Noah Blackstein on the Dynamic National Advisor Call

May 10, 2022

On May 10, 2022, Vice President & Senior Portfolio Manager, Noah Blackstein CFA, spoke about his outlook on the markets and the opportunity he sees for growth stocks over the longer-term.

When investing in stocks for our portfolios, we always start with our disciplined, repeatable bottom-up investment process that we have employed over the past 25+ years. There have been a number of mutual fund companies launching growth funds, (or what they call growth funds), without the track record or experience we have had, as they wanted to capitalize on a hot sector at a certain period of time.

It's not unlike what we saw in the late 1990s, when several Fund companies appeared and then disappeared in the 2000-2010 time frame. Having begun managing Dynamic Power American Growth Fund since its inception in 1998, I was managing growth funds at that time and saw these companies launch and then close, while we are still managing funds today because we stuck with the same investment process we have always employed and didn't waver from that process during difficult periods for growth stocks.

Why is that important? Most Portfolio Managers or investors could have simply rotated into energy stocks before they went down 13% and chased the relative strength in the consumer staples and utilities, (before they went down a lot today). That's not hard to do. If you're paying 50 times earnings for a breakfast cereal company or 38 times earnings for a company growing 2% per year because you somehow think it will have low volatility and is unlikely to decrease in price, that's not a disciplined investment process, and that's not someone looking out over the next five years.

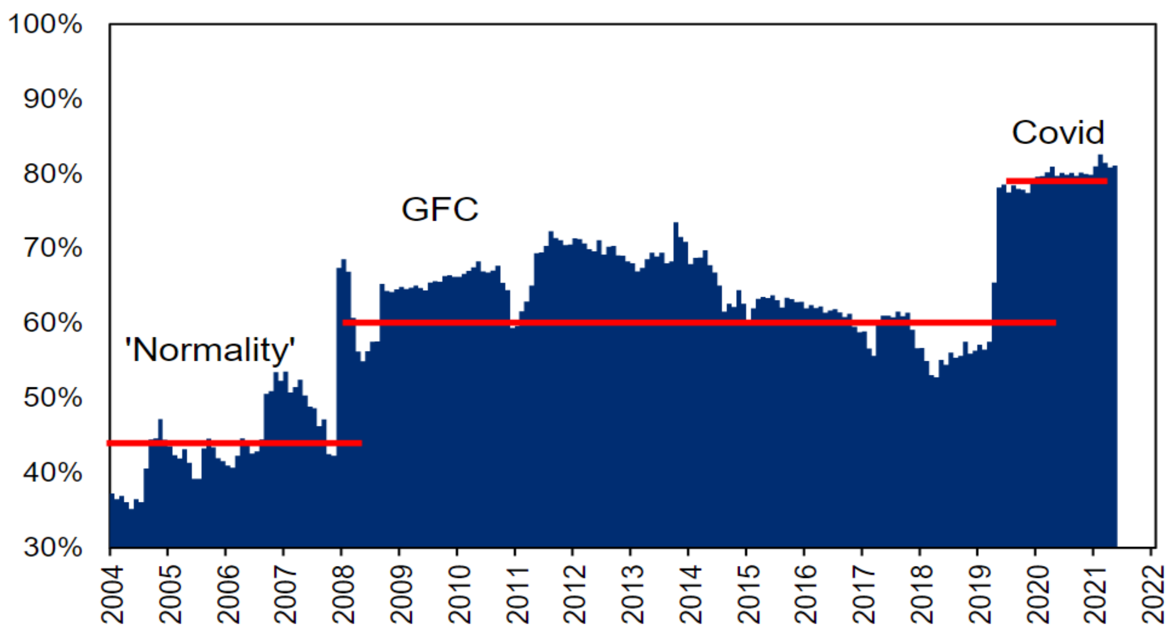
Our bottom-up investment process begins by looking at a universe of around 5,000 companies. We screen those companies quantitatively, looking for high teens or better revenue and earnings growth. Those companies are in the rapid phase of their growth. They are companies that can become significantly larger companies. Companies growing at 3%-5%, can be tripped up if one little thing goes wrong.

We're looking for companies that have a large addressable market opportunity (the overall revenue opportunity that is available to a product or service if 100% market share was achieved), in front of them. We're looking for companies that can go from $500 million to a billion, to $10 billion in overall sales. Once we narrow the list down, that gets us to about 100 to 150 stocks, and then we employ our fundamental due diligence to figure out the length and width of the runway that the company has ahead of it. We want to try to determine what these companies can earn over the next three to five **years**, not over the next three to five weeks or three to five days. If you were looking out over the next three to five years, you most certainly wouldn't be focusing on a breakfast cereal company.

There are portfolio managers who must be invested in many if not all sectors, to protect themselves against perhaps going down a little bit farther than their benchmark in a bear market. We believe that what investors should be doing in difficult periods of time, (and I'm speaking from the experience of having managed through two of the worst three bear markets in history), is focusing and concentrating their portfolios even more, especially on the names with a secular growth opportunity (secular growth occurs when something fundamentally changes within a sector or industry, creating a wave of new demand).

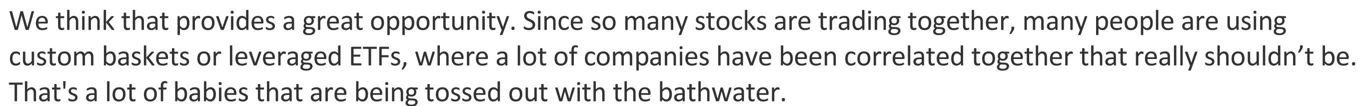
Since 2018, both Amazon and Tesla have experienced six peak to trough corrections of 20% or more. During those periods, the average correction was 27% for both companies. Since 2018, Amazon is still up 300% and Tesla is up 2,800% during that time. Selling companies like those each time they pull back and not understanding what the companies do, is where investors can lose money overall. You won't be able to make a strong return on a stock every time it goes down more than 10%. That's not how longer-term investing works.

Similarly, that opportunity presents itself with growth stocks today. The graphic below provides one of the reasons why we have found the recent period to be quite interesting as it shows the impact of macro or non-company-specific factors on stock prices. You'll see the period of normality from 2004 to about 2008, and that during that period, roughly 45% of a stock's movement could be explained by macro events. 55% to 60% of it was explained by idiosyncratic or stock-specific reasons.



Source: Citi

Coming into QE (QE - quantitative easing - the introduction of new money into the money supply by a central bank) and the Global Financial Crisis changed what a stock's movement was based on with about 65% of a stock's movements being based on the macro. You still had about 35% - 40% based on individual stock price performance. You'll see that when QE ended around 2012-2013, that began to normalize once again, and approximately 50% to 60% of a stock's performance was based on stock-specific factors and not macroeconomics. You'll see also in the pandemic period (COVID), stocks are moving together based on macro, like we haven't seen previously. Today, about 80% of a stock's price movement is based on macroeconomics, and less than 20% is based on a stock's fundamentals.



We think that provides a great opportunity. Since so many stocks are trading together, many people are using custom baskets or leveraged ETFs, where a lot of companies have been correlated together that really shouldn't be. That's a lot of babies that are being tossed out with the bathwater.

With our disciplined, bottom-up, investment process, we can focus in on real growth companies. (A growth company is any firm whose business generates significant positive cash flows or earnings, which increase at faster rates than the overall economy. Real growth companies have actual or anticipated records of growth). The reason why we recovered so much and so fast from the 2001-2002 market experience, was due to sticking to our investment process. We found new growth stocks, such as Whole Foods, and we found the companies that were continuing to grow, such as Amgen, Genentech, Apple, or eBay in 2002. The stocks that are going to go to new highs first, will be the ones that continue to demonstrate strong fundamentals. Many investors today are piling into expensive consumer staples companies with no growth, or they are moving into utilities companies. In the S&P 500 Utilities index, 20% of the companies are paying yields that they are not earning. They are borrowing to pay their dividends. We don't know how that makes an investment safe, but apparently, some people must think it does. That can change quite quickly.

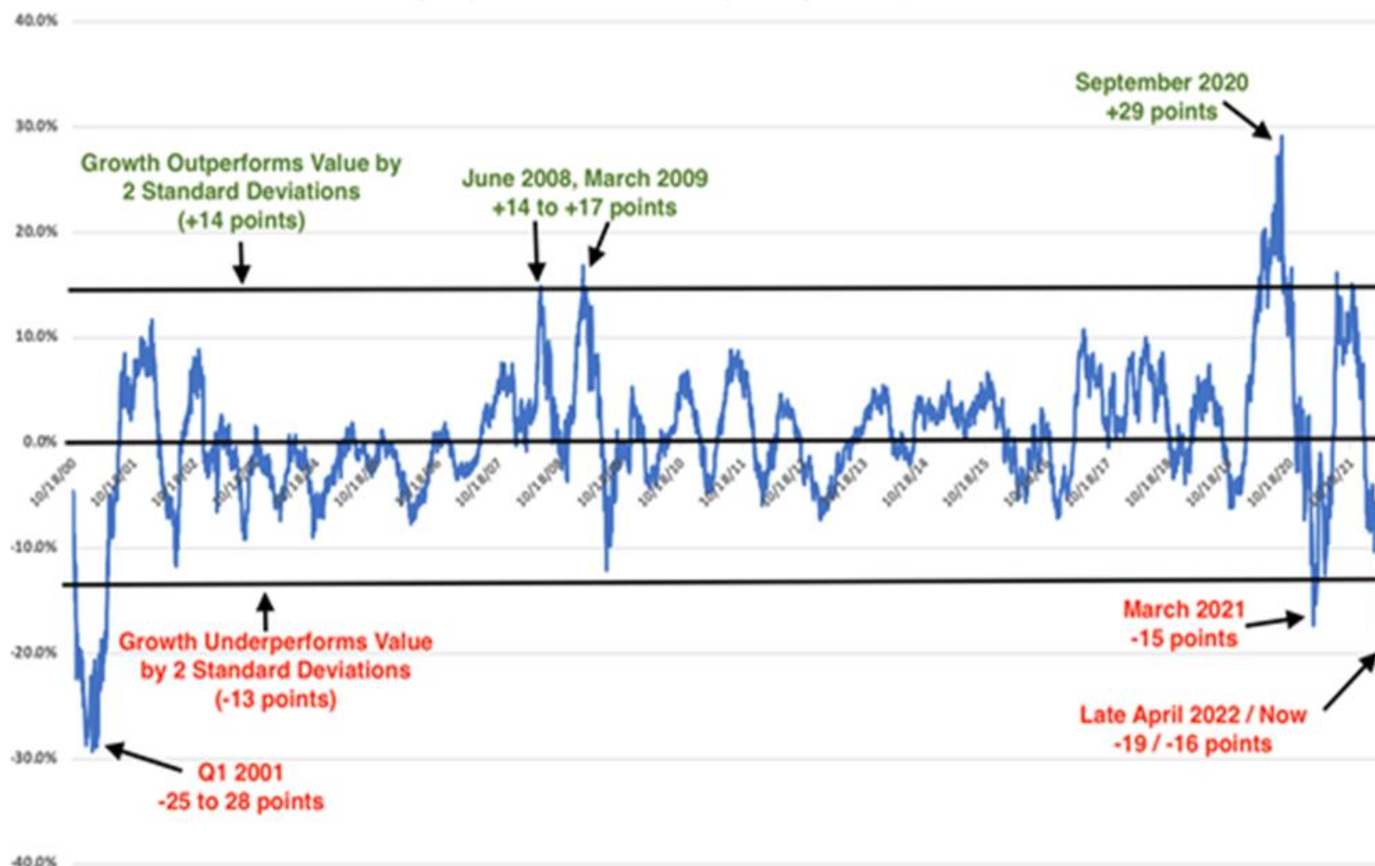
Biohaven Pharmaceuticals with their next generation of migraine drugs, was one of the more interesting biotechnology companies out there. Recently, they engaged in a partnership with Pfizer. Many money management shops have people that are part of a risk control group. They might say to a Portfolio Manager: "We think the price-to-earnings ratio (P/E ratio - the ratio for valuing a company that measures its current share price relative to its earnings per share), or the beta on your Fund is too high and it's a risk-off market." We don't have these people discussing those types of things with me. Back to Biohaven Pharmaceuticals, which was down over 40% in the last two weeks, based on many investors thinking that it was expensive because it was a biotech stock. On the morning of May 10th, Pfizer made an 80% premium bid for the stock. I'm sure the people who sold for risk reasons, don't feel great about selling it after the 80% premium paid for the stock by Pfizer. Pfizer pledged to buy $25 billion worth of revenue over the next five years. Biohaven Pharma only covers 20% of that, and so I believe growth remains the scarce commodity.

We've come through a unique period, and the single largest contributor to the year-over-year inflation numbers was Congress sending out stimulus cheques in March of 2021, that were completely unnecessary. The $1,400-$1,500 windfall for many people, coupled with tight supply chains, spiked goods inflation. As we look forward, we don't see the major aggregate demand to drive nominal GDP growth to 11% as it was last year. I don't think that will happen again for a long time. The free money that came out from the government is not still happening and in fact, it's reversing. Companies that can truly grow are going to become scarcer and scarcer commodities going forward just like they have been for the previous 10 years.

The chart below shows large-cap growth stocks versus value stocks on 100-day trailing returns from 2000 to the present. This was not updated for yesterday's move, but you can see the move that we've had in such a short period of time in terms of growth versus value. These are really growth factors versus value factors. Many value quantitative companies are basically looking for companies with a low price to book, a low price to sales, positive estimate revisions, and strong price momentum. I believe that Value investing is basically momentum investing with low P/E multiples; this is sort of what these value quantitative shops are doing. To me, real value investors would be looking at the over 200 biotechnology companies that today are trading for less than cash. They'd be buying them 100% and they'd stop whatever they're doing, maybe out-license a drug, and just pay themselves the

cash. To me, that's value investing the way well know value managers such as Peter Cundill and Michael Price invested. It wasn't just about buying a company with a low P/E and price momentum as many are doing today.

US Large Cap Growth – Value: 100-Day Trailing Returns (2000-Present)

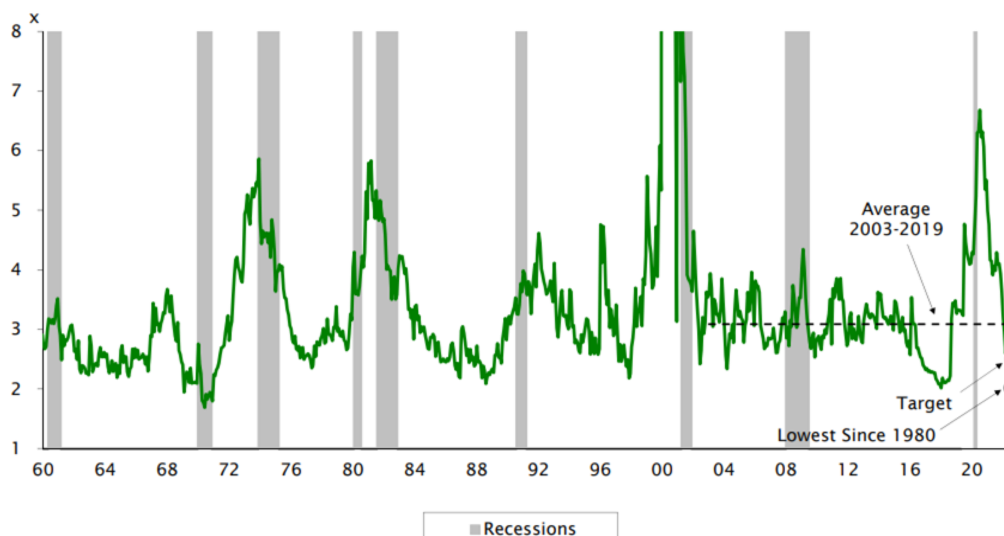


Source: Merrill Lynch

The markets have experienced a dramatic move. It's a move that rivals the lows that we saw several years ago. More importantly, we should discuss valuation. I get this question a lot about valuation, and the similarity between now and the year 2000. In 2000, you had companies trading at 100 to 200, to 500 times earnings. You had Amazon, pets.com, and other companies like that. Now, Facebook trades at the same P/E multiple as Altria Group, (previously Philip Morris, the tobacco company). Microsoft trades at about 15 multiple points lower than Costco on forward estimates. As you go through the big growth companies out there, they are really not expensive stocks, and certainly nowhere near as expensive as they were in 2000. The multiples are significantly lower now. There were a lot of speculative stocks in 2000 - companies without revenues and without earnings. Those types of speculative companies have been in a bear market for the last 16 months. We haven't owned those types of companies, but some other high-profile investors have, and that has tainted the entire growth category to some extent. Those companies will never come back. Companies with real revenues and real earnings that are growing rapidly, will come back.

The chart below is from Empirical Research. It's showing the big growth stocks today which are classified as the top 75 of the 750 growth stocks with the best growth attributes and it is rebalanced annually. Looking at it on a price-to-sales ratio, which is the best way to value these companies because you don't know where margins are going either way for cyclical, or growth stocks, it could be a lot higher or a lot lower. But. if you look at it today, those stocks are below the lows that they were, (the data point is from about two weeks ago). Right now, we're at the lowest relative valuation for growth stocks since 1960. That's below where we were in the year 2000. That's below where we were on a relative basis in 2008. **Growth stocks relative to the market have never been cheaper.** That's a very, very powerful thing on a relative basis. Does that mean we're going up today or we're going to be up by four o'clock on Wednesday? That's not what it means. It does mean that if you're looking for an entry point on a relative valuation basis, this is about as good as it gets.

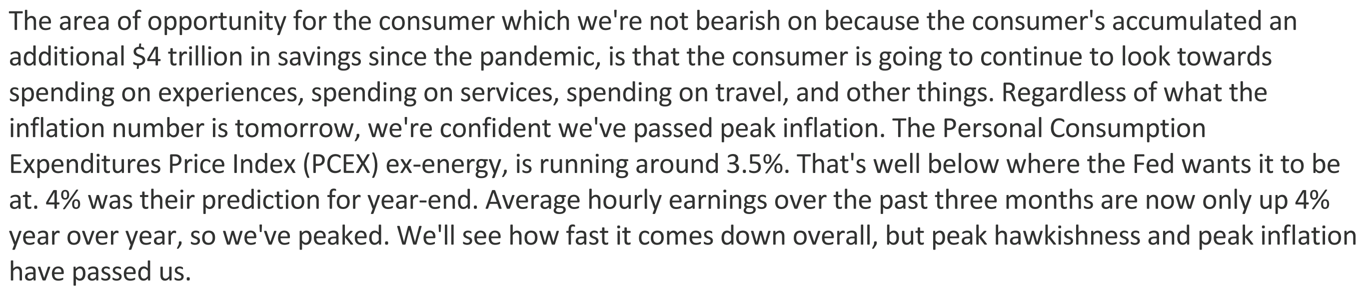
The Big Growers: Relative Price-to-Sales Ratio
1960 Through Late-April 2022



Source: Empirical Research

As I look at where we've gone, when the analogies about what is happening today are 1973, 2001, and 2008. We're at a period of time when we have certainly seen a big move in interest rates, and I think that is going to have an impact on a few things. First of all, it's definitely having an impact on housing affordability in the United States and we're seeing that begin to wane. Some homeowners are going from a 3% mortgage in December, to a 5.5% mortgage. That's going to have an impact and that'll slow things down.

You're also starting to see huge inventory accumulation by retailers. What's happened to Amazon and what's happened to a lot of the e-commerce retailers who are having trouble anniversarying the pandemic highs and demand for e-commerce, is spreading to home furnishings, used cars, and washing machines to name a few items. Even with supply chain issues, there's so much inventory, and the markdowns are coming for a lot of that. We've been short a major U.S. home improvement retailer, which has worked out for us. We think a lot of the home furnishing companies are going to look a lot like the e-commerce companies over the next little while.



The area of opportunity for the consumer which we're not bearish on because the consumer's accumulated an additional $4 trillion in savings since the pandemic, is that the consumer is going to continue to look towards spending on experiences, spending on services, spending on travel, and other things. Regardless of what the inflation number is tomorrow, we're confident we've passed peak inflation. The Personal Consumption Expenditures Price Index (PCEX) ex-energy, is running around 3.5%. That's well below where the Fed wants it to be at. 4% was their prediction for year-end. Average hourly earnings over the past three months are now only up 4% year over year, so we've peaked. We'll see how fast it comes down overall, but peak hawkishness and peak inflation have passed us.

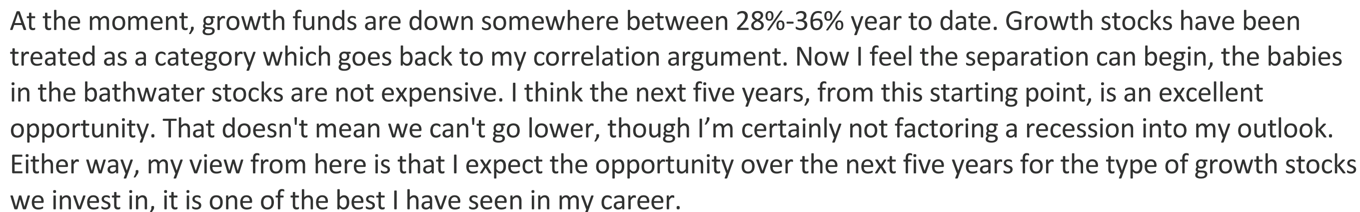
I look back on the history of how long we've been doing this and how long these bear markets have gone on. This has been a large decline in a very short period. That's characterized what we've seen over the last number of years. We saw something that up until three days ago was about the same as the fourth quarter of 2018 where we dropped about 25%. We were still up in 2018 by about 20-ish plus percent, but we certainly saw that drop of about 25%. By the end of March 2019, we had recouped almost all that loss.

Much of the pandemic sell-off was policy-driven, but that was recouped within a few months. Our funds dropped about 16% in the spring of 2021 and then rallied 25% over the next number of months. That is not past performance being indicative of future results and that is not a prediction. However, these down periods in the market now happen a lot faster and recover a lot faster than they have in the past, barring a recession.

I'm not in the recession camp right now. I'm in the moderating slower growth camp. In 2016 growth stocks had a tough fourth quarter and tough year. Near the end of 2016 and into 2017, I wrote in a year-end commentary that "In my opinion the opportunities for those who are actual stock pickers are vast and some of the greatest we have seen during the 24 years we have been managing portfolios". We believe that performance since 2017 and until this recent difficult period for growth stocks, was encouraging. Once again, I really like this current setup over the next five years. Not the next five days, not the next five months, but the next five years. A 5–7 year time horizon (and possibly beyond), is the only time horizon you should be looking at when investing in growth stocks. Whether it's company-specific in retail or healthcare, whether it's to the digital transformation of businesses, more investments in Artificial Intelligence and Machine Learning in Digital Marketing, the economy is not going back to the way it was pre-pandemic. Especially from a sales and marketing perspective, where investments are going and what companies are demanding in terms of business intelligence and business continuity. There are many babies being thrown out with the bathwater here – companies that are highly profitable that now look very reasonable to us from a valuation perspective.

Unitholders of our funds may be asking what we have been doing in our portfolios in 2022. Did we rotate into energy? No. Did we buy staples and utilities? No. Did we increase the cash levels of our mutual funds 50% to 80%? No. Then what did we do? We decreased the number of names in our mutual funds from 25-26 down to 20-21, and we dramatically increased the position sizes. The moves we've seen in the markets in the last few weeks haven't made sense to us and they're clearly being driven by forced selling, maybe there's a large hedge fund in trouble that needed to sell stocks. We've concentrated our names more and focused even more intently, on the names we like.

There aren't a lot of <u>real</u> growth funds in Canada. The vast majority were growth funds when growth had relative strength, and now they look like commodity funds. If you look at real growth managers throughout the United States whom I have a lot of respect, you'll see there are really no funds that have been spared.



At the moment, growth funds are down somewhere between 28%-36% year to date. Growth stocks have been treated as a category which goes back to my correlation argument. Now I feel the separation can begin, the babies in the bathwater stocks are not expensive. I think the next five years, from this starting point, is an excellent opportunity. That doesn't mean we can't go lower, though I'm certainly not factoring a recession into my outlook. Either way, my view from here is that I expect the opportunity over the next five years for the type of growth stocks we invest in, it is one of the best I have seen in my career.

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