

PORTFOLIO ACTIVITY

In January, we executed several rebalancing trades, trimming positions that had run ahead of our fair value estimates and adding capital to those which represent a more attractive risk-reward tradeoff.

FEATURE STOCK

Constellation Software (CSU)

Software consolidator CSU is one of the truly exceptional stocks on the TSX and has been a prodigious performer in DM's Canadian mandates for several years. The company has followed a disciplined strategy of deploying free cash flow to the acquisition of vertical market software companies, with past success driven by (1) a low customer churn rate, (2) an organizational structure that pushes operational and capital allocation decisions down to division managers, and (3) an acute focus on return on invested capital and organic growth throughout the organization. In recent months, CSU has spun out Topicus.com into a separate public entity (the first such transaction in company history) and created an internal team dedicated to larger acquisition opportunities. Given that CSU's revenue growth in the past has been driven by an opportunistic and effective acquisition strategy, its stated intent to increase the scale of this approach could have a transformative impact on the company. In late February, CSU reported year-over-year revenue and EBITDA growth of 14% and 34%, respectively.

THE STOCK MARKET IS DANGEROUSLY EXPENSIVE – OR IS IT?

The market's almost unrelenting ascent from its spring 2020 low has raised concern that stock prices have become precariously disconnected from fundamentals and are being buoyed primarily by the tsunami of liquidity unleashed by fiscal and monetary authorities. To be sure, the S&P 500 has rarely been as expensive as it is right now when judged by the commonly referenced price/earnings ratio; if cash flow is used as the yardstick, though, equity valuation doesn't appear to be particularly stretched against where it's tended to reside over the past 30 years. As the accompanying chart indicates, the free cash flow yield of the S&P 500 is only slightly below its long term average and well above where it spent most of the 1990's and early 2000's. So why would a valuation metric derived from free cash flow look so much better than one based on earnings? A clue can be found in our December 2020 monthly comment which showed how intangible assets (patents, brands, intellectual property, etc.) have become the dominant component of S&P corporate value in recent years, overtaking tangible assets (plant, equipment, property) as the favoured target for capital allocation. Through a quirk of accounting, however, when a company such as Microsoft, Google, or Pfizer invests in R&D, the entire outlay is most often reflected immediately on the income statement, imparting a substantial hit to current reported earnings. Funds deployed to hard assets, on the other hand, are generally recorded on the balance sheet with a relatively small amount of depreciation finding its way to the company's expense line each year. All else equal, this means that accounting rules may cause the income of a 'capital light' business to be understated as compared with that of a 'capital intensive' enterprise. So, as S&P composition has tilted decisively toward technology, health care, and consumer brands and away from manufacturing, resource development, and chemical fabrication, it's not unreasonable to assume that investors would begin to assess value in a different way. And, on the basis of the free cash flow generated by the average market component, valuation may not be as alarming as some popular measures would presently suggest.

