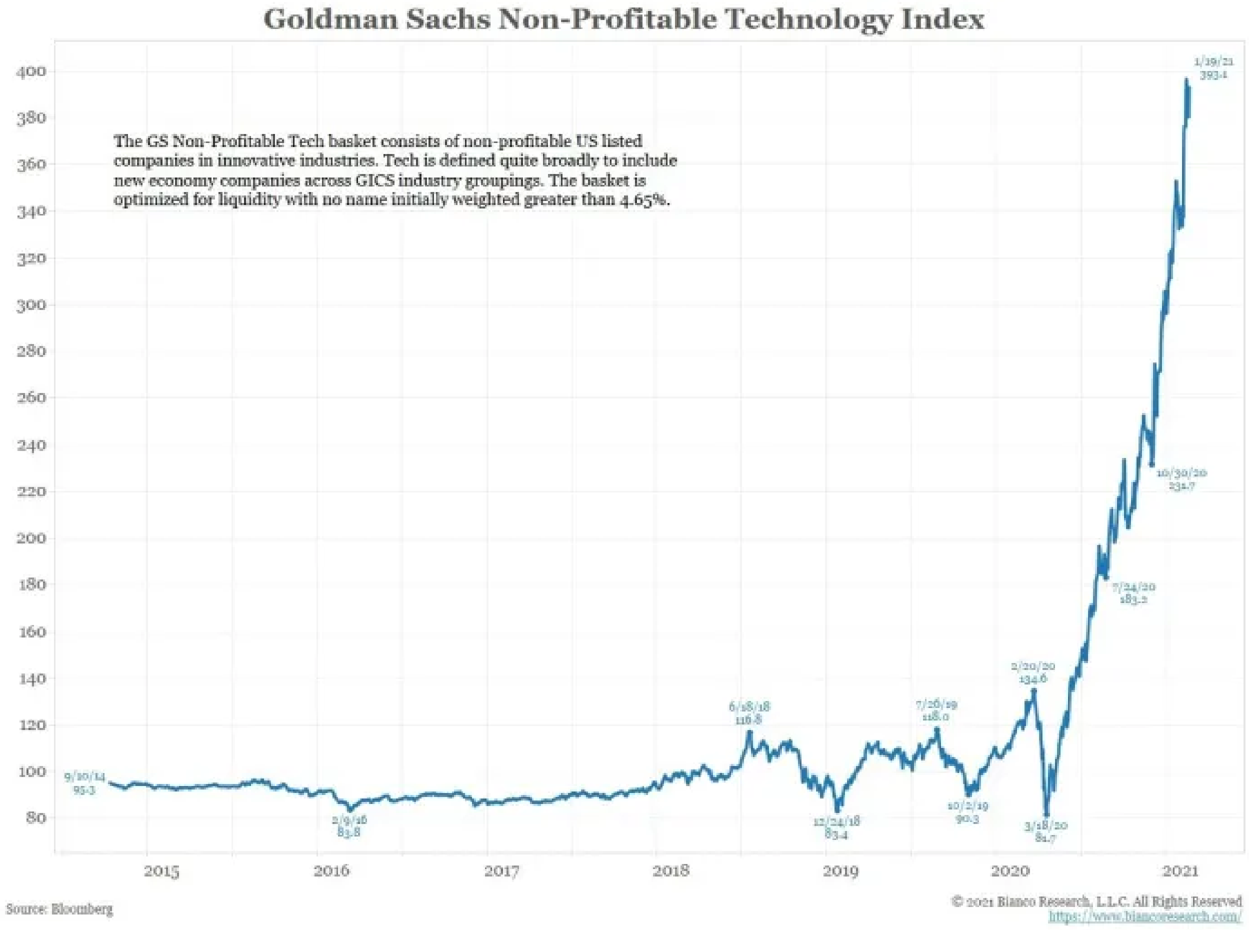
Dear fellow shareholder,

Are We in a Bubble?

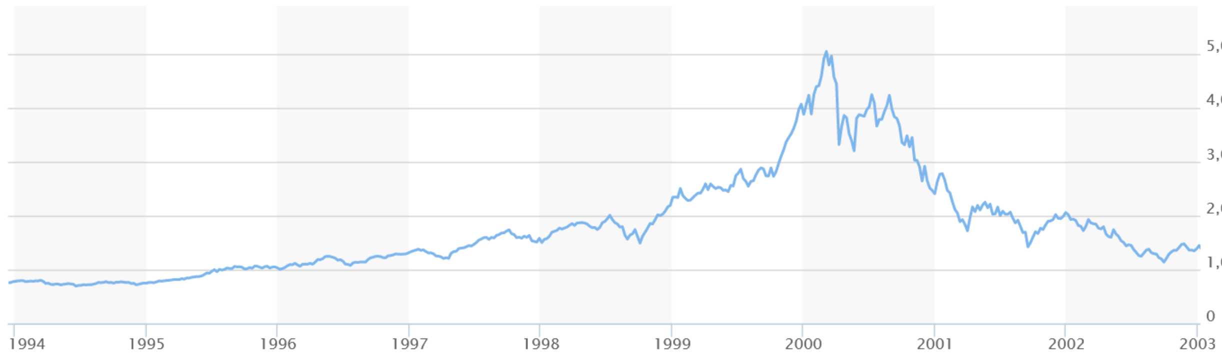
What could you be thinking of? The high price earnings ratios of most major stock markets? SPACs, crypto ledgers, crypto coins, crypto-joke-coins, NFTs, Beeple, meme stocks, RobinHood stocks, GameStop stock shorts or stocks of socks and secondhand sneakers? And what about this leviathan –



History

Let's try some perspective. Bubbles, enthusiastic price spikes in securities well in advance of actual profits, have accompanied each big Something New – canals, railways, cars and airlines. You will no doubt recall the dotcom bubble and crash twenty years ago. This is how Wikipedia sums it up:

"Between 1995 and its peak in March 2000, the Nasdaq Composite stock market index rose 400%, only to fall 78% from its peak by October 2002, giving up all its gains during the bubble. During the crash, many online shopping companies, such as Pets.com, Webvan, and Boo.com, as well as several communication companies, such as Worldcom, NorthPoint Communications, and Global Crossing, failed and shut down."



Source: MarketWatch

You may have already spotted the let-out in Wikipedia's summary. An increase of 400% followed by a decline of 78% equals a profit. As the graph shows, the level of the NASDAQ was 750 before the bubble and 1,200 at its low in late 2002. Some bubble! And here is what happened next:

Source: MarketWatch

Even before the effect of the pandemic, the index had risen again from 1,200 in late 2002 to 8,950 at the beginning of 2020. The speculative froth was…not speculative. Sure, Pets.Com and Webvan disappeared, but now there is Chewy (market cap $33 billion) and Uber ($106 billion). Even if you believe these two companies are themselves speculatively valued you will probably have fewer doubts about the biggest survivor of the "bubble", Amazon, solidly profitable and valued now at $1.7 trillion.

Other infamous bubbles are similarly problematic. The tulip mania of 17th century Holland? No proof it ever happened. The Wall Street Crash of 1929? The Dow Jones index exceed its pre-froth level within four years. As Mao supposedly said when asked about the impact of the French Revolution, which was two hundred years earlier, it is too soon to tell.

But these incidents do say something about the nature of bubbles. What we call a bubble is in some cases but the first part of how security markets deal with innovation. The bubble phase is characterised by indiscriminate optimism, pushing up the price of all securities rapidly so long as they are even tentatively associated with the craze – put a dotcom after your name and go public. In the second phase, the bubble bursts and all prices plummet, again indiscriminately. In the third phase the survivors, those who have successfully defended market share and become profitable, rise again, the prices of their securities often far exceeding the level achieved in the first phase.

So if you were considering participating in the current boom in electric vehicle stocks, first know that at least five companies have forecast over $10 billion of revenue in under seven years, and then you might choose one of these options:

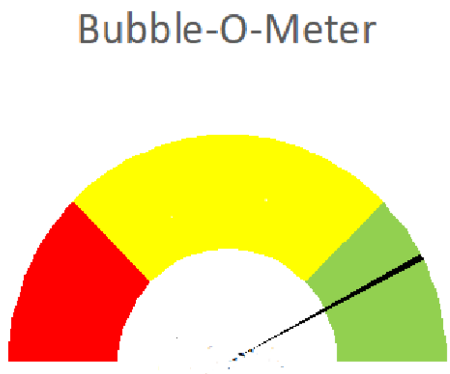
1. Invest only in those you believe will be the long-term winner/s
2. Buy everything and wait
3. Wait until the bubble bursts, and pick the profitable companies at low prices

Speculation

While the electric vehicle boom is a classic example of this paradigm, we are still left with bubble-like behaviour breaking out in other ways. Crypto and NFTs (Non-Fungible Tokens) are security-like but have unique aspects, so what can we say about them and the other examples listed at the start of this letter? I'd like to go through them one at a time and say something about how bubble-like or speculative each appears. Please do not take this as investment advice.

SPACs

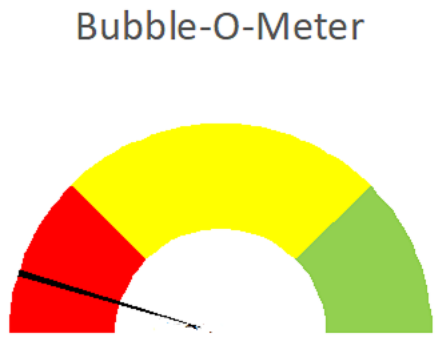
- or Special Purpose Acquisition Companies. These are already listed companies looking to merge with private companies. Usually investors have the right to get their money back before a merger completes. Inherently, these are not speculative. They are just an alternative way for private companies to go public without going through a formal IPO (initial public offering). But while the format is not speculative in itself, the types of private company that have merged with SPACs have been early stage (= not profitable). Moreover, the costs and hidden costs (to do with warrants) are large, so we are unlikely to invest.



Meme Stocks

Emblematic is GameStop, a New York Stock Exchange company whose stock has appreciated some forty times in the past year. It is a videogame retailer, through thousands of stores and an ecommerce business. Even before the pandemic the stores business was in trouble and the company has been loss making for years. Like many retailers it is reducing its store count (and therefore the source of its historical business) while trying to grow its smaller ecommerce offering, which itself competes with many other companies. It featured as a short for a number of hedge funds and they were subject to a short squeeze; in other words, investors bought the stock in sufficient quantity to drive up the price and force the shorts to close their positions. This happens frequently. There are three unusual aspects to this go round. First, the buyers seem to be small, retail customers, many associated with the low cost stockbroker Robinhood, and often buying using options, a leveraged alternative to going long the old fashioned way. Secondly, buying was encouraged and coordinated on websites such as Reddit, using similar memes to those promoting cryptocurrency. This is innovative but does not promote collective wisdom. Thirdly, GameStop's share price has remained high well past the capitulation of the shorts. The market cap of GameStop is now above $11 billion and although it is possible it will be successful in ecommerce, at present it is difficult to see how its profits would exceed that figure. Any major retreat in the stock price would hurt the new, retail investors and devastate those using leverage.

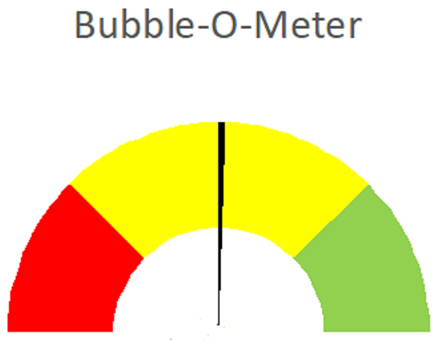
This is not an isolated example. Hertz, which attracted plentiful attention on Reddit *even after it declared for bankruptcy* was also associated with retail clients and meme postings. This is a wild crowd and meme stocks must be labelled:



Cryptocurrency

The traditional method of detecting speculative excess hesitates before the phenomenon that is crypto. The rapid movement in prices, the unregulated markets, the absence of any underlying trade or source of profits would usually be signs of a bubble phase, at least. The total value of all crypto is over $2 trillion and for your trillions you are buying – nothing.

One must, however, suspend judgement because crypto proponents have one argument in their favour and this can only be tested over time. They believe that crypto is a new currency or store of value, with advantages over traditional formats – less prone to inflation than government money, cheaper to hold than gold and more secure than either, as ownership is proven via a ledger. While all of these claims are contestable (there have been numerous cases of theft and fraud, for example), it is a plausible tale. We are not investing in it, as there is no ascertaining its final value and that value may turn out to be zero, but it is difficult to say today how speculative it is. Just bear in mind that when you "invest" in crypto you are not buying money, you are buying the mattress under which the money is stored. And space does not allow a fuller appreciation of Dogecoin.



Non-Fungible Tokens

Perhaps you find crypto too tame, or an investment in Dogecoin too conservative? Let's say you own the Mona Lisa. Well done! You are the French government. The Mona Lisa is unique and would fetch an enormous price if sold. But you don't want to sell it. You are the French government, you are already rich. Times being what they are, though, a little extra cash would be useful so you sell the reproduction rights – T-shirts, mugs, calendars and so on. Comes a new wave of technology and you sell the digital reproduction rights – reproduction on websites, downloadable art etc.

You've sold the bacon and you've sold the sizzle. What's left? Try selling a Non-Fungible Token (NFT). This is a unique token on the blockchain giving the owner the right to a piece of digital code, typically art. But it conveys no reproduction rights. The digital art could be a copy of the Mona Lisa, in other words, but it is not the Mona Lisa nor does it let you exploit the original as a reproduction.

It produces no income so its entire value rests on persuading someone to pay a higher price than you did.

Conclusion

“It’s a bubble, according to a survey of retail stock investors. And they don’t want to miss it. An E*Trade Financial survey found that roughly three-quarters of retail investors believe the market is ‘fully or somewhat’ in a bubble, a 3 percentage-point increase from the previous quarterly poll. At the same time, bullish sentiment has increased, rising to pre-pandemic levels at 61%.”
Bloomberg, April 2021

A notable element of this tour of the speculative is how easy it is to accept each new instance as plausible in light of previous successes.

Each step makes sense but looked at as a whole it seems likely that some or all of these phenomena are the result of hysterical buying. We have noted in previous letters that major stock markets are trading at historically high values compared to earnings. This is probably the result of low interest rates, which have made anything with a yield attractive compared to cash. Procter & Gamble, that bellwether of international expansion and brand value, has merely been able to maintain its earnings for the past decade in the face of the retail revolution. But its stock including dividends has well over doubled in this period. That makes a kind of sense as long-term treasury yields have halved in the same decade. So each dollar of earnings Procter & Gamble has made should be worth twice as much. But this ignores the twin risks that the company’s earnings may actually start to decline and that interest rates could go up.

Once you accept the logic behind paying more for less it is a small step to the other excesses laid out in this letter. Amazon made it to a trillion dollars, so why shouldn’t Tesla? GameStop, Bitcoin and NFTs are untethered from any likelihood of profit but as long as someone is speculating on them, why shouldn’t you?

The word *speculate* is derived from the Latin word *specula*, watchtower. I like the optimism of the technology markets. I am interested in the new coordination methods of meme stock investors. I applaud the creativity of blockchain adopters. But collectively it does feel like the world has lost its mind. So let us applaud the inventiveness and bravado of this new world; let us by all means enjoy the fruits of these new waves of technology; and then let us slip into our self-driving cars and command them to our watchtowers, from where we may observe the carnival at a safe distance.

Thank you for supporting Derby Street. We look forward to speaking to you all soon,

Richard Simmons
Portfolio Manager
Derby Street Investments

Important Information Note

The content of this promotion has been approved by Eschler Asset Management LLP which is authorised and regulated by the Financial Conduct Authority in the United Kingdom. Investors are warned that past performance is not necessarily a guide to future performance, income is not guaranteed, share prices may go up or down and you may not get back the original capital invested. The value of your investment may rise or fall due to changes in tax and rates of exchange if different to the currency in which you measure your wealth.

It is only suitable for professional, high net worth and sophisticated clients as set out in COBS 4.12 of the FCA handbook. If you do not meet these criteria you must not place reliance on this document and will not be eligible to invest in the fund. This document has been created for information purposes only and has been compiled from sources believed to be reliable. None of Eschler, Derby Street or their directors, officers or employees accepts liability or for any loss arising from the use here of or reliance hereon or for any act or omission by such person or makes any representations as to its accuracy and completeness. No part of this report may be reproduced or distributed in any manner without the written permission of Eschler.

No investment in the Fund should be considered without reading the prospectus in relation thereto and in particular the risk warnings contained therein.