

“ *There are two kinds of forecasters: those who don't know, and those who don't know they don't know.* ”  
-John Kenneth Galbraith



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## The Folly of Forecasting

In our year-end letter at this time last year, we said the following:

*“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.”*

As we enter 2022, the pandemic remains a fact of life, with its evolving strains presenting challenges. At times, it seems that the cycle of on-again/off-again lockdowns will be with us for years.

However, science is catching up (I am an eternal optimist!) and there are presently 137 COVID-19 vaccine candidates undergoing clinical trials and an additional 194 candidates in pre-clinical development. The following

quote from Churchill may offer an apt description of the current situation:

*“Now this is not the end. It is not even the beginning of the end. But it is, perhaps, the end of the beginning.”*

Despite the impact of COVID, the markets performed well, as corporate earnings rebounded significantly in 2021 and the upward trend should continue this year.

Most of the businesses we have invested in will continue to grow in spite of the pandemic. The reality is, regardless of how long COVID stays with us, we still have to use banks and insurance companies, go to the pharmacy, use Microsoft Windows and search on Google. Even Disney, with its theme parks, was able to pivot by quickly expanding its streaming platform.



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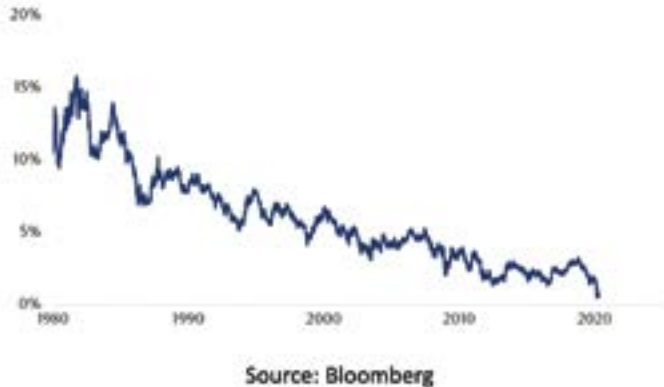
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## Traditional fixed income: the end of the bull market

Bond yields have declined over the past forty years, as can be seen in the chart below:



After the Federal Reserve's recent indication that interest rates will be raised this year, the U.S. 10-year bond yield rose to 1.8%. The Fed also indicated that it will start to reverse its quantitative easing program (purchasing bonds to keep yields low), which suggests that bond yields will be higher at the end of 2022 than they are today.

Rising yields will have a major impact on both borrowers and investors. If rates rise faster than expected, consumer spending may be impacted. With yields almost certain to rise, we expect traditional bond funds will probably decline again in 2022 as they did in 2021.

For those worried about rising rates, it is worth mentioning

that stocks have risen at an average annualized rate of 9% during the 12 Fed rate hike cycles since the 1950s and delivered positive returns in 11, with the one exception coinciding with the 1973-1975 recession. (Bloomberg)

### Tightening Without Turmoil

How the S&P 500 performs in Fed rate-hike cycles



Source: Trust Advisory Services

However, the same cannot be said for traditional bonds. In a rising rate environment most bonds lose value, whereas the only fixed income class that tends to do well is high yield corporate bonds.

Last year was no exception. In 2021 the Canadian bond index declined 2.5%, while high yield bonds were up about 5%. Our high yield bond fund remains conservatively positioned with a short duration (in case yields rise more than anticipated) and broad diversification.

## Capital Gains Tax

When investors file their annual tax returns, they are often disappointed that they may have to pay some capital gains tax. In fact, many investors decide not to sell shares that may be overvalued, simply because they have a large capital gain. They end up making investment decisions based on tax considerations, rather than focusing on the value of the securities they own. This is especially true when it comes to the big winners – the ones that stand out and look so good in your portfolio.

When investors bring up their concerns about capital gains tax, I am always reminded about Nortel. As many of you may remember, Nortel was one of the most successful stocks of the late 1990s dot-com boom. Towards the end of that era, it seemed to be going up every day (trust me, I remember this period very well, as we didn't own it). By the time Nortel reached its peak in 2000, it represented an astounding 33% of the entire TSX index! Nortel was originally controlled by BCE, and therefore many Canadians ended up owning Nortel shares when it was spun out as a separate holding. As the shares rose, it often became the largest holding for

many investors, and, by far, their best performing stock.

As is so often the case, many Canadians refused to even trim their positions, as the tax bite would be too painful. You all know the end of the story. The shares peaked at around \$125 in July 2000 and ended up at zero.

One of our corporate directors was a respected accountant who unfortunately passed away a few years ago. When I first met him in 1999, he said the following to me:

*"I am hiring you to manage my investments, but I want you to know that I am different from my clients. Every year they come to me to file their taxes, and they want to find a way to pay less tax. I am the opposite, Lorne. Your job as my investment manager is to increase my tax bill by 10% per year."*

He understood that while no one enjoys writing a cheque to the government, if you are paying more in taxes, it is because your investments are generating a return.

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## Q4 ACTIVITY



**CP RAIL** - CP Rail is Canada's second largest railway company and operates a network of some 20,000km of track from Montreal to Vancouver, up to Edmonton and dipping down into the U.S. (Chicago, Detroit, Minneapolis, Milwaukee and Albany).

Today, about 25% of revenues are generated from the U.S. Barriers to entry for railroads are obviously huge, demand is relatively predictable, incremental network

expansion opportunities abound, and (as a result) returns on investment are high. In addition, the company has agreed to buy Kansas City Southern (subject to regulatory approval) which should be completed this year. This acquisition would be an excellent fit, as it would result in North America's first truly transcontinental railroad, offering compelling synergies that should drive increased value.



**META PLATFORMS** - The recently renamed Meta Platforms consists of Facebook, Instagram and WhatsApp; applications on which nearly half the people on this planet send over 100bn messages per day, while connecting with over 200m businesses. The company also owns Oculus, which makes virtual reality headsets. Today, Meta still derives the vast majority of revenues from advertising, over half of which are generated outside the U.S. Revenues have quadrupled over the past five years, while free cash

flow margins are a hefty 30%. The company is using its cash to invest in its core businesses while also expanding into some promising new areas, such as virtual reality and the development of the metaverse. While sales growth will inevitably slow, and profit margins will probably be reduced due to increased investment, the business is likely to generate 15% earnings per share growth over the next several years, for which we are paying only a market multiple.



**RECKITT** - While Reckitt may not be a household name, the brands of this global hygiene and healthcare business certainly are (the U.S. being their biggest market at just over a quarter of sales). These market leading brands include Lysol and Dettol disinfectants, Finish dishwasher tablets, Woolite and Vanish laundry

detergents, along with Harpic, Air Wick, Strepsils, Gaviskon and many others. While the business has been a beneficiary of the pandemic, we are attracted more to the long-term growth characteristics of the brand portfolio, which has historically delivered excellent organic sales growth and steadily rising profitability.



**ROGERS COMMUNICATIONS** - The well-publicized executive turmoil within the boardroom at Rogers Communications caused the share price to decline sharply, thus providing the opportunity to pick up the stock close to its valuation lows. Of the 3 telecoms companies that we currently own in our Canadian dividend growth strategy, Rogers is actually the most exposed to the

(more competitive) wireless segment and, therefore, offers modestly lower growth than Telus and BCE. That being said, following three years of lackluster share price performance, the discount to its peers is now well beyond historical norms for what are essentially similar businesses. In addition, growth should accelerate if the proposed acquisition of Shaw Communications is approved.



**UNIVERSAL MUSIC GROUP** - Based in Amsterdam, Netherlands, Universal Music Group (UMG) is the world's leading music company in an industry with only two other major competitors: Sony Music and Warner Music (WMG). UMG is 50% bigger than Sony and twice the size of WMG, with a market share of about one-third of all recorded music globally and one-quarter in publishing.

UMG is home to some of the most successful artists of all time (e.g. The Beatles, Rolling Stones and U2), as well as many of today's leading singer-songwriters (such as

Taylor Swift and The Weeknd) and happens to represent today's top ten artists in the world. The ongoing global consumer adoption of streaming is driving sales and profit growth, which is likely to continue for many years yet to come. Digital (i.e. streaming and subscription services) now accounts for about half of sales. Over the past few years, artists such as Neil Young, Bob Dylan and Bruce Springsteen have sold their interests in their catalogs of songs for hundreds of millions of dollars, which gives some indication of the underlying value of this business.

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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

The start of a new year brings with it the usual market forecasts from various “strategists” who believe that they can offer insight into how markets will perform in 2022.

This reminds me of a New York Times bestseller written in 1999 titled “**Dow 36,000**,” in which the author predicted – illustrated with an assortment of compelling graphs and charts – that the stock market would soar in the coming years. His timing did not turn out very well, as the dot-com collapse and market bust followed soon after the book’s publication.

However, not to be dissuaded about his forecasting abilities, in 2011 the same author published another volume called “**Safety Net: The Strategy for De-Risking Your Investments in a Time of Turbulence**,” where he recommended reducing

equity exposure, just as the stock market was entering a lengthy bull market!

The lessons from history are obvious: ignore the forecasts and focus on owning a portfolio of high quality, profitable businesses that will create value for shareholders through the various market cycles.

Sincerely,



Lorne Steinberg  
President



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