# VT Lyndon Fund

Quarterly Commentary 31st December 2020

ContraCapital

The final quarter of 2020 was a better one for the markets, with the positive vaccine news in November leading to a global surge of optimism. This was reflected in the FTSE All-Share (Total Return) Index rising +12.6% during the quarter, whilst the VT Lyndon Fund (B Accumulation) was up by +21.3%. Over the year, the All-Share was down by -10% on a total return basis, with this the worst calendar year performance since 2008.

2020 was a year in which political and economic commentators witnessed unprecedented levels of "unprecedented" events, observed veritable oceans of "uncharted territory" and positively abnormal rates of "new normals" were heralded. The year was both way too "interesting" in the apocryphal Chinese curse kind of way and yet, from the perspective of most people's personal experience, it was also crushingly dull. We can only hope that 2021 is less interesting than 2020 on a world historical basis, but much more diverting in terms of actually getting out of your front door and engaging with the world. The year hasn't started all that well on either front, but if nothing else, we will hopefully be able to find some new clichés with which to describe events.

So far in 2021 we have Coronavirus once again raging largely out of control (with the added bonus of a new, more transmissible variant), renewed lockdowns across much of Europe, the inevitable and yet "unforeseeable" Brexit-related chaos in the UK and, the one new twist, something like an attempted coup in the US.

The world is a big place and there will always be zones of instability and no shortage of things to worry about, but what is, ahem, unprecedented, is that on the day that the Capitol was stormed by home-grown American terrorists and there was quite literally "blood in the streets", the US stock market responded by hitting a new all-time high. This is definitively not what Baron Rothschild had in mind when he issued his exhortation to "buy when there's blood in the streets." Whilst it is true that the active civil unrest looks to have been swiftly calmed, it only takes one nutter with a gun, and the US is richly stocked with both of those commodities. The president and vice president's security details are going to need to be very much on their toes over the next four years.

The depth of the division in the US is quite remarkable, even from a Brexit-torn British perspective. The vitriol is all the more striking given that the Republican and Democratic parties are really just minor variations on what is a very narrow theme. The narcissism of minor differences applies here. Recent polls show that nearly 90% of those who voted for Trump think that the result of the election was not legitimate. Similarly, more than half of registered Republicans believe that Joe Biden, a man so emollient he could be prescribed for piles, was primarily responsible for the storming of the Capitol by Trump superfans. OK, right you are, Chad.

The detachment from objective reality in the US is not limited to the political sphere, with the US stock market increasingly resembling nothing so much as a bubble looking for a pin. At the aggregate index level, valuations are looking as stretched as at any point in history, with only the periods around the peaks of 1929 and 2000 even in the same ballpark. Like the bubble at the turn of the millennium the most extreme action is concentrated in tech-related stocks and it is all-but impossible to avoid, once again, making special reference here to Tesla, the emblematic poster stock of this particular bubble.

Bubbles tend to do strange things to people's critical faculties and we recently came across a piece of research from Bank of America in which, in order to keep up with events, they raised their target price for Tesla's stock from $500 to $900. In their research note the Bank of America analysts opined that "...the higher the upward spiral of TSLA's stock goes, the cheaper capital becomes to fund growth, which is then rewarded by investors with a higher stock price. The inverse of this dynamic is also true, and it is this self-fulfilling framework that appears to explain the extreme moves in TSLA stock to the upside and downside." So, the more the stock goes up the more it's worth. What could possibly go wrong?!?



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For Tesla investors, so far so good. Indeed, so good that, at the time of writing, far-fetched Bond villain (and Tesla founder), Elon Musk, is reckoned to be the richest man on the planet. Tesla is currently valued at more than $800bn, which is c. 27x revenues and more than 300x profits. Or, to put it another way, the company is valued at $1.6m for each of the nearly half million cars it sold last year. Cars that cost c. $60,000 each. If this seems ridiculous then you're in good company, as last year a well-known tech guru tweeted that "Tesla stock price is too high imo", with this immediately sending the shares down by more than 10%. The tweeter in question was, of course, a certain Mr Elon Musk, but it did not take long for Tesla true believers to regain their composure and the share price has now risen by more than +450% from the point at which its founder, CEO and largest shareholder observed that it was overvalued. For what little it's worth, Tesla continues to lose money selling cars, with what scant profit the company currently generates is derived from the sale of excess carbon credits.

In another excerpt from the big book of "history doesn't repeat, but it does rhyme", we can recollect a *cri de coeur* from a successful tech founder and CEO from another era. Back in 2002, after the TMT bubble had collapsed, the CEO of Sun Microsystems, Scott McNealy, had this to say in light of the company's share price having fallen c. 90% from its peak:

*"… two years ago we were selling at 10 times revenues when we were at $64. At 10 times revenues, to give you a 10-year payback, I have to pay you 100% of revenues for 10 straight years in dividends. That assumes I can get that by my shareholders. That assumes I have zero cost of goods sold, which is very hard for a computer company. That assumes zero expenses, which is really hard with 39,000 employees. That assumes I pay no taxes, which is very hard. And that assumes you pay no taxes on your dividends, which is kind of illegal. And that assumes with zero R&D for the next 10 years, I can maintain the current revenue run rate. Now, having done that, would any of you like to buy my stock at $64? Do you realize how ridiculous those basic assumptions are? You don't need any transparency. You don't need any footnotes. What were you thinking?"*

Well now, and as already observed, Tesla is trading not at 10x or even 20x, but at nearly 30x revenues. And Tesla is not a capital light software business that will prospectively enjoy sky high gross margins and therefore huge economies of scale as it grows, but a very capital intensive manufacturing business with no such structural advantages.

Another straw in an increasingly febrile wind is that several companies that were planning to seek a US stock market listing at the end of 2020 reportedly pulled their IPOs *because the market was too hot.* After several IPOs, such as Airbnb and Snowflake, saw their share prices more than double on the first day of trading, Roblox (an online gaming platform) and Affirm (a point of sale lender) decided to hold off on their own floats for fear they might meet a similar fate. The feeding frenzy in the new issue market is such that the way to price an IPO seems to be to think of a very high number, double it and then hope that you haven't left too embarrassing an amount of money on the table.

Where we are at is well summarised by Jeremy Grantham, legendary investor, co-founder and Chief Investment Strategist of US asset management firm GMO, a noted historian of investment bubbles and solid Yorkshireman to boot. In his recent investment letter he observed that:

*"The long, long bull market since 2009 has finally matured into a fully-fledged epic bubble. Featuring extreme overvaluation, explosive price increases, frenzied issuance, and hysterically speculative investor behavior, I believe this event will be recorded as one of the great bubbles of financial history, right along with the South Sea bubble, 1929, and 2000."*

According to one US bank's chief technical equity strategist and in an inversion of Franklin D. Roosevelt's phrasing: "The only thing we have to fear is the lack of fear itself." How we got to such a fevered point, with large swathes of the US market seemingly unhinged from any semblance of fundamental economic sense is a good question and one that we will at least attempt to address below.

That's perhaps rather more on the excesses of the US market than may seem strictly necessary, but it is very hard to ignore and it clearly does matter. Not least when the swollen US stock market currently accounts for more than 66% of the MSCI World Index (the most widely used global equity benchmark). And, having noted last quarter that nine of the ten largest companies listed in the MSCI World Index were American, we now find that it has become a US clean sweep, with Tesla crashing into the top 10 as a new entry at #6.



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However, whilst we need to be cognisant of what is going on across the Atlantic, we must also remain aware that the US is a marked outlier, with valuations in most of the rest of the globe looking very different, with the UK looking more different than most. The UK continues to trade at or around a multi-decade valuation low relative to other markets, so there is huge scope for improving fundamentals and more positive investor sentiment to drive a substantial recovery in the UK stock market. For now, a good part of the UK's discount remains all-too comprehendible; the stock market of a deeply dysfunctional state actively engaged in economic self-harm is always likely to struggle to find new admirers. Confidence in a swift turnaround would be greater if the populace had a firmer grip of reality and the political debate was at least vaguely honest. As it stands, until remarkably recently a majority of UK respondents believed that the British government was handling the Coronavirus crisis "well" or "very well", whilst the on-going mendacity around all-things Brexit-related is as breathtaking as it is depressing. It is very hard to fix a problem if you don't understand it.

It is not all bad news, though, as whilst the dominant market narrative remains the proliferation of bubbly warning signs in the US, beneath the surface there has been something of a shift in what is driving the UK equity market. Having been hammered relentlessly for the first nine months of the year, the fourth quarter saw a sharp reversal of fortunes for the more lowly valued and out-of-favour segments of the UK market. The result being that, in spite of market hedges holding back performance, the VT Lyndon Fund was up by +21% during Q4 (with the market +13%), with many of the portfolio's individual holdings recording very large gains.

The momentum shift between Q3 and Q4 was substantial, with many previous laggards rebounding very strongly. For example, during the quarter Tapestry, Inc (the owner of Coach and Kate Spade brands) was up by +99%, M&S rose by +72%, whilst Aggreko (a supplier of temporary power solutions) was +69%, easyJet +66% and Superdry +60%. In fact, there was only one company in the portfolio that was down during the quarter, which is something that is unlikely to ever happen again. Underlining the reversal in momentum that was witnessed in Q4, the solitary portfolio stock that fell during the period was Kingfisher plc (owner of B&Q and Screwfix), which had hitherto been one of the Fund's strongest performers, whose share price had more than doubled over the preceding six months.

What we saw in Q4 was a nascent "reflation trade", with the markets seizing on the better-than-expected vaccine news and seeing a plausible route to a post-Covid world sooner rather than later. The optimism engendered naturally saw the more economically sensitive parts of the stock market perform well, especially those parts of the economy that had been most battered by Covid. As a corollary, there was a slight move higher in interest rates and also in inflation expectations. It is very early days and the trends witnessed in Q4 may not persist, but if they do have legs then this would have profound implications for all major asset markets; equities, fixed income, commodities and real estate.

An environment with higher growth, higher inflation and higher interest rates would see a great rotation in investment markets, with value stocks, commodities, financials and Emerging Markets likely to be the new big winners, whilst high growth stocks, long-dated bonds and the US equity market in general would be the relative losers. Essentially, "the first shall be last and the last shall be first."

Why such a reflationary scenario would be good for value stocks, commodities and financials should be fairly self-evident, but why it would be actively bad for the more growthy and techy parts of the equity market is perhaps less intuitive. To a minor extent, high growth names would suffer from rotation, as you have to sell something in order to buy another thing, but it would be more than that. Over the last few years many market participants have convinced themselves that low interest rates *per se* justify sky-high valuations for those parts of the equity market that hold out the prospect of high growth. Whilst this is a specious argument (see below), it is nevertheless very widely held. That being so, one must presume that higher interest rates will bring high-flying growth names sharply back down to earth. Just so long as the story that investors tell themselves remains constant, that is.



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The simple gravitational pull of economic fundamentals suggests that such an outcome is likely in due course, but whether this is as a consequence of a reflationary environment is rather less certain. There are many solid arguments in support of a more inflationary outcome, with these including but not limited to: an end of "globalisation" trends (and a possible partial reversal thereof); a shortening of supply chains after Covid has highlighted the risks of relying on low cost producers on the other side of the world; China exporting inflation as its wage rates continue to rise and its currency strengthens further; re-shoring of manufacturing to high wage economies; shrinking working age population in both the West and China to increase labour's bargaining position (and labour's share of the economic pie is at historic lows).

Whilst the inflationary arguments are persuasive, we take no particular view, not least as many of the same arguments could have been (and were) made a decade or so ago and proved to be very wide of the mark. Rather than attempt to divine the macroeconomic auguries we seek instead to buy fundamentally cheap stocks that we believe have underappreciated recovery prospects. Nevertheless, should such a reflationary outcome eventuate, the portfolio would be well positioned.

**How low can you go, how high can you fly?**

Seemingly for want of a better explanation, it has become increasingly accepted by market commentators that historically stretched valuations levels (in the US at least) are justified by rock bottom low interest rates. For example, this is from a recent article by the Financial Time's senior investment commentator:

"*One justification for higher equity valuations has been the dramatic drop in long-dated government and corporate bond yields, which lifts the value of future cash flows via a lower discount rate. The prospect of much lower bond yields — and, crucially, the expectation that central banks will contain any sharp rise — has encouraged investors to boost their exposure to the technology and healthcare sectors in particular."*

Whilst this may seem superficially convincing it does not really stand up to scrutiny. For, if interest rates are lower and forecast to remain so (and they very much are, as implicit in yield curves), then doesn't this also imply that inflation and therefore nominal growth must also remain low? That being the case, the future cash flows that you are now discounting with a lower discount rate will also be lower, meaning that the whole thing is likely to more or less be a wash. We are just not going to have interest rates of 1% or less for a prolonged period if nominal growth is in the 'normal' range of c. 4-6%. There is therefore an unresolved contradiction inherent in any assertion that low rates justify high valuation multiples of equities.

Or, to put it another way, the notion that low interest rates justify high equity valuations implicitly ignores the implications that logically flow from a low interest rate environment. Low interest rates go hand in hand with low rates of nominal growth, so any valuation model that books the benefits of low prevailing rates of interest should also simultaneously reflect the attendant hindrance of low growth. To do otherwise is the valuation equivalent of having your cake and eating it. Some stock markets, most especially those in the US, seem to be operating in an odd liminal phase where the positive of low interest rates (a lower discount rate) has been baked into equity valuations, whilst the concomitant and necessary negative (a lower nominal growth rate) has been wholly ignored. Lower interest rates are neither intrinsically good nor bad for equities, no matter how 'high growth' the equities in question are purported to be.

There is an empirical problem too, in that interest rates in the bubbly US, at around 1% for the 10-year Treasury, are rather higher than in many other developed markets, notably Europe. The UK 10-year gilt yields c. 0.2%, whilst the German and Swiss 10-year government bonds yield *minus* -0.60%, and yet equity markets across Europe are not notably frothy. The same is true also of Japan, which provides the firmest empirical disproof of any claims that very low interest rates necessarily justify very high equity valuations. Not only are Japanese rates very low – the 10-year government bond yield currently hovers around 0% – but they have been very low for decades. The 10-year rate has not struggled above 1% in a decade and has not been as high as 2% since the late 1990s. These minimal interest rates have very much *not* seen very high equity ratings as a corollary, but they *have* gone hand-in-hand with very low rates of nominal growth. This is logically consistent.



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Perhaps a stronger argument for low prevailing interest rates justifying high equity valuations is that the dismal rates of return available on fixed income and cash instruments, which are typically negative in real (after inflation) terms, has essentially forced investors seeking any kind of yield into equities. This is the "There Is No Alternative" to equities theory or TINA for short. More recently, as rates have fallen ever lower it has been suggested that the apposite acronym now is TRINA (There *Really* Is No Alternative). This is harder to gainsay, but it does not really match the actual facts of the case all that well.

It falls down on a geographic relative basis (US versus everywhere else) and also on a sector relative basis. The stocks, such as Tesla, that have been bid up to the most absurd levels, typically offer little or nothing by way of dividend or even earnings yield, and are unlikely to do so for many years (if ever). The vast majority of the potential value of such stocks necessarily lies many years in the future, 10 or maybe 20 years hence. If investors "reaching for yield" was really what was driving equity markets, then they would surely be reaching somewhere else than US tech stocks.

Any investment bubble worth its salt needs a good *post facto* justification for its inflation and some, like this one, have more superficially convincing explanations than others. We do wonder, though, just what valuation would proponents of this iteration have us place on stocks were US long rates to go below zero, as they already have in much of Europe?

**David Lynch, Fund Advisor, VT Lyndon Fund, January 2021**



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