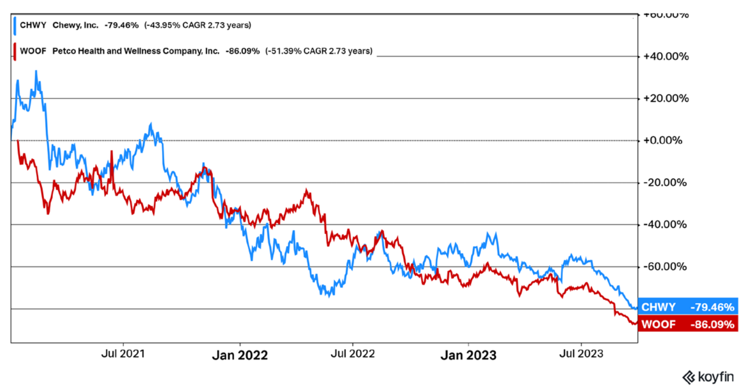
Breaking concentration

According to Statistics Canada, a child born today will cost parents on average $300,000 before age 18. A handsome sum. This enormous financial burden has been the major reason why birth rates have plummeted over the past few decades. Canadian households currently only produce 1.4 children per couple, a significant drop from the average 4 children per couple during the 1960's. This is a significant problem given our population requires a minimum fertility replacement rate of 2.1 children per couple to break even.

While Canadians are having less kids, total family size has remained steady. This is because families are replacing human babies with puppies, kittens, and birdies. Shockingly, there are more households with pets (60%) than households with children (41%), a trend that has been expanding since the late 1990's. We collectively spend around $11 billion a year on pet supplies and vet bills, about the same amount we spend on human children's toys, clothes, and food, combined.

Interest in pets further accelerated during Covid as more people decided they needed a furry or winged companion while hunkered down at home. Canadians have a seemingly insatiable appetite for housebound animals. Given this trend, one might be tempted to invest in businesses directly involved in the pet goods and services industry. There are two large publicly investable pet care businesses, both headquartered in the US; Chewy and Petco. These two heavyweights make up more than 50% of the North American pet goods and services market. Had an investor purchased either of these stocks at the beginning of Covid, their return (and experience) would have been decidedly negative (see chart to the right). Both investments have performed abysmally (80%+ losses), even though their underlying businesses continued to take market shares from their competitors.



Why would Chewy and Petco stocks be poor investments at the same time pet ownership has never been more popular? To answer this question, one must remember the prime determinate underlying what makes a prudent investment (or not). There is an enormous difference between a 'good business' and a 'good investment'. The difference is determined by purchase price.

Paying a rational price for an investment is among the most important criteria for financial success. On the flip side, overpaying for an 'exciting investment' is a recipe for financial ruin. First time homebuyers are acutely aware of this concept; would a young couple like to buy their first home on a desirable street, close to restaurants, schools and parks? Sure, but purchase price will largely determine whether they will ever sell it for more than they paid. For most young couples, $500,000 for a small house next to great amenities is terrific, $10 million is not. In the case of Chewy and Petco, their stock prices during Covid were exceptionally expensive; akin to buying a first-time home for $10 million. These companies were growing at exceptional rates, so investors got excited about their future prospects, pushing share prices to values not justified by actual profitability. There is little hope of a positive return on investment for those that greatly overpaid for these stocks.

The US stock market has had a decent first 3 quarters in 2023, up 12%. However, there may be trouble brewing underneath the surface. The S&P500 is the most widely followed stock market benchmark in the world. It is a listing of the 500 largest US companies, which most investors use as a proxy for the overall US investment market. To provide ample diversification, these 500 companies are similarly weighed across 11 different sectors (technology, financial, health care, etc.), which means each sector represents about 9% of the total stock market. Occasionally, the market skews towards one or two sectors, which means the overall index becomes concentrated in just a few popular companies. Historically, when this shift persists for an extended period, it is because the price of the most popular firms have reached exorbitant levels. When this overconcentration skew occurs, the 'trendy' sector rarely exceeds more than 20% of the overall index (instead of the usual 9%).

Currently, the top 10 companies make up 33% of the value of the S&P500, mostly in the technology sector*. The other 490 companies make up the other 2/3. This is extremely limited sector breadth and is a potential problem. Technology stocks have performed wonderfully over the past few years as investors have sought to invest in companies with above average growth. These tech companies are household names with highly profitable business models. However, the prices demanded for shares of many of these businesses are no longer rational. When significant sums of money chase only one sector already at an aggressive valuation, prices may need to recede to return to more realistic levels. This represents a potential problem for an overvalued sector, while presenting an opportunity for sectors which have not participated in the runup.

How many of the following companies do you recognize; Polaroid, JC Penny, IBM, Kmart, Sears, ITT, Kodak, American Express, Xerox, Dow Chemicals? These were the largest 10 companies in the S&P500 in the early 1970's. Back then, these 10 companies made up 33% of the S&P500 index, similar to the overconcentration we see today. They were by far the most popular companies in their day and were priced accordingly. Investors treated them as 'hold forever' stocks, assuming these companies would never stop growing. Over the next decade, these companies collectively lost 2/3rds of their value as their stock prices returned to more reasonable levels. At the same time the bottom 490 stocks rose in value by more than double the return of these top 10. History does not exactly repeat but it does have a way of rhyming.

While our client portfolios do have some limited exposure to the top 10 stocks in the S&P500, we have far higher weightings among the other 490. These companies should be better positioned if the market returns its focus to business profitability rather than just future growth projections. This change of focus is common as an economy slows.

As stock valuations have grown progressively more expensive, we have added more short-term fixed income to our mix. Our portfolios currently have less exposure to stocks than fixed income, where we are generating consistent yields higher than those offered by GICs, with better tax treatment and more flexibility. As an example of the opportunities in fixed income, let's review a Loblaws bond.

Bond Issuer	**Maturity Date**	**Coupon**	**purchase price**	**Matuity value**	**Yield to maturity**
Loblaws	May 7, 2030	2.3%	$83.02	$100	5.4%

This bond is issued by Loblaws, Canada's largest food distributor. It matures in 6.5 years (May 2030) and pays annual interest every year of 2.3% (the coupon). The purchase price of this bond was $83.02, and at maturity we receive $100, which means we will generate a 20.5% capital gain between now and May 2030. By adding the coupon interest and the capital gain, we calculate the total return of the bond (called yield to maturity) of 5.4% per year. Because interest rates have spiked, this low-risk investment is a great alternative to many expensive stocks.

The biggest difference between this bond and Loblaws stock, is the bond is a contractual obligation of Loblaws. In other words, by purchasing this bond, investors have a legal contract with Loblaws that must be honored. Loblaws stock will move up and down based on other stock market participants' views about the company and its future prospects, whereas bond investors simply collect interest payments and the eventual capital gain. As interest rates have dramatically increased over the past 18 months, we have significantly increased our bond holdings, including Loblaws bonds, as the risk/return payoff is meaningful.

The top 10 companies that have dominated the stock market over the past few years are wonderful enterprises. They are household names and are used daily by a large portion of the world. However, it was not too long ago that in a similar way Polaroid and Kmart dominated the market. Worldwide economies are slowing moderately. Given a resilient labour market, and expanding GDP, most sectors have so far avoided recession. Political instability and violence across the globe have the potential to increase volatility across asset classes. Our defensive positioning, including a significant exposure to investment grade bonds, is prudent.

Your *can't believe how much I spend on our dogs* portfolio manager,

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*Current Top 10 holdings in the S&P500: Apple, Microsoft, Amazon, NVIDIA, Alphabet (Google), Tesla, Meta (Facebook), Google, Berkshire Hathaway, United Health.