> *The future's so bright I gotta wear shades*
> *(song by Timbuk 3)*

Lorne Steinberg,
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PRESIDENT

Where To Go From Here?

Dear Investor,

When markets are rising, Wall Street tends to focus on the positives, and that is certainly the case today. Despite the recent uptick in inflation, analysts are forecasting that 10-year bond yields will remain below 2% through the end of the year and rise modestly in 2023. If the scenario unfolds as forecast, this will provide the perfect backdrop for equities to climb higher as corporate earnings rebound closer to 2019 levels.

If Wall Street analysts were meteorologists, the daily forecast would always call for sunny skies.

The U.S. inflation rate rose at a 9.7% annualized rate (seasonally adjusted) in the second quarter. If the inflation rate remains at elevated levels, central banks would be compelled to raise interest rates, which in turn might cause a pause in the bull market. The economy is poised for a very strong recovery, with consumers having record savings and the U.S. likely to pass a major infrastructure spending bill. The question for investors is how much of the good news is already factored into share prices.

Is it "too late" to buy stocks?

With markets having experienced a significant rebound off the March 2020 low, a number of investors are asking whether it is too late to invest now. I have been asked this question many times over the years, and when one looks back over a long time horizon, the answer becomes clear.

A perfect example was the purchase of my house.

In 2001, after going to countless open houses, my wife and I finally found a house that we wanted to buy. It was mid-July of that year that our offer was accepted, with the closing scheduled for September 25, 2001. Of course, two weeks before our closing, the 9-11 tragedy took place. The stock market sold off and home prices fell. As we were signing the paperwork to finalize the purchase, I turned to my wife and said that this was the worst timing of any investment we had ever made, as our new home was probably worth 15-20% less than the price we had just paid.

Almost twenty years later, however, despite the initial "correction" in the real estate market, our home purchase has turned out to be a perfectly good investment.

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The message here is that volatility is a fact of life for any investor. One simply must accept that markets will overshoot on both the upside and the downside, often for reasons that no one could have predicted. However, if one has a long enough time horizon, good quality stocks (or real estate) will usually deliver a return well in excess of inflation. Said differently, time in the market, not timing of the market, is what is most important.

Below are the results of a study done by Fidelity as to what would happen to a hypothetical $10,000 investment (S&P 500) from 1980 to 2018 if you missed the best five, ten, thirty, or fifty market days.

While "the market" as a whole is certainly not cheap, we do not own the market, we own stocks in the market; and the diversified portfolio of businesses that we hold are trading at attractive valuations, pay solid dividends and offer excellent opportunities for long-term capital appreciation.

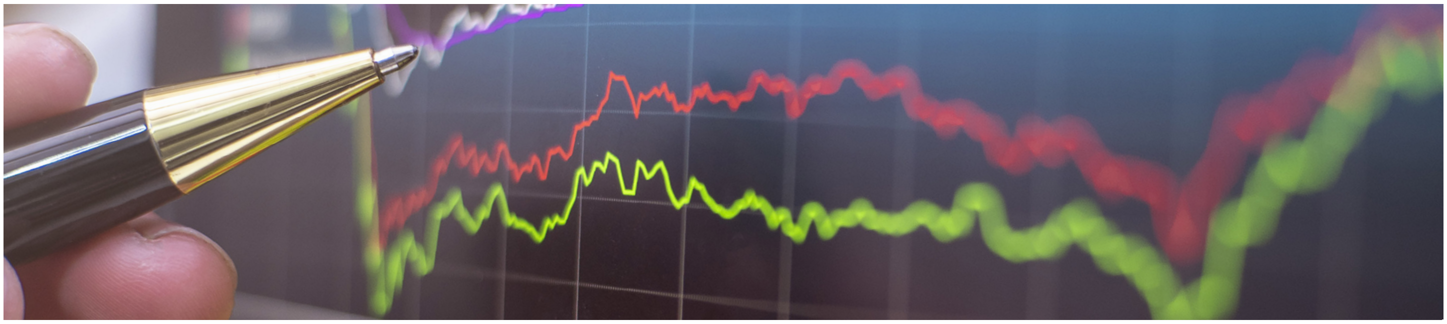
	P/E	Dividend Yield
LSWM Global Value Equity	15	2.0%
S&P 500	22	1.3%
LSWM Canadian Dividend Growth	15	3.5%
TSX	18	2.6%

Time for a raise

In March of last year, many developed nations demanded that their banks suspend dividend hikes and share buybacks – a restriction put forward to protect the banking industry from a wave of bad loans and the possibility of another banking disaster (after 12 years of recovery from the last one). Flash forward to today and U.S. banks have managed through the pandemic well enough to have been given the green light to resume with dividend raises and buybacks. Banks have accumulated significant excess capital over the past year, while loan losses are minimal.

The result is that banks are well-positioned to resume dividend increases and buybacks. Last week, Morgan Stanley announced it will double its dividend as of the third quarter, while Goldman Sachs raised its dividend by 60% to $2 per share. Canadian banks are arguably in an even stronger financial position, and dividend increases are on the agenda in the near future.

Bank stocks have suffered somewhat over the past several years due to a flat yield curve and low interest rates. This situation appears to be abating, which is why the sector is finally recovering.



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Activity

We sold both Intel and Hewlett Packard Enterprises (HPE) from our global equity portfolios during the quarter. In terms of Intel, new management have announced an effective 'doubling down' on internal manufacturing which carries considerable execution risk. We had hoped that the company might decide to outsource some of their production, which would have freed up considerable cash flow. That optionality has now been removed and thus the investment thesis has been altered. With the market having reacted quite favourably to the appointment of a new CEO, we took the opportunity to realize our profit and look elsewhere. With regards to HPE, what has not changed is that this remains a fairly low growth commoditized business facing tough competition. What has changed is the near doubling of the share price from 6 months ago. Therefore, in a relatively short period of time, the valuation has gone from one of the more attractive in our portfolio to one of the least. Accordingly, we sold our position.

While not a direct replacement for either of the above, Taiwan Semiconductor Manufacturing Company (TSMC) is the preeminent chip manufacturer in the world today in what increasingly appears to be a winner-take-all industry. Founded in 1987, TSMC was the world's first dedicated semiconductor foundry business and has long been the leading outsourced chip manufacturer. Over 95% of their assets are based in Taiwan, but 60% of sales are to customers in the U.S., with the balance going to China, Japan and elsewhere. In contrast to what used to be a very competitive and highly cyclical industry, today there are only 3 major companies left (TSMC, Samsung and Intel) and, even then, TSMC has around 85% market share of leading-edge foundry technology. Barriers to entry are huge, with a new leading-edge fabrication facility costing at least $10 billion. Additionally, the Taiwanese entity is now reckoned to be some 5 years ahead of Intel and 10 years ahead of the Chinese competition in terms of its technological prowess. We are anticipating double-digit earnings growth from TSMC over the next several years and believe it can broadly hold its current multiple, translating into attractive shareholder returns from here.

We also initiated a position in Kirin Holdings of Japan. Known best for its domestic beer brands, Kirin is actually quite a diversified entity, with a leading portfolio of both alcoholic and non-alcoholic beverages sold around the world. As Japan's second largest beer company, they have about 30% share of their domestic market; but the attraction of Kirin is about much more than its domestic beer business, which only contributes about one-third of group profits. Firstly, they have about the same share of ready-to-drink alcoholic beverages in their home market, the #1 black tea brand and other notable non-alcoholic domestic beverages, as well as considerable revenues from abroad (principally Australia and the US, but also Europe and other parts of Asia) including an American Coca Cola bottling operation. Secondly, they have sizable stakes in a pharma subsidiary (Kyowa Kirin) and a cosmetics & dietary supplements business (FANCL), both of which are quoted and whose combined value today accounts for about two-thirds of Kirin's market cap, but contribute only around one-third of group income. Therefore, netting out these other assets, we are getting the beverages business for a single-digit multiple of earnings, with a 3% dividend yield and healthy free cash flow.

Closer to home, we also initiated a position during the quarter in Open Text (within our Canadian Dividend Growth Strategy). As Canada's 3rd largest software company, they sell enterprise information management software which helps management better understand the content and unstructured data that various parts of their business generate.

Revenues come 60% from the Americas, just over 30% within EMEA (Europe, Middle East, and Africa) and with the balance made up from customers mostly throughout Asia Pacific. Their addressable market is about $80bn, of which they only have about a 4% share, and they compete against behemoths such as Oracle and SAP, as well as local and regional smaller companies. One of the key attractions is that some 80% of their business is recurring revenue-based, and this will grow as the company moves away from the traditional business model of one-off sales. As with most software companies, margins are high and free cash flow is significant. Excess cash has been used to fund acquisitions of related businesses, which has led to double-digit annual revenue growth. Unlike a lot of other software companies, they actually pay a dividend (about a 2% yield today) and we are paying a low-teen multiple of earnings and enjoying a near 7% free cash flow yield.

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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

Bull markets lead to excesses, and a number of stocks are trading at prices which assume a growth trajectory that defies logic. While Wall Street is focused on its perfect scenario, we remain focused on making sure that each investment we own is trading at a price which should create long-term value for our clients, while giving us the comfort of a margin of safety when the markets inevitably correct.

There has been more activity in our portfolios over the past two years than in the past. This reflects the fact that markets have been volatile, and we are focused on only holding that which continues to offer attractive upside.

Even if the scenario that unfolds is not as perfect as Wall Street is expecting, we are well positioned to continue to deliver the long-term returns that our clients expect.

Sincerely,

Lorne Steinberg
President

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