The Krygier Report

An exclusive newsletter from Mark J. Krygier, Vice President & Portfolio Manager | August 2018 www.krygierwealthmanagement.ca

Mark J. Krygier
Vice-President, Portfolio Manager & Wealth Advisor
416-733-5750
mark.krygier@rbc.com

Avital Pearlston
Associate Wealth Advisor
416-733-5751
avital.pearlston@rbc.com

Irene Hama
Associate
416-733-5752
irene.hama@rbc.com

Tiffany Wong
Assistant
416-733-5749
tiffany.x.wong@rbc.com

And then there was one…

At its peak, the video rental chainstore Blockbuster had over 9000 stores across North America. In 2011 the company filed for bankruptcy, in 2014 it closed its last corporately owned store, and, last month, on July 15, 2018, the last two stores located in Alaska closed, leaving only one store left of this once giant chain, in Bend, Oregon. Reasons for its demise parallel most other corporate failures. Primarily, it was the failure of management to anticipate the impact of the internet and other technologies on consumer tastes, and their failure to adapt accordingly. As access to videos via the internet, cable and other "streaming" internet-based services, such as *Netflix,* gained popularity, users of rental videos declined dramatically. Compounding its demise was a dearth of ownership of the buildings in which the stores were located so, as profits declined, its inability to maintain sufficient revenue to cover expensive commercial leases forced many of the store closures, as happened recently with the Alaska stores. The corporate world is strewn with similar stories of companies which failed to anticipate the changes that technology or consumer tastes would have on their ability to compete. As the expression goes, "the definition of insanity is doing the same thing over and over again and expecting a different result."

Netflix of course is one of the five so-called "FAANG" stocks, together with its celebrated "partners" Facebook, Apple, Amazon and Google, all of which have garnered much investor attention. Recently, the shine in two of these high-flying stocks, Netflix and Facebook, started to get a little tarnished, perhaps a harbinger of future volatility and negativity amongst the "high-flyers" in the markets. Despite each of these companies growing their sales at a very high rate, despite continuing to expand their respective user bases at exponential rates, and despite huge market share in their respective industries, investors may be starting to reevaluate how they value the FAANG and other technology stocks. Until very recently, the stocks of these companies, and others like them, have been valued based primarily on their sales growth rates, and their potential for continued exceptional growth going forward, rather than for their actual net earnings, as is common for "concept" stocks.

In truth, this approach to valuation is inevitable to some extent, as stock markets have always been future looking predictors of the direction of earnings. Therefore, the brighter the future appears for a company the higher the valuation it will get by investors today. However, caveat emptor as the inverse is also true - the lower the earnings growth rate is expected to be in the future the lower the stock price based on that expectation will be priced in by investors today. Compounding this up and down volatility is the common human tendency to react in the short-term based on binges of fear and greed. The combination of these factors can exacerbate the directions of the stock prices both to boost high-growth stocks to significant premiums and in the reverse to push slower-growth stocks to significant discounts. In the short-run, stocks can stay at huge premiums or discounts to their valuations, however, as *Facebook* investors recently discovered, an overpriced stock priced based on exponential user usage can change direction overnight if that positive momentum in user usage changes. Facebook's stock dropped in July by almost 20% the day after it announced a "surprising" decrease in user usage, resulting in the largest one-day drop in market capitalization of any company in market history. Interestingly, not everyone seems to have been caught off-guard as Facebook CEO Mark Zuckerberg reportedly had been selling some of his own shares at an increasing rate in the days and weeks leading up to the earnings report.

While investors ought to be cautious when evaluating stocks, they also have to be careful not to throw the proverbial baby out with the bathwater. With the tendency for technology stocks to lead both booms and busts in the markets, as they help stimulate an individual's excitement for a better future, some investors may be inclined to avoid purchasing them altogether to avoid the potential drops in value and this I believe is a critical mistake. As hedge fund manager and investment newsletter author Jared Dillian recently wrote, "For as long as I have been in the market, it has been tech stocks that were the [leaders] except for a brief window between 2002-2005. So while the valuations of these innovative companies can fluctuate at times between excess premiums and despair-like discounts, Dillian suggests that, "If we get a bear market next year…my advice would be to buy tech stocks, just like you should have done in 2002. It is a time-tested strategy."

Bottom line

Businesses are constantly being challenged to innovate in order to stay competitive and stay relevant in a changing market-place. For a company's senior management to take its collective "eyes off the ball" is to risk losing both its competitive edge and perhaps even its entire business. Investors are constantly being challenged to try and participate in the growth of these emerging technologies and an ever-changing business landscape, while trying to balance the understanding that valuation still matters. The successful investor will try to avoid both the excesses of premiums and discounts while keeping one's long-term financial goals in mind.

Global benchmarks
As at July 31, 2018 (Canadian $ Returns)

Asset class	1 year	3 years	5 years
S&P/TSX Composite T/R (Canada)	11.7%	7.5%	8.8%
S&P 500 TR - US$	16.2%	12.5%	13.1%
NASDAQ Composite - US$	20.9%	14.4%	16.2%
MSCI Europe Index Price Return	7.1%	1.1%	7.5%
MSCI Emerging Markets	6.3%	6.2%	7.8%
China S.E Shanghai A Price Return	-9.6%	-10.8%	10.4%
MSCI World Index Price Return	14.4%	6.6%	12.6%

Asset class	1 year	3 years	5 years
30-year U.S. T-Bond - US$	-0.8%	1.5%	4.9%
10-year U.S. T-Bond - US$	-3.2%	-0.1%	1.6%
Long GOC Bond (2048)	5.4%	0.4%	4.8%
10-year GOC Bond	-0.3%	-0.4%	2.8%
5-year GOC Bond	-0.2%	-0.5%	1.6%
3-month CDN T-bill	0.9%	0.6%	0.7%
US$/CDN$ (1.3055)	4.2%	-0.2%	4.8%

Source: RBC Capital Markets Quantitative Research

For past copies of ***The Krygier Report*** visit **www.krygierwealthmanagement.ca.**

Wealth Management
Dominion Securities