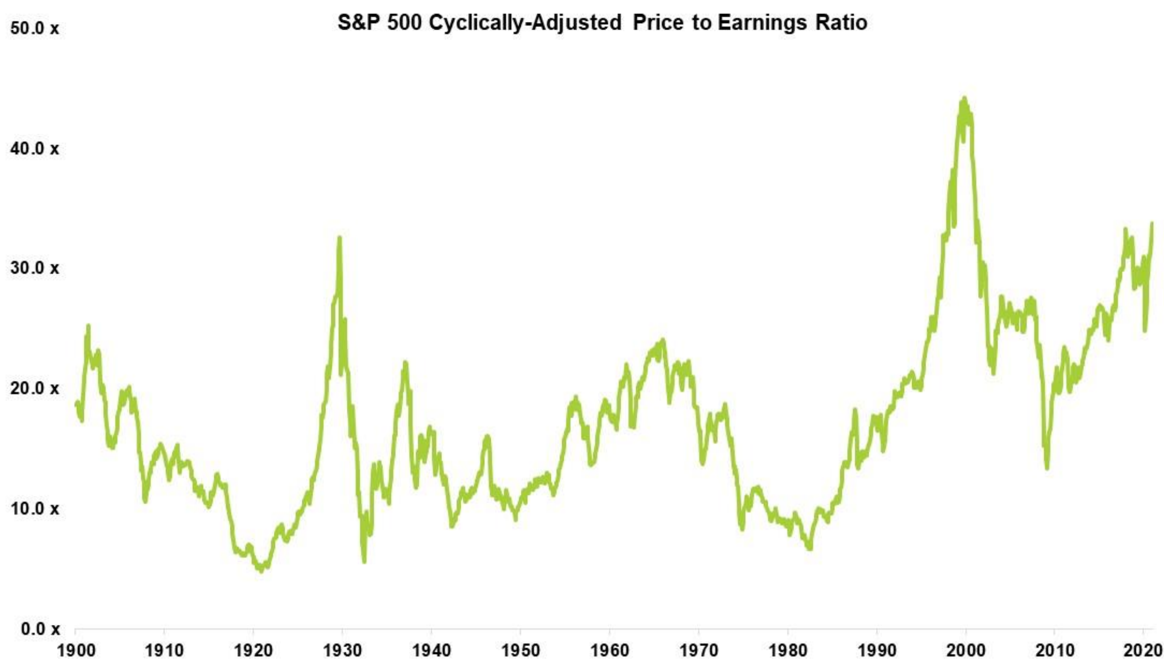
JANUARY 2021

What Bubble?

It likely comes as no surprise, amongst our small cadre of followers, that Fulcra sits firmly in the camp that the current valuation of financial assets is expensive and *virtually* without precedent. An overwhelming driver is the low level of interest rates and a prevailing view amongst investors that they will stay low, virtually, forever. Valuations aren't virtual, they are real. The full extent of this fully valued reality, however, will only likely playout once life gets back to being more normal… in a pre-pandemic way. In a relative value world the march higher in risk assets could continue. While the CAPE[1] is at a level like that when the stock market bubble of 1929 burst, the recent historic monetary and fiscal support by governments globally may increase this simmering bubble to a boil. In a relative value world, liquidity needs to find a home and with interest rates at their historic lowest level, the aggregate value of global stock markets versus the supply of capital does suggest that equity markets could go higher.

[1] Cyclically adjusted price-to-earnings ratio is determined by dividing the current price of a stock by its avg. inflation adjusted earnings over the last 10 years.



However, looking at this phenomenon we would suggest not reaching for investment returns (i.e., employing leverage and/or being fully invested) now. Cash and its liquid equivalents should never be disrespected and especially at this time.

As fundamental investors, we purposefully process information both current and historic to map the commercial path of a corporation and determine where they sit on it. Charting the financial state of a corporation to the end of this pandemic and thinking through how different businesses will perform in the new normal (achievement of herd immunity) has been an intellectually stimulating exercise.

Understanding and determining a business' strengths and / or weaknesses is only one element of the equation in finding an attractive investment opportunity. The other is price. Tell that to investors in the company's that make up the index below and you might get a decidedly different opinion on what represents value. The mere requirement to own, in their eyes, is a big part of the value proposition.

Source: Bloomberg, Goldman Sachs

An out of publication book that we recently bought (used), “Eboys: The First Inside Account of Venture Capitalists at Work” by Randall Stross does a great job of tapping into the mindset of investors that value company’s not many steps removed from the concept being scribbled on the back of a napkin. The book, published in 2000, is an interesting read on the formation of venture capital firm Benchmark and some of its early investments. One of which was eBay. At the time eBay initially had difficulty attracting an investment from a noteworthy VC firm… because it was profitable!

In credit, the disconnect between fundamentals and price can be more nuanced but distortions do exist. Below we provide a couple of examples. Both were new issues… and surprise surprise! We bought one of them. Earlier this month, T Mobile came to market with a 3-part bond issue that was upsized 50 percent to USD $ 3billion. The just below investment grade rated bond issues (BB, BB+ rated) benefited from this demand as pricing (coupon) came in lower than initial price talk at 2.25 percent (5 year), 2.625 percent (8 year), and 2.875 percent (10 year). Regardless of the quality of the parent company, these bonds still fall into the category of “junk” bonds. But don’t let the label scare you. The proceeds of this capital raise are to be used to purchase 5G broadband spectrum so the company can eventually raise more money to buildout the 5G network. TBC, as a leader in 5G, T Mobile, through this capital spend, will likely be protecting its position as a leading provider of 5G services in the US for years to come.

Regardless of the price consumers/corporations are willing to pay for this ubiquitous “always” connected service it is the duration and low coupon of the bonds that will not protect a long only investor if interest rates move much higher. Its not expensive because of the fundamentals, although the prophet of 5G hasn’t arrived yet, it is the price that makes it expensive.

In the 3rd quarter of 2020 we began to buy, at a significant discount in the secondary market, the 7.625 percent coupon bond of Tervita, a waste management and environmental company that operates in western Canada. With dominant market share, strong corporate and government counterparties, a business that helps the oil and gas industry with their ESG imperative, and contractual free cash flow we found the company’s debt attractively priced with mid teen yields. With this one bond issue of the company coming due in Dec. 2021 we were confident that the combination of excess balance sheet liquidity and the ability to come to market would allow this bond to be refinanced. The surprise, however, was the apparent difficulty the company had with it getting it done at initial price talk of 10%. We normally don’t buy new issues but in this case there seemed to be a pricing anomaly. The USD $500 million senior secured second-lien notes due Dec. 2025 priced with a 11 percent coupon at a discount to par ($98) for an all-in yield of 11.532 percent. As of writing the bonds are marked at $109.25.

With the announcement of the Pfizer vaccine in early November and 10-year Treasury yields moving above 1 percent, most asset classes were rallying, except for the leveraged loan market. We have held the view for several months that some leveraged loans are cheap. They represent a unique opportunity as they possess floating coupons, are senior in the capital structure and are largely influenced by the robotic dynamics of CLO’s. In the last quarter of 2020, and in the first few weeks of this year we have purchased three loans in the secondary market. Two were purchased around $90 and another at par with an above average yield (spread).

As 2021 begins, the world is aware of more known unknown risks than perhaps any period in history. Central bankers, world leaders, and the medical profession have done there best to get us past the initial scare of this pandemic. What follows, will likely be a brighter future filled with opportunity… even in boring bond land ;)