Newsletter and Quarterly Update :: September 2020

CAIRN INVESTMENT GROUP

GREETINGS FROM THE NORTHWEST

Well, it's Fall at last and it's beginning to cool off a bit, although more slowly than usual, as it's still been in the 80s when the smoke's not too thick. We did kick off October with the first foggy mornings of the season and that seems to make a cup of coffee just a little more enjoyable. I look forward to the wonderful, natural changes that happen this time of the year, in stark contrast to some of our human constructs. Below, I'll dig into some of my thoughts about our man-made world, but first I'll share a moving personal experience with you.

Some weeks ago, I woke up along the banks of the Madison River in Montana, having spent a few days fishing and revisiting one of the favorite memories from my youth. Wow, had it changed! Trophy homes are perched on every hill and a very active tourist/fishing racket drags paying customers down the river in small armadas, slapping the water continuously with their bright strands of fly line, all hoping to catch the same fish that had successfully ignored the prior dozens of presentations. Having had enough of that, I packed up camp early and headed east to Wyoming, through Yellowstone Park. I always enjoy Yellowstone, but unless one can stay awhile and explore, it's just a slow drive through some pretty country, albeit a bit smoky this time.

Midway through the drive, along the banks of the Yellowstone River, I found myself coming to a halt behind a line of stopped cars and a scene straight out of an apocalyptic movie, with drivers abandoning cars mid-road, grabbing cameras and optics, while lunging towards the river with much excitement.

What I witnessed was one of nature's greatest and most brutal spectacles. A very large grizzly had chased a mature bull elk into the river and was dispatching him as I arrived. Despite the elk's long powerful legs and massive pointed antlers, he was no match for the bear's practiced approach and agility. By entering the river, he had unwittingly sealed his fate. I watched as the bear finished this task, essential to his survival, and then slowly, working with the current, brought the elk to shore. Having assured survival for another week or so, he sat on his haunches, resting and considering his victory. This entire episode, from well before I arrived on the scene and for days thereafter, has been photographed and recorded by many, and you can easily find this on YouTube if you're interested.

To the Victor Go the Spoils

While this is a cool story and a great memory for me, I think it also has some instructional value when it comes to our lives, our decisions and our investing behavior.

The outcome of this event was not preordained. Why did the elk give up its advantage and play into the strengths of the bear? My theory is that in this case the bear was much more experienced at killing than the elk was at not getting killed. The elk lived in a predator-rich environment, being on guard at all times and occasionally experiencing the loss of a herd member, but it probably had not been in such close proximity to death and had an exaggerated sense of his ability to escape.

OF NOTE

:: Cairn Welcomes New Team Member, Muriel Templeton!

:: Bank Holidays: Oct 12 and Nov 11. No Checks or Settlements

:: NYSE Closed for Thanksgiving Nov 26 and Early 10:00am Close Nov 27

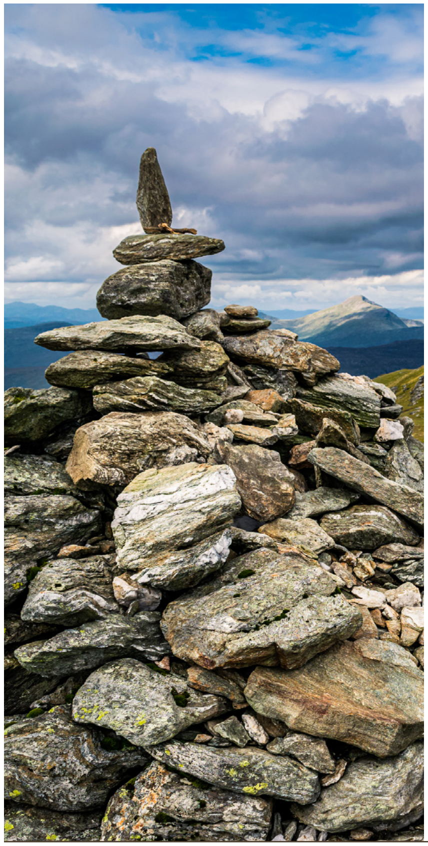
:: NYSE Early 10:00am Close Dec 24 and Closed for Christmas Dec 25

NEW FEATURE

:: Cairn Client Portal. A fresh way to keep up to date on your accounts. More to come soon.

He was the amateur in this fight. Seeking safety was his undoing. By contrast, the bear, evidenced by his mere existence, was a professional. Each and every meal not scavenged, was preceded by a successful hunt. He is an expert at the end game.

I draw a parallel from this to our own behavior: what we think and do when we're afraid, and again when we're confident. Our current human environment is unprecedented. To some extent we are all amateurs today. Who could imagine a year when the impeachment of the President of the United States is page three news? I cannot claim that we here at Cairn have some special insight into the future, or that we're even smarter than the average bear, but I can tell you that we have a process and that process works much better than running into the river for safety. Please take a moment and consider what Patrick has to say about what we do and what we plan to do to keep your money in a good place.



PATRICK'S PART

It was only a few short months ago that we were writing about the deep recession and corresponding market correction. Contrast that to today where we're witnessing exuberance in parts of the equity markets that resembles the tech bubble that took place 20 years ago. The US stock market, not to mention Robinhood traders, must be fans of the late musician Prince because it is partying like it is 1999. My apologies if that song is now stuck in your head. The difference being, in 1999 you had stock tips on AOL message boards and discount brokerage firms that would take your trades 24 hours a day. Today, you have a slew of new traders with Twitter and a phone app that lets you trade stocks like a video game.

We have written in previous quarters on some of the reasons investor enthusiasm is at its peak (Fed intervention, low interest rates, etc.). This optimistic behavior has driven valuation metrics across the board to historic highs. One of our favorite valuation metrics is the Price to Revenues (P/S) ratio. It gives a clear picture of what investors are willing to pay for a stream of revenues before costs and other accounting factors. It has been observed that there are now more companies in the S&P 500 trading at 10 times revenues (37) than there were in March of 2000 (30). This data point reminds me of a quote from former Sun Microsystems Founder and CEO, Scott McNeely, when he discussed the investor euphoria that was taking place prior to the tech bubble bursting:

> *"At 10 times revenues, to give you a 10-year payback, I have to pay you 100% of revenues for 10 straight years in dividends. That assumes I can get that by my shareholders. That assumes I have zero cost of goods sold, which is very hard for a computer company. That assumes zero expenses, which is really hard with 39,000 employees. That assumes I pay no taxes, which is very hard. And that assumes you pay no taxes on your dividends, which is kind of illegal. And that assumes with zero R&D for the next 10 years, I can maintain the current revenue run rate. Now, having done that, would any of you like to buy my stock at $64? Do you realize how ridiculous those basic assumptions are? You don't need any transparency. You don't need any footnotes. What were you thinking?"*

The recent price performance of Tesla showcases a current example of investor euphoria when their share rose 50% after the company announced a stock split on August 11th. A stock being split may sound like a good thing, but there is no economic value created with a stock split! The market value, earnings, revenues, and cash flows of the company remain the same. There are simply more shares outstanding being offset by a lower price. Tesla's 50% increase in market cap in the two short weeks following their split announcement generated more wealth for investors during that period of time than any of their car designs have ever done.

Wonderful companies (many of which we own) that create essential products and services have seen their share prices shoot past the fair value of the underlying business. However, this means that the prospects of these companies have been accounted for in the high share price. This potentially leaves little room for growth and heightens risks if the prospects fail to materialize. Down the road many investors may be looking back on this period asking themselves, "What was I thinking?"

> *We continue to focus on what we can control: being disciplined, patient, having a historical perspective, and straying away from the herd when opportunities or excessive risks are present." —**Patrick Mason***

With the levitation in growth stocks, investors have ignored other well-run businesses and asset classes. This is where we are finding opportunities for new investments. As value investors, our primary focus is not looking for new investments based on what has previously done well, but rather we look for companies and markets that are under appreciated that will do well in the future. The current divergence in price returns has been shown to reward some companies too much while punishing others too harshly. Mean reversion is a powerful phenomenon and the evidence suggests that such anomalies tend to reverse.

Below are charts showing the relative valuation of value stocks vs growth stocks, and small company stocks vs large company stocks.

Looking at these charts together tells a strong message. While focusing on risk, the opportunity for investors to earn returns is found by looking at value over growth and smaller companies over larger companies. The companies and asset classes we are investing in fit this criterion as investor enthusiasm has swung the pendulum to extreme levels in both instances. Unfortunately, no one can predict precisely when the pendulum will lose momentum and swing back in the other direction. We continue to focus on what we can control: being disciplined, patient, having a historical perspective, and straying away from the herd when opportunities or excessive risks are present. Thank you for your continued trust and please reach out if you would like to discuss any topic in greater detail. Stay safe and healthy. —Patrick Mason

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Thanks, Patrick.

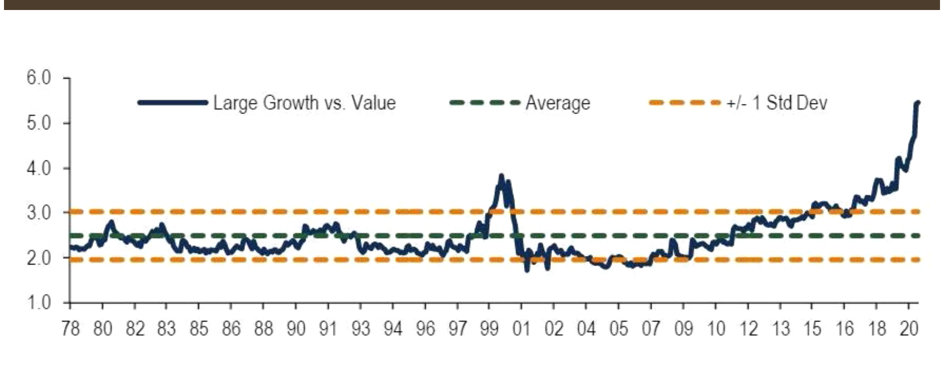
Wishing you all good health and dry feet as the Autumn soaks in.

Happy trails,

Tim Mosier, President
Cairn Investment Group, Inc.

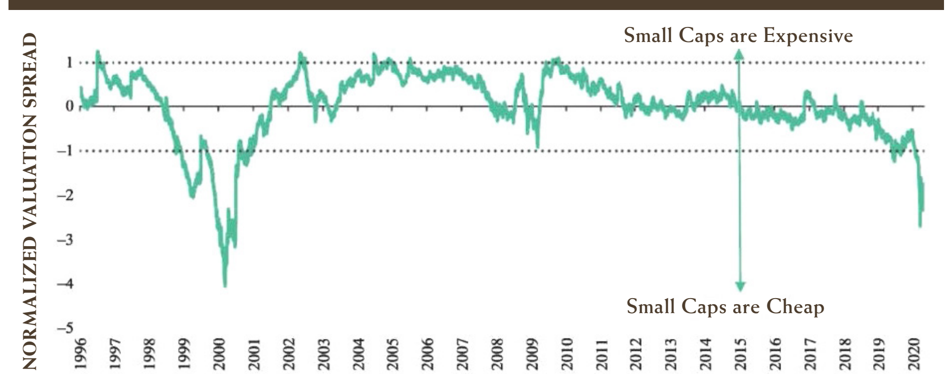
On P/B, Growth vs Value Valuations in the Stratosphere

Russell 1000 Growth vs Russell 1000 Value Relative P/BV 1978 – 7/24/20



Source: BofA US Equity and Quant Strategy, FactSet, Compustat, FTSE Russell

Composite Valuation Spread: Russell 2000 vs Russell 1000



Source: PanAgora Asset Management