Quarterly Newsletter

Lorne Steinberg Wealth Management

Wealth Management | Steinberg High Yield Fund | Steinberg Global Value Equity Fund

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> *"There is nothing so disturbing to one's well-being and judgment as to see a friend get rich."* -Charles P. Kindleberger

The Investor Conundrum

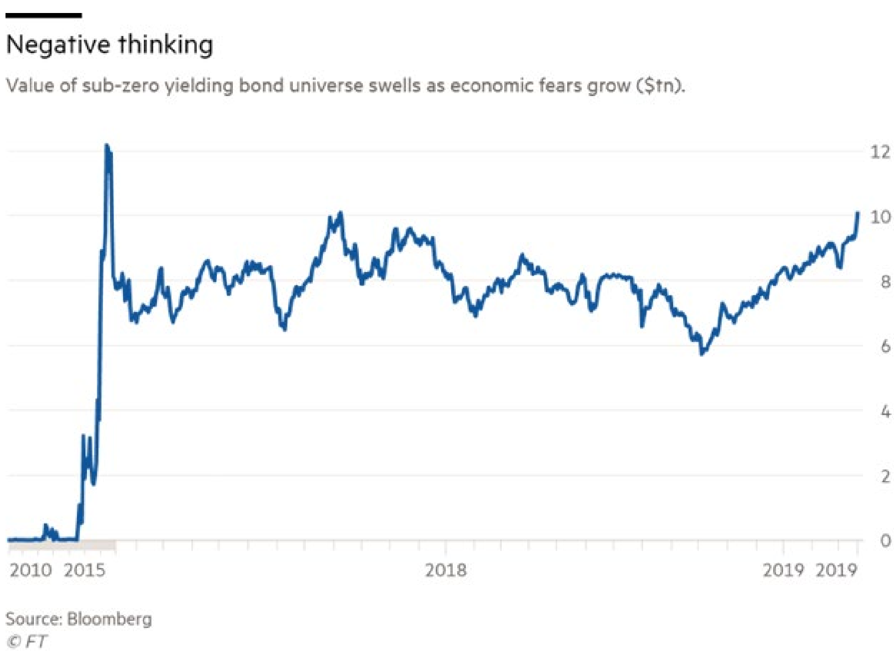
Dear Investor,

Investors have breathed a sigh of relief thus far in 2019, as global markets rebounded -- but the reason for the strong returns has more to do with central bank policy than any fundamental improvement in the economy.

After a series of rate hikes over the past two years, the Federal Reserve Board surprised markets by signaling that it would take a pause (due to slowing global economic growth). The result has been a decline in bond yields and a stock market rally.

Disappearing bond yields

Investors buy bonds for their security of capital and yield. In the years leading up to the financial crisis, the global economy was booming and investors were paying more attention to yield than risk. The financial crisis led to bond defaults across a wide spectrum of the bond market, including the restructuring of Greek government debt. As a result, investor focus shifted back to safety, and the result was negative bond yields – a trade whereby investors *pay for the privilege to lend* (with a guarantee only to receive less at maturity than their original investment). The aggregate value of the sub-zero yielding bond universe peaked in 2016 (at approximately $10 trillion), at which time the economy picked up steam and yields started rising. As global growth has started to slow, the amount of negative-yielding bonds is rising once again, as illustrated in the chart below.



Retrieved: March 25, 2019

Negative yields are an extreme example of the low rate environment facing investors. The chart below illustrates the "investor conundrum," whereby traditional bonds are generally yielding less than the inflation rate.

10-year Government bond yields*

Canada	1.7%
U.S.	2.5%
U.K.	1.1%
Germany	0.0%
France	0.4%
Spain	1.0%
Japan	0.0%

Inflation rate of advanced economies: 1.6%**

*Bloomberg, April 2019
**International Monetary Fund, April 2019

Historically, most investors, including large institutional investors (such as pension funds), have had an asset allocation which included a significant weighting in bonds. As the era of low rates continues, investors have been reducing their exposure to traditional bonds in pursuit of increased returns.

Funds have been flowing into other assets, such as equities, real estate, infrastructure and private equity. This increased demand has resulted in higher valuations, and therefore, increased risk. Valuations for private equity deals, for example, have soared, reaching an all-time high of 11 times EBITDA in 2018 (up 50% over the past 15 years). Investors have been bidding up the price of assets, virtually guaranteeing lower returns for these investments than in the past. It is also worth noting, as investors continue to take on more risk in search of yield, none of the aforementioned asset classes offer the security of fixed income.

Where is the value?

In response to higher growth, the U.S. central bank has raised interest rates more than most countries, offering comparatively higher bond yields. These higher yields have attracted a flow of funds into U.S. assets, resulting in higher valuation metrics in the U.S. compared with other countries. This is reflected in the following chart.

Five valuation measures for global stock markets
15-year average shown in brackets

Schroders

	CAPE	Forward P/E	Trailing P/E	P/B	DY
UK	16 (13)	13 (12)	15 (14)	1.7 (1.9)	4.6 (3.7)
US	31 (25)	17 (15)	21 (18)	3.5 (2.8)	1.9 (2.0)
Europe ex UK	20 (16)	14 (13)	16 (16)	1.8 (1.8)	3.3 (3.2)
Japan	23 (24)	13 (14)	13 (17)	1.3 (1.3)	2.4 (1.9)
EM	14 (16)	12 (11)	13 (14)	1.7 (1.7)	2.6 (2.6)

Figures are shown on a rounded basis and have been shaded dark red if they are more than 10% expensive compared with their 15-year average (median) and dark green if more than 10% cheap, with paler shades for those in between. Source: Schroders, Thomson Reuters Datastream, MSCI, Robert Shiller. Data covers 15 years to 12 April 2019. CS1396

The chart illustrates that U.S. equities are trading above historical valuation metrics, while the Japanese market remains cheap. It is especially interesting to note that the dividend yield of Japanese stocks, at 2.4%, is now significantly higher than that in the U.S.

In an effort to revitalize corporate Japan and encourage foreign investment, the government adopted a corporate governance code in 2015, and companies are responding to the new rules.

After much criticism for sitting on hoards of cash, Japanese companies have started using their large cash positions to buy back shares (at prices below book value) and increase dividends. Several of our Japanese holdings, including Nippon Antenna and Sanyo Engineering and Consulting, have been aggressive buyers of their own shares, and their shares have rallied because of it.

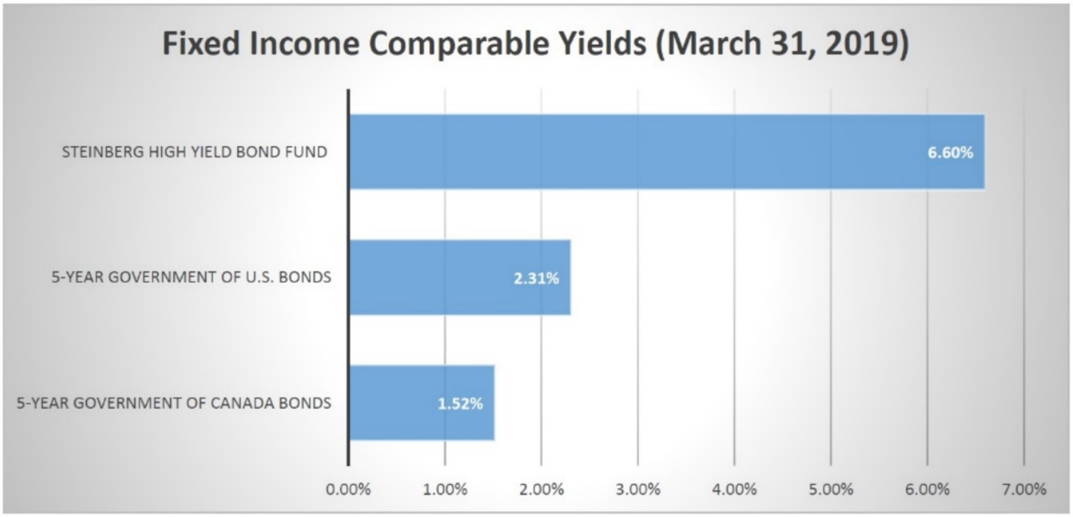
In the U.S., elevated valuations are coupled with slowing corporate earnings growth. In fact, EPS growth for the S&P 500 in 2019 is estimated at a rather anemic 3.4%, the slowest growth rate in years. (FactSet, April 18, 2019)

Despite the recent outperformance of the U.S. stock market, it should be noted that the 20-year annualized total return of the S&P 500 (to March 31, 2019) is 6%, only slightly above the Morgan Stanley World Index. We live in an integrated global economy, and it is not realistic to expect valuations in the U.S. to continue to rise as global growth is starting to slow.

Value in bonds

For those investors who require fixed income, low rates present a real problem. As we have stated for years, the best value in the fixed income market is in high yield corporate bonds. These bonds tend to have shorter maturities, more restrictive covenants (investor protection) and significantly higher yields than the bond market as a whole. While this asset class offers the potential for higher returns, the tradeoff is that one has to accept a greater level of volatility. Like any investment, one needs an adequate time horizon in order to realize the yield to maturity.

As illustrated below, with a 6.6% yield at the present time, high yield bonds offer an excellent return in this low interest rate environment.



*As of March 31, 2019 the average maturity of the Steinberg High Yield Bond Fund is approx. 5 years.

A review of the high yield bond market and our high yield fund is available here: High Yield Quarterly.

Final Thoughts

Investors are enjoying the market rally. As one client recently said to me, "... your job must be easier this year…" In some sense, he is right, as the volume of client calls has certainly declined. However, we are focused on making sure that we continue to own a portfolio of high-quality businesses that are financially sound and trading at rational valuations.

Charles Kindleberger was a respected economic historian. His quote (at the outset of this letter) reflects his observation that, in a rising market, no one wants to feel they are missing out on an opportunity to make money -- whether that be in cryptocurrencies or cannabis, tech unicorns or tulip bulbs. If discipline and criteria are compromised in the pursuit of wealth creation, history has shown that investors have not fared well. As I write this letter to clients, Uber is seeking to raise $9B in an IPO (valuing the company at $84B). The company has logged $10B in operating losses over the past three years. More broadly, as cited recently in the Wall Street Journal, money-losing companies are going public at a record rate (with 83% of U.S. - listed IPOs in 2018 unprofitable, a number exceeding even that of the dot-com bubble). That should give one pause.

In this era of persistently low interest rates, investors are faced with a conundrum – take on increased risk in order to maximize returns, or maintain some liquidity in order to minimize risk, and wait for better opportunities. We believe it far more prudent to choose the latter.

Sincerely,

Lorne Steinberg
President