Préfontaine Capital Inc.

- FINANCIAL LETTER -

FOURTH QUARTER OF 2020

Review and lessons from 2020

In its January 2021 report, the World Bank estimates that the world economy shrank by -4.3% in 2020 and according to its baseline forecast, will grow by 4.0% in 2021 and 3.8% in 2022. For the United States, the figures are -3.6% in 2020, 3.5% in 2021 and 3.3% in 2022. If we focus on the long-term, the World Bank forecasts average "potential" growth of 1.9% for the next ten years compared to 2.5% for the last ten years and 3.3% for the first decade of the 21st century. What matters to us in these projections are not the precise numbers, but rather the factors underlying these forecasts. The World Bank believes that growth will be affected by an aging population, declining trade due to rising economic nationalism, high debt levels, lower capital investment and educational disruptions caused by the pandemic. Technological discoveries and thoughtful public policies would counterbalance this. The Canadian government, for its part, predicts that the pandemic has reduced the long-term "potential" growth of the Canadian economy by 0.5% to an estimated annual real growth rate of 1.4%. This potential depends in particular on business investment, productivity growth, training, and the maximization of labor force participation. The actual future figures will therefore depend on government policies.

With respect to the stock market, 2020 has been a year full of lessons. The pandemic caused a very rapid stock market crash (S&P500) of around -35% and an equally rapid rise of 68% as of December 31st. It is obvious that this stock market rise was due to unprecedented measures by governments and central banks to mitigate the effects of the pandemic on the economy. Without these measures, we believe stock markets would still be in negative territory, even with vaccines, as the economy will probably be weaker for several years to come. The meteoric rise in the stock market has also led, in our opinion, to a sectoral speculative bubble, particularly in the cloud computing and electric vehicles/green energy sectors, but also other sectors that have an aura of "novelty". From this, we draw some conclusions for us, individual investors:

1. Any amount invested in the stock market should be able to be subject to a severe correction without the investor panicking and deciding to sell. Everyone should therefore reassess their risk tolerance in light of their behavior during the correction in March 2020;
2. Risk tolerance depends on several factors, including our employment situation and/or the extent of our emergency cash reserves to cover family expenses; our understanding of the history of the stock market; our understanding of the factors affecting the revenues and expenses of each of our companies, and finally our past experience of going through several stock market cycles;

3. The technology bubble we are currently experiencing should lead us to examine our behavior during this bubble;
4. The long-term impact of government and central bank interventions on the economy and on stock markets remains to be determined.

Psychological effects of the pandemic and of speculative bubbles

It is important to identify the emotions we are experiencing and see how this affects our investments. The pandemic causes emotional stress, anxiety, boredom, weariness, fear and hope in a very uncertain environment. In a highly anxiety-provoking environment, the natural tendency is to want to take action to make ourselves feel like we are in control of our destiny. Often, our buy/sell decisions in times of anxiety will turn out to be misguided.

Speculative bubbles always start with a very realistic investment thesis but end with exaggeration and irrational exuberance. In this case, the transformation towards a cleaner, digital, dematerialized, and automated economy is an indisputable reality. So, the initial idea is good. The problem, as in 1997-2000 with dotcoms, is that this good idea is the subject of a gradual swelling where, at a certain point, investors no longer consider the price paid and are motivated by the fear of regret of not participating in the rise ("FOMO" or "Fear of Missing Out"), by the dopamine released during an investment and by the tendency to listen only to what one hopes to be true (the "wishful thinking" from confirmation bias).

Currently, it appears that the growth of the traditional "tangible" economy in the coming years will be weak. Investors are therefore looking for sectors that will have stronger growth such as software, biotechnology, gene therapy, video games, online sales, videoconferencing, social networks, cloud applications, online entertainment and training, industrial automation and robotization, the Internet of things, renewable energies, etc. While it is true that these sectors will grow faster and that innovation will be the engine of economic recovery, it does not mean that we can easily identify which companies will win the fierce competition in these sectors and that the sometimes explosive growth of some of them in the first years will continue long enough to justify their current market values. Here are some indicators of our speculative bubble thesis:

1. Initial Public Offerings (IPO) in 2020 in the United States were launched with an average price/sales ratio of 24x compared to an average of 6x since 2010 (and 45x during the technology bubble of 2000). There were 480 IPOs in 2020, a record, compared to 233 in 2019 and the previous record of 397 in 2000. 70% of those companies generate negative income and their stock market prices rose on average by around 64% in 2020;
2. Margin investing (borrowing to invest) is at a record high;
3. The price of Bitcoin is at an all time high, which in our opinion, is an indicator of popular frenzy;
4. Around 10 million new brokerage accounts were opened in 2020 in the United States, as casinos were closed during the pandemic;

5. A certain level of aggressiveness from investors, who do not want to be told by their advisers that they are speculating and/or in a bubble, for fear of losing the opportunity for a rise (FOMO). This aggressiveness was also present towards the end of the last two bubbles of 2008 and 2000;
6. Accounting and financial overstatements by company executives (during this current cycle: exaggeration of concepts such as "recurring revenue", "new customers", etc.);
7. Here are some current valuations (which remind us of Cisco Systems (CSCO) in March 2000 which had a Price/Earnings ratio of 196x and a share price of $77, compared to $45 today, twenty years later) :

	Market Value (US$ billions)	**Sales**	**Price/Sales**	**Earnings**	**Price/Earnings**
Tesla	$806.1	$28.2	28.6x	$0.5	1 512.5x
Snowflake	79.8	0.5	163.1x	-0.4	Not Meaningful
Zoom	111.7	2.0	57.1x	0.4	262.6x
Airbnb	96.0	3.3	29.4x	-1.0	NM
Doordash	60.2	2.2	27.2x	-0.3	NM
Crowdstrike	50.1	0.8	65.8x	-0.1	NM
Docusign	47.6	1.3	36.7x	-0.2	NM
Twilio	59.3	1.5	38.4x	-0.4	NM
Datadog	31.8	0.5	58.9x	0.0	NM
Shopify	147.5	2.5	60.0x	0.2	747.4x
Okta	34.2	0.8	44.5x	-0.2	NM
Atlassian	57.7	1.7	33.7x	-0.4	NM
Coupa Software	24.3	0.5	49.6x	-0.1	NM
Dye & Durham	2.2	0.1	41.3x	0.0	NM
Nuvei	8.3	0.3	24.5x	-0.1	NM

Of the hundreds of stocks that are extremely overvalued, there may be a few that will grow to justify their price, but the odds for us hitting the bullseye on these are not favorable. For every Amazon, a few thousand will lose their shirt. It is like trying, in 1910, to choose among the hundreds of auto companies, which ones would survive.

What is important to remember with speculative bubbles is that they can last several years, which tests our convictions and our patience as we will look foolish during all the years when we judge the prices as being detached from reality. As price increases feed on themselves, their rate of amplification accelerates and provokes an irresistible temptation. This goes on until the day when reality catches up with the exaggerated prices and the ensuing crash happens very violently, at an unpredictable moment.

How to invest during a speculative bubble: 1/ Look at portfolios stock by stock and client by client; 2/ Stay disciplined and have the humility to limit yourself to companies that you understand well 3/ Avoid euphoria, greed, and envy.

Just like during the tech bubble of 2000 where we were very successful despite the -82% crash of the Nasdaq, during the current bubble we continue to look at each of our stocks individually and try to estimate as best as possible the position of each on a rating scale ranging from extreme undervaluation to extreme overvaluation. In the current context, we think there are sectors and companies that remain at reasonable valuations.

Our main role as portfolio managers is to identify to the best of our knowledge the risks and opportunities and to find the balance between these two uncertainties. Risks for the next several years include rising inflation and interest rates, a weak economic recovery, a more severe coronavirus mutation or a more severe pandemic, major cyber-attacks, and/or other external political or natural shocks. Among the opportunities, we always look for situations with little media coverage and/or that are neglected in favour of passing fads, but which have long-term strategic potential. At the same time, we are working on a dashboard of innovative companies to help us stay informed of potential technological disruptions. We are also looking to establish natural hedges to deal with different scenarios. For example, if inflation and interest rates rise, some stocks in our current portfolio would benefit. If rates remain low for a long time, another portion of the portfolio would benefit. In the event of a more serious mutation or an extension of the coronavirus, some of our companies would benefit.

> ***Always remember the two basic rules of investing: number one: do not lose money; number two: remember rule number one.***

The following sections are reserved for our clients.