DART CAPITAL

Views from Dart Capital

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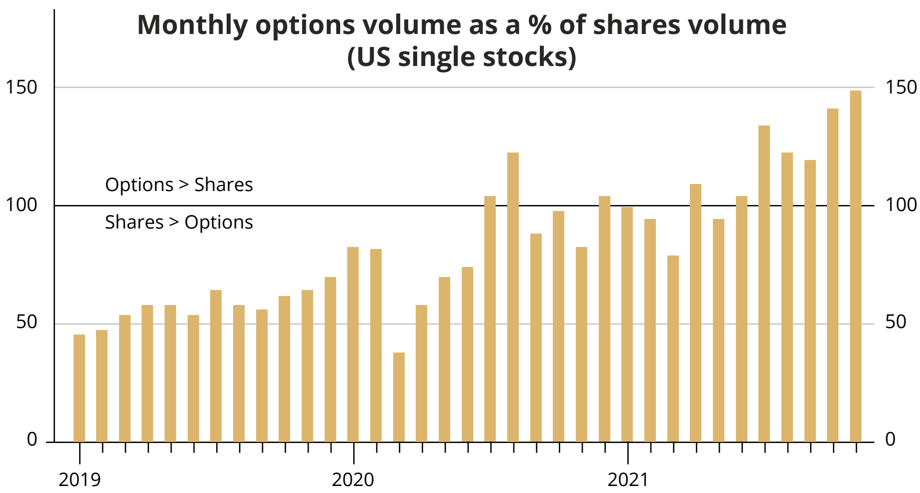
At the time, some market commentators called the extended period from the bottom of equity markets in March 2009 through to 2017 "the most hated bull market in history", as, despite the broadly positive gains for stock markets, retail investors, having experienced the severe losses of the financial crisis, remained generally cautious. However, as you will likely be aware, the situation has shifted dramatically over recent years with investing and trading by retail investors picking up strongly. This shift was in part catalysed by the lockdowns of last year that witnessed many people fill their time by entering into the world of day trading, particularly through the options market where it is possible to gain leveraged exposure to share prices. This change in behaviour has also coincided with institutional investors becoming more tolerant of risk, most notably in their willingness to invest in relatively unproven businesses at expensive valuations.

Surging activity in the US options market is indicative of increasing levels of speculative activity

US options trading volumes have vaulted above equity trading volumes



Sources: Goldman Sachs Global Investment Research; OptionMetrics
FT

The shift in investor sentiment from sceptical to exuberant has driven many areas of asset markets to bubble-like valuations. One such example is recently listed electric truck & car manufacturer Rivian, which in the space of a week after its IPO had a market capitalisation larger than Volkswagen, making it the third largest listed automaker in the world. Whilst the latter have a growing EV business, established distribution network and own reputable brands such as Porsche and Lamborghini, Rivian has sold less than 200 cars in their history. Distortions such as this are, according to some, a direct result of Central Bank policy, which has met each subsequent financial crisis or significant sell-off with ever more extravagant monetary intervention. Most recently, the COVID-induced recession saw Central Banks slash base rates to zero and engage in huge QE programmes in an attempt to support their respective economies. Policies which – whilst well intentioned - have made many investors perceive permanent losses as unlikely and therefore are entering into increasingly speculative investments in search of "easy gains".

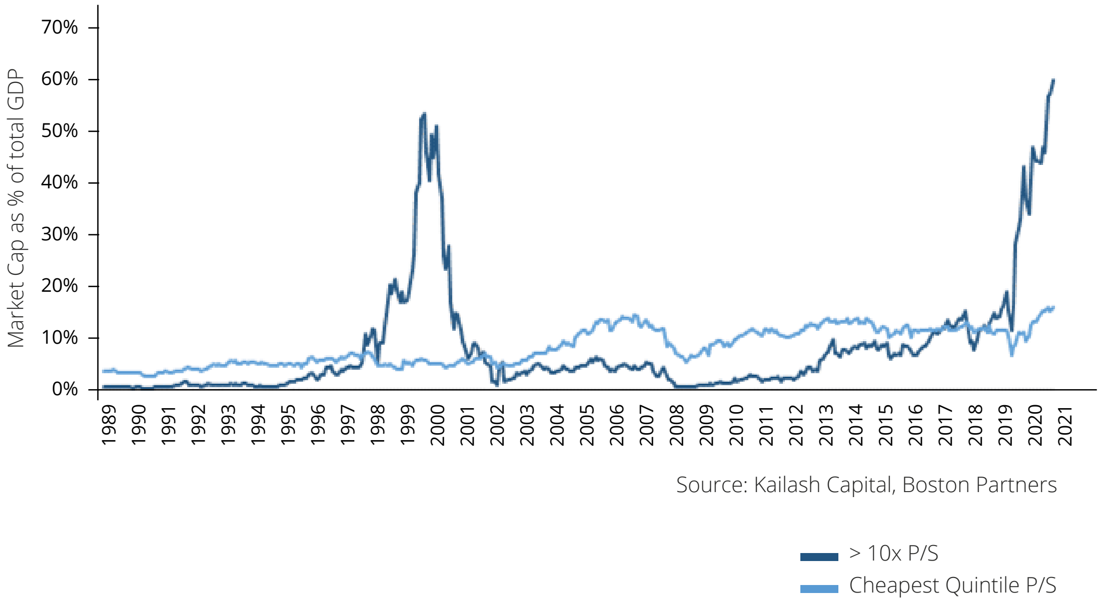
Further to the factors discussed above, and as history has demonstrated many times before, technological innovation has created a compelling narrative that speculators can buy into. Put simply, if electric cars are the future of transport and cryptocurrencies are here to stay, people new to investing may be wondering whether there is any price too high to pay for Tesla stock and Bitcoin respectively. Financial market history is littered with speculative bubbles where traders followed a similar line of thinking, and subsequently lost the vast majority of their investment as valuations eventually revert back to more normal levels.

The fervour for high growth companies has pushed valuations in some areas of the market to very high levels

The US Equity Market continues to be populated with many expensive companies

Stocks priced for the improbable (Stocks >10x P/S) vs the cheapest stocks on the market

Stocks with P/S > 10x vs. Cheapest Quintile of P/S as a % of total GDP



Source: Kailash Capital, Boston Partners

Taking the current situation more specifically, one element we believe is under appreciated at the moment is competition, in particular the degree to which high growth industries will see increasing competitive pressures over coming years as capital floods into these sectors. There are a number of industries where several companies are being priced as if they will be the sole leader, and there is huge amounts of capital chasing the same opportunities. Take electric cars, where Tesla will have to compete with incumbent players, such as BMW, Volkswagen and Toyota, as well as well-financed new entrants, including Nio and Lucid. Another example is in the semiconductors industry, where Nvidia, whilst clearly having a strong position within the graphics chips segment and seeing strong growth for their chips, will have to invest huge amounts in order to retain their ascendancy over competing businesses. It is these types of competitive pressures, that eventually drive down profit margins in high growth industries, which have historically caused the most expensive stocks to underperform the broader market, and we believe this historical relationship may well re-assert itself in this market cycle.

Against this backdrop, we are positioned with a strong bias towards established, profitable businesses. We have long gained this type of quality exposure from holding the US S&P 500 index, which has large weightings in the likes of Apple, Microsoft and Google, all of which share these desired characteristics, and this was an area where we were adding to heavily during the market sell-off of March of last year. More recently, as valuations rebounded strongly in US technology stocks, we have supplemented this with the likes of Fidelity Global Dividend whose dividend-bias keeps it away from the most expensive areas of the market. The fund has hefty weightings in stocks such as Roche, Procter & Gamble, Samsung and TSMC, which themselves are highly profitable and possess solid growth prospects but don't share the same regulatory risks of the aforementioned US mega-caps.

Further afield, we also find underappreciated quality in Japan, where many companies have higher profits and dividend pay-outs than pre-COVID, yet have not seen their share prices rise sufficiently to reflect this. The quality characteristic of these companies derives largely from the strength of their balance sheet, with many companies having large net cash positions which, allied with solid operating performance and an increasing focus on corporate governance, should support growing distributions to shareholders over coming years.

From an overall portfolio perspective, at times of elevated risk sentiment it has generally been prudent to add to underperforming safe haven assets and currencies. With this in mind, over recent months we have added exposure to out-of-favour areas, most notably government bonds, US Dollars and Japanese Yen, which we expect to deliver resilient performance should market sentiment deteriorate. Looking ahead, we may add another active manager to our equity allocation that emphasises high quality stocks, and is able to actively avoid some of the more speculative names in the US market that appear to be trading well ahead of fundamentals.