May 8, 2020

Market Recap

Equity markets trended higher in the month of April, recovering a portion of last quarter's steep decline. The S&P 500 Index was up 12.7% during the past month as unprecedented levels of monetary and fiscal stimulus flooded the world with liquidity. Though much of the world remains in lockdown, some countries have begun to announce a gradual reopening of their economies.

The scale and scope of this reopening depends on continued progress on the healthcare front. We remain many months away from achieving herd immunity for COVID-19, therefore we do not foresee an economic recovery taking hold in the near term. As described in our April 2020 *Economic and Capital Markets Outlook*, the impact from the virus will be front-loaded, with sharp declines in activity observed during the first half of 2020. Global activity will progress in a choppy manner as countries constrain and relax virus mitigation measures on varying timelines. Our current forecast calls for a strong rebound by the second half of 2021.

The full economic impact is ultimately unknowable as we are navigating in uncharted waters. It is, therefore, too soon to speculate whether the damage to equity markets is behind us or whether further volatility lies ahead. We are paying a lot of attention to COVID-19 and its short- and long-term impacts, as well as keeping an eye on corporate resilience and many other economic and social challenges. But this once-in-a-century event, despite its recent significance, has not been at the center of our concerns over the last 10 years. We have been dealing with an unusual and remarkable economic recovery from the 2008-09 financial crisis, and it is worthwhile to reflect on this when reviewing recent market and portfolio performance.

COVID-19 is a once-in-a-century event … but has not been, until recently, at the center of our concerns

It is very difficult to structure a portfolio against extremely rare events such as a pandemic, but there are other risks that are very important to protect against. Over the last decade, our focus has been protecting the portfolios against record-low interest rates and the resulting bubbles in certain asset prices. This has had an opportunity cost in the past few years, but we remain convinced our investment strategy will ultimately continue to deliver solid long-term returns at a reasonable level of risk.

Low interest rates concern us for several reasons

Current interest rates are at their lowest levels in 225 years. There are reasons for this, but times change and reasons change. For the vast majority of time, the reasons lead to higher rates, most often much higher. This is our first and simplest basis for concern.

Secondly, the risks are asymmetric. If long rates rise to a level of just 2%, the price of long bonds falls by 14%; if rates rise to 3%, the price falls by 34%; and if rates rise to 5%-6% – their average over the very long term – the decline in price is even greater. On the other hand, if interest rates remain at current levels, the return over the next 30 years will be around 1.3%. One cannot help but conclude that investing in long-term bonds has a large downside potential and a small upside potential. This asymmetry in risks is not normally a good bet, even if you think that the upside is more probable than the downside.

Third, long-term bonds offer an unappealing value proposition, not only because rates are currently below inflation and very likely lower than the expected average rate of inflation over the next three decades. If you buy a 30-year government bond yielding 1.3%, you will pay nearly 80 times interest income for the bond, with no hope of growth in this revenue stream. In contrast, equity markets have traded around 15 times earnings over the long-term; even at the peak of the dotcom bubble, equities were trading at 40-50 times earnings, with some expectation of growth in earnings. Bond valuations are at bubble-type levels and history shows that bubbles tend to end badly.

History of U.S. Long-term Interest Rates

Source: Bianco Research, U.S. Federal Reserve

A fourth reason is that lower rates have incentivized higher levels of leverage in the financial system. The rise in debt-financed corporate buyouts, the use of leverage in managing pension plan assets, the prevalence of companies borrowing to buy back their shares, can all be traced back to low interest rates.

Fifth, lower yields have inflated real asset prices. One of the areas most affected is real estate. When an investor buys a property, they use a discount rate to determine the present value of future rents and expenses. As yields have fallen, so too has the discount rate, and just like long bonds, property values have risen and risk substantial declines if rates rise. In a similar vein, residential home prices have increased to unusual levels. Over the last 40 years, Canadian homes have traded around 3.5 times average family income. As interest rates have fallen, house prices have risen to an astonishing 6 times family income.

Sixth, low rates have impacted some equity prices, particularly those trading at high multiples, as a result of a lowering of implied discount rates of future earnings.

And finally, we are concerned with the loss of flexibility in the economic and financial system. One of the arguments most often cited to explain the persistence of low interest rates is that with so much debt in the system, interest rates cannot rise. This is a reason to be careful about what you buy and how much you pay, in order to avoid the trap.

Low interest rates affected how we structured our portfolios

During the 1990s, when yields were in a range of 6%-9%, our bond portfolios had very long durations and we even held long coupons. However, we began to avoid long-term bonds once yields on these securities fell below 3%.

This has meant that we have missed out on the rise of long-term bond prices over the last 5-7 years. But what have we left behind? Bond returns are often misunderstood. Unlike a stock, which may provide a 10% or 20% return because the company's sales and profits have risen, when a bond returns 10% or 20% in a given year, is it normally due to a fall in interest rates, not an increase in the annual interest payment. For example, if we buy a 30-year bond at par with a coupon rate of interest of 3% and hold it to maturity, we will earn 3% over the 30-year term, no more and no less, regardless of how the returns are measured in the intervening years. A higher return may be recorded some years (if interest rates decline) and some years a lower one (if rates rise), but in the end, the return will be the 3% coupon rate. It cannot be otherwise. In comparison, an investment in a quality company can continue to grow.

We have also elected to avoid corporate debt, junk debt and other lower-rated bonds because we believed that the expected returns did not reflect the higher risks associated with low interest rates, higher levels of leverage and now, the impact from COVID-19. A key tenet of our balanced portfolio strategy is that the place to take risk is the equity markets, where the rewards are much greater, and not fixed income markets, where upside is limited.

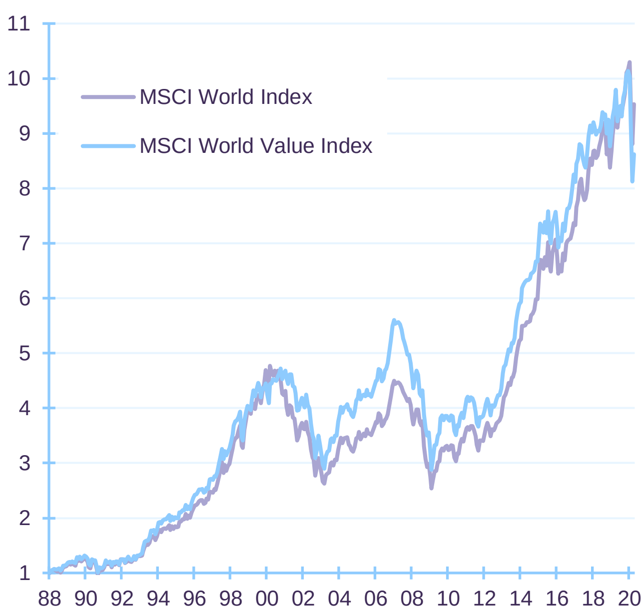
In our equity portfolios, we have always been very sensitive to the price we pay for our companies. We carefully consider various measures of valuation, including the multiples paid for company earnings, cash flows, sales and book value. We also pay attention to leverage, profit margins, tax rates and other operating parameters. The purpose of this is to avoid the valuation and operating excesses that can occur as a result of an interest rate bubble. Companies with these characteristics tend to be associated with an investment style called “value” investing. Companies that trade at higher multiples, and have high margins, low tax rates and higher leverage are typically associated with other styles such as “growth” or “quality”. While we are attracted to growth, we will only pay a reasonable price for that growth.

The pandemic has affected the real economy and caused interest rates to fall further

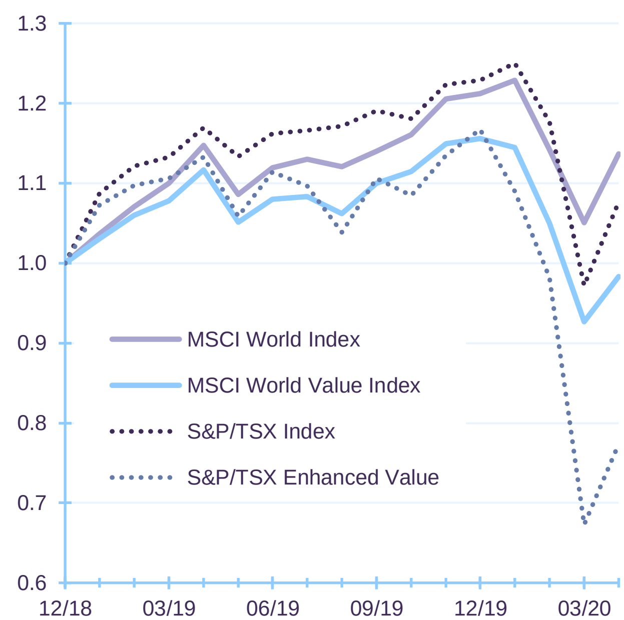
President Trump’s trade war with China weakened the global economy, prompting central banks to lower rates. Just as a Phase 1 trade agreement put growth back on track, COVID-19 hit, plunging the world into recession. Interest rates have fallen further, inflating the bond bubble even more.

Value stocks have tended to be more closely tied to the real economy and, regrettably, were among the first to be affected by the physical consequences of the mitigation measures introduced to combat the pandemic. Oil and gas demand has fallen an estimated 30%, demand for metals and other materials has similarly declined, and travel and transportation have been curtailed. Low interest rates have negatively impacted other value-type sectors such as banks and insurance companies. As a result, value indexes have fallen more than broader market indexes and our portfolios have followed the value indexes, in Canada and Internationally. The size of the economic response overwhelmed the cautious valuations of these sectors. But these effects are temporary and will correct when the pandemic passes.

Value vs. Broad Market Indexes
Long-Term Track Record



Value vs. Broad Market Indexes
Short-Term Track Record



Source: MSCI, S&P Dow Jones Indices LLC

Paying attention to valuations is as important as ever

Protecting the portfolios against the wide-ranging impact of the bond bubble has had an opportunity cost. In a sense, this can be likened to taking out insurance to mitigate the risk of a bad outcome. If you own a house on Florida's East coast, you will want to take out hurricane and flood insurance. You would also be wise to build your house a little stronger, tie down the roof trusses, put in battens, all at extra cost. Sunny skies may last for many years but, when the wind picks up, you will be happy with the care you took.

Over the last decade, growth stock valuations have benefited from the decline in interest rates. More of their earnings are far into the future, and the value of these future earnings rises as the discount rate declines, just as the value of future interest and capital payments rises for a bond when interest rates decline. But the effect disappears if interest rates hold steady and it is reversed if interest rates rise.

For example, in the case of Shopify, the Canadian domiciled e-commerce firm, investors are willing to pay 34 times revenues and 420 times pre-tax earnings, even though the company has never made a profit and is expected to lose another US$300 million this year. Our forecasts suggest that Shopify will only become profitable in 2024, at which point it is expected to earn about US$60 million. The current share price of US$630 implies a valuation of 1,250 times earnings five years forward. Of note, the company's market capitalization of US$75 billion is the same as that of Rogers Communications, Canadian Tire, Manulife and Nutrien combined. Taken together, these companies trade at 9x current earnings with solid growth prospects and an attractive risk profile.

We believe that paying careful attention to valuations, leverage, margins, tax rates and many other fundamental factors is as important as ever. This prudent approach is how we have been able to outperform the markets by substantial margins over the years. Our Canadian Equity, International Equity and Emerging Markets portfolios are diversified and structured with well-valued companies that are world leaders in their industry often with a compelling growth profile, including:

- **Intel** – Dominates the market for microprocessors for personal computers and data centers with market share in excess of 80%. Intel also supplies the chips for AI technology, Internet of Things and autonomous driving vehicles.
- **AMS** – World's leading producer of sensors, including the 3D sensors behind the facial recognition technology for Apple's iPhone. Also, a pioneer in solid state LIDAR, a key enabler of autonomous cars, and a developer of medical sensors.
- **Roche** – Global leader in oncology and MS with numerous blockbuster drugs on the market and a rich pipeline of new therapeutics. Its world-class diagnostic business will play a key role in providing testing for the COVID-19 pandemic.
- **Alibaba** - Largest e-commerce company in the world with over 800 million monthly customers and more than $1 trillion transacted on its platform in the last year. Its payment system (Alipay) has registered over $8 trillion in transactions, the equivalent of 65% of China's GDP.
- **China Mobile** – Beneficiary of growth in Chinese consumers' data consumption with more than 900 million subscribers. Leader in 5G network rollout.
- **Reliance Industries** – Unique portfolio of assets that are a structural play on India's growth. Reliance owns the most advanced refinery-petrochemical complex in the country, the largest wireless operator (370 million subscribers) and the dominant retailer with a strong online presence. Research firm Sanford C. Bernstein & Co has called it India's Exxon, AT&T and Amazon rolled into one.
- **Wal-Mart** – World's largest retailer, recognized for its everyday low-price value proposition. Also, the second largest e-commerce player with an unrivaled store footprint providing delivery flexibility.
- **Nutrien** – Dominant low-cost producer of fertilizers and the largest global retailer of seeds, fertilizers, and crop protection chemicals. Farmers use its products to increase crop productivity, thereby reducing the amount of arable land needed to feed the world's population.
- **Siemens** – World leader in factory automation and mass-transit systems, as well as healthcare imaging and diagnostic equipment.
- **Manulife** – Top 3 provider of life insurance to Asian consumers, an under-penetrated market driven by the long-term structural improvement in the region's living standards.

Concluding Thoughts

With the exception of the last 18 to 24 months, the portfolios have generally kept up with the markets. We acknowledge that we have not outperformed as consistently as we have in previous periods, as we have sought to avoid the consequences of the significant risks posed by low interest rates. Over the longer term, the positive impact of our fundamental, price-sensitive investment style has more than covered any opportunity cost. The portfolio's future progress will be driven by a return of demand for commodities and other economically-sensitive sectors, as well as a further appreciation of the many attractive investments held in the portfolio.

On the flip side, investing in assets that have benefitted from record-low interest rates and which trade at inflated prices does not bode well from a risk-return perspective. Countless studies have been conducted on bubbles and they have repeatedly concluded that it is not possible to predict how long bubbles last, how far they go, nor when they end. Most importantly, these studies agree that when you see one, it must be avoided.

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