Lorne Steinberg Wealth Management
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"Volatility is the price of admission. The prize inside are superior long-term returns. You have to pay the price to get the returns."

-Morgan Housel (author of "The Psychology of Money")

Lorne Steinberg,
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Nowhere to Hide

As of September 30th, U.S. stocks (as well as many other markets) experienced the longest run of consecutive quarterly losses since the financial crisis. In almost every previous bear market, the decline of stock prices was accompanied by a rising bond market as investors ran for cover to the safety of fixed income.

However, 2022 has been an exception as even government bonds have fallen sharply due to the rapid rise in interest rates, with the major U.S. and Canadian bond indices down 17% and 13%, respectively. In fact, almost every traditional and non-traditional asset class has declined – from gold and real estate to Bitcoin.

At times like this, when markets are dominated by fear and uncertainty, Warren Buffett's comments (in his 2018 Berkshire Hathaway annual letter) now seem all the more relevant:

"Stocks surge and swoon, seemingly untethered to any year-to-year buildup in their underlying value... Berkshire, itself, provides some vivid examples of how price randomness in the short term can obscure long term growth in value… Year by year, we have moved forward. Yet Berkshire shares have suffered four truly major dips.

Here are the gory details:

Period	High	Low	Percentage Decrease
March 1973-January 1975	93	38	(59.1%)
10/2/87-10/27/87	4,250	2,675	(37.1%)
6/19/98-3/10/2000	80,900	41,300	(48.9%)
9/19/08-3/5/09	147,000	72,400	(50.7%)

… Investors become unsettled by scary headlines and breathless commentary. And an unsettled mind will not make good decisions."

The onslaught of negative news has resulted in many investors starting to panic and sell great businesses out of fear. Decisions that are driven by emotion are rarely the correct ones.

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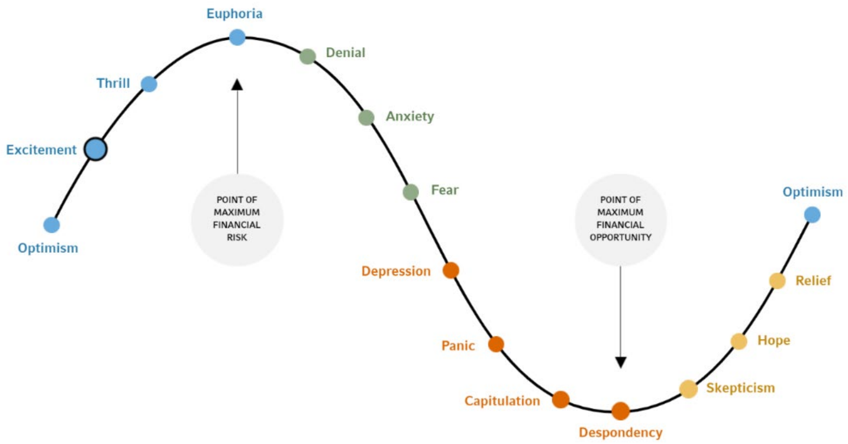
Capitulation

Many of the major news outlets in Canada (including BNNBloomberg, Toronto Star, CTV, etc.) circulated an article highlighting a survey[1] that reported that 25% of Canadian investors were looking to cash out their investments and had "lost confidence in the stock market." For many, the interpretation of this report may provide further evidence that the worst is yet to come, and that their own feelings and anxieties are well reflected by the survey.

Investing in financial markets can be an emotional roller-coaster, with human emotions oscillating between two extremes (fear and greed). The balancing act between the two has been well studied for years and is known as the "Cycle of Market Emotions". As can be seen in the graphic below, it points to the highs and lows one can experience while investing, from optimism and euphoria to panic, capitulation, and despondency. However, it is important to note that the highs (euphoria) tend to correspond with the point of maximum financial risk, and the lows (capitulation and despondency) with maximum financial opportunity.



The term "capitulation" is a military reference with respect to the terms of surrender. In market terms, it is the point when investors tend to "throw in the towel" or give up hope that the market will ever turn around again and is doomed to exist in a downward spiral permanently.

Moments of maximum fear and pessimism have led to some of the greatest opportunities, and outsized returns.

Activity

JPMorganChase

John Pierpont Morgan founded what many still call the "House of Morgan" in 1871 and JPMorgan Chase today is the largest bank in the U.S. by assets and the most valuable in the world. About 40% of profits come from its retail banking business, roughly the same from its investment banking operation, and 10% apiece from commercial banking and asset & wealth management. Although this is a global business, the U.S. represents close to 80% of earnings. JPM is well capitalized and is a market leader in almost every area in which they operate. The company maintains a "fortress" balance sheet, which is a critical attribute when investing in banks (as many learned during the financial crisis). Since 2009, as much of their competition has fallen by the wayside, they have almost doubled the size of the business, while continuing to increase dividends. The company is well-positioned to navigate the inevitable challenges ahead and continue to grow their business.

1. "Bear Market Blues | 7.5 million Canadians have no confidence in stocks." Finder.com, 22 September 2022, https://www.finder.com/ca/bull-vs-bear-market. Accessed 18 October 2022.

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Activity

An iconic consumer food business, Kraft Heinz has a portfolio of over 200 longstanding brands sold globally. Aside from the eponymous ones, other key brands include Philadelphia, Oscar Mayer, Jell-O, Cool Whip, HP and Maxwell House coffee.

The group continues to invest in R&D, in order to meet the evolving needs of consumers. After several years of underperformance, we are buying the stock today following a significant reduction in debt levels as well as a major reset in profitability, both of which position the company to reward shareholders in the years to come.

Founded in 1856, Smith & Nephew today is a leading global provider of medical products, such as hip and knee implants, soft tissue repair systems, arthroscopic enabling technologies, sports medicine, and advanced wound care treatments. While based in the U.K., the U.S. accounts for over 50% of sales.

After a period of consolidation, leaving only a handful of competitors, this industry offers the prospect of long-term secular growth, owing mostly to an aging population and a growing middle class. Following a period of reduced demand for elective surgeries (due to Covid), we anticipate a rebound in demand over the next several years, which should translate into improved profitability.

Despite being classified as a bank (the second oldest in America), State Street is mainly a provider of custodial services to institutional investors. As the world's largest custody bank, the company has about $50 trillion of assets under administration. They make the bulk of their money by charging clients a fee for their custodial/administrative services.

While their fortunes are invariably tied to financial markets, unlike traditional banks, they take no credit risk, remain well capitalized, and should be able to continue to deliver dependable earnings-per-share growth over time.

As one of Canada's Big 6 banks, BMO derives about 60% of its revenues presently from its domestic market, a third from the U.S., with a small contribution from its activities overseas in Europe and Asia. There has been a significant increase in growth and profitability over the past few years, boosting returns on equity; this should be further enhanced by the acquisition of California-based Bank of the West – which should close by the end of the year.

In addition to the above, it is worth mentioning that we also took the opportunity to add to existing positions in Amazon, Berkshire Hathaway, Disney, Goldman Sachs, and Diageo.

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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

In my 33 years in the investment business, I have made many mistakes along the way, but one of the most important lessons I have learned is to stay focused on the long-term value creation of the great businesses we have invested in, and to ignore the day-to-day noise.

It was only 13 years ago that, in the depths of the financial crisis, bank stocks were down 50% or more, and the outlook was as gloomy as I had ever seen. Today's situation is nothing like that. All of the issues that are impacting markets (the war in the Ukraine, supply chain problems, and elevated inflation) will find resolution with the passage of time. In the meantime, each of the companies mentioned above will continue to invest in profitable growth, which should result in healthy long-term returns for shareholders.

Regardless of what happens in the short-term, every decline in asset prices ends up setting the stage for healthy returns going forward. While the headlines and numbers can make it feel like there is nowhere to hide, there is shelter and peace of mind to be had in quality.

Sincerely,

Lorne Steinberg

Lorne Steinberg
President

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