Lorne Steinberg Wealth Management

QUARTERLY NEWSLETTER

> *"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*

Trust the Process

Lorne Steinberg, MBA CFA
PRESIDENT

2020 is finally over. It was a year we will never forget. Although much of the world remains in lockdown as we enter 2021, the world should return to some type of new normal by early 2022, assuming the vaccines are effective.

Despite the wild volatility, if a client went to bed one year ago and woke up on Dec. 31st, markets would have reflected somewhat of a boring year. The market collapse in March was followed by a rally that continued through December. While a number of investors panicked and sold near the bottom, this year was a strong reminder of why investors need to stay the course when things look bleakest – so long as one owns financially sound businesses whose survival is never in doubt.

As we wrote to our clients in March, the sell-off provided an opportunity for us to spend our cash and buy some of the world's best companies at very reasonable prices. These investments included companies such as Alphabet, Walt Disney, Diageo, Unilever, and Visa. Despite the fact that no one knew how the pandemic would unfold, like the quote at the top of the page, it was our process that gave us the comfort to step in and buy those businesses at the time.

"Stay-at-home" stocks dominated markets until the vaccine news was announced. We own several (Microsoft, Google, and Techtronic, for example), but we also own many other great businesses in other industries, which were ignored (or worse) for most of the year. When the vaccine was announced, investor focus shifted back to value, with the result being that our portfolio rebounded nicely over the past few months.

As we look forward, assuming a sufficient vaccine efficacy and some global GDP growth, we would expect that the Fed and other central banks will reduce monetary stimulus (as government deficits start to decline) and the result will be that bond yields will rise, at least somewhat. The U.S. 10-year bond yield, which is about 0.9% today, was about 1.75% last year at this time.

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Not a cheap market, but … we don't own the market

Low interest rates have been driving up asset valuations for quite some time. As we start 2021, the major stock market indices are reflecting a very bullish sentiment. Markets, in general, are not cheap by historical metrics. The S&P 500 is currently trading at a valuation of 25 times the projected earnings for 2021, with a dividend yield of 1.5%.

However, it is important to note that we do not own "the market."
There are, indeed, a number of companies today trading at valuations that appear very stretched, and the market-cap weighting of mega-cap tech can certainly skew "the market" and the opportunity set. However, many strong businesses are trading at values that would be considered cheap and attractive in any market.

Our goal is to focus on the latter – companies which are financially sound, with a proven business model, whose share price offers very attractive return potential, while cheap enough to give us a comfortable margin of safety.
As can be seen in the chart below, the metrics of our equity strategies today look very different (in terms of valuation) from the market as a whole:

	P/E	Dividend yield
Global Value	14	2.2%
Canadian Dividend	13	3.9%

Volatility may remain elevated for quite some time, but the companies that we have invested in are well positioned to continue to increase their earnings and dividends, which should benefit long-term shareholders.

2020 was a difficult year in many ways, but it serves as a valuable reminder for investors that in the worst of times, great companies have the financial capacity and ability to adapt to challenges and weather the storm.

Diversification is the key to capital preservation and is critical for any long-term investor. The downside is that (at any given time) one group of investments will be outperforming the rest, and the investor fears missing out. Irrational outperformance in one investment, group or sector will always reverse itself over time.

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Q4 Activity

Following a fairly subdued period of portfolio turnover during the third quarter of the year, we were a little bit more active during the months of October and November. Given the continued strength in markets, we trimmed several stocks that had performed very well and thus become rather large position sizes, including Techtronic, Middleby and Morgan Stanley. We also exited our holding in Takasago, a Japanese flavours & fragrances business. These sales funded the purchase of 4 new holdings.

VIATRIS™

Viatris, which was formed from the merger of Mylan with the Upjohn business spun out of Pfizer, is a specialty pharmaceuticals company, which boasts a very diverse portfolio of products.

Just over half of revenues come from branded drugs, including old stalwarts like Lipitor, Xanax and Viagra, with the remainder made up of generics, biosimilars and products sold over the counter in pharmacies. The combined entity has a premier global distribution infrastructure and is particularly strong in emerging markets.

While group sales growth may be minimal in the early years, the new management team from Pfizer has considerable potential to cut costs as well as divert the prodigious cash flows into developing the pipeline and acquiring new assets. For that we are paying a mere 5x earnings and receiving an anticipated 5-6% starting dividend yield.

COMPASS GROUP

Based in the UK but operating globally, Compass is the world's leading contract catering company, providing food services to corporations, hospitals and care homes, educational facilities, sports stadia, and defence and offshore installations etc. in 45 countries.

As a result of the pandemic, not surprisingly, some of their activities have been significantly curtailed, which resulted in the group deciding to significantly strengthen their balance sheet through an equity issue.

With ample available cash resources and their most recent quarter witnessing almost no cash burn whatsoever, we are buying into the leader in a structurally growing and still highly fragmented market where a large swathe of the local / regional competition may well disappear. At some point the virus outbreak will be behind us and we have been able to pick up the shares at a price approaching half of where they had been previously.

As vaccine optimism rose towards the end of the year, we saw quite a sell-off in stocks that had previously been seen as beneficiaries of the 'work from home' environment and this threw up a couple of opportunities to purchase businesses with secular growth prospects at attractive valuations.

TSC TRACTOR SUPPLY CO

Firstly, we added Tractor Supply to the portfolio, a retailer that serves rural U.S. customers through a network of some 1900 stores in 49 states and their eponymous e-commerce website, where they sell an extensive mix of products for the home, land, pets and animals.

Despite being the largest rural lifestyle retailer in the country, they still only have about a 10% market share.

They have an enviable track record of growing their revenues every single year this millennium, helped by a longstanding reputation for exceptionally high customer service and a correspondingly very loyal customer base. While the business may well pause for breath next year, given such strong trading through the pandemic, they carry negligible net debt and are presently investing heavily in expanding and modernizing their store portfolio while also rewarding shareholders through both growing dividends and sizable share buybacks.

With anticipated continued solid underlying sales and profits growth, this is a high-quality business for which we are paying below average multiples.

EA

Finally, Electronic Arts is a leading video gaming company, with arguably the most utility-like earnings of the lot owing to a broad portfolio consisting more of dependable franchises (FIFA, Madden NFL, The Sims etc.) rather than one-off hit titles. The video gaming industry is still far from mature, with anticipated structural growth for many years to come, and the shift to selling downloadable content, including in-game micro-transactions, and subscription services are improving both customer stickiness and overall profitability. Sales growth, almost all of which is organic, has averaged about 8% pa over the past 20 years and with margins invariably trending higher. With net cash of some $5bn or over $20 per share (1/6th of the market cap), prodigious cash generation has seen them retire over 2% of their share count annually in recent years and they have just initiated a quarterly dividend.

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High Yield Bonds

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

Final Thoughts / Trust the Process

My colleague, Liam Card, a former Canadian National Team track athlete, often speaks about his late Coach (Earl Farrell) reminding him to "trust the process" over the course of their years working together.

He recounts the stories of athletes chasing the hot new training methods of the day who showed strong performance very early in the season, but whom were often unable to compete, injured, or burnt out by the summer season, when it mattered most. Seeking bursts of performance while taking excessive risk or compromising one's process for the possibility of short-term outperformance puts portfolios, retirement plans (and athletic careers) at risk of serious injury. The message to "trust the process" is more important today, than ever.

We are witnessing a number of stocks today whose share price has become divorced from reality as a result of being driven up by throngs of amateur traders on various new trading platforms (Robinhood, for example). While these investors may experience a temporary euphoria from seeing these values pop up for a short period of time, we suspect the "high" will be short-lived.

The world is in a constant state of evolution. As our own process here naturally evolves and improves over time, we are (and will forever be) focused on quality and purchasing strong businesses who are competitively positioned and trading at a discount relative to intrinsic value.

Liam's coach produced several National Champions, National record holders, and Olympians in a proven, lower-risk framework. This speaks to our philosophy, and when creating robust portfolios that will stand the test of time, we trust the process.

We wish you and your families peace and good health through these difficult times.

Sincerely,

Lorne Steinberg
President

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