Investing without research is like playing stud poker and never looking at the cards.

—Peter Lynch

Lorne Steinberg,
MBA CFA
PRESIDENT

The Best Medicine

Dear Investor,

"Have you had your vaccine yet?" I am being asked that a lot lately!

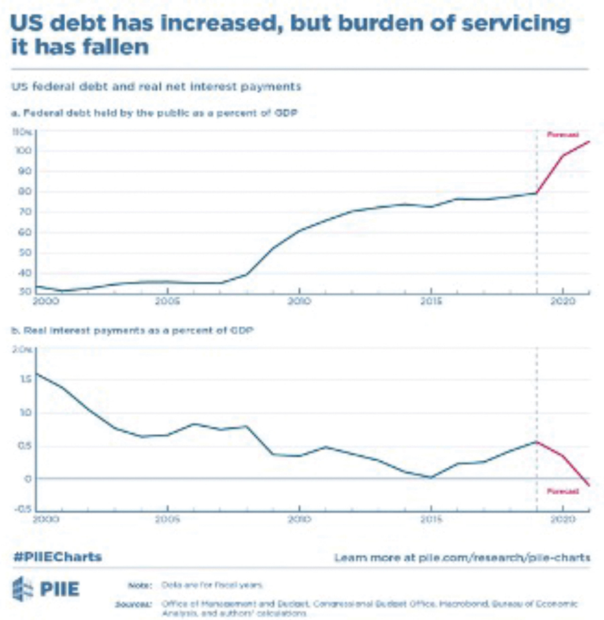
Barring a serious problem with new COVID variants, or some nasty side-effect of one of the vaccines (I hope not, as I just had my first shot…), most of the developed world will be returning to some level of normal by the end of this year.

As the vaccines roll out, the global economy will continue to rebound, buoyed by pent-up consumer demand, increased employment and ongoing government spending.

Pre-COVID, economists were concerned about the high levels of household debt, fuelled in large part by mortgage debt. One impact of the pandemic has been that the U.S. personal savings rate is at its highest level in over 50 years. Consumers are eagerly awaiting the opportunity to spend again, and global economic activity is forecast to exceed 2019 levels by 2022. This, at least partially, explains the ongoing stock market rally.

In contrast to consumer savings, government debt as a percentage of GDP is at its highest level since 1946, as government spending has continued unabated, and the U.S. Congress is debating further stimulus in the form of major infrastructure spending.

For those concerned with the high level of government debt, it is important to note that a significant amount of this debt has been issued at very low interest rates and, thus, the interest burden is less onerous than may be apparent, as can be seen in the following chart:



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Inflation and markets

With the economy poised for a significant rebound, and governments continuing to spend, investors are wondering whether all of this may lead to an elevated level of inflation.

When I was growing up, my father used to remind me that when he was a kid, a loaf of bread cost 10 cents. Of course, we would roll our eyes every time he told us this. Now that I have a teenager, I occasionally let her know that when I was growing up, a loaf of bread cost about 60 cents (I can see her rolling her eyes). Today, a loaf of bread costs about $3.50. That is inflation! However, over the same many years, average incomes have risen by at least as much, as have property values and equity markets. In fact, the standard of living today is higher than ever before.

Some inflation is very positive for the economy. Consumers want to buy houses because home prices have risen over time. This has made residential real estate a good hedge against inflation. If house prices were declining for an extended period of time, then home sales would decline (which would negatively impact the economy). Declining prices, known as deflation, has a long-term negative impact on the economy, as consumers prefer saving to consumption, and the economy goes into a downward spiral. Who wants to buy anything if the price of that item might be cheaper next month? That is exactly what happened in Japan in the 1990s when their economy went into a long recession.

Inflation is a necessary component for economic growth, but like anything else, it is best in moderation. For most of the post-World War ll period, U.S. inflation averaged around 2%; however, there have been periods of time when inflation was much higher.

The last time the U.S. experienced very high levels of inflation was 1978 - 1981. The inflation rate reached 9% in 1978 and rose to over 13% (1979), before finally falling below 9% by 1982. When inflation rises, central banks are forced to raise rates in order to restore price stability (which often results in a recession). This is exactly what happened back then. To slow the economy, the Fed eventually raised short-term interest rates to 18%. Higher interest rates incentivize people to save vs. spend, which has a cooling effect on the economy.

However, how did investors fare during this time? The answer is informative. During inflationary times government bonds are among the worst investments because investors lock themselves into low yields. The rate of inflation eventually surpasses the bond yield, and the price of the bonds fall as investors lose purchasing power against inflation.

Equity investors, however, had a different experience, and the reason is simple. In an inflationary environment, input costs for items such as wages and raw materials rise. If input costs rise, then most companies simply pass on these increased costs to consumers by raising prices. For example, one of the companies that we own in our portfolio is Unilever, which makes Dove soap. Unilever is going to make a consistent profit margin on Dove, regardless of input costs. If the costs go up, so does the price, and Unilever's profits per share actually rise partly due to inflation. Therefore, corporate profits tend to rise during inflationary periods (as do dividends), and that creates value for shareholders.

This explains, at least in part, the performance of the S&P 500 during that time of high inflation, as can be seen in the chart below.

Year	S&P 500 Value	Total Return %
1978	90	6.56
1979	99	18.44
1980	110	32.42
1981	133	-4.91
1982	117	21.55
1983	144	22.56
1984	166	6.27
1985	171	31.73
1986	208	18.67
1987	264	5.25
	10 YR Annualized Return:	**14.8%**

Despite the high inflation rate, equity performance beat inflation at an annualized rate of 8%. Conclusion: the markets may be highly volatile in the years ahead, and it is possible that we may run into another period of elevated levels of inflation. If that happens, equities will probably deliver better returns than most other asset classes.

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Q1 Activity

In his 1949 book, The Intelligent Investor, Benjamin Graham introduced the character of "Mr. Market," a hypothetical investor prone to dramatic mood swings, often wrestling between unbridled optimism and abject pessimism. Some days he turns up at your doorstep, brimming with confidence and willing to pay you high prices for the stocks that you own. On other days, his mood is darkened and he is willing to sell to you what he owns at low prices. Some investors look to be informed by Mr. Market, while other investors look to take advantage of him. We are obviously in the latter camp, and there is no better evidence of that than our (decidedly atypical) activity in Discovery this past quarter.

Discovery is the American television company whose properties include not only the Discovery Channel, but also Animal Planet, Science Channel, Food Network, HGTV, TLC, Travel Channel and others. Discovery has both a standard TV offering, as well as several of its own streaming services, most notably Discovery+.

At the time of initial purchase ($32), the shares were trading at a steep discount to intrinsic value. Despite the cheap valuation, the shares fell after our initial purchase to the low $20's and we added to it. Over the next 12 months, significant investor appetite drove the stock up to around $50 by the middle of February and we trimmed the position. The shares continued to rise, and we sold an additional tranche at $75. A couple of weeks later, Discovery (along with some other media stocks) was caught up in the forced selling spurred on by the collapse in Archegos Capital, and we were able to buy back shares in the low $40s.

In terms of other activity during the quarter, we added one new holding to each of our global and Canadian equity strategies.

HomeServe PLC (HSV), offers homeowners one-stop-shopping services for a wide array of home maintenance and repairs (including electrical, plumbing and HVAC), in the UK, U.S. and Europe.

The company offers its services both on a subscription basis, and on-demand. While there are many small, local competitors, HomeServe is a market leader in each country in which they operate. They have a track record of strong sales growth, rising operating margins and a successful acquisition strategy. All of this, combined with strong free cash flow generation, fragmented markets, low penetration rates, and the ability to cross-sell, suggest a continuation of both market growth and potential share gains.

Include high levels of customer satisfaction (as seen in their 80%+ renewal rates) and all of this points to a niche secular growth business that offers the prospect of continued double-digit profit growth possibly leading to earnings multiple expansion as well.

Closer to home, Canadian Apartment Real Estate Investment Trust (CAR.UN), Canada's largest residential landlord, is our first REIT investment. It owns 55,000 residential apartments and townhouse suites across Canada, and an additional 10,000 units in the Netherlands and Ireland. They are also involved in manufactured housing, where they maintain ownership of the land after selling the house.

The key attraction of this business is the stability of their occupancy rates (around 98%), their success in collecting rents (around 99%) and the stability on their gross margins (around 65%), combined with the ability to continue to invest in (and grow) their portfolio over time. We anticipate that the combination of rent increases and square footage growth should result in a 6-8% annual revenue increase. Paying out about 70% of the net funds from operations in distributions, the dividend yield is 2.5%, with the prospect of rising dividends over time.

Over the first quarter, we sold several positions. In our Canadian Dividend Fund, we sold BMO, and in our global equity strategy we sold Aegon, the Dutch insurance group, and TOA, the Japanese manufacturer of sound systems.

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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

Clients often ask what we expect from markets in the next year or two. Our answer is always the same. In the short-term, no one knows. Imagine answering this question in January 2020 just before the pandemic shocked the world. No one could have predicted the steep decline in March followed by the rebound thereafter.

A better question is whether we think our equity portfolios will continue to create wealth for clients regardless of the inflation rate or whatever else befalls the world over the next decade. And the answer is a resounding yes! The companies that we invest in should continue to deliver excellent earnings growth over the next decade, which should result in returns for shareholders well in excess of regular bonds and bank deposits. However, during the next ten years, it would not surprise us if there were a number of market corrections that would test investors' mettle.

We all hope that the vaccines do their job, and we can get back to some level of "new normal" in the coming months. The world would then breathe a sigh of relief, and consumers would get back to spending on restaurants and vacations. Every so often, a crisis will confront investors, be it a pandemic, financial crisis or something else, and hopefully the lessons will not be forgotten; always invest in quality businesses, which will survive the inevitable shocks, and be able to thrive in the aftermath.

The quote from Peter Lynch at the beginning of this letter is a reminder that a disciplined research process is the best medicine for a volatile stock market.

Sincerely,

Lorne Steinberg
President

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