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CIO Investment Note
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The Prophets of doom are getting louder and the "winners curse" is getting closer.

Over the past four weeks the price to earnings ratio (PE) for the 100 largest Nasdaq listed companies (NDX) has dropped by 4 PE points. For perspective, during the worst four weeks of the COVID pandemic and the Global Financial Crisis (GFC), the NDX lost 5 PE points. We believe that much of the current weakness in the NDX reflects overly ambitious positioning in momentum stocks more so than the prospect of an imminent financial calamity.

However, the prophets of doom are getting louder. By extrapolating the recent strength in commodity prices and input costs into inevitably higher inflation rates, the bear case is that resurgent inflation will drive long bond yields higher over the coming months. Although NDX valuations have already experienced a meaningful de-rating, we need to be mindful that the current PE of the NDX is 26x next years' expected earnings and is still more than 30% higher than average over the past two decades.

Growth-at-any-price managers are highly exposed to an evolving reflationary backdrop; their financial models have historically emphasised blue sky revenue scenarios and stable margins. An exponentially expanding stream of free cash flow projections have subsequently followed. A low discount rate has typically been applied to these ambitious cash flow predictions and extremely high present value estimates had become inescapable.

Unsurprisingly, if the tables are turned and margins begin to diminish and this coincides with an elevation in discount rates, then valuations will taper rapidly. This is hardly rocket science, but it could imply that the most successful investment strategies over the past decade are about to be exposed to the "winners curse".

Back in 1983, Max Bazerman and William Samuelson released a wonderful paper titled "I won the auction but don't want the prize.[1]" Their premise was:

> *The "winner's curse" occurs in competitive situations when a successful buyer finds that he or she has paid too much for a commodity of uncertain value. This study provides an experimental demonstration of the winner's curse and identifies factors that affect the existence and magnitude of this bidding abnormality. In an auction setting, two factors are shown to affect the incidence and magnitude of the winner's curse: (1) the degree of uncertainty concerning the value of the item up for bid and (2) the number of competing bidders. Increasing either factor will increase the range of value estimates and bids, making it more likely that the winning bidder will overestimate the true value of the commodity and thus overbid.*

In the current data driven world of machine learning it should be of no real surprise that success breeds success. Accordingly, we cannot help but feel that the "winners curse" is more relevant than ever. From a stock market

[1] Source: The Journal of Conflict Resolution, Vol. 27, No. 4 (Dec 1983), pg. 618-634

perspective, given that the NDX has delivered a total return of more than +20%pa over the past decade, exponents of this style of investment management have had great success in asset gathering pursuits. Unfortunately, late comers to a successful investment style are exposed to the twin peak cycles of valuations and earnings. The most successful asset raising ventures late in any cycle are the incubators for the “winners curse” contagion.

At K2, we believe that a company run by effective management within a well-structured growth industry will be successful. Importantly, when K2 Funds acquire shares in such companies, it is typically at a sufficient discount to intrinsic value to ensure that the investment will also be successful. Our discount rates do not vary too often. Our hurdle rate has always been 6%pa, and this has functioned as our risk-free rate. Hence, we are not fazed by the rumblings from the prophets of doom. We certainly appreciate their views, but we are mindful that most year-on-year indicators are cycling a very low base.

We are also conscious that Central Banks are committed to a low interest rate environment. Hence, if bond markets get too disorderly, we have little doubt that Central Banks will purchase Treasury securities and agency mortgage-backed securities with vigour. As a result, we believe that the current dislocation in equity markets will present us with some compelling new investment opportunities.

We remain optimistic about equities and believe that the COVID-19 pandemic will prove to be the catalyst that swung the investment pendulum away from decade old Growth-at-any-price cycle. To our minds a new Valuation-ultimately-matters cycle has commenced and should be with us for several years to come.

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