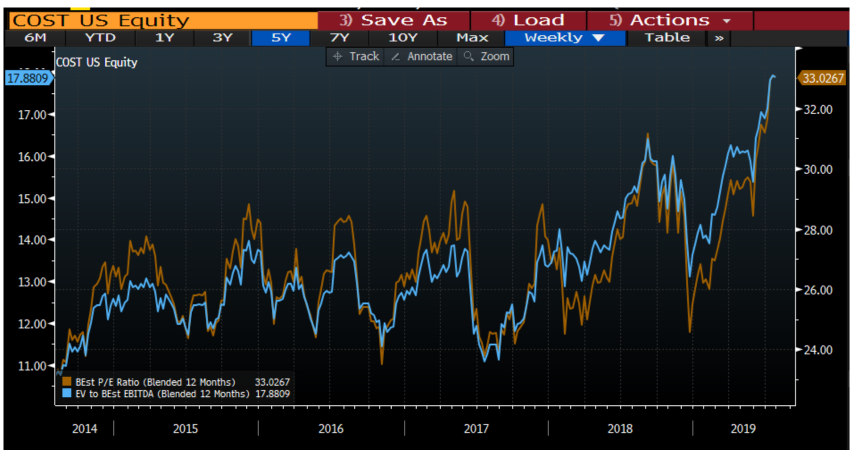
I have put together a series of charts that show how valuations have expanded over the last few years. These are not your typical stock charts. Instead of showing how a stock's price has changed, these charts show how P/E and EV / EBITDA valuations have change over time. All of these stocks have at least one thing in common: I own all of them in the Waratah funds that I manage. For most of them, I can't defend the expansion in their valuations. I continue to own them for two reasons: 1) they keep going up and 2) I'm short other stocks that make these stocks look like bargains on a relative basis.

Canadian Apartment REIT

This REIT owns apartment buildings in Canada's biggest cities. It has great supply-demand fundamentals. In 2015, I could buy it for 19x EBITDA and today it costs 25x EBITDA.

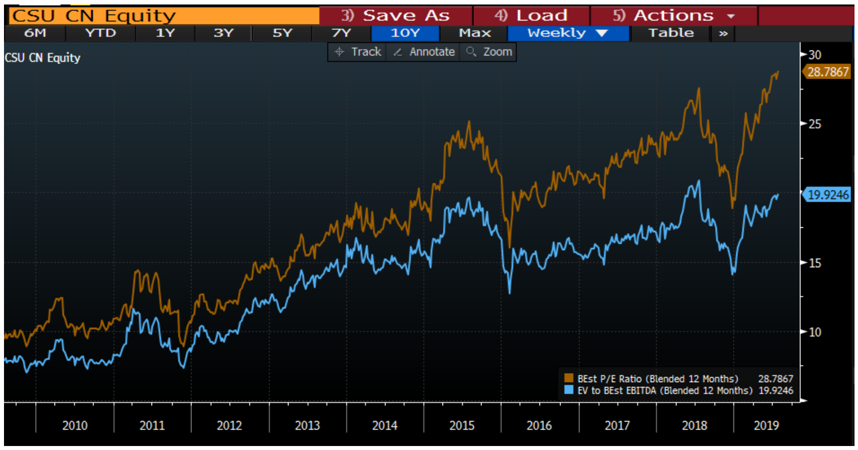
Costco

It's a great long-term compounder and it has no net debt. I have a high degree of confidence that it can grow its earnings in the range of 7%-9% per year on average. So does everyone else. In 2015 I could buy this business for around 12x EBITDA and today it costs almost 18x EBITDA.



Constellation Software

I've owned this name for so long that I remember when it traded for less than 10x EBITDA. Today it trades for 20x EBITDA despite growing slower than it used to. It's still a great company with fantastic free cash flow conversion but it costs twice as much as it used to for less growth today.



Cintas

Cintas is the largest supplier of uniform rentals and laundry services in North America. It has a nice recurring revenue business and it doesn't have many competitors with scale. As long as we don't get a recession, I expect its EPS to compound at 10% - 12%. Unfortunately, this used to be a 15x P/E stock and now it trades for 30x. On EV / EBITDA it used to trade at under 10x and now its 18x.

Danaher

Danaher has been a consistent earnings compounder for decades. It is a diversified industrial in the life sciences, environmental and diagnostics business. Until 2016 it was available for 15x P/E. Through 2018 I could still buy it for 20x P/E. Today I have to pay nearly 28x P/E to own Danaher.

Equity Lifestyle Properties REIT

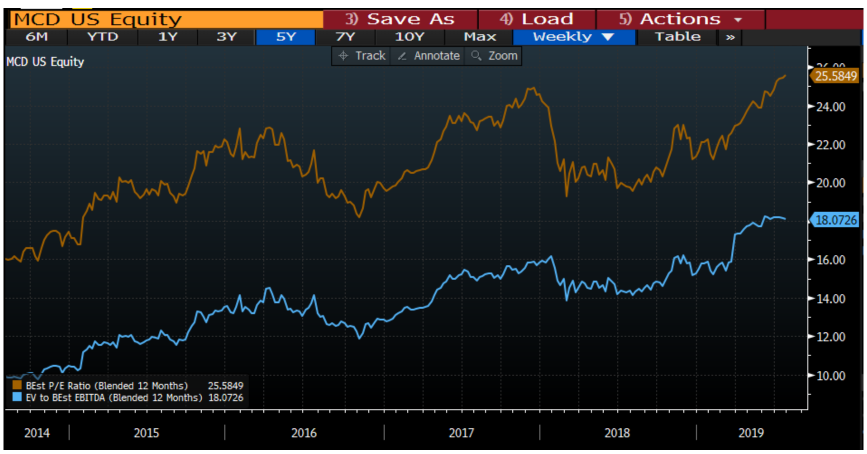
ELS is the largest owner of manufactured housing communities and RV Resorts in North America. I love this industry due to the combination of strong demographics and restricted supply. Unfortunately, ELS now trades for 27x EBITDA compared to 16x as recently as 2014. The increase in public market valuations is one of the reasons we decided to launch Summerhill Resorts to buy private assets at much lower valuations.

Mastercard

Mastercard and Visa are two of the most beautiful businesses ever. Everyone knows this and they are easy to love. Since 2015, 15x EBITDA has become 26x EBITDA and 25x P/E has become 34x P/E.

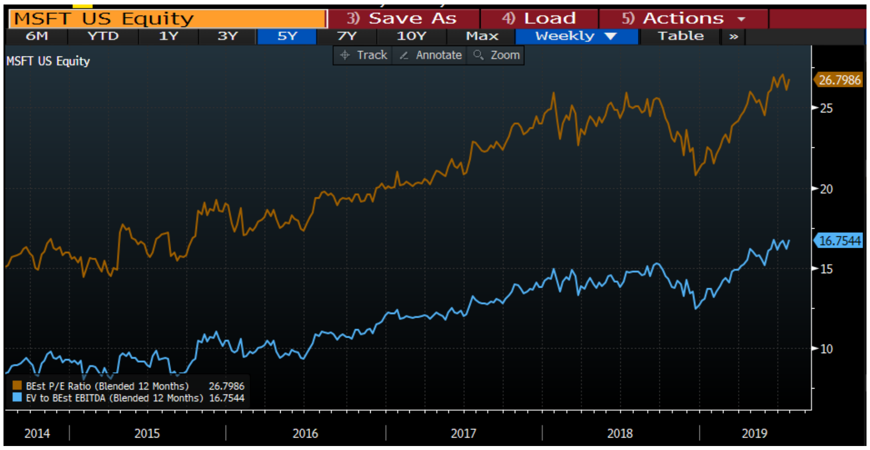
McDonald's

McDonald's has the highest sales per restaurant in the quick service industry. This gives it a tremendous advantage when it comes to labour costs, product innovation and technological roll-outs such as digital kiosks and home delivery. In 2014, I could purchase McDonald's for 10x EBITDA and today it costs me 18x EBITDA.



Microsoft

Microsoft has had great success converting its legacy software business into a recurring revenue subscription model. With its cloud computing business, Azure, it has become a strong challenger to Amazon's AWS business unit. What was once 15x P/E is now 27x.



Planet Fitness

Planet Fitness is the dominant gym franchise in North America. Its capital light business model leads to high free cash flow conversion and it has room to open many new locations. We've owned this stock for about 18 months. In that short time its price has gone up 140%. It was trading around 17x EBITDA when we first bought it and today it is over 28x EBITDA despite no change in its growth rate.

Roper Technologies

Roper has been a favourite name for years. What's not to like with 65% gross margins, 35% EBITDA margins and capital spending of just over 1% of sales. Roper is a free cash flow machine and they keep buying great businesses with the retained cash flow. It's still the same Roper and our growth expectations have not changed but it now costs almost 22x EBITDA up from 14x as recently as 2016.

Notes:

- All stock price and return information sourced from Bloomberg.
- All company-specific financial information sourced from SEC filings, investor presentations, quarterly earnings conference calls, investor communication materials or Bloomberg.

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