


*"You've got to know when to hold'em, know when to fold 'em..."*

*–"The Gambler," song by Kenny Rogers*

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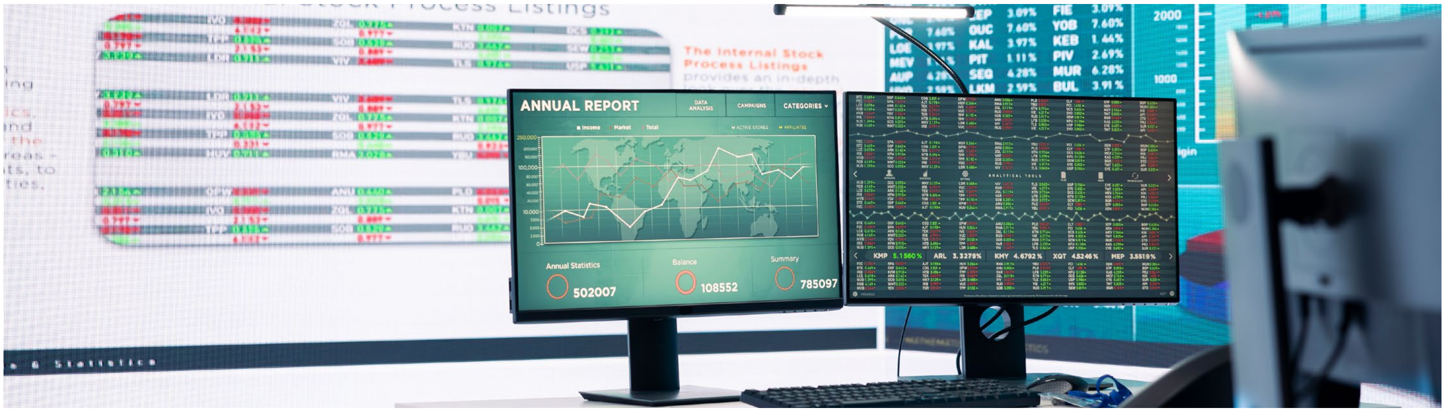
# Breaking Biases – The Blank Sheet of Paper Portfolio

The second quarter finished much like the first, as technology and communications stocks continued their ascent while most of the rest of the market lagged. The anticipated decline in interest rates has not yet occurred (with the exception of the June rate cut in Canada) as the inflation data has remained mixed.

The level of interest rates is putting pressure on consumer spending, as wage growth has not kept pace with the combined impact of inflation and higher interest rates. This has negatively impacted the earnings of companies such as McDonald's, Starbucks, Home Depot, and others, as consumers tighten their collective belts.

When markets are dominated by one sector, diversification becomes a dirty word, and everyone wants to ride the momentum. However, investors would be wise to remember the lessons of every past cycle: "nothing stays expensive forever and nothing stays cheap forever."

Now is the time to be building positions in the many great companies whose share prices have lagged, while reducing exposure to equities that may no longer represent good value.



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## Investor biases

In a famous study by Nobel Prize winners, Daniel Kahneman & Richard Thaler (the founding fathers of behavioural finance), it was found that participants who already owned an "item" placed a much higher value on it, compared to what those same participants would be willing to pay for the exact same item if they did not already own it. In other words, those who own something, tend to believe it is worth more than it actually is. This is referred to as "endowment bias."

Another bias that has led to irrational investor behaviour is known as the "sunk cost fallacy." This occurs when investors hold onto a position, just because they have invested heavily in it, even when it is clear that selling the investment would be more beneficial in the long run.

Hope is not a strategy, and the market doesn't care about how much you've already spent. What matters is the future potential of the investments and the optimal allocation of capital going forward.

We recently faced a situation with one of our holdings, Reckitt, the manufacturer of Lysol, whose share price had declined. If the price had declined for temporary reasons, such as a weaker-than-expected earnings report, we probably would have added to our position. However, in this case, the price decline was due to a lawsuit in the U.S. regarding the unfortunate death of a baby who had consumed the company's infant formula. The plaintiff was awarded $60 million, and Reckitt is now faced with several class actions that, if successful, could cost the company billions of dollars.

No matter how much research one does, it is impossible to predict the outcome of these situations. That is why we have a diversified portfolio.

When confronted with this type of situation, we must ask ourselves the following question: if we did not currently own this stock, would we buy it today? If the answer is no, then the only rational decision is to sell that investment – and that was our decision with Reckitt. There are plenty of other companies to invest in that do not have this type of risk to deal with, and our money is best invested elsewhere.


## Recent Activity

**Here is a brief overview of three companies that we added to over the past quarter:**

BD

**BECTON DICKINSON**

In 1897, Maxwell Becton and Fairleigh Dickinson founded Becton, Dickinson (BD), a company that today is a leading global medical technology company that manufactures a broad range of supplies, devices, and laboratory equipment (syringes, catheters, drug-dispensing systems) as well as reagents that are sold to hospitals, physicians, research labs, pharmaceutical companies, and even the general public. Their operations are divided into three segments: BD Medical, BD Life Sciences, and BD Interventional which together cover a wide range of healthcare needs, from diagnostics and drug delivery to surgical and interventional specialties.

Their key competitive advantages lie in a broad product portfolio, an extensive distribution network, and a strong focus on innovation, spending 6-7% of annual sales on R&D to continually improve their product offering. A large proportion of revenues are consumables (90% of sales are deemed recurring) and, while price is obviously of some importance, product quality and reliability are paramount to the end user. As a result, BD not only commands an approximately 25% share of the markets in which they operate, but the company also maintains high and sustained levels of operating profitability.

The group has a history of delivering solid organic sales growth augmented by periodic acquisitions. With a strong balance sheet and significant free cash flow, they are well positioned to pursue additional acquisitions or continue their recent practice of buying back their own shares.



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**DIAGEO**

Tracing their roots back to 1886, Diageo is the world's leading spirits producer, boasting an impressive portfolio of iconic brands such as Johnnie Walker, Smirnoff, Baileys, and Guinness beer. Scotch whiskies account for a quarter of sales with vodka and, increasingly, tequila being notable contributors. The company operates in over 180 countries (albeit North America contributes half of its profits) with unparalleled distribution capabilities. In tandem, Diageo is pursuing a premiumization strategy in developed markets alongside more of a volume growth / market share strategy in emerging ones.

They also own 34% of Moët Hennessy, LVMH's wine and spirits business (mainly cognac and champagne) and the two companies distribute their premium brands together in both France and throughout Asia Pacific. Spirits brands have remarkable longevity (many of today's top-selling liquor brands were in existence 100 years ago) and while industry sales growth may not be stellar, it is almost always positive. Diageo's innovation pipeline is robust, with continuous product development and marketing campaigns that keep their brands relevant and appealing. For example, they have been quick to capitalize on the growing demand for ready-to-drink (RTD) beverages and non-alcoholic alternatives, expanding their portfolio to include products like Gordon's alcohol-free gin.

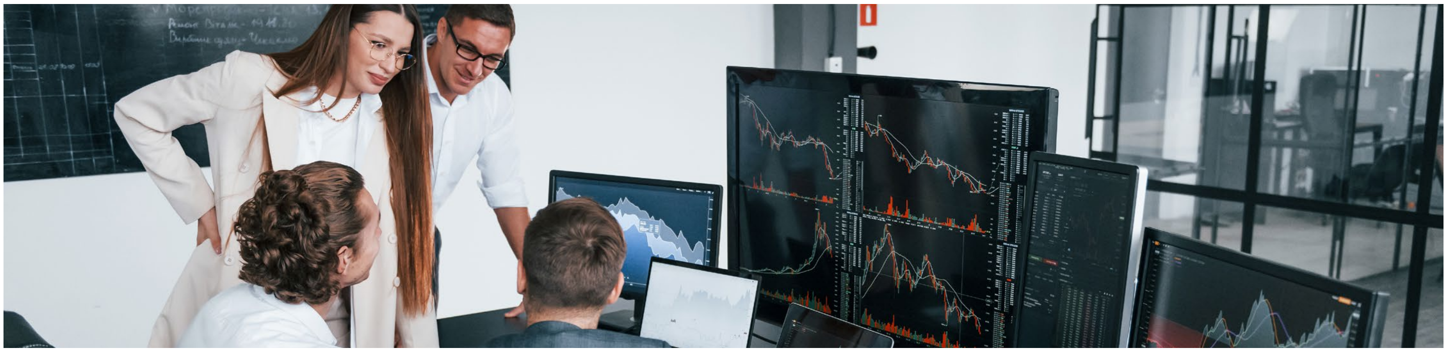
Despite the challenges posed by economic downturns and changing consumer preferences, Diageo's strategy of investing in high-growth categories and regions, along with their focus on premiumization, positions them well for sustainable growth. Their strong balance sheet and consistent free cash flow generation support a progressive dividend policy as well as share buybacks, enhancing shareholder returns.

**SMITH & NEPHEW**

Founded in 1856 by Thomas Smith of Kingston upon Hull, England, and subsequently joined by his nephew in 1896, Smith & Nephew today is a leading provider of medical products such as hip and knee implants, soft tissue repair systems, arthroscopic enabling technologies, sports medicine, and advanced wound care treatments. Revenues are split roughly 40% from orthopedics, 30% in sports medicine & ENT (Ear, Nose & Throat), and 30% in advanced wound care. While they operate in over 100 countries, the U.S. is by far the most important market, accounting for over half of sales.

There are two trends that are beneficial to this company: people are living longer and getting heavier, leading to increased healthcare demand generally but even more so in areas such as hip and knee replacements and advanced wound care. The sports medicine portfolio, featuring minimally invasive surgical techniques and advanced biologics, addresses the growing demand for procedures that enable quicker recovery times and better long-term outcomes.

Over the past number of years, the industry has consolidated, leaving just a few competitors, including Stryker, Zimmer Biomet and the DePuy division of Johnson & Johnson, and Smith & Nephew holds a top 4 position in each of its areas of operation. Reduced demand for elective surgeries during the pandemic is now witnessing catch-up and, by focusing on unmet medical needs and leveraging their expertise in medical technology, Smith & Nephew is well-positioned for continued market leadership and sustainable growth.





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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 order to avoid the biases discussed earlier, we start every day with a "blank sheet of paper" mindset, asking ourselves, "what do we want to own today, regardless of what we currently hold?" If there is a position in the portfolio that we would not purchase today, it is sold. If there is a stock that we want to own, and do not own it, it is purchased.

From time to time, a stock that we own simply gets too expensive, and we will trim it back or sell it. And from time to time, there will be an event that negatively impacts the value of a company, and our goal is to recognize this early and redeploy the funds elsewhere.

I am not a poker player, but in the spirit of the legendary song lyrics sung by the late Kenny Rogers, if one is sitting at the table with a losing hand, it is better to fold than to continue adding to the pot.

Sincerely,

Lorne Steinberg

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President





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