2020 Year End Review

*"**Outperforming** the majority of investors requires doing what they are not doing. Buying when others have despaired, and selling when they are full of hope, takes fortitude."*

- Sir John Templeton

Reflecting on some of the major developments over the past year, a few observations are instructive to remind us of the mercurial behaviour of financial markets and the importance of remaining calm and rational, particularly when others are not.

By late January 2020, we had our first confirmed case of COVID-19 in North America. There was certainly enough publicly available information to be very concerned about the potential impact of COVID-19 on our lives and the economy. Perplexingly, the S&P 500[1] was reaching new highs in February, apparently dismissing the potential risk of a pandemic outbreak. At the time, we were finalizing the necessary requirements to register Oak Bay Capital with the provincial securities regulator, and we were anxious to open for business to help protect clients from what my partners and I thought was an enormous mispricing of risk in the markets. Unfortunately, it would take until late summer to clear all the necessary hurdles to begin managing our flagship U.S. Risk Managed Equity strategy.

Despite the premise of the Efficient Market Hypothesis[2] that market prices always accurately reflect all available information, we often find times when prices imply far too optimistic or pessimistic futures. February was such a time, with extreme optimism reflected in high stock market prices despite the growing threat of COVID-19. Shortly thereafter, based on facts that had already been circulating for weeks in advance, the S&P 500 suddenly declined 34% in less than a month. This was a significant and rapid price decline with very few historical precedents. While the stock market was in free-fall, the economy was also declining, with U.S. unemployment levels reaching a high of 14.8% in April[3]. Worried about extended lockdowns, consumers fervently purchased durable food inventory from grocery shelves while supplies were still available. As the economy was deliberately turned off by governments around the world to slow down the spread of Covid-19, oil inventories surged due to reduced demand and continued supply (exacerbated by an

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[1] The S&P 500 is one of the most followed stock market indices, comprised of the 500 or so largest companies listed on U.S. exchanges. Currently there are 505 index constituents.

[2] The Efficient Market Hypothesis (EMH) states that share prices reflect all available information, therefore it is impossible to generate Alpha (excess returns) on a consistent basis. The term was coined by the father of the EMH, Dr. Eugene Fama, Nobel prize in Economics.

[3] Economic Research, Federal Reserve Bank of St. Louis: https://research.stlouisfed.org/publications/

ill-timed oil price war between Russia and Saudi Arabia), leading to overflowing oil storage facilities. The situation became so extreme that oil futures briefly turned negative in April. Market prices were incredibly volatile.

Significant and rapid declines in the stock market typically offer good long-term buying opportunities for the patient investor. During times of uncertainty, there is frequently an abundance of public companies trading for prices that are below a conservative estimate of their intrinsic value. In March, we had such an opportunity and although we were not yet managing client portfolios, I was actively buying stocks in my family's portfolio. Taking a long-term view, I'm happy to buy stocks at attractive prices during falling markets and panic selling, provided that those companies meet my safety, governance and valuation criteria.

On March 23rd, the U.S. Federal Reserve announced that it would buy assets in amounts needed to "support smooth market functioning and effective transmission of monetary policy."[4] Despite the turmoil in the real economy, stock prices appreciated significantly on the news. By the end of the summer, the S&P 500 had fully recovered, and soon thereafter was making new highs. As prices rose, confidence returned and human psychology pivoted from fear to optimism, pushing equity prices even higher in the process.

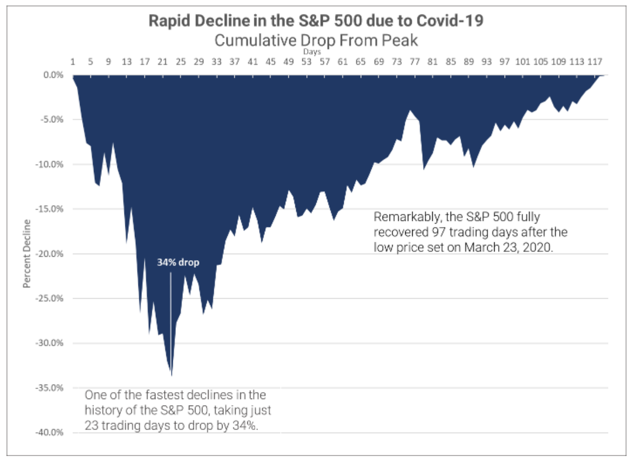


Chart data: FRED (Federal Reserve Bank of St. Louis), Oak Bay Capital

Financial assets are typically valued based on their potential future earnings or cash flows, discounted at an appropriate discount rate, which in large part depends on long-term corporate bond yields. When these yields are low, it raises the value of stocks and vice versa. Corporate bond yields depend on the prevailing long-term interest rates and credit spreads. The U.S. Federal Reserve lowered both these rates to historic lows in 2020 via Quantitative Easing. This caused a rapid increase in stock prices at a time when the real economy had rarely looked worse.

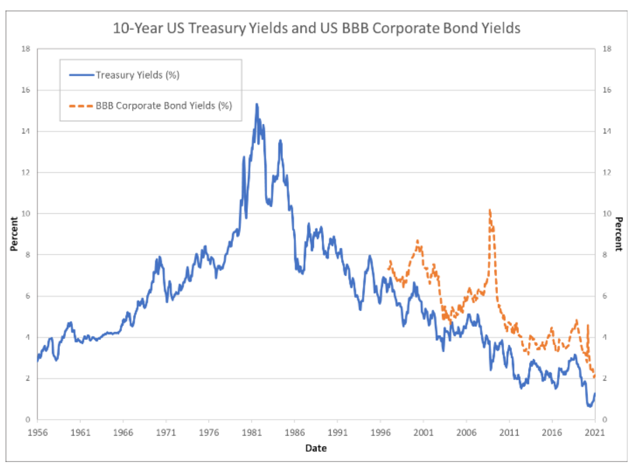


Chart data: FRED (Federal Reserve Bank of St. Louis), Oak Bay Capital

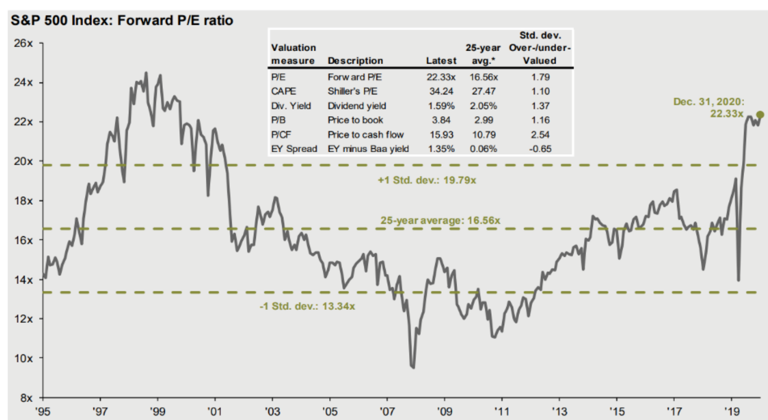
Human ingenuity and motivation were on full display by late 2020, as several promising vaccines for COVID-19 were developed in record time, giving the world hope that we can overcome the pandemic. However, new, more contagious variants subsequently emerged, causing alarm about whether we could control the virus. Fortunately, it didn't take long for pharmaceutical companies to announce that their vaccines could be tweaked to control the new strains. Certainly, these vaccines

[4] Market Watch, Greg Robb, March 23, 2020

gave all of us something to cheer about, and undoubtedly, much of that enthusiasm found its way into rising stock prices.

It is always good to keep some perspective regarding investment risks, especially as rapidly rising prices entice otherwise cautious people to do uncharacteristically risky things in the stock market. With both record low interest rates and narrow credit spreads, the stock market was red hot by late 2020. Rapidly rising stock market prices led to frenzied buying and rampant speculation in cryptocurrencies, blockchain technologies, biotech, technology IPOs, special purpose acquisition companies (SPACs) and short-squeeze opportunities, to name a few. We saw a significant rise in day trading and surging interest in leveraged ETFs, as well as an unprecedented spike in the trading of Call options.

The U.S. IPO[5] market was the hottest it has been in over two decades, with first-day performance averaging a 40% return[6]. Highly speculative SPACs, often referred to as "blank-cheque companies," raised over $70 billion in 2020[7], more than the entire prior decade combined. This amount of IPO and SPAC placement can only occur in an optimistic market as rising prices and quick profits often overcome people's better judgment. The last time we had this type of a market was in 1999, during the Dot Com bubble. In the years following that mania, the Nasdaq fell by 80%, as I remind my 4th year students in the Strategic Investing course I teach at the Richard Ivey School of Business. The comparisons are vivid and investors in high flying technology companies should be very cautious that they understand the businesses they are buying.



Source: FactSet, FRB, Robert Shiller, Standard & Poor's, Thomson Reuters, J.P. Morgan Asset Management.

While financial bubbles can only be clearly identified after they burst, we feel that it is now prudent to act as if we were in one. We take this approach with our client portfolios because of what we believe is a general mispricing of risk in the market. Many of the macro-economic valuation techniques we use indicate that the stock market is now quite expensive. Even simple, more traditional valuation techniques indicate that the stock market price is near historically high valuation levels.

The current stock market price depends heavily on a continuation of super low long-term interest rates and narrow bond credit spreads. We believe that, as the economy recovers, interest rates will rise and corporate bond yield spreads will widen, and this will let some of the hot air out of the balloon which has been lifting bond and equity prices.

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[5] An IPO is an Initial Public Offering, the process of selling first time market-listed shares of a private corporation
[6] Haefele, Mark. "Sparkles and Bubbles." *UBS House View*, UBS AG. 14 January 2021
[7] Haefele, Mark. "Sparkles and Bubbles." *UBS House View*, UBS AG. 14 January 2021

As Mark Spitznagel refers to in his book *The Dao of Capital*, we take a roundabout approach, avoiding what is currently over-inflated in the market and instead opting for attractively priced businesses, prudent balance sheets and good management teams. We believe these businesses will perform well should markets continue higher and expect them to do considerably better than the market should markets suffer a steep decline.

We launched our U.S. Risk Managed Equity (RME) mandate on September 1st, 2020, and our track record will be presented on an absolute and a risk-adjusted return basis in our Q1 2021 note. We believe that our firm's focus on risk management will continue to be a crucial factor in delivering good results to clients over the long-term, especially given the current market conditions in which we now invest.

Wishing you and your family a safe and prosperous 2021.

Reyer Barel
Co-CEO & Chief Investment Officer
Oak Bay Capital Inc.