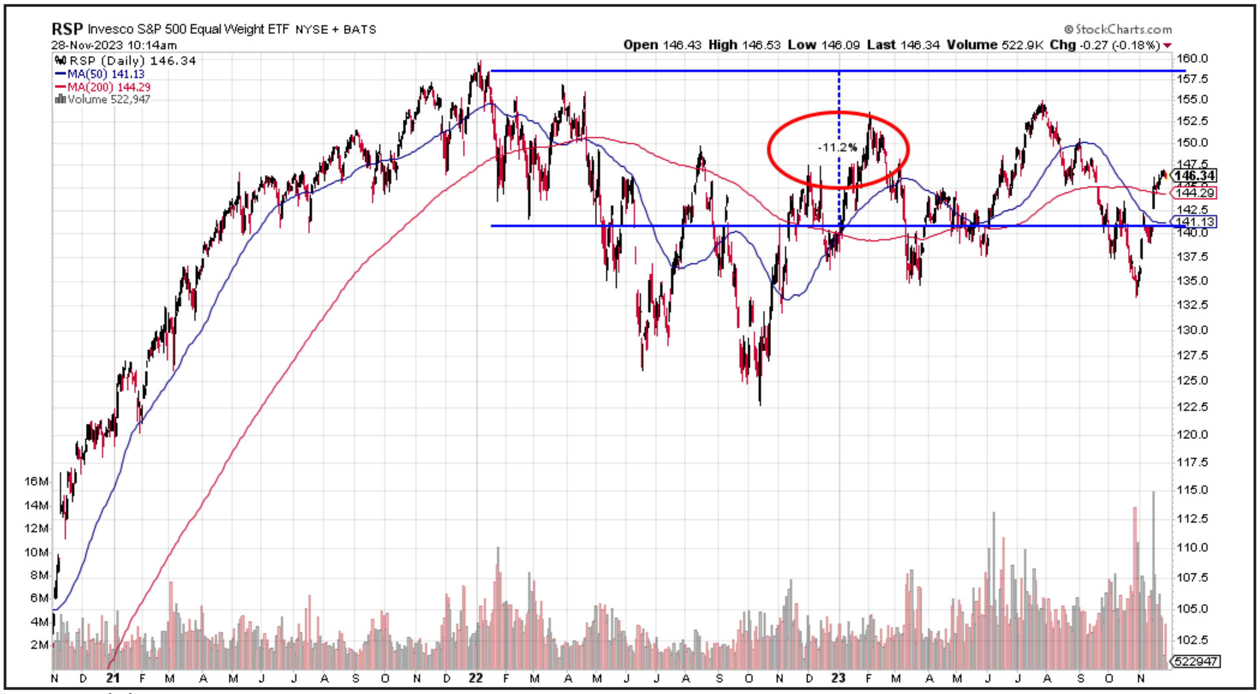
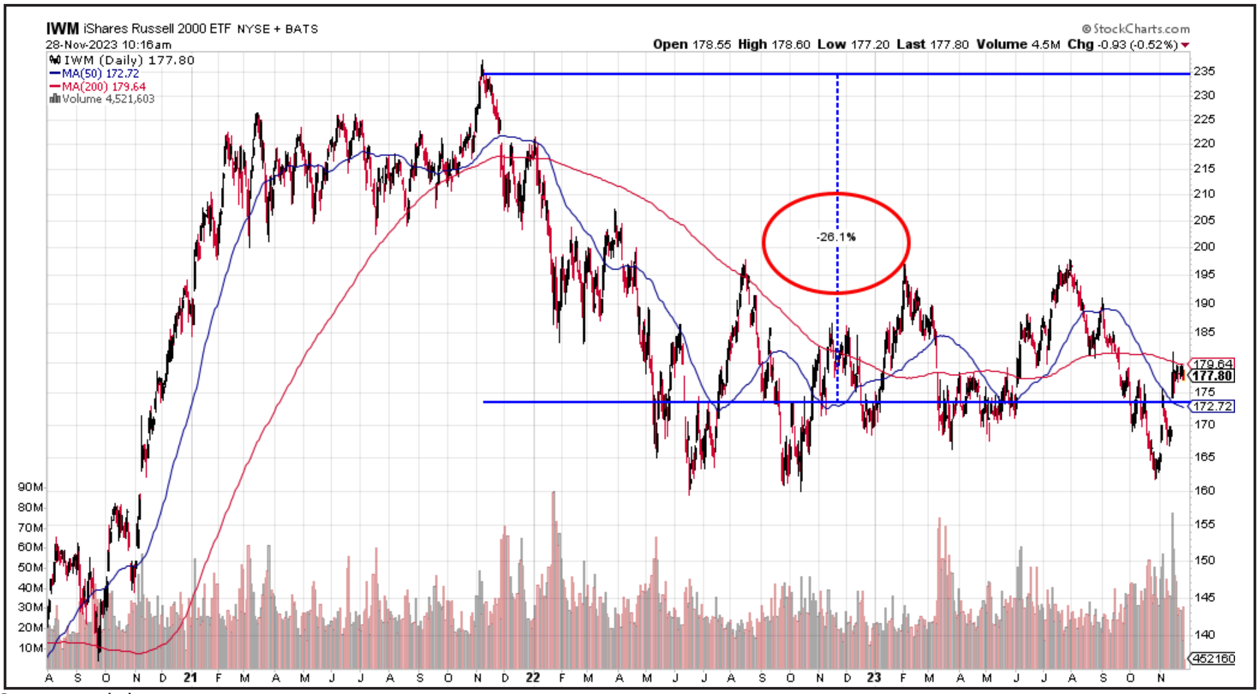
THE PRETENDING GAME

There seems to be a lot of pretending around investors these days. Let's pretend the economy is fine and we just started a new bull market – let's pretend paying employees millions (billions in some cases) in stock compensation is not a real expense – or let's pretend deficits don't matter (the USA is at a run rate deficit of about 8% of GDP). We can observe that it's all very optimistic out there considering the S&P 500 is almost back at an all-time high.

One other area where we believe the valuation is too high is private equity (PE). According to reports we've seen in the media, many funds have successfully reported positive returns for their funds despite the large and rapid rise in interest rates. We would have expected the valuation of a highly levered investment be impacted by the rise of interest rates in addition to impacting cash flow (higher interest costs reduce cash flow). Considering the Equal Weighted S&P 500 has return about -11% since early 2022 with on average lower leverage ratio (S&P 500 companies have on average lower leverage than many PE fund). Or look at the Russell 2000 small cap index which is down about 26% from late 2021. In our opinion, those different classes of equity exposures should rhyme along the same direction.

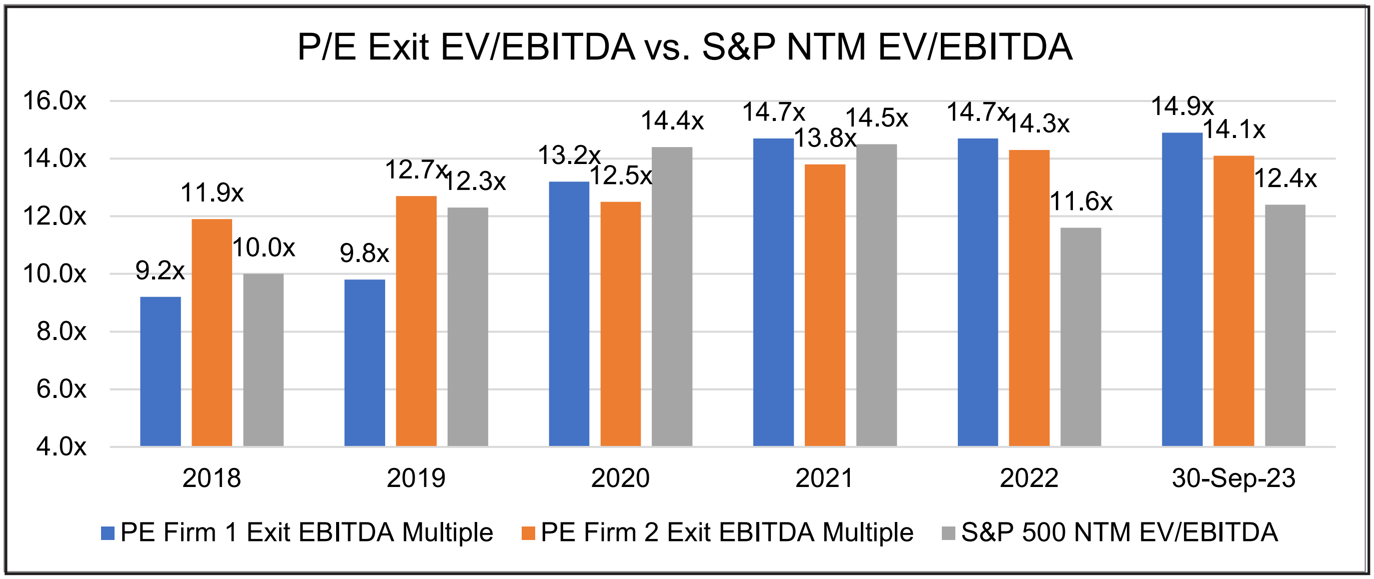


Source: stockcharts.com



Source: stockcharts.com

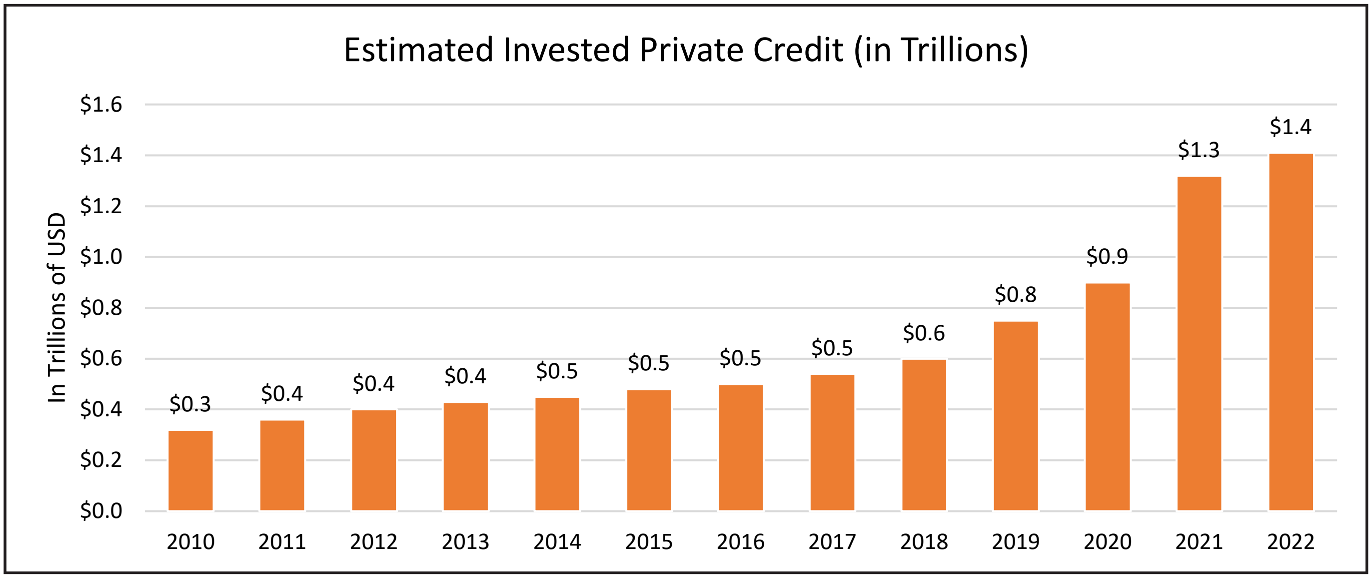
As you can see in the chart below, two unnamed public PE firms increased the exit EV/EBITDA multiple (part of the formula to value a holding) on their portfolio companies to 14.9x. Our expectation is the multiple on most assets (stocks, real estate, utilities, infrastructure and private equity) should come down if interest stay higher for longer (our view – we expect important correction on equity valuation in 2024).



Source: Company Filings, Bloomberg

INVESTORS PRETEND THEIR PRIVATE CREDIT IS LOW RISK (PROBABLY NOT IN A RECESSION)

Private lending firms have been growing many private credit solutions with industry assets (invested and dry powder) nearly tripling since 2016 to $1.4 trillion. This private credit can come in many different forms and can employ varying degrees of leverage in the structure.



Source: https://www.moodys.com/web/en/us/private-credit.html

All investments carry a form of risk and reward and in bonds, risk is often quantifiable and measured by Moody's, Fitch or Standard & Poor's global ratings. The primary focus of risk revolves around one's ability to make payments on time as well as return the principle upon maturity. Every business is unique, with their own circumstances and are rated from a high of AAA to a low of C, with BBB marking a clear cut off between investment grade. With elevated risk one expects to be compensated accordingly.

The Risk & Return Characteristics of Stocks vs Bonds (1996-2019):

	AAA	AA	A	BBB	BB	B	CCC	US Equities
Annual Return	5.1%	5.2%	5.4%	6.0%	6.9%	5.8%	6.8%	7.8%
Volatility (StDev)	5.0%	4.4%	5.3%	5.6%	7.1%	8.9%	14.3%	15.4%
Return/Risk	1.0	1.2	1.0	1.1	1.0	0.7	0.5	0.5
Max Drawdown	-9%	-11%	-18%	-17%	-25%	-34%	-49%	-51%

Source: https://verdadcap.com/archive/a-flight-from-safety

Public bonds with a BB to CCC only yield an additional 1% annualized return above BBB but with volatility that is 25% to 150% greater. A clear risk to be aware of considering the incremental upside.

To understand the appeal of private debt, it is important to understand that investors dislike volatility and by limiting transactions in a credit instrument, you are unable to see where broad market participants value it. Public debt is rated and assessed for all to see and then traded by many different investor types, whereas private credit is generally owned and controlled by a single counterparty.

According to an S&P analysis of mid-sized companies with corporate debt pooled in collateralized loan obligations, many that utilize private credit are not in good shape. In fact, if the elevated interest rates were to persist many would struggle to pay their debt obligations hence why 87 companies were downgraded to CCC from the start of this year to August, with S&P Global calling their capital structures "unsustainable absent favorable economic and financial conditions, or upcoming loan maturities without a definite plan to extend, refinance, or redeem the debt".[1] Bank of America expects defaults to reach 5% next year if interest rates remain above 5%.[2] In short, private credit does have risks.

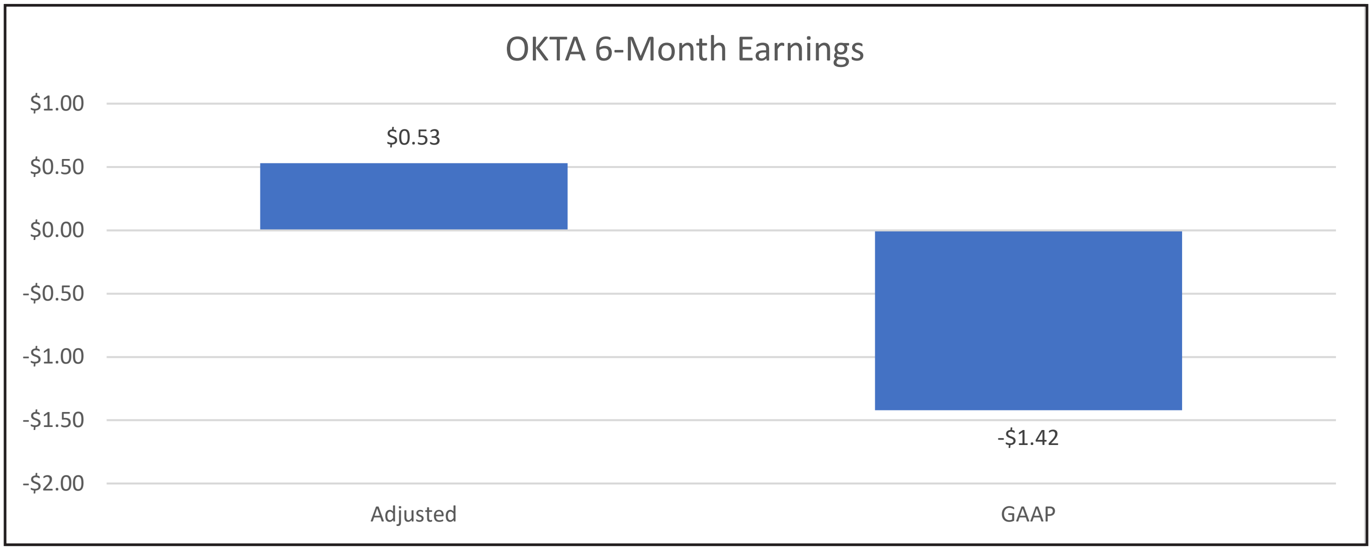
We believe that private credit is also an area where some investors don't appreciate (or pretend) the downside risk, especially if we are right and we see a recession in 2024. We are watching to see the impact of the estimated $30 Billion of debt set to mature in 2024, the $60 Billion maturing in 2025, and the $100 Billion maturing in 2026.[3]

1 https://www.wsj.com/finance/how-risky-is-private-credit-analysts-are-piecing-together-clues-79762038?mod=hp_lead_pos10
2 ibid.,
3 ibid.,

LETS PRETEND THE "ADJUSTED" EARNINGS PER SHARE ARE THE REAL EARNINGS

A common metric provided by companies is "adjusted earnings per share", which typically adds back non-recurring expenses and stock-based compensation (SBC). While one-time non-recurring charges are fair to add back, we take issue with adding back SBC as this is pretending that it's not a real expense. Companies have pushed investors' acceptance of adjusted earnings by shifting cash salary expenses into SBC which serves to protect adjusted earnings per share and adjusted margin during periods of slowing growth.

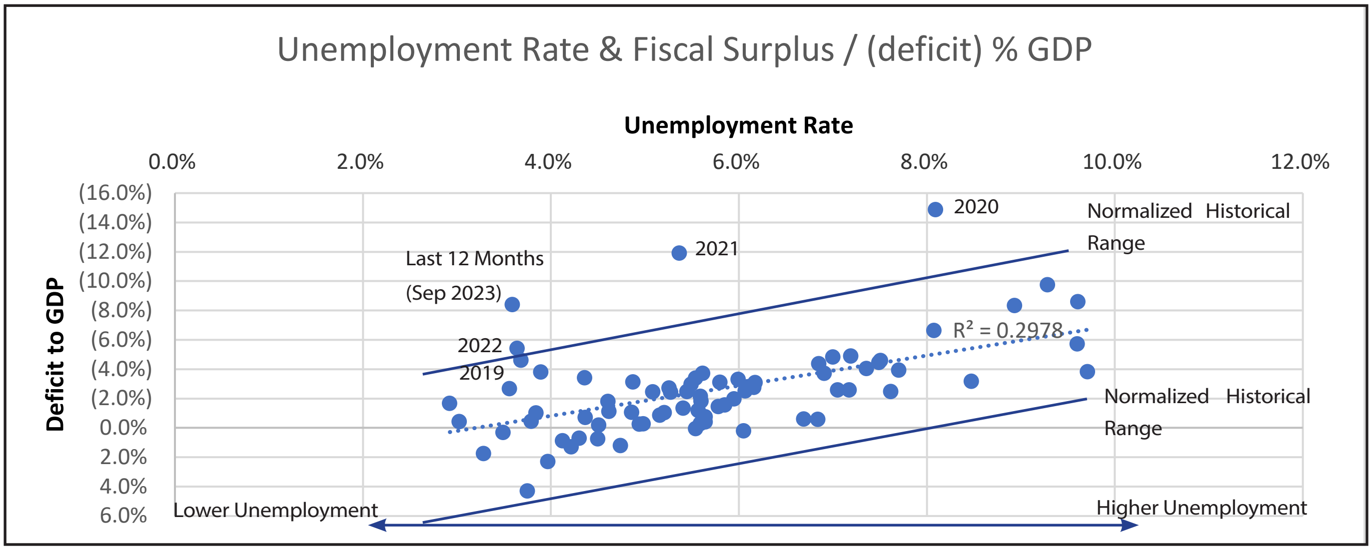
Okta is a perfect example, in the first 6-months of its fiscal year, it spent $351mm on stock based compensation, while its revenue was only $1,074mm, a shocking 33% of revenue. Its adjusted earnings were $0.53, while its GAAP earnings were a loss of $1.42. What is so incredible is this isn't just adjusted earnings being slightly higher than GAAP, it's a change from a large loss to small net earnings, completely pretending.



Source: Company Materials

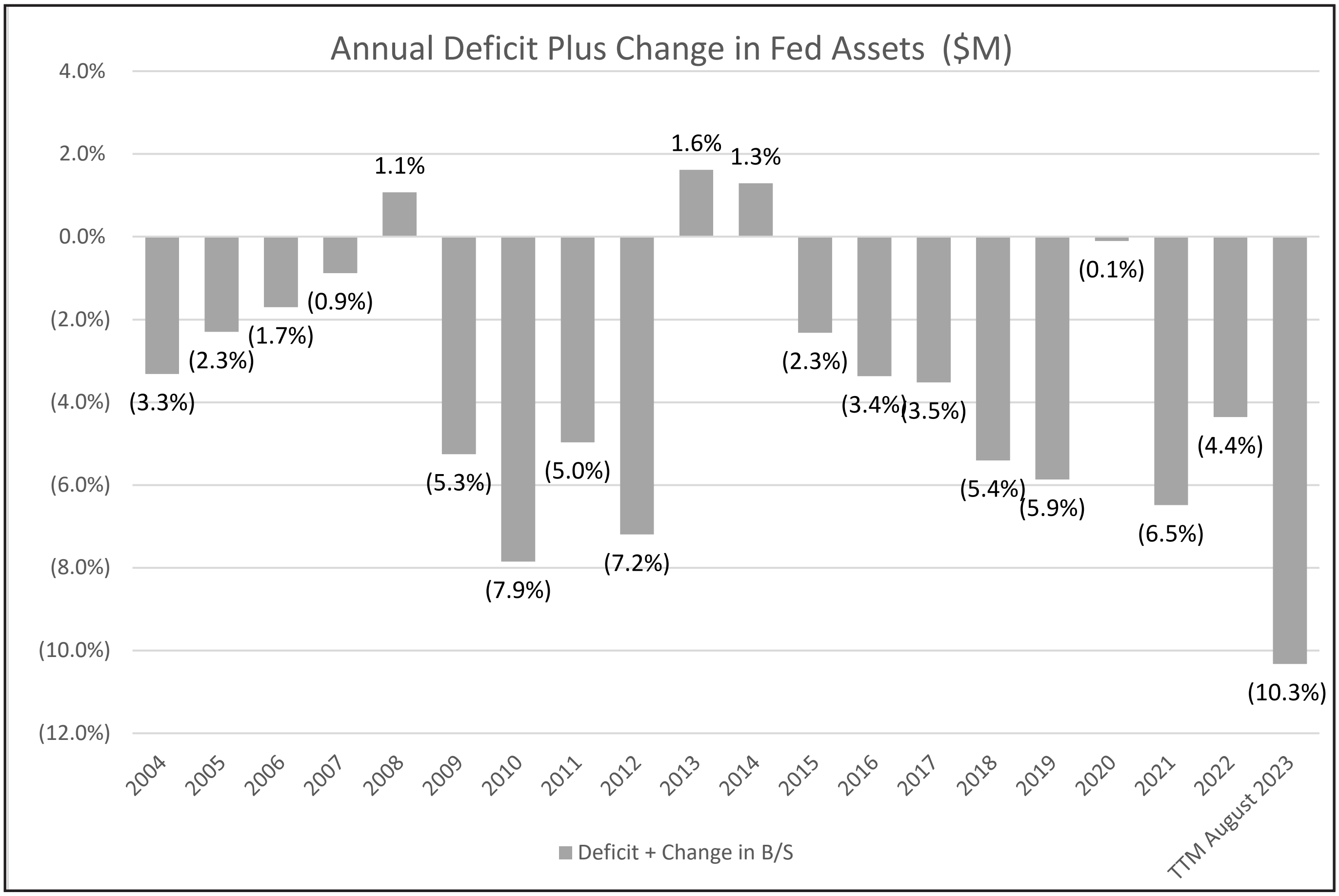
PRETENDING U.S. FISCAL POLICY IS SUSTAINABLE

It seems most of the U.S. politicians are pretending that an 8.4% deficit is completely normal and not going to cause problems. The 2023 fiscal situation saw $4.0 trillion of revenues and $5.5 trillion of expenses. If you as an individual were spending almost 40% higher than your personal income, the bank would be scared, apparently it doesn't count if you are the U.S. government.



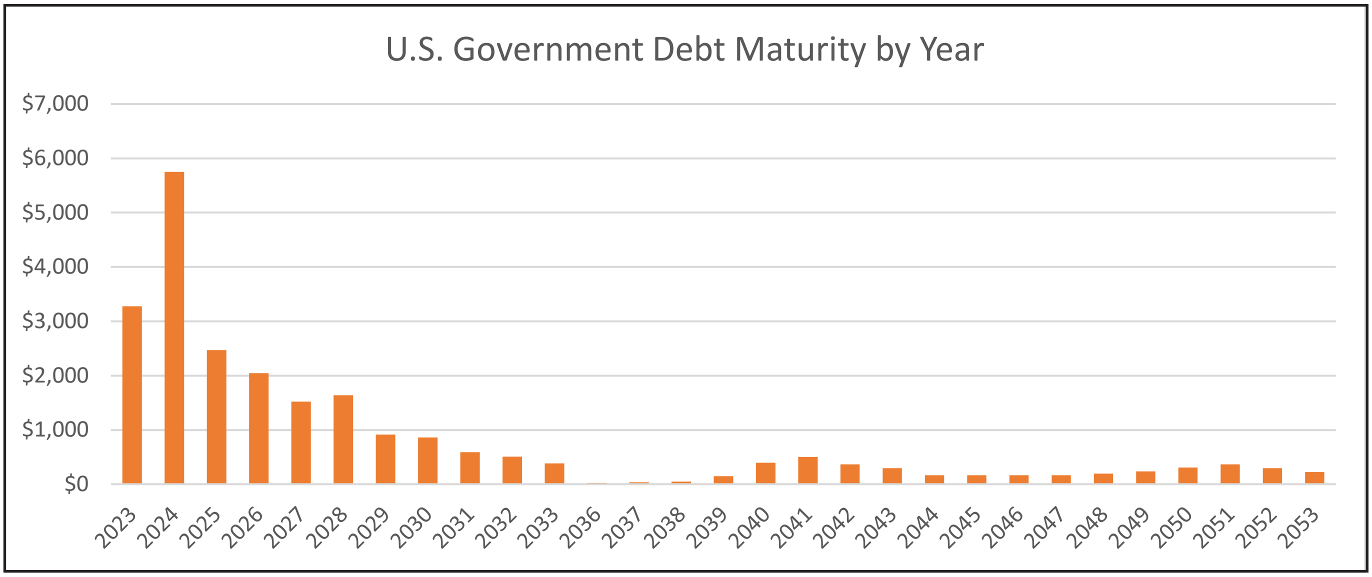
Source: FRED

Investors are also pretending that the current record amount of money (around 10% of GDP- see chart below) being pulled from the economy to finance the Government and Quantitative Tightening (QE) won't impact asset prices. This is the highest we have seen in the last least 20 years. This is at a time when the savings rate is only 3.4% of disposable income.



Source: FRED and Timelo Investment Management Inc. (Periods are September year ends)

The Treasury pretended there was no chance of higher rates as it relates to not widely extending duration of the debt stack of the country, making it more at risk to changes in near term interest rates. We take Druckenmiller's side on this debate with Janet Yellen. Check the debate out here.



Source: Bloomberg

PORTFOLIO POSITIONING

While much of the world plays pretend, we remain focused on the real and that means real business models, real free cash flow, real balance sheets and real opportunity on valuation upside. We continue to remain conservatively positioned in terms of gross and net exposures. At times we are seeing better risk adjusted returns in fixed income rather than in equities and are allocating capital there as opportunities present themselves.

Jean-Francois Tardif
President & Portfolio Manager
Timelo Investment Management Inc.

For more information please contact:
Timelo Investment Management Inc.

647-725-2865
Info @riskreward.ca

372 Hollandview Trail Suite #305
Aurora ON L4G 0A5