Lorne Steinberg Wealth Management
July 2022 QUARTERLY NEWSLETTER

> *"If you go to Minnesota in January, you should know that it's gonna be cold. You don't panic when the thermometer falls below zero."*
>
> *-Peter Lynch*

Lorne Steinberg, MBA CFA
PRESIDENT

One Step Back, Two Steps Forward

Dear Investor,

Markets have declined, and the news is focused on the war in Ukraine, high inflation, rising interest rates, and impending recession fears. At times like these, many investors panic because of the volatility and forget about the strength of the companies that they have invested in, and the fact that these businesses have survived through much more perilous times.

Over the past hundred plus years, investors have experienced two world wars, the 1930s depression (when the unemployment rate reached 25%), a number of recessions, the high inflation rate in the early 1980s (which caused the prime rate to rise to over 21%), 9/11, and the financial crisis (when the stock market fell over 40%). Following each of these events, the global economy always emerged stronger, while corporate profits and share prices reached new highs.

On March 23, 2020, we sent an email to our clients ("Investing in a World of Pandemic") which stated the following:

> *As investors, every time that we are faced with crises that are unquantifiable, in terms of impact and length, the first reaction is to sell; or at least hold on to whatever cash one has, with the fear that things may get a lot worse. Yet, every time we look back on such situations, we realize that we should have been investing in great businesses when they were on sale.*

Looking forward over the next 12-18 months, we would expect that the war in the Ukraine will have come to an end (possibly to no one's satisfaction), supply chain issues will abate, and new challenges will emerge to dominate the headlines.

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Opportunity

Over the past few months, virtually every asset class has declined: stocks, bonds (including government bonds), and real estate. All have been impacted by the aforementioned issues.

In this environment, shares of many truly great companies have fallen along with everything else.

This presents us with the opportunity to sell a few of our holdings in businesses which may be underperforming, smaller in scale or more cyclical, and replace them with higher quality companies whose share prices now trade at bargain levels.

One company that had been an underperformer is HomeServe.

HomeServe is a UK-listed provider of home emergency repair services, mainly in North America and Europe, offering homeowners effective peace of mind against a breakdown in their furnace, boiler, HVAC or home appliance.

The company guarantees that repairs will be carried out in a timely manner by an experienced tradesperson. This business has experienced substantial growth as the company gained market share, while consumer demand has also increased.

However, despite the company's impressive track record, the share price has languished over the past couple of years, falling to as low as £6 in March. In the short-term, stock prices can be volatile, resulting in shares being overvalued or undervalued, but if a company remains undervalued for an extended period of time, it frequently becomes an acquisition target. That is exactly what has happened with HomeServe.

A short while ago, Brookfield Asset Management made a bid to buy the company at a price of £12 per share, a significant premium to the recent price, which has been accepted. We believe the shares are worth more, but in the current environment, the offer was accepted. We will use this buy-out opportunity to deploy the proceeds into best-in-class companies, such as Goldman Sachs and Disney, whose shares present compelling value.

Despite the recent decline in its share price, Goldman Sachs has done an excellent job of creating value over the past many years.

Bank stocks have been one of the worst performing sectors this year, partly due to a flat yield curve (short and long-term interest rates are about equal) and also because of the slowdown in investment banking activity. However, both of these issues are cyclical in nature, and the long-term value of the business remains intact.

Following the financial crisis, a number of Goldman's competitors either disappeared or reduced their exposure to capital market activities. As a result, the remaining few players enjoy much higher market shares than in the past, and Goldman Sachs has consolidated its leadership in its chosen areas of business.

While investment banking is cyclical, the swings in profitability are likely to be less severe than in the past. In addition, Goldman maintains high capital levels, which should buffer the company in the event of an economic contraction.

While Goldman Sachs is not immune to economic slowdown, this best-in class business trades at a valuation that offers significant upside, as well as a comfortable margin of safety.

Disney's share price has fallen back to the price we paid for it during the depths of the pandemic in March 2020. What hasn't changed is that Disney remains one of the most successful content creators in everything from movie franchises, television, theme parks, cruise ships, news and sports broadcasting. What has changed is how we consume that content.

Over the past six months, Disney's share price became caught up in industry-wide streaming subscriber worries, causing investors to panic about growth prospects going forward.

However, travel has resumed, movie attendance is rebounding, and we are anticipating strong revenue and earnings growth going forward. Therefore, at the current share price, this is an opportune time to add to our position.

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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 economy may go into recession, but if so, we would expect it to be a mild one, for the following reasons. The rise in interest rates has had an impact on the valuation of all asset classes, but it is worth noting that rates remain relatively low. For 50 years, until 2009, the U.S. 10-year bond yield averaged above 4%. Today it is only 3%. Also, the unemployment rate is at historical lows, and consumers are in good shape, with adequate liquidity and rising wages.

However, when markets decline rapidly, investors often fear those trends will persist. It is important to remember that bear markets, such as the one we are in, are not terminal events. They are part of a cycle. Bear markets always present investors with the best opportunities, and this one is no different.

The quote at the top of this letter is from Peter Lynch, one of the most successful fund managers of the 1980s-90s. He was referring to investors who became nervous when markets were volatile and wanted to sell. Just as someone should not be surprised by the cold temperature in Minnesota in January, investors should not be surprised when markets fall. Market volatility is a fact of life. As investors, we must accept volatility in exchange for higher rates of return over time.

Occasionally, investors have to take a step back before moving two steps forward.

Si
ncerely,

Lorne Steinberg
President

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