



Lorne Steinberg
Wealth Management

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QUARTERLY NEWSLETTER

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“A market downturn doesn’t bother us. It is an opportunity to increase our ownership of great companies with great management at good prices.”
—Warren Buffett



Lorne Steinberg,
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PRESIDENT

A Lesson from Father Fred

Dear Investor,

In 2022, global markets suffered their worst year since the financial crisis. In past downturns, bonds were a safe haven, but last year, this was not the case, as both the Canadian and U.S. bond markets suffered double-digit declines.

There were a number of reasons for the market weakness, but the major factor was an elevated inflation rate, which led to the rise in interest rates. As most of the world was opening up after the COVID shutdowns, supply chains were constrained, labour was in short supply, and consumers had plenty of cash to spend, leading to the highest inflation rate in many years. As this was unfolding, Russia invaded the Ukraine in February, which caused energy and food prices to rise even more, and central banks responded by aggressively raising rates.

As we enter 2023, a number of these issues remain, yet there is good reason for investor optimism.



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Reasons for optimism: inflation and interest rates

Although the U.S. inflation rate remains elevated, it actually peaked in June at 9.1% and has been in decline since then, ending the year at 6.5% in December. Food prices have remained stubbornly high, but other sectors are seeing some moderation.

Prices for homes and used cars rose significantly during 2020-2021. The Manheim Index (which measures wholesale used vehicle prices) rose 47% in 2021 from the prior year but

fell almost 15% by the end of 2022, an indication that higher interest rates are having an impact on sales of autos and other big-ticket items.

Of course, the housing market is also feeling the impact of higher rates. These trends suggest that the inflation rate should continue to moderate as the economy slows and that we are, therefore, getting close to the end of this rising interest rate cycle.

Reasons for optimism: supply chain and semiconductor shortage

When the world shut down at the beginning of the pandemic, the global economy was at a standstill, and manufacturers quickly shut down capacity. When the world opened up, demand soared, and supply chains could not keep up, resulting in shortages of many goods. At the same time, semiconductor capacity was already somewhat constrained, partly due to the fact that newer vehicles require significantly more chips than their predecessors.

As we look forward, China is finally opening up, and supply and demand are coming closer to equilibrium, as capacity is increasing at the same time as the slowing economy has caused demand to weaken.

In response to the semiconductor shortage, the major manufacturers are investing over \$100 billion to build new capacity in the U.S., which should result in ample capacity by next year.

Reasons for optimism: valuation shortage

The result of the steep drop in asset prices (stocks, bonds, and real estate), due in large part to the rise in interest rates, as well as the other factors mentioned above, is that many great companies are trading at valuations that offer excellent return potential from these levels.

Assuming there is a recession, we expect it to be a mild one. Past recessions have been accompanied by significant job losses, but this time around there is a shortage of labour

and the unemployment rate still hovers around historic lows. We are witnessing layoffs, especially in the technology sector, but there remain plenty of unfilled positions in other industries.

Corporate earnings may be down somewhat this year, given the slowdown in economic activity, but this is already priced into the market. At current prices, there is ample opportunity for long-term investors.

Fixed income is back

For most of my career, the highest-quality bonds (such as those issued by the Government of Canada, BCE, and similar entities) offered investors a reasonable income stream as well as a way to reduce portfolio volatility. However, in each of the past two years, these bonds suffered significant negative returns (due to rising interest rates), while generating minimal income.

The good news is that at least most of the damage has

been done, and fixed-income investors can once again earn a reasonable yield, with the opportunity to dampen portfolio volatility. High yield bonds have also benefited from the current rate environment, with yields back over 8%, closer to their long-term average.

Although higher rates may be a shock to borrowers, investors finally have a viable alternative to equities.

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Recent Activity

We made a number of new purchases in the summer and fall, which were highlighted in previous letters. With no new purchases made during the most recent quarter, we would like to highlight three of our long-term holdings that have created value for shareholders over the past many years. While each of these companies' share prices were impacted by the market volatility, each of them used their free cash flow to buy back shares and increase dividends – a tribute to their financial strength and competitive position in their respective industries.



Allstate is arguably the best North American property and casualty insurer, whose main business is home and auto insurance. Insurers make money in two ways: through the underwriting of the policies themselves, and the investment returns achieved on the float from the premiums received in advance of the claims paid out.

Many insurance companies actually make minimal profits from writing insurance policies and look to their investment division to generate the bulk of their returns.

Allstate is an exception, and has a demonstrable track record of profitable insurance underwriting. They have eschewed growth merely for the sake of it and have chosen instead, to return excess cash flows to shareholders through continuous share buybacks, resulting in

a share count today that is close to half of what it was 10 years ago.

Management has two principal functions: operating a business and allocating capital. It is rare to find a company that excels at both.

While the insurance industry has a degree of cyclicity to it, Allstate has been able to deliver ongoing dividend growth well in excess of the inflation rate, while reducing the share count and growing its market share.



Cisco remains the world's leading manufacturer of networking systems, as it has been for the past twenty-plus years. It is the global market share leader in switches, routers, and other data centre products. However, the technology industry is ever changing,

and today Cisco's profit growth is coming increasingly from software and services, where margins are higher and pricing is subscription-based. Also of note, is that Cisco has become a major presence in the world of cybersecurity, an area of increased spending for most businesses.

In terms of financial performance, the company has been a free cash flow machine, consistently generating \$12-\$15 billion of free cash flow annually. About

half of that is paid out in dividends, with the balance spent on acquisitions and share buybacks. Consider that while their revenue today is a mere 13% higher than it was 10 years ago, both earnings and dividends per share are significantly higher than in 2012. For example, ten years ago, Cisco paid a dividend of \$0.28 per share, while last year's dividend was \$1.50. With no net debt, and opportunities for growth, these shares are compellingly cheap, at a P/E of 13 and a 3.2% yield.



While in some ways Microsoft needs little introduction, the business has evolved considerably over the past several years. While they still "own" the desktop through their Windows and Office products, Microsoft has become a leading provider of cloud computing services,

which is now, by far, the fastest-growing division of the business.

After a number of years of slow growth, revenues have doubled over the past five years to over \$200 billion. In addition to reinventing themselves over the past decade, they have rewarded shareholders via dividend growth and share buybacks. While revenue growth from the existing businesses may moderate going forward,

the company continues to invest in new avenues of growth, as exemplified by their R&D spending, acquisitions, and direct investments in new tech and start-ups, most recently in the field of artificial intelligence (AI).

While the stock today still commands a premium valuation to the market (23x P/E), it remains a value stock given its high-quality growth profile.

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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

Some of you may know that I have played squash (albeit poorly!) for decades now. Several times over the past many years, I have played with a Catholic priest we warmly refer to as Father Fred. After one of our games, Father Fred told me that for his Sunday sermon, he was going to speak about why going to church was like taking squash lessons.

He suggested that when you have been playing squash and taking squash lessons for many years, you already know what the pro is going to tell you well before he or she steps on the court – “Always stand in the T (middle of the court),” “hit the ball tight to the wall,” “keep your racquet up,” “stay on the balls of your feet, and not flat on your heels,” etc.

As an avid squash player, I can attest that these fundamentals have been entrenched in us for years. However, most of us tend to forget the basics during the pressure of a game. Emotions can take over and lead to bad decision-making on the court. So what are we to do? We continue to take squash lessons because we need to be reminded of what to do when the going gets tough.


According to Father Fred, going to church is the same thing. He said, “...when you come to church, you already know what I am going to tell you: treat others as you would like to be treated, be kind to all, welcome the stranger, etc.” Simply put, he says “...going to church is still important because we need to be reminded of the core principles that we already

know, as we tend to forget them, especially when going through stressful times.” The same can be said for investing. Intuitively, we know that we should be buying great companies when stock prices are low, regardless of how bad the headlines are. We also know that we should own a high-quality, well-diversified portfolio, even when a particular stock or sector is all anyone can talk about. And, finally, during recessions and bear markets, the worst thing to do is panic and change course.

However, emotion often takes over, and we all need to remind ourselves of the core principles of long-term investing: focus on investing in a diversified portfolio of financially sound businesses that are trading at attractive valuations, and don’t be tempted to sell them just because the stock market is down and the outlook is negative.

Great investors such as Warren Buffett always seem at peace, even during tumultuous times, because they are immune to the inevitable market volatility and comfortable that the companies they invest in will continue to create value over time.

Sincerely,


Lorne Steinberg
President



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