Market's Neither Expensive Nor Cheap

Here's where David Fingold sees upside for his gold-rated global equity fund.

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There has been much ado about 'high' valuations in the equity space for some time. But credit looks good, and MI 1832 Asset Management's David Fingold sees a green light for the economy – which matters more than P/E ratios he says.

Since bottoming in March 2020, the benchmark MSCI All Country World Index C$ is up about 75% and some pundits have noted the market would appear to be expensive. Yet Fingold, a value-oriented stock picker who oversees the $1.2 billion gold-rated Dynamic Global Discovery Series F, continues to see upside while arguing that the market is neither expensive nor cheap.

"I don't think you can get information about the investing environment by looking at the so-called valuation of the market," says Fingold, vice-president at Toronto-based 1832 Asset Management LP and a senior portfolio manager who oversees a group of eight global, U.S. and international equity funds with a total value of about $13 billion. "This is an area where some are obsessed with the valuation of the cap-weighted indices. Some people say that they can derive some informative power by looking at the 'value' of the market. I don't think you can. For instance, there were as many opportunities in March 2000 as there were dangers. A lot of people are unaware that the average stock was doing poorly for two years going into March 2000. But they did well for the next two years after March 2000, although there was a correction for the average stock during 2002."

Put P/E in Perspective

Too much attention is spent on whether markets are expensive or cheap, says Fingold, who joined the firm in 2002, after working for 14 years at a merchant banking organization and earning a Bachelor of Science from Babson College in 1988. He notes that Myles Zyblock, the firm's investment strategist, has examined the price-earnings ratio of different benchmarks and whether those ratios can predict future returns. "The answer is, broadly, that they do not. What is important is whether or not there will be a recession. Recessions in the last 70 to 80 years were accompanied by a bear market in the magnitude of 30%. How reasonable is it that there will be a recession in the next 12 months?"

The yield curve is upward sloping, and "it would be without precedent to have a recession in the next 12 months." However, Fingold admits there are exceptions to the rule. Such was the case in the late 1940s and early 1950s when the Federal Reserve applied so-called yield curve control and the Bureau of National Economic Research declared a recession, although the yield curve itself did not invert. "The Fed is not currently utilizing yield curve control. In fact, it's talking about tapering. So the yield curve is increasingly determined largely by the market and it is upward sloping."

Broad Market Says Go

Is there a risk, Fingold muses, of a market correction? That requires destabilization in the credit markets, he notes, and yet conditions are quite healthy. "There's been a slight widening in credit spreads since late August, but they remain incredibly low. There is no reason to believe the market is starved of credit," says Fingold. "We are not getting a yellow light or a red light. We are getting a green light. To summarize: the curve looks good, credit looks good and we should be optimistic. There is no reason to be pessimistic. This is a dramatic change from when we raised a pile of cash in March 2020. The yield curve was inverted and credit spreads were blowing straight out. The current circumstance is constructive," says Fingold, adding that based on current data a recession is not likely in the next 12 months.

Yellow Flag on Oil

"The only thing flashing yellow light is the rate of change in gasoline futures which is up 100% year-over-year. A number of recessions in the last 80 years were preceded by gas prices doubling in the 12 months leading to the recession. But it didn't predict the 2020 recession because energy had been doing poorly going into 2020," says Fingold. "That indicator is out there. But there is also a very strong employment environment, which works counter to the rate of change in gas futures."

Although he is a bottom-up investor, Fingold points out that he and his team are keen to manage macroeconomic risks. "Every company we invest in is exposed to macro risks. We have to worry about what might, in the words of Charlie Munger [vice-chairman of Berkshire Hathaway Inc. (BRK.A)] invert our investment hypothesis. From a risk management point of view, we see some yellow lights at worst. But we largely see green lights as we look across the economy."

Year-to-date (Oct. 26), Dynamic Global Discovery Series F has returned 8.55%, compared to 12.93% for the Global Equity category. But over the longer term, the fund has outperformed the category. In the past five and 10 years, the fund returned an annualized 13.81% and 13.61%. In contrast, the peer group returned an annualized 10.74% and 11.54% respectively. Fingold has managed the fund since 2004.

All-Cap, All-Period Advantage

Running a portfolio of 25 stocks, the fund is an all-cap product, with a mixture of small-, mid-and large-cap stocks, whose holding periods vary. "It depends on why we acquired a stock and if it turned out the way we expected it to," he says, noting that holdings such as Switzerland-based Schweiter Technologies AG (SWTQ) go back to 2005 and others, such as Israel-based defence electronics firm Elbit Systems Ltd. (ESLT), go back to 2013.

"If you are talking about a small- or mid-cap company that has a control block and we think it has a sustainable competitive advantage and not a lot of people have heard of, but we believe it has the capacity to be a long-distance runner, we will hold it for a very long period," says Fingold, noting smaller companies are held for several years to ride out the economic cycle.

However, since part of the portfolio is held for relatively short periods it has skewed the portfolio turnover rate, which hit 311.34% for the 12 months ended June 30, 2021. "We have some very large liquid names that we own because we think they are timely. If we don't think so, then we will sell them. They are different from another part of the portfolio which is very much part of a buy-and-hold philosophy."

From a geographic perspective, 40.9% of the portfolio is in U.S. stocks, followed by 18.4% Switzerland, 18% U.K., 10% Israel, 5% France, 4.8% Sweden and 3.4% Japan. On a sector basis, the fund is dominated by a 26% weighting in information technology, followed by 20.5% industrials, 15.1% financials, 13.5% materials, and smaller weightings in areas such as consumer discretionary and healthcare.

Attractive Returns in Rentals

One of the top holdings is Ashtead Group PLC (AHT), an industrial rental equipment firm based in London, England. The firm gets about 85% of their revenues from the U.S., through a subsidiary called Sunbelt Rentals which has 388 locations. "We like it because the equipment rental business is very misunderstood. A lot of companies that traditionally owned equipment have benefitted from renting instead. To be blunt, why own a piece of equipment that you use infrequently if you can get it very quickly, when you need it and give it back to the rental company. Then you can invest your own capital in something that can generate a higher return," says Fingold. "If you have the right fleet with the right locations you can get a very high utilization rate out of your equipment and earn an attractive return. It's a network-effect type of business that requires expertise in logistics and customer support. It lets the customers focus on running their business, instead of worrying, "We have to change the oil filter in the front-end loader.'"

Ashtead Group, which has a market cap of (Sterling) 26 billion (C$43.9 billion), generates operating margins of 28.9%. The stock trades at 22 times price-to-estimated 2022 earnings. Acquired in 2020, the stock is (Sterling) 60 (C$101.4), or double the acquisition price.

Income in Israel

Another favourite is Tel Aviv-based Mizrahi Tefahot Bank Ltd. (MZTF), the third-largest bank in Israel and one of the largest providers of mortgages. "We are drawn by the quality of management, which we have known for a very long time. This bank has built the leading position in the mortgage market in Israel and in 2020 merged with Union Bank of Israel. There are significant synergies from that merger. I've followed them for a long time and they've been able to generate significant returns," says Fingold, adding that the bank has a return on equity of 13%.

Mizrahi Tefahot Bank has a market cap of 29.4 billion Israeli shekels (C$11.5 billion) and its shares are trading at 10 times estimated 2022 earnings. "Like many banks, in 2020 they were required to restrain themselves on returns to shareholders. We think there is significant upside to dividends as regulators permit more normal returns on capital. The dividend yield is 1.7%, but the market is expecting a significantly higher dividend."