October 2019

> ***"[Benjamin] Graham's wonderful sentence is, an investor needs only two things: Cash and Courage. Having only one of them is not enough. Courage is a function of process."*** *Seth Klarman*

The Canary in the Coal Mine?

Dear Investor,

Open any financial publication today and one will inevitably read about the risks that the U.S. economy is likely heading into a recession. In some way this is not a surprise, as the current U.S. economic expansion, standing at 10 years and 3 months in duration, is now officially the longest on record.

That said, what defines this particular economic expansion more than anything else is just how shallow or subdued a recovery it has been. One, perhaps, should take encouragement from the fact that the less 'boom' we have seen this time around might argue that there is less potential for a serious 'bust'. In addition, as evidenced by Australia, the U.S. expansion is a mere infant when compared to the Antipodean nation which is now in its 29th successive year of growth.

The simple fact is that economies spend a lot less time in recessions than they do in recovery and expansion. As the following table shows, there have been 14 recessions in the United States over the past 90 years, or one roughly every six to seven years. Moreover, most last less than one year and the time between each one has typically lengthened, with only 3 downturns seen since the early 1980s.

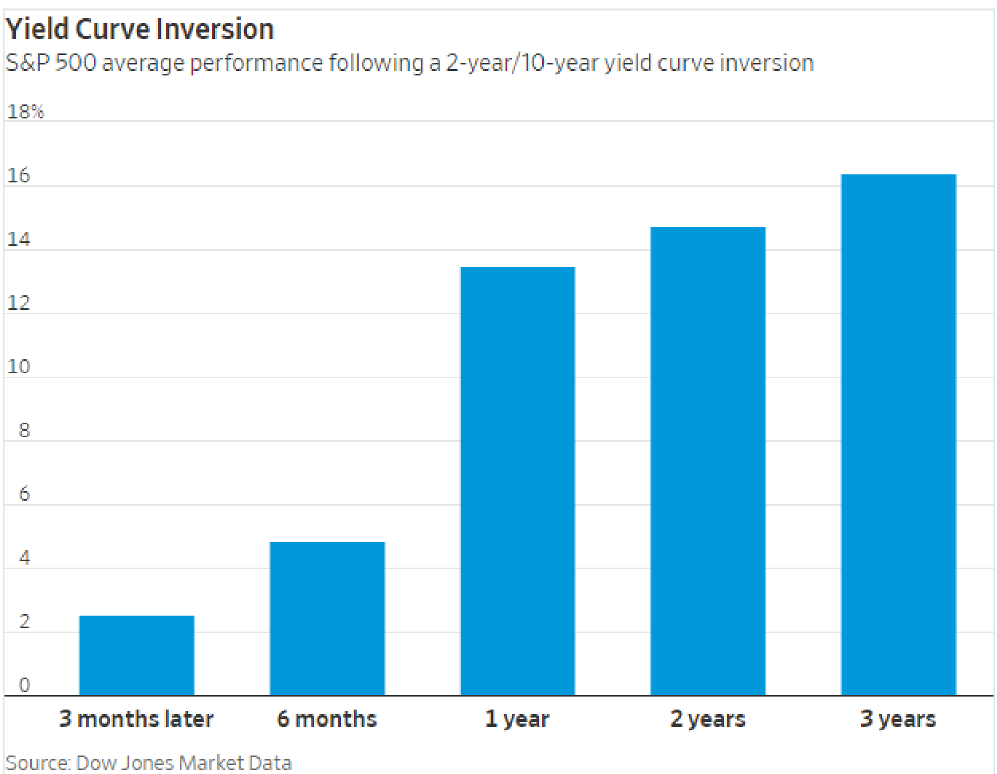
Recession	GDP Contraction	Duration	Time Until Next Recession
August 1929 - March 1933	-26.7%	3 Years 7 Months	4 Years 2 Months
May 1937 - June 1938	-18.2%	1 Year 1 Month	6 Years 8 Months
February 1945 - October 1945	-12.7%	8 Months	3 Years 1 Months
November 1948 - October 1949	-1.7%	11 Months	3 Years 9 Months
July 1953 - May 1954	-2.6%	10 Months	3 Years 3 Months
August 1957 - April 1958	-3.7%	8 Months	2 Years
April 1960 - February 1961	-1.6%	10 Months	8 Years 10 Months
December 1969 - November 1970	-0.6%	11 Months	3 Years
November 1973 - March 1975	-3.2%	1 Year 4 Months	4 Years 10 Months
January1980 - July 1980	-2.2%	6 Months	1 Year
July 1981 - November 1982	-2.7%	1 Year 4 Months	7 Years 8 Months
July 1990 - March 1991	-1.4%	8 Months	10 Years
March 2001-November 2001	-0.3%	8 Months	6 Years 1 Months
December 2007-June 2009	-4.3%	1 Year 6 Months	???
Median	**-2.7%**	**9 Months**	**4 Years 2 Months**

Source: National Bureau of Economic Research

Many are of the view that a correction is long overdue, and the recent inversion of the yield curve (where long-dated interest rates are lower than those seen at the short end of the curve) has added further fuel to the fire. Such an inversion has preceded each of the last seven recessions.

No doubt economists and market strategists will, therefore, continue to vex over the likelihood of a U.S. (and possibly global) recession for the foreseeable future. At an individual level, recessions can be nasty affairs with loss of income, housing, etc. At a national or societal level though, recessions can have somewhat of a cleansing effect by unwinding some of the tightness/excesses built up during the previous economic boom. But, at a corporate or stock market level, what does it usually mean for investors?

History shows that the inversion of the yield curve or an actual recession itself is not necessarily a bad thing for equity markets, a fact that seems to be somewhat lost presently on most commentators. As the following chart shows, on average, the S&P 500 has returned 2½% in the three months after an inversion, gained almost 5% after six months and delivered mid-teens % returns one to three years after the event. For investors who can be sidetracked by the gloom of headlines, and are looking to try and time a market pullback or recession, this is compelling data.



But what about during actual recessions themselves? Below we can see the performance of the S&P 500 over various periods leading up to, during, and after each of the past 9 U.S. recessions.

	1 Year Prior	Recession	+1 Year	+3 Years	+5 Years
Aug 1957 - Apr 1958	0.8%	-6.4%	37.2%	66.1%	89.3%
Apr 1960 - Feb 1961	3.1%	18.3%	13.5%	34.8%	67.7%
Dec 1969 - Nov 1970	-10.7%	-3.4%	11.3%	20.4%	24.8%
Nov 1973 - Mar 1975	-0.1%	-18.2%	28.3%	21.6%	54.8%
Jan 1980 - July 1980	18.5%	16.4%	13.0%	56.0%	100.0%
July 1981 - Nov 1982	20.7%	14.4%	25.5%	66.4%	102.4%
July 1990 - Mar 1991	16.5%	7.6%	11.1%	29.9%	98.3%
Mar 2001-Nov 2001	-8.2%	-7.2%	-16.5%	8.4%	34.2%
Dec 2007-June 2009	7.7%	-35.5%	14.4%	57.7%	136.9%
Averages	**5.4%**	**-1.5%**	**15.3%**	**40.1%**	**78.7%**

Source: awealthofcommonsense.com

The data largely speaks for itself, namely that market performance is typically sub-par in the period up to and around an economic downturn but, remaining invested through the cycle is clearly the right strategy. Moreover, investing in strong businesses with robust balance sheets through these periods, and holding some cash to spend as opportunities present themselves is prudent.

In addition, the table above speaks only to aggregate index performance. In any economic and stock market environment, there will be relative winners and losers. While the reduction in aggregate growth is typically bad for all businesses in the short term, one would imagine that those entities that are best prepared for such an eventuality may well be best placed to prosper in the long term. Indeed, McKinsey published a report in May of this year "Bubbles pop, downturns stop," examining exactly that.

The report starts with the admonishment that we should "waste no time trying to predict the next economic cycle" before proceeding to discuss their findings from studying the behaviour of over 1,000 corporations during the downturn and subsequent recovery witnessed between 2007 and 2011. They discovered that approximately 10% of their sample size fared materially better than peers *within the same sector*. Of note, they highlighted that this group of "resilients," as they termed the subset, actually *underperformed* somewhat in the 3 years prior to 2007.

Their analysis showed that it had very little to do with a better revenue profile, but was almost entirely to do with profits holding up better than the pack. They identified 3 factors that the relative winners possessed in abundance, that of:

1. stronger balance sheets and, hence, not only the ability to survive, but to thrive by deploying excess capital into M&A at the first signs of recovery
2. cutting costs ahead of the beginning of the downturn, i.e. being prepared well in advance
3. those in the more countercyclical sectors continuing to focus on growing their businesses organically even if it meant incurring additional costs

The above analysis supports our conviction that we should spend less time worrying about where the economy is heading and much more in trying to identify individually strong businesses that can survive and thrive over time regardless, and where we can deploy our capital with a margin of safety.

An example of our focus on quality would be a new company that we added to the portfolio during the quarter, Sanofi, the French pharmaceuticals group. With a diversified portfolio of drugs, as well as sizeable consumer healthcare and vaccines businesses, there is little individual product risk. Earnings are, therefore, quite predictable and should enjoy some modest progression from here. For that, we are presently paying a low teens multiple of earnings and enjoying a 4% dividend yield.

We also added to our holding in Corteva. Following its spin-out from DowDupont, this agricultural chemicals entity is a top global seeds & traits supplier along with boasting a leading crop protection chemicals business. Even if we see no recovery in the currently depressed North American farmers market, substantial cost savings are likely to drive significant profits growth. Were we to see a recovery back to the valuation multiples that previous independents have typically traded on, that would result in considerable upside from here.

High Yield Bonds

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

Final Thoughts

The allusion of the canary in the coal mine harkens back to the days when miners would carry caged canaries into the mines with them. If toxic fumes or gases became present in the mine, the birds would die well before the levels became deadly for humans. Thus, 'the canary in the coal mine' is used as a warning to get out or exit in the face of growing danger. The inversion of the yield curve as a harbinger of a forthcoming recession (months or years away) should not cause panic, but should give investors pause to reflect on that which they hold, and how their portfolios are structured. While the advice to flee is particularly important for miners, the same is not true for investors. Trying to time a downturn or recession has proven disastrous for investors, and the compelling data shown in this letter speaks to why investors should focus on quality and are far better off to stay the course. Couple that with a healthy cash position, and investors are not only prepared to weather the storm, but ready to take advantage of it.

We welcome the opportunity to discuss our outlook and investments with you.

Sincerely,

Lorne Steinberg
President

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1. McKinsey & Company Quarterly (May, 2019) - "Bubbles pop, downturns stop."