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EQUITY COMMENTS

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The Certainty of Uncertainty

By Geoff MacDonald, portfolio manager

Have you noticed how uncertainty has become less and less a part of our daily lives? In this commentary, we ponder what the long-term effects will be for the human race getting accustomed to this incremental dose of daily certainty.

Stepping back in time

Remember your days as a student when you waited for the bus but had no idea when it would arrive? On some occasions you'd time it perfectly and it made your day. You'd get home and tell your parents how amazing it was that the bus pulled up as soon as you arrived! Today, a trusty app offers more certainty as it tells you exactly when the bus is due to arrive. Every day seems as mundane as the last. You show up one minute before the scheduled arrival, board the bus and the uncertainty is gone. How about the good old days when you waited 20 minutes for that arrival? While waiting for the bus one day, the neighbourhood bully would show up. On another day, you'd get into some mischief with your friends. On another day, you'd find yourself talking to a stranger waiting for the same bus, because what else was there to do? You didn't really know what was ahead, so each day was a new day with new adventures. In short, you experienced the uncertainties in life and embraced the possibilities. You were also getting used to dealing with the uncertainties of life like we have for generations of our existence on Earth.

I remember the 30-minute walks to school with my friends when I was in grade one! I can't even begin to explain the randomness of that 30-minute stroll. The only thing that stayed the same each day was the outcome – we arrived at school. Today, we crave a mindless path to the outcome because uncertainty is no longer wanted. Think about it for a minute and you'll see how life has changed:If the average investor wades into the stock market, they tend to feel comfortable buying two types of businesses – the obvious growers and the obvious safety names. Let's briefly talk about each one of these.

- Do you remember having to pick up the phone without knowing who was calling?
- Or wondering if you were paying a good price for a product at your neighbourhood store?
- Or asking for directions when you were lost? Is it even possible to get lost anymore?
- Or driving somewhere without knowing the best route? Why even drive these days? Just have an autonomous car so we have one less thing to do.
- Or asking your parents or friends how to spell a certain word or what it meant?
- Or learning about someone on a first date instead of checking out their app profile beforehand?
- Or playing with friends while your parents had no way to contact you until you walked back through the door? Could today's parent deal with that kind of uncertainty?

No thoughts

Today, someone knows the newsfeeds I want to read and the products I want to buy. They know the music I like and will even curate it into a playlist for me. And that somebody is pretty accurate. I barely have to lift a finger and I don't have to exercise much judgement. No investigation required and no excitement of discovery experienced. And that's not even talking about Artificial Intelligence (AI) and how it makes more and more decisions for us, so our only concern is getting to the outcome we want.

Surprise me not

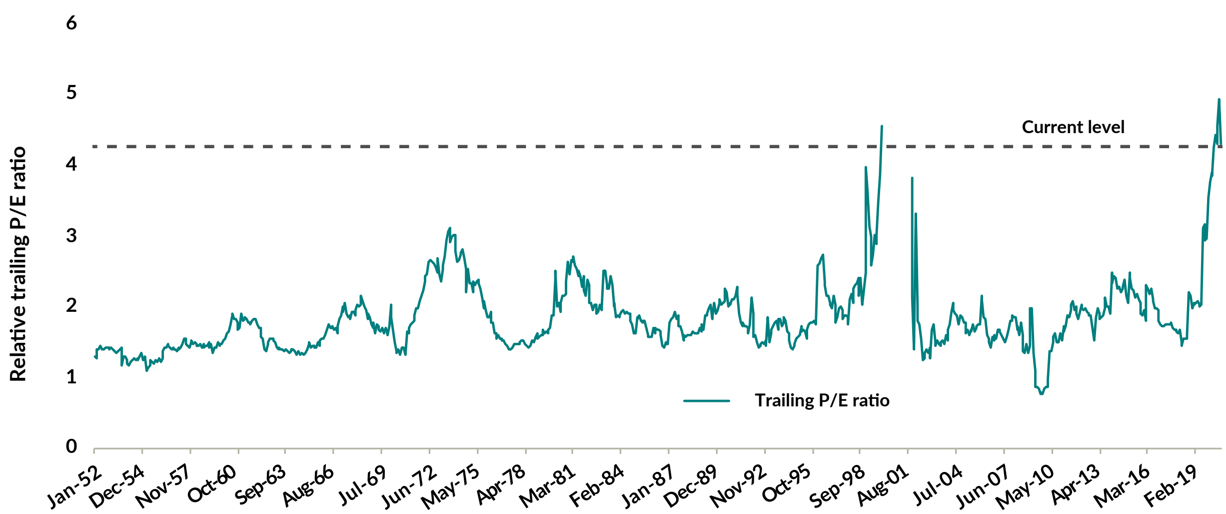
This mindless existence must be something we crave because the demand is huge. Before, we always knew the road ahead of us would have twists and turns. So we had to be okay with those turns to get to the end of the road. But we now want the twists and turns and surprises to go away. We rave about a new app that can take away another twist. We're now guided to the outcomes more often, exhibiting less free will in the process. But it seems to be what we like as a society. Take me to the outcome without a blip and with the least amount of critical thought required. This is our future.

Do we really want a life with no surprises? As we try to avoid negative surprises and inconveniences, aren't we also missing out on opportunities for more positive outcomes? We believe this "cost of certainty" also translates into the same effect when investing.

What about investing?

Do investors today want less uncertainty as well? We suggest there is strong evidence of that. Here's a chart showing the premium put on the top-75 obvious growth stocks today, represented by their trailing price-to-earnings ratio relative to the rest of the U.S. large-cap universe. These are stocks that represent "certainty" today. The dotted line shows today's valuations.

Big Growers trailing price-to-earnings (P/E) ratio relative to the rest of the largest-cap universe
Jan. 1952 to late-Aug. 2020



Source: Empirical Research Partners Analysis, National Bureau of Economic Research. Big Growers are a group of approximately 75 large-capitalization stocks classified by Empirical Research Partners, LLC to have faster and stronger growth credentials than the rest of the market. Trailing P/E ratios are equal-weighted and relative to the rest of the U.S. large-capitalization universe. Data between January 2000 and September 2001 was excluded due to extreme valuations.

This is happening in the middle of a pandemic and, thus, one of the most uncertain times to invest in a generation. It's worrisome that those investors not doing the calculations fail to realize the steep price they're paying for this certainty.

What narrative has taken hold to allow this to happen?

Let's look again at the chart above. In 1999, there was a strong narrative about how the internet would change the world. That's what propelled technology stock valuations to nosebleed highs (the valuations couldn't even be shown on the chart because they were so extreme). It was a very strong and pervasive narrative. Yes, the internet did change the world, but by early 2000, investors realized the tech sector was grossly overvalued, panic selling ensued and many investors lost their savings because they craved the certainty of the crowd.

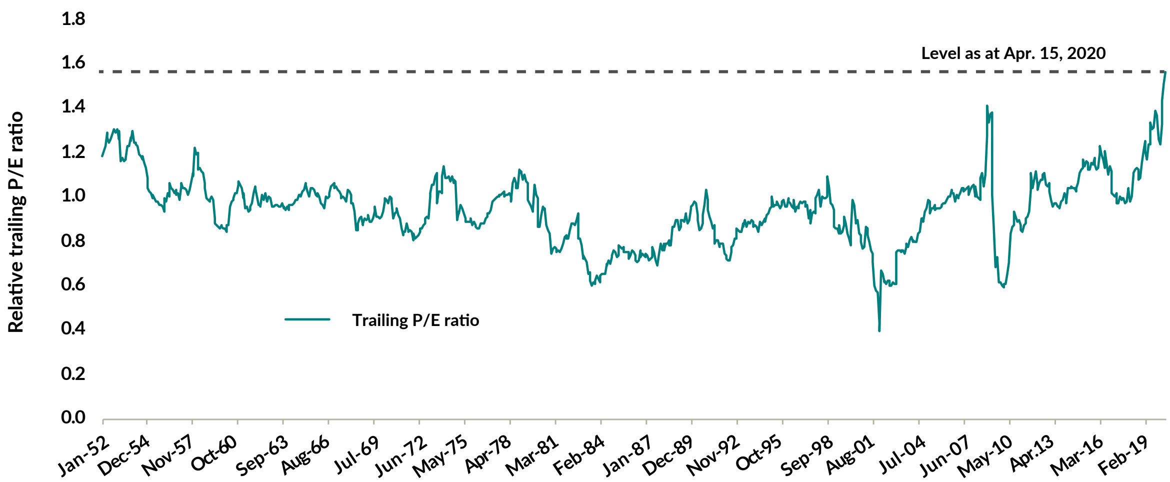
You can also look at the drop experienced after the 1973-1974 "Nifty 50" craze, a group of 50 companies widely regarded as solid "buy-and-hold" businesses. The consensus believed these companies were so good, it didn't matter what you paid for them because their continuous growth would bail you out. The narrative was compelling then as well and, thus, 50 great stocks were propelled, at least temporarily, to extremely high valuations.

Again, what's the narrative today?

If we ask 100 investors that question, we wonder how many different answers we'd get. Though there might not be a strong narrative shared by all, we'd contend there's an insatiable demand for certainty in an uncertain time. Don't give me any twists or turns. Just buy me something obviously doing well in this uncertain environment and I'll rest easy.

Here's a chart that illustrates this:

U.S. large-capitalization stocks in the lowest beta quintile
Relative trailing P/E ratios vs. the rest of the largest-cap universe
Jan. 1952 to Apr. 15, 2020



Source: Empirical Research Partners Analysis, National Bureau of Economic Research. The group of companies are large-capitalization U.S. stocks in the lowest quintile of beta. There are total of 166 companies in the group. Beta is a measure of an individual stock's volatility relative to the market. Stocks with a beta of 1 move in line with the market. The lower the number, the less volatile a stock is relative to the market, while a higher number indicates that the price is more volatile compared to the market.

It shows the all-time high valuations of the stocks with the lowest beta (volatility) relative to the rest of the large-cap universe. We call these stocks the "obvious safety" names (businesses that fall into this camp would include telecommunication, pharmaceutical and packaged goods companies). The fewer the twists, the higher the price. You pay dearly for that perceived safety.

Another period when people paid an extremely high price for fewer twists and turns was in 2009. Investors were hiding out in the "obvious safety" names after the market got crushed during the credit crisis. In other words, investors didn't like the surprise of 2008, so their reaction was to pay up for certainty. The EdgePoint investors who invested with us then remember how well the Portfolios did over the ensuing few years by owning non-obvious survivors.

The cost of certainty

The two previous charts are excellent visuals illustrating the currently high cost of certainty. Oddly, in investing, the high price that's put on certainty often results in losses. When it comes to investing, certainty can often be overpriced.

- Look at the return potential of a 10-year government bond, the epitome of safety in investing. The price has been bid up to the point where the yield is a paltry 0.56% for the right to hold it for 10 years.[i] That's a great example of the price, or cost, of certainty today.
- Below is a table showing the stocks that have achieved such "greatness" that they reached a 3% weight in the S&P 500 Index. When reaching this threshold, they were all admired for their past and likely future successes. Few businesses seemed to have a more certain future than these, but just look at their lacklustre five- and 10-year returns over the period that they represented these large weights in the index.

S&P 500 Index companies with a year-end weight over 3%
1980 to 2014

Year	Company	Index %	Share price performance over the…	
			…next 5 years	…next 10 years
1999	Cisco Systems, Inc.	3.0%	-18.45%	-7.74%
1999	Microsoft Corp.	4.9%	-12.42%	-4.40%
1998	Microsoft Corp.	3.5%	-4.45%	-3.94%
1999	General Electric Co.	4.1%	-4.73%	-8.92%
2001	Microsoft Corp.	3.4%	0.82%	0.03%
2000	General Electric Co.	4.1%	-3.82%	-6.34%
1998	General Electric Co.	3.4%	-0.03%	-4.76%
2002	Microsoft Corp.	3.5%	10.03%	3.12%
1997	General Electric Co.	3.2%	1.49%	6.52%
2001	General Electric Co.	3.8%	1.16%	-4.68%
2004	General Electric Co.	3.5%	-12.92%	-0.17%
2005	General Electric Co.	3.2%	-8.79%	2.43%
2003	General Electric Co.	3.1%	-9.27%	2.43%
2009	Exxon Mobil Corp.	3.1%	9.09%	3.54%
2002	General Electric Co.	3.0%	11.80%	1.89%
1986	International Business Machines Corp.	4.3%	-1.93%	5.80%
2014	Apple Inc.	3.4%	23.69%	n/a
1985	International Business Machines Corp.	6.4%	-2.60%	-1.79%
1983	International Business Machines Corp.	6.1%	3.40%	-3.71%

Source: S&P Dow Jones Indices, Bloomberg LP, Horizon Kinetics Research. Data is at year-end for the listed year. The S&P 500 Index is a broad-based market-capitalization-weighted index of 500 of the largest and most widely held U.S. stocks. Returns shown include companies with a year-end P/E ratio of 13.5 or greater and a minimum weight of 3%.

The price that investors paid for owning these "certain" businesses was a lower-than-expected return in most cases. There has to be a cost for certainty. Following a mindless, mundane trajectory can't be the best outcome. And don't think this isn't happening today. It is.

A twisty road

There's no way to straighten the road ahead when it comes to investing. It's very long and there will always be twists and turns. Paying a high price in exchange for the prospect of fewer twists doesn't work. Why not? Because, as time passes and you go further down the road, things change. The world is always evolving.

Let's look at how things change over time from what may seem obvious at one point in time. This chart shows the top-10 stocks globally, by market cap, at the start of each decade.

Top-10 companies in the world, by market cap

1980	1990	2000	2010	Sep. 30, 2020 (US$B)
IBM	NTT	Microsoft	Exxon Mobil	Apple ($2,008)
AT&T	Bank of Tokyo-Mitsubishi	General Electric	PetroChina	Saudi Aramco ($1,914)
Exxon	Industrial Bank of Japan	NTT DoCoMo	Apple Inc.	Microsoft ($1,592)
Standard Oil	Sumitomo Mitsui Banking	Cisco Systems	BHP Billiton	Amazon ($1,577)
Schlumberger	Toyota Motors	Wal-Mart	Microsoft	Alphabet ($998)
Shell	Fuji Bank	Intel	ICBC	Alibaba ($770)
Mobil	Dai-Ichi Kangyo Bank	NTT	Petrobras	Facebook ($746)
Atlantic Richfield	IBM	Exxon Mobil	China Construction Bank	Tencent ($632)
General Electric	UFJ Bank	Lucent Technologies	Royal Dutch Shell	Berkshire ($509)
Eastman Kodak	Exxon	Deutsche Telecom	Nestlé	Visa ($426)
Prominent belief Peak oil	**Prominent belief** Japan takeover	**Prominent belief** Tech/telecom boom	**Prominent belief** Oil and China	**Prominent belief** Tech/telecom 2.0

Source, decades: J. Mauldin, "Bonfire of the Absurdities", Mauldin Economics, November 17, 2017, http://www.mauldineconomics.com/frontlinethoughts/bonfire-of-the-absurdities/. Source, 2019: Bloomberg LP. Market cap in US$.

It appeared certain in 1980 that oil stocks would be great investments. The chart above shows that six of the world's most valuable stocks in 1980 were oil stocks. After all, experts claimed we were running out of oil reserves in 70s and 80s. Well, things change, don't they?

And 10 years later, Japan was the new source of future certainty. People believed there would be no twists on the road ahead. It would just be Japan forever and back up the Brink's truck! Oops. It's thirty years later and those investors only have about half their money back![ii] These investors just wanted to remove a few bumps on the road and have a more certain investing future.

I guess we don't have to spend much time on those toxic-waste technology stocks in 2000 – you know what happened there.

And then look at the oil stocks coming back in 2010 for their last hurrah, representing four of the top 10 most-valuable stocks in the world.

Times change. And with time, everything else changes, except the future bumps and twists of the road. We can always count on those.

Crave uncertainty

When an investor eliminates thought from the equation and craves certainty regardless of the price, the result has usually been, and will likely continue to be, a slim chance for pleasing returns. More often than not, this results in losses. Of course, the average investor doesn't realize this is happening today. They never do – until it's too late and hard-earned savings are lost.

The reality is that an investor needs the discomfort of uncertainty. There's serenity to investing when one realizes this fact. Uncertainty allows you to have a view about a business that others don't. If there was perfect certainty, others would share your views. But, if everyone shared your views, there would be no undervalued securities to buy. You'd have no positive surprises and no positive outcomes – just the risk-free rate of return[iii] (which, as we already discussed, might not amount to much of a return at all). So, in the world of investing, don't ever crave certainty as it won't get you very far.

And be careful of the masses craving the same thing today.

Bifurcated market

Today the market is heavily bifurcated. There are the "obvious safety" names and the "obvious growers". Those are the "certain" names today. Ironically, the highly uncertain outlook driven by the pandemic has caused the most certain names to be the most expensive. Luckily, there are many compelling businesses under the radar that are not in line with today's market narrative. That's what you own and that's what will get you to your Point B.

[i] Source: Bloomberg LP. 10-year Canadian government bond yield as at September 30, 2020.

[ii] Source: Bloomberg LP. Nikkei Index price level measured from January 1, 1990 to September 30, 2020. The Nikkei Index consists of 225 companies that are among the most actively traded issues on the Tokyo Stock Exchange.

[iii] Risk-free return is the theoretical return attributed to an investment that provides a guaranteed return with zero risks.

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