January 2020

> ***"Those who have knowledge don't predict. Those who predict don't have knowledge."*** *Lao Tzu, 6th century BC poet & philosopher.***"***

Groundhog Day

Dear Investor,

<u>2019: Perception and reality</u>

In 2019, stock markets rallied, but surprisingly, earnings for the S&P 500 over the course of the year were up less than 1%,[1] which was well below the 8% forecast at the beginning of the year.[2] Despite the weakest earnings growth in several years, stocks rebounded. In fact, it wasn't just stocks. For example, most homeowners are smiling these days as they have seen the value of their homes rise well above the inflation rate over the past number of years.

Investors are becoming complacent as interest rates remain at record low levels, and they are driving up valuations in search of yield. As of the writing of this letter, **the Forward Price-Earnings Ratio of the S&P 500 is at its highest level since 2002.** Does this imply that markets are poised for a correction? No. If yields decline further, then markets could continue to rally, but the risk level is certainly elevated.

The reality is that the global economy is slowing. GDP data has been weaker than expected in Europe and the U.S., while emerging markets such as China and India are losing traction. The coronavirus is another negative factor, at least in the short-term. In past slowdowns, central banks had significant room to maneuver, but with interest rates already at record lows, the impact of further easing by the Fed and others is questionable. If consumers won't buy homes with a 2.5% mortgage rate, are they going to be enticed by a rate of 2.25%?

All of this brings to mind the issue of inflation. Economists have been grappling with the fact that after ten years of recovery, inflation remains below the desired level for a healthy economy (2% in the developed world). The question is, why haven't low interest rates resulted in inflation?

The answer thus far, is that although we have not experienced significant inflation in the CPI (consumer price index), low rates have resulted in a big bump in asset price inflation. Investors have been willing to pay increasingly high valuations for real estate, infrastructure and stocks – and these valuations have continued to rise.

Is value dead?

We are all reading articles indicating that "value is dead," and that the traditional metrics that determine the value of a business have less relevance today. To this point, I just read an article (Barrons, Oct. 15, 2019), in which a hedge fund sold its Berkshire Hathaway shares and blasted Warren Buffett for his poor investment decisions over the past few years, lamenting Berkshire's stagnant share price. True, the return of Berkshire Hathaway over the past two years is less than 2% per year (Jan. 30, 2018 - Jan. 30, 2020), but one must ask whether Buffett has lost his mojo, or if something else is going on. The last time I remember this kind of Buffett-bashing was during the dot-com period of the late '90s, when value investing was out of favour, and the "star" investors at that moment in time were those who had loaded up on Nortel, JDS Uniphase (when is the last time you heard that name?) and the like.

The value of a business is a function of its business model, financial strength and earnings growth. That's it. Nothing else. Investors in this market are buying those stocks which continue to rise, while ignoring the rest of the market, regardless of valuation. We need to stay disciplined and not get caught up in chasing that which has already done well and focus on investing in companies that offer attractive risk-reward metrics, so that we are well-positioned for the correction that will inevitably occur.

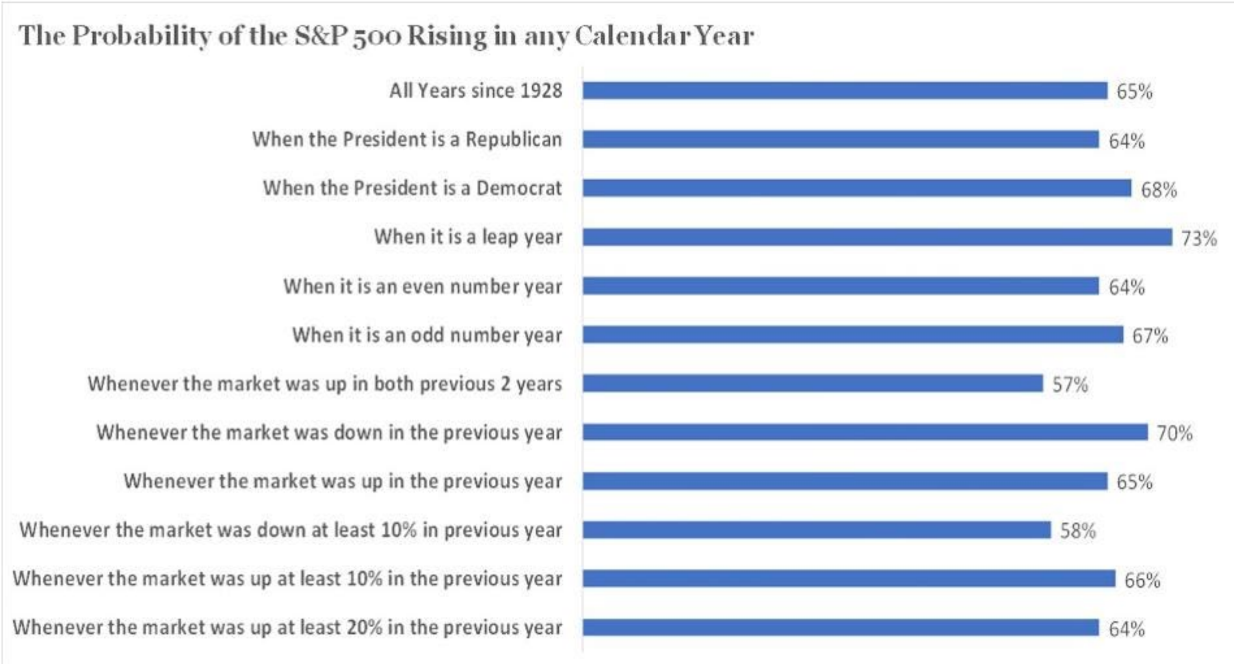
2020 Vision

At this time of year, the question we are most often asked is: "what is your outlook for the year ahead?" Indeed, January is a month filled with market commentators offering up prognostications for the forthcoming year, whether it be the economic outlook, how geopolitics will evolve and where bond, equity and other asset markets will end up in 12 months' time. We do not do that. We do not possess a crystal ball.

James Montier, publisher of several books on behavioural finance, while working as a strategist at DrKW Macro research in 2005, wrote a critique entitled, "The Seven Sins of Fund Management". The first of these transgressions that he delved into was titled "The Folly of Forecasting," where he highlighted that experts are generally no better at predictions in their field of expertise than complete amateurs. However, experts tend to have a lot more confidence in their predictive abilities. To this point, we noted in the first paragraph of this letter that consensus 2019 S&P 500 earnings were projected to rise by 8%. Instead, they rose by less than 1%.

Why is it, therefore, that despite all such evidence, investors continue to seek out the predictions of experts? Mostly, it has to do with our psyche. Humans are uncomfortable with uncertainty. It causes a chemical reaction in our brains (the release of cortisol), which makes us feel stressed. When we resolve such uncertainty, another chemical (dopamine) is released, which makes us happy. We are, by nature, wired to seek out certainty. In addition, psychologists have found that people prefer to listen to others who *sound confident*, even when their predictions are not terribly accurate.

In terms of predicting markets, such experts will often draw upon one or more supposedly "indicative factors" in support of their forecasts for the year to come. A recent article in Forbes magazine compared the probability of the S&P 500 index rising against a number of independent variables with arguably predictive prowess.



The chart highlights that, regardless of what the experts tell you, there is about a two-thirds chance that the U.S. market will be up in any one calendar year and that's about it.

Our Approach

Ben Graham (Warren Buffett's finance professor at Columbia) once said that "forecasting security prices is not properly a part of security analysis" and we wholeheartedly agree. Here, we focus our attention on identifying and understanding businesses – purchasing only those whose value, as measured by assets or cash flows, is not adequately reflected by the market price.

Take, for example, our purchase of Sanofi, a French pharmaceutical, consumer healthcare and vaccines conglomerate, in the middle of last year. With a widely diversified portfolio of drugs in its pipeline, Sanofi is not overly reliant on a "wonder drug" or two in order to be successful over time. Having first purchased the stock in August, we paid a low-teens multiple of earnings for anticipated steady profits growth, while enjoying a 4% dividend yield.

In terms of other activity, we have taken advantage of substantial strength in several of our Japanese holdings to either trim positions or exit them completely. There was one notable exception to our selling though and that was Topre, an automotive parts supplier, where we doubled our holding. Boasting a rock-solid balance sheet, like so many of the Japanese companies that we own, Topre has also been profitable every year now for more than three decades. It trades on a prospective earnings multiple of about 8, price to assets of 0.6x and has a dividend yield of 3½%. Were the stock just to get back to the midpoint of its historic valuation ranges then it would be worth some 50% more than it is being valued at today.

Another area that has been largely overlooked by investors recently has been financials; and we have found excellent value here. One purchase that we made recently was American Express. Founded in 1850, Amex was one of only a handful of U.S. financial services entities to remain solidly profitable throughout the depths of the global financial crisis. Today, we are paying around 13 times anticipated 2020 earnings for a stalwart of the U.S. financial sector. Closer to home, we also purchased our first Canadian bank in The Bank of Nova Scotia, paying a mere 10 times earnings for a very robust business with a 5% dividend yield that should grow over time.

Indeed, the purchase of Scotiabank is an example that, with Canada having been a very lackluster market over the past decade, we are increasingly finding attractive stocks in our own backyard.

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 purported death of value investing makes it feel a lot like Groundhog Day. We've heard this story before from the dot-com boom to the prediction of permanently high oil prices. Today, investors face a conundrum: holding cash equivalents and living with minimal yield or chasing expensive assets with the hope that others will continue to bid them up even further.

We are not in the forecasting business, but we are in the valuation business and the one sure thing in investing is that nothing stays expensive forever, and nothing stays cheap forever.

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

Sincerely,

Lorne Steinberg

Lorne Steinberg
President

[1] FactSet, Jan. 31, 2020
[2] FactSet, Dec. 31, 2018