January 2021

Don’t Bet Against the Home Team

Conditions appear very good for equities heading into 2021. Making money in bonds is very difficult. Deposits in banks in Europe, the U.K., Japan and elsewhere “earn” negative returns. Borrowing costs are near or at all-time lows. Governments are spending trillions to stimulate economies. Meanwhile, globalization and technologies are concentrating profits in corporations and a greater number of individual investors are entering the market at a time when the number of public companies has shrunk. Markets have momentum, comparisons are easy, and investors aren’t requiring fast growing companies to show a profit.

Three Lessons

Ever since the Housing and Financial Crisis (2007-2009) we’ve been on the look-out for hidden structural factors that influence moves in financial markets. We keep coming back to three lessons we learned in the crisis. During the lead up the bursting of the housing bubble, we felt sure that the housing prices had become unreasonable. However, we didn’t understand the mechanism by which excessive speculation had infected banks and created a serious systemic risk*. This taught us our first lesson which is to actively search for underlying structural factors influencing stock prices. The resolution of the crisis was set in motion when the Federal Reserve stepped in to solve for losses in the banking system generated by the housing crisis. In this was the second lesson: the capacity of central banks to stabilize markets is vast and profound. Lastly, we worried at the time about ballooning public debt and deficits, which did little to aid our investment decision making. This brought us to the third lesson: Entertaining existential fears about the market doesn’t pay. Leave the black turtleneck and beret at home.

Not Quite as Simple as Supply and Demand but…

What are the applications of the above lessons to the current market? As best as we can tell, there are multiple structural factors coming together simultaneously to drive equites higher. Many of these are tied to low interest rates and the promise of sustained low interest rates. Leaving aside a discussion of how lower interest rates increase the present value of future cash flows (you’re welcome) consider instead that there are currently $18 Trillion of sovereign (government) debt with negative yields. Bank deposits in Switzerland, Denmark, Japan, all euro-zone countries, and the U.K. are also all getting dinged and lose money daily. (Take a minute and think through the consequences of long-term negative compounding. Ask yourself who might be signing up for this outcome.) It is not much better in the U.S. The average interest rate on U.S. bank savings accounts is currently 0.05% according to the FDIC. There are currently about $9 trillion parked in U.S. savings accounts. Euro-denominated accounts have about €10 trillion, according to the internet. Both figures understate the colossal piles of money that are either earning next-to-nothing or less-than-nothing. (They don’t include certificates of deposit or money market funds, for example.) Regardless of the actual total, simply adding negative yielding sovereign debt ($18T) to U.S. bank deposits with no effective interest ($9T) and euro-based money-losing bank deposits (US$12T) gets us a total of $39 trillion of useless investments, without even factoring in the sorry savers in British Pounds, in Japanese Yen, or in the currencies of other assorted countries. Now consider that the total value of all U.S. public companies (which represent more than 50% of total global equity markets) is currently about $36 trillion. Also note many of these companies pay dividends to shareholders with

*Collateralized debt obligations and credit default swaps. If you’re lucky in life you’ll never have to encounter those phrases again.

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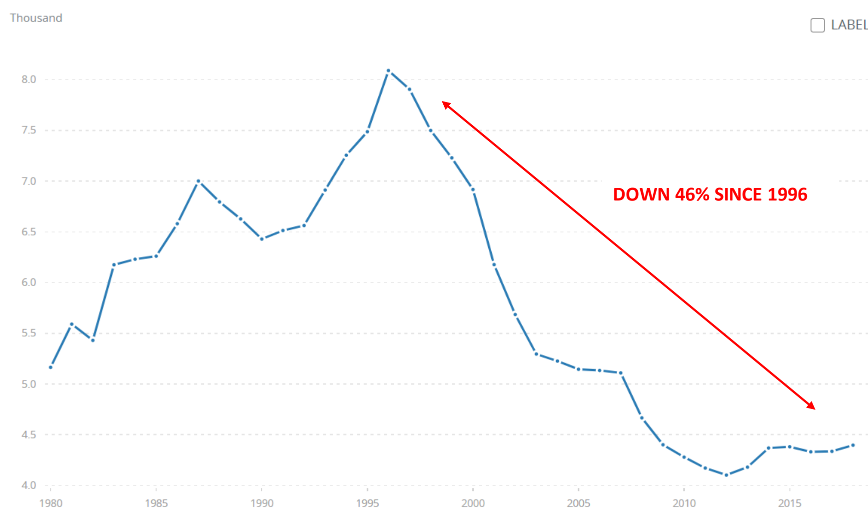
the S&P 500 currently producing a dividend yield of 1.6%. Might some of the holders of negative or zero-yielding deposits decide to shift their funds into U.S. equities? The relative sizes of these asset classes suggest it would only take a small percentage to result in a material move in U.S. equity prices. Likely this has been a factor for some time in the strength of U.S. equity prices (we don't have the data to prove it) but our point here is that we expect it to continue.

But There is More

Just in time for funds to switch into equities, there are a lot less of them to go around. Above, we tried to quantify one of the structural conditions stemming from ulta-low interest rates that we believe has supported rising equity prices. There are additional factors. Among these has been a decline in the number of public companies. We won't get into the reasons for the shrinking number of public companies, but will instead simply point out that between 1996 and 2018 (the most recent data we have) the number of public companies was reduced by nearly half (see figure below). That's right, there are trillions of dollars' worth of negative or zero-yielding funds looking for a better home and a much smaller pool of potential companies to call their very own.



Source: The World Bank

Are High Valuations Really That Surprising? No.

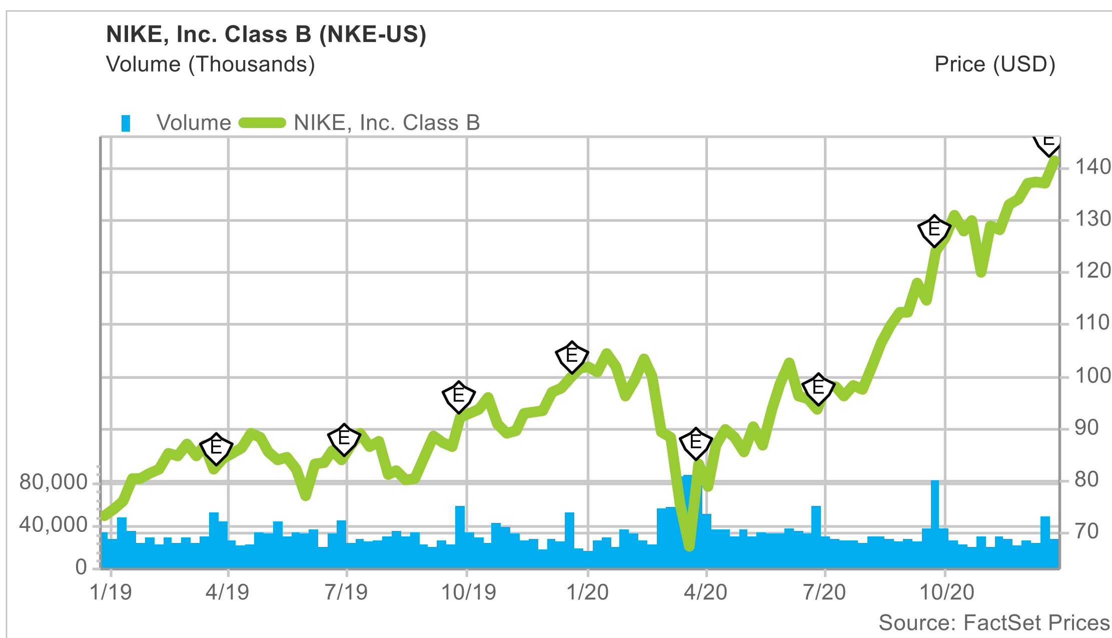
Add technology and globalization of consumer culture to the mix and it's a recipe for massive stock values. Even before government stimulus spending and negative yields, market dynamics were changing due to business model shifts and changes in global cultural norms. The use of technology both in the business world and by consumers created global platforms enabling the rapid spread of ideas, the homogenization of consumer behavior, and global scale and growth. Companies benefited either by supplying the technology or by adapting existing distribution and taking advantage of digitization of the consumer on these platforms. The result has been faster access and deeper penetration in existing and new markets for leading businesses, all of which support higher profits and justify bigger valuations, in our opinion.

2020 Contained a Big Test of Investment Strategies

Did you panic and sell at the wrong moment? No one was predicting Covid19 at the start of 2020 and if they tell you otherwise you should not believe them (ahem, Bill Ackman). However, the market's March dive did provide a test of risk-management strategies and personal investing fortitude in the face of volatility. Did you mistake diversification for a risk management strategy? Did you try to "limit downside" by reducing exposure after stocks had already gone down? Our approach to risk management is different. We believe by owning the best companies that are managed by the most talented individuals that have the strongest brands, the biggest competitive advantages, superior business models and the best global growth opportunities, we can effectively offload market-related risk to our investments. After all, the collective knowledge within these businesses is much deeper than anything we would ever hope to acquire on our own.

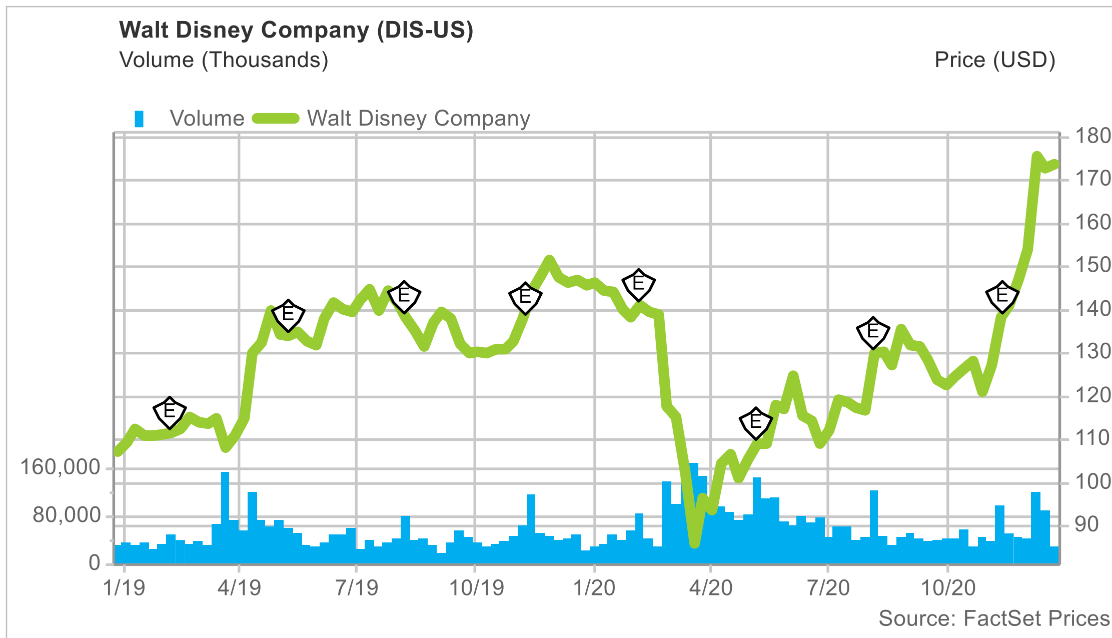
Business Model Transformation Cases Powered Gains

Nike (NKE) and Disney (DIS) are cases-in-point. We've owned both NKE and DIS in our client portfolio since inception and written about each company in previous newsletters. We believe Nike and Disney are two of most well known, most respected, and most powerful global consumer brands. They are also two companies currently undergoing business model transformations that we expect to accrue value to shareholders. In Nike's case, the company's business model is shifting to a direct-to-consumer distribution strategy from a wholesale distribution strategy. In the wholesale model, Nike marks up his products to sell to retail partners, which in turn add another mark-up to sell to the end consumer. In the direct-to-consumer model, aided by the digitalization of the consumer, Nike sells direct to the end consumer at the same price as its retail partners, keeping both mark-ups. This is partially offset by higher distribution expenses but the net is a higher overall margin. A business that is undergoing a favorable structural shift in margins grows profits faster, generates higher financial returns, and increased cash flows, all conditions that correlate and justify a higher stock price and valuation.



For Disney, the transformation is related to shift in distribution of movies and sports content (DIS owns ESPN) via subscription based streaming services (Disney+ and ESPN+) from landlocked cable, third party streamers (Netflix) or in theaters. The growth in these offerings has been shocking with Disney+ signing up 87 million in

the first year. DIS' success with streaming surprised the Street, sending shares to an all time high, even as most of the theme parks remain closed or at reduced capacity due to Covid.



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Yours,

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Mr. Zolidis started his career in finance in 1996 following degree studies in Philosophy at Kenyon College and the University of Oxford. He has followed U.S. consumer companies as a senior analyst since 1999, mostly on the sell-side, writing research for institutional investor clients. He also managed money in a buy-side role at a long-short equity fund over 2013-2014. He was named in the Wall Street Journal's Best on the Street list in 2005. Mr. Zolidis founded Quo Vadis Capital, Inc., a Registered Investment Advisor (RIA) and research consultancy, in 2017 and works from New York and Paris, France.

Aller-Retour de Long Island, New York. I did manage to get back to the U.S. during the first two weeks of December but after suffering three Covid brain-swab tests and several menacing messages from the NYC Sheriff (warning me to quarantine or face a large fine) we had to cancel our planed Holiday trip to Florida. Additionally, my usual January investment conference in Orlando has gone virtual. I'll

tune in from Paris or the French countryside but I will definitely miss the sunshine. Speaking of the countryside, together with my in-laws, we are currently restoring a previously uninhabited stone home in our village. To an American, these properties appear totally unsalvageable. By unsalvageable, I mean borderline death-trap. To illustrate, I found the below magazine featuring a long-forgotten Swedish star and which dates to 1936 in a pile of detritus in the back of the house behind. My amateur archeological conclusion is this means the house *had already been* a ruin 84 years ago. Despite that, some of these previous residents were well ahead of their time. Another home restoration in the village featured a space for livestock on the ground floor, outdoor cages for rabbits and chickens in the garden, its own well, and a tower with framework for raising silkworms (possibly to make clothing but more likely to sell) and normally each property had access to a plot of land in the valley for growing vegetables and fruits. I am pretty sure our restoration efforts will not reproduce anything as sustainable.

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