

It Was So Obvious

By Simon Fillmore - CIO

It's funny how, after thirty years in financial markets, you occasionally witness similar bubble patterns emerge. A feeling of déjà vu. A sense of having experienced this before. While the players, context and narrative might differ, the theme is the same. As Mark Twain is often quoted as saying, *"History does not repeat itself, but it does rhyme."*

I cut my teeth during the dot.com boom, working in London (33 King William Street) as an investment analyst on the global team at Merrill Lynch Investment Managers. It was a chaotic time of disruptive innovation, mega-mergers, stratospheric valuations, and widespread disbelief that the bull market would continue as long as it did. Startup internet businesses attracted insane valuations as they promised to revolutionise business and deliver super-profits. Many of the leading analysts and fund managers on my team left to chase their dreams, lured by the promise of untold riches in the private equity industry, to the extent that our team was hollowed out, and the average age of the team was 25 years.

Arguably, it has been relatively easy to identify some of the bubbles over the last three decades as valuations demonstrably lost touch with economic reality: dot.com, treasury bonds (2021), solar, cannabis, 3D printing, meme stocks, SPACs, and consumer staple stocks (2022). Other bubbles, like the US housing market (2008) and commodities (2003-2008), were more difficult for me to identify correctly, and I was surprised at the 40% drawdown that equity markets experienced during the global financial crisis. With the commodity boom, I was a late-cycle investor, which had an adverse investment outcome.

Looking at markets today, I am seeing similar *"rhyming"* signals in US equities.

- The **valuations of US equities are extended** by any measure when considered in a historical context.
- An **unprecedented flow of capex** into artificial intelligence (AI) and related infrastructure. When too much capital enters an industry, returns typically decline, and vice versa.
- The S&P 500 has become **highly concentrated**, with less than a dozen stocks representing a significant portion of the index.
- A barrage of **new IPOs** whose business models are untested, and, as yet are unprofitable.
- A flood of **crypto treasury businesses** with some trading at a premium to net asset value. Many of these businesses ditched their existing business model to follow the crowd into a hot new sector.
- **Retail and institutional herding** - investors from the UK to Thailand to Japan are long US tech at the expense of their local bourse.
- Justification of why certain sectors will **grow earnings at 3-4x GDP** in perpetuity.

Even if you can identify the *"rhyming"* signals, it does not make one omnipresent because timing markets is notoriously difficult. *Manias often last longer than expected and end faster than investors can react.* Some of the best names in the

Directors LK Faure, RJ Macmillan, JG Solms

Reg. No. 1998/001650/07 | Member of the JSE. Authorised Financial Services Provider.

isec.co.za

Head Office: Johannesburg

Ferguson Place
39 Ferguson Road, Illovo
Johannesburg, 2196
P: (+27) 11 489 5400
E: jhb@isec.co.za

Pretoria

Barbet Place, Hillcrest Office Park
Lynnwood Road, Hillcrest
Pretoria, 0083
P: (+27) 12 362 2767
E: pta@isec.co.za

Stellenbosch

153 Dorp Street
Stellenbosch
7600
P: (+27) 21 882 8680
E: bos@isec.co.za

Cape Town

5th Floor - Mariendahl House
Newlands on Main - Main Road
Newlands, Cape Town 7700
P: (+27) 83 659 9086
E: cpt@isec.co.za

investment industry were short the market during the dot.com bubble and still lost money because the timing of their shorts was not perfect. Investing is by no means a perfect science, and perhaps at best, is 70% science / 30% art.

Equity markets point to the aggregate expectations of all investors. At the moment, bulls are highlighting imminent interest rate cuts, market at all-time highs, no likely recession, an uptick in M&A, ex-mag seven valuations being reasonable, big tech's strong net cash position, a business-friendly Trump presidency, lower taxes and limited tariff impact. At the other end of the spectrum, bears are concerned about stretched valuations, exuberant investor behaviour, slowing earnings growth, the delayed impact of tariffs and high embedded expectations.

In terms of investment management, I began to become more defensively positioned a year ago and have our highest allocation to cash in global equity portfolios since 2010. Admittedly, in the short term, the cash allocation has been a drag on performance as equity markets have marched higher. However, it has diffused portfolio volatility, and I believe it to be a prudent strategy in light of the risks mentioned above. Importantly, I am also in good company as Warren Buffett holds ~\$350 billion in net/near cash, his highest cash exposure ever. Several high-profile figures, including the likes of Sam Altman, Jeff Bezos, Mark Zuckerberg, Ray Dalio, Leon Cooperman, and David Solomon have suggested that AI is already exhibiting some characteristics of a bubble. Often, once a bubble has burst, investors reflect that, in hindsight, "It was so obvious."

It's difficult to guess what the catalyst will be for US equity valuations to normalise. More often than not, it is something unexpected, but if I were to guess:

- An **AI/cloud** company signalling their intent to **slow capex** as they are not seeing an adequate return on investment.
- **Dislocation in the private equity / credit markets**, both of which have seen massive capital inflows and may struggle to deliver expected returns.
- **Legal challenges** to President Trump's tariffs succeeding in court.
- An **unexpected inflation spike**, triggered by tariffs, forcing the Fed to revise its rate path.
- A global economic **slowdown outside of the US**, particularly in export-driven economies hit by US trade policies.

The emergence of similar bubble patterns does raise red flags. While calling the peak of a bubble is difficult, recognising the bubble itself should trigger caution. This does not mean you need to change your investment style to suit the circumstances but rather check that your actual investments are aligned with your overall investment philosophy and strategy. Be cognisant of equities with exceptionally high valuations. Judiciously review balance sheets for any weakness, as this is the foundation of a business. Businesses with a weak balance may not survive any economic downturn. Check your sector exposure for over-allocation.

As an investment manager, it's a delicate balance between remaining fully invested over the long term and making a tactical decision to reduce risk and protect capital. To illustrate this point, I will use the example of Costco. As an investor,

Directors LK Faure, RJ Macmillan, JG Solms

Reg. No. 1998/001650/07 | Member of the JSE. Authorised Financial Services Provider.

isec.co.za

Head Office: Johannesburg

Ferguson Place
39 Ferguson Road, Illovo
Johannesburg, 2196
P: (+27) 11 489 5400
E: jhb@isec.co.za

Pretoria

Barbet Place, Hillcrest Office Park
Lynnwood Road, Hillcrest
Pretoria, 0083
P: (+27) 12 362 2767
E: pta@isec.co.za

Stellenbosch

153 Dorp Street
Stellenbosch
7600
P: (+27) 21 882 8680
E: bos@isec.co.za

Cape Town

5th Floor - Mariendahl House
Newlands on Main - Main Road
Newlands, Cape Town 7700
P: (+27) 83 659 9086
E: cpt@isec.co.za

I would want to own the world's best retailer over the next decade as it continues to dominate and grow earnings above its peer group, but at 46x this year's earnings, the valuation does not, unfortunately, leave any room for error.

So, what does this all mean, practically?

At this stage of the economic cycle, I believe it is more important to protect capital rather than chase returns. There are times to be aggressive and times to be defensive. This view may also reflect my maturity as an investment manager, and the realisation that generational wealth is built over decades, not quarters. I continue to advocate holding around 20% in cash, with the balance remaining invested in a selection of businesses that have reasonable valuations, decent growth prospects, strong balance sheets, and, of course, are likely to be secular winners in their industry.

Directors LK Faure, RJ Macmillan, JG Solms

Reg. No. 1998/001650/07 | Member of the JSE. Authorised Financial Services Provider.

isec.co.za

Head Office: Johannesburg

Ferguson Place
39 Ferguson Road, Illovo
Johannesburg, 2196
P: (+27) 11 489 5400
E: jhb@isec.co.za

Pretoria

Barbet Place, Hillcrest Office Park
Lynnwood Road, Hillcrest
Pretoria, 0083
P: (+27) 12 362 2767
E: pta@isec.co.za

Stellenbosch

153 Dorp Street
Stellenbosch
7600
P: (+27) 21 882 8680
E: bos@isec.co.za

Cape Town

5th Floor - Mariendahl House
Newlands on Main - Main Road
Newlands, Cape Town 7700
P: (+27) 83 659 9086
E: cpt@isec.co.za