> *I skate to where the puck is going to be, not where it has been."*
> *– Wayne Gretzky*

Lorne Steinberg,
MBA CFA
PRESIDENT

A Tale of Two Markets

Dear Client,

Much has been written about the skewed performance of the stock market in 2023. Technology and communications companies were the drivers of market performance, while most of the other sectors lagged. It was truly a tale of two markets.

Technology and communications shares got a boost from AI (artificial intelligence), as early investors such as Microsoft (which invested over $10 billion in ChatGPT) released new product offerings that are already having a significant impact on everything technology-related. The rest of the market was less exciting, as sectors such as financial services, healthcare, utilities, and consumer staples underperformed, despite generally improved earnings and healthy cash flows.

Although clients enjoyed a good year from an investment perspective, it feels like so much of the news has been negative. Between geopolitical events, inflation, rising interest rates and slowing growth, there hasn't been much to cheer about.

When we look back at forecasts for 2023, many economists were predicting the worst: a recession accompanied by continued elevated levels of inflation. However, as is so often the case, the prognosticators were wrong. The economy grew in 2023, albeit at a slower rate, while the rate of inflation declined throughout the year. We have written in the past about "The Folly of Forecasting," and this past year presents no better example of that.

At this time of year, we are often asked how we think the markets will perform over the next 12 months. The simple answer is that we have no idea. What we do know is that we own a portfolio of great businesses, which should deliver healthy earnings growth over the next many years, and this should result in value creation for shareholders

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The S&P 493

The "S&P 493" is a term that describes market performance over the past year. The market was dominated by a small group of technology companies, which accounted for most of the market's gains. Unsurprisingly, the best-performing companies in our global strategy were Adobe, Alphabet, Amazon, Meta, and Microsoft. However, there are many other outstanding businesses whose shares have been overlooked and that offer compelling value, and this is where the best opportunities lie.

Here are three such examples:

Nike

Nike is the market leader in both athletic footwear and sportswear. Footwear accounts for about two-thirds of revenues (25% global market share), while sportswear accounts for the balance (16% global market share).

In addition to their eponymous brand, they also own Converse as well as sub-brands such as Air Jordan. This is truly a global business, with 40% of sales and profits from North America, a quarter from Europe, and the balance from China and the rest of the world. With Converse being their only acquisition of note in the past 20 years, Nike's growth has been almost entirely organic. Over the past decade, revenues have more than doubled, while earnings per share have grown even more, due to margin expansion and share buybacks.

Today over one-third of Nike's sales are through its own distribution channels, with over 60% of those via its Nike Digital offering. Ultimately, this should lead to both higher margins and greater consumer engagement. The dividend yield is about 1.4%, as the company has prioritized share buybacks while also maintaining a net cash balance sheet. The share price fell earlier in 2023, offering us the opportunity to invest in this excellent company.

Kenvue

Kenvue derives its name from the fusion of knowledge ("ken" being Scottish for such) and vision ("vue" being French for insight) and was, until recently, part of Johnson & Johnson.

Kenvue became a public company in August of last year when it was spun off from Johnson & Johnson. The latter kept its pharmaceutical and medical device businesses, while Kenvue owns the consumer health brands that we are all familiar with.

The company operates three distinct but somewhat related divisions. The "Self Care" division accounts for about 50% of profits and includes cough, cold and allergy treatments, pain care, digestive health, and smoking cessation, with major brands such as Benadryl, Sudafed, Tylenol and Nicorette. "Essential Health" (30%) includes oral care, baby care, women's health and wound care. Listerine is the most important contributor to this division, but major brands also include Band-Aid and Johnson's baby products. "Skin Health & Beauty" (the remaining 20%) offers face, body and hair care along with sunscreen and other products, with Neutrogena and Aveeno being the two most important brands. With roughly half of sales in North America and half from the rest of the world, the vast majority of Kenvue's products typically command leading market shares in their respective categories. The group has historically delivered low but dependable single-digit revenue growth, while enjoying strong margins and consistent profitability. This new company has modest leverage (with an "A" credit rating) and generates significant free cash flow, which we expect to be deployed through acquisitions, dividends, and share buybacks.

As the company does not have much of a track record as a stand-alone public entity, the shares trade at a discount to the sector, offering good value for investors.

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CVS Health

CVS Health

While CVS Health is probably best known for its 9,000 or so pharmacies spread throughout the United States, it is increasingly a major integrated healthcare company, offering a range of services including primary care, pharmacy benefits management (PBM), and healthcare insurance.

Given its physical footprint, CVS is as well placed as anyone to take advantage of the shift toward offering more primary care away from the doctor's office and has been active in acquiring businesses that do exactly that, purchasing both Signify Health (in-home health evaluations) and Oak Street Health (primary care clinics for seniors) within the past year. While these (and previous) acquisitions were quite sizeable, they are possible because the group generates annual free cash flow in excess of $10 billion (of which roughly one-quarter or so is typically paid out in dividends), providing considerable resources to continue to broaden their offering and migrate the business towards the faster growing segments of healthcare services.

There is no other healthcare company with as broad an offering as CVS, which provides the company with ample room to improve the sales densities of their retail stores and productivity of its staff. Added to all of this is the demographic opportunity – an aging population and its requisite needs, which gives this company exposure to some very attractive long-term market dynamics.

High Yield Bonds

A review of the high yield bond market and our high yield fund is available here: High Yield Quarterly.

Final Thoughts

As mentioned earlier, despite the market gains of the past year, the performance was concentrated in a small number of companies. The reality is that most of the market did not perform well, leaving investors with ample opportunities to invest in excellent companies at attractive prices.

The quote at the beginning of this letter, from the legendary hockey player Wayne Gretzky, underscores this theme: we need to focus on investing in high-quality companies whose shares are unloved and undervalued, rather than skating toward stocks that have already done well.

We wish everyone a year filled with peace, joy, and good health.

Sincerely,

Lorne Steinberg

Lorne Steinberg
President

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