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# Investing for the post-pandemic period

Record amounts of fiscal and monetary stimulus have helped sustain global economies and will fuel a strong rebound. We believe we are past the worst point of the recession. The road to recovery, while not devoid of speed bumps, lies ahead.

As we emerge from the devastating economic and social effects of the pandemic, our investment strategy is focused on: (1) capitalizing on the post-pandemic recovery; (2) capturing long-term transformational trends; (3) harnessing the growth potential of emerging markets and (4) avoiding asset bubbles. We believe our portfolios are well positioned to grow and prosper.

## 1. Capitalizing on the post-pandemic recovery

The nature of the pandemic's lockdown in the first half of the year disproportionately impacted companies in the travel and hospitality sector as well as those present in the physical economy, such as energy, materials, mining, transportation and financials. However, some sectors have bounced back quickly. Residential construction has been strong, driven by renovation demand and low mortgage rates. Lumber and oriented strand board (OSB) prices have surged, sending share prices for building materials companies sharply higher. For example, Norbord, the largest OSB producer in the world, saw its stock price fall by about two-thirds between mid-February and mid-March. The stock has since tripled, demonstrating the temporary nature of the economic impairment. We see similar potential in other sectors which are still experiencing lower than normal levels of demand and whose share prices remain well below pre-COVID levels.

As discussed in detail in our October Economic and Capital Markets Outlook, the global economy bottomed in the second quarter and is now firmly trending upwards. We forecast that growth will return to pre-pandemic levels in the second half of next year, driven by progress on the healthcare front and by the cumulative effects of massive global stimulus. A vaccine should be approved in the months ahead and the process of immunizing the general population should begin by mid-2021.

As a result, we expect to see a significant rebound in the share prices of those industries more tied to the real economy, once investors see tangible signs that life is returning to normal. More than 40% of our global equity portfolios are exposed to autos, financials, materials, oil and gas and transportation. Consensus estimates for our investments in these areas over the next two years call for an increase of 135% in profits, compared with a forecast of 50% for the MSCI World. Furthermore, this group of companies trades at 11 times 2022 earnings, a 30% discount to the global equity benchmark.

The strategy for this part of the portfolio calls for patience. As the world recovers from the pandemic, we expect demand in these industries to be fully restored, which should result in strong performance for these companies.

## 2. Capturing long-term transformational trends

In the past, structural change took generations, or even centuries. Today, we see developments with the potential to reshape society within the next decade or sooner. Disruptive innovation in the field of artificial intelligence and secular forces such as climate change are just two of the many powerful investment themes that present both challenges and opportunities for the companies we invest in.

Selecting companies that are best positioned to benefit while steering clear of those at risk of being hurt by these transformations—and doing so at the right price— is a fundamental aspect of our investment strategy.

TABLE 1

| Long-Term Trend | Examples of Letko Brosseau Holdings |
|---|---|
| Artificial Intelligence | Facebook, Alphabet |
| Internet of Things | AMS, Samsung |
| Automation | Siemens |
| Online Commerce | Walmart, Alibaba |
| Data consumption | Telus, China Mobile, Verizon |
| Climate Change / Pollution | EDP, Veolia |
| Infrastructure needs for the developing world | China Water Affairs, Reliance Industries, Mitsui |
| Population Growth | Nutrien |
| Aging population | Sanofi Aventis, Gilead |

## 3. Harnessing the growth potential of emerging markets

Exposure to emerging markets has played a key role in our global equity portfolios. Though some of the larger emerging economies are less equipped to deal with the health consequences of the pandemic, we believe these challenges are transitory. This region benefits from powerful secular forces, such as favourable demographics, rising incomes and enormous unmet needs. The long-term growth prospects remain compelling.

Emerging markets already account for over 60% of global GDP and have been growing at three times the rate of the developed world over the past decade. The OECD forecasts that the size of the Indian economy will surpass that of the U.S. by 2037, and by 2060 the combined economies of China and India will be larger than the entire OECD. With 85% of the world's inhabitants seeking to improve their standard of living, the need for infrastructure, utilities, health care and other goods and services is significant, representing a powerful driver for growth.

Today, emerging market equities only account for about 30% of total world stock market capitalization. We have allocated around 15% of global equity portfolios to direct investments in companies based in these regions, indirect investments represent even more. Our emerging market equity investments trade at an extremely attractive average 10x estimated 2021 earnings—a 60% discount to the U.S. stock market—and offer a 4.5% dividend yield. We own many best-in-class companies with exciting growth prospects, such as Alibaba (the world's largest e-commerce company), Infosys (a key IT outsourcing partner to blue chip multinationals) and China Mobile (a leader in 5G network rollout). Emerging market consumers are a large and growing market for the developed world. Expanding needs for infrastructure, utilities, health care and financial services, as well as an increased appetite for consumer products and services create an enormous opportunity for multinationals.

Offering a unique combination of growth and value, we believe our exposure to emerging markets should deliver compelling long-term results going forward.

## 4. Avoiding asset bubbles

Ultra-low interest rates have had an unfortunate side effect of inflating prices of certain assets. As outlined in detail in our May and July Investment Updates, exceptional monetary policy measures over the past decade, amplified by the most recent stimulus due to COVID-19, has led to record high bond valuations. They have also allowed investors to give more value to earnings expected in the far future, a big reason why some leading NASDAQ stocks are trading at very high multiples. We have always been very sensitive to the price we pay for any investment as an emphasis on price discipline has been instrumental in avoiding bubbles.

At end-September, the 10-year Government of Canada bond yield stood at 0.57%. This is the equivalent of paying 182 times the interest income of the bond with no possibility for growth over the next 10 years. In fact, at this level, there is a substantial risk that long-term bonds will not keep pace with future inflation, resulting in real value destruction. We have chosen to maintain a conservative positioning in our bond portfolios, lowering the interest rate sensitivity (as measured by the duration) and keeping very high credit quality. While this strategy may generate low returns in the medium-term, we are aiming to avoid the risk of capital losses. In practical terms, one can view this like taking out insurance: you may have to pay a small opportunity cost but, when the accident happens, you will be glad to have protection.

A second order impact of the low interest rate environment can be seen in the premium valuations present in a small group of large cap technology stocks. Given that a greater portion of their earnings and economic value is far into the future, and the value of these future earnings rises as the discount rate (i.e. interest rate) declines, these so-called growth stocks have benefited from falling interest rates. Some, like Tesla or Netflix, which trade at 155 and 57 times 2021 earnings respectively, embed aggressively optimistic expectations of revenue growth and profitability improvement. We worry that such premium valuations leave little room for imperfect execution and do not properly factor in the threat posed by industry competitors. One need only be reminded of the irrational pricing present in Canadian marijuana stocks and the subsequent 80% loss of their value from the October 2018 peak to see the potential capital destruction which can occur during the deflation of an asset bubble.

Ensuring that valuation metrics, such as price-to-earnings, price-to-cash flow and price-to-book remain reasonable, and that growth prospects are well supported by favourable macro-economic and industry trends, are the keys to controlling equity valuation risk. Our global equity portfolios trade at substantial discounts and generate more income than the broad markets.

TABLE 2

| | Price/Earnings 2021 | Price/Cash Flow 2021 | Price/Book Value | Dividend Yield (%) |
|---|---|---|---|---|
| **Letko Brosseau Equity Fund** | 12.6 | 5.8 | 1.0 | 3.7 |
| **Letko Brosseau Emerging Markets Equity Fund** | 9.7 | 5.4 | 1.0 | 4.4 |
| **MSCI World** | 18.7 | 11.7 | 2.4 | 2.3 |
| **MSCI Emerging Markets** | 13.4 | 7.5 | 1.5 | 2.7 |
| **S&P 500** | 20.3 | 13.8 | 3.4 | 1.8 |
| **S&P/TSX** | 15.8 | 9.0 | 1.5 | 3.4 |
| **BLOOMBERG EURO 500** | 16.0 | 8.5 | 1.6 | 3.4 |
| **NIKKEI** | 18.4 | 10.7 | 1.6 | 2.0 |

Source: Bloomberg (October 1 2020)

## The importance of discipline in delivering long-term returns

One of the many pitfalls of investing is an extrapolation of recent past performance into the future. Expecting that an investment that has done well in the past will continue to outperform—or that an investment that has underdelivered in a recent period will be doomed to disappoint in the future—can play into the dangers of herd mentality. We believe price discipline is essential in managing the risk of a portfolio as is avoiding asset bubbles.

In our assessment, the low point of the recession was reached in March/April and our portfolios are positioned to capitalize on the economic recovery. We see an exciting future runway for economic growth particularly given the record amounts of fiscal and monetary stimulus that have been deployed. We continue to actively seek attractively-valued investments that will benefit from transformational changes and capture long-term growth of emerging market economies.

Though challenges remain in the short-term, there is light at the end of the tunnel. We are confident that our strategy should continue to yield attractive rewards going forward.

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