April 2020

> ***"Success means being very patient, but aggressive when it's time"***
> *-Charlie Munger*

Doors Close. Windows Open.

Dear Investor,

"It's the end of the world as we know it" (song by R.E.M.)

The above song by R.E.M. was released in 1987, but it has recently become popular again, as COVID-19 is causing many to suggest that the world will be forever changed by recent events.

It is true that the present has a surreal feel to it. Most of the world is in some degree of lockdown, and we are told to keep our distance from others, while repeatedly washing our hands until they are dry and cracked. Aside from essential services, much of the world has closed its doors until further notice. However, there is some good news. As these measures appear to be working, the number of new patients has peaked in a number of countries and is headed in the right direction (at least for the moment). That being said, there is, of course, a huge economic impact.

Governments and central bankers to the rescue

We may, indeed, be on the verge of the worst recession since the 1930s. However, this time around, most governments and central banks have acted quickly to blunt the impact on society with massive fiscal and monetary stimulus. Governments are paying people to stay at home by running record deficits. With long-term bond yields hovering around zero, and central banks providing an unlimited backstop, these deficits can be funded with minimal interest expense.

Where does all of this money come from? Simple. Central banks are printing it, by buying up trillions of dollars of government debt. What are the implications of this? No one knows. When I studied macroeconomics (a few years ago!), we were taught that excessive money printing by central banks could lead to high levels of inflation. Over the past number of years, however, inflation has actually remained below historical norms.

Post-financial crisis, the Federal Reserve and other central banks embarked on a record monetary expansion to buffer the economic fallout, with the idea of unwinding this policy as the economy normalized. However, faced with a rather weak global recovery, this never happened. At the same time, despite the record monetary stimulus, inflation has been muted, so there was no incentive to do so. In March, faced with the sudden prospect of an economic shutdown, the Fed wasted no time in promising unlimited quantitative easing, through the purchase of government and mortgage securities, as well as extending this support to the corporate bond market (for the first time). Several economists have come up with a new theory to describe what is going on, and have named it "Modern Monetary Theory (MMT)."

They argue that governments can borrow as much money as they need and finance it by printing money, saying deficits don't matter. However, there is much disagreement on this within the economic community.

No one knows the ultimate impact of these fiscal and monetary policies. Given that, we need to make sure that we invest in a portfolio of companies which will survive the current recession and be able to thrive once the world returns to some level of "normal."

Cash

The sudden realization in March that COVID-19 would result in an economic shutdown caught policy makers and investors by surprise. Despite the promise of record stimulus and rescue packages, the result was a sharp decline in stock markets globally, followed by a partial rebound, with wild volatility throughout. Exacerbating the volatility were margin calls on a number of hedge funds caught with too much leverage in a falling market. A window of opportunity opened. For the investor with cash, this historic sell off was a call to action.

We had maintained a sizable cash position for a long time, patiently waiting for opportunities. The recent volatility provided us the chance to invest some of our cash in a handful of excellent businesses whose fall in share prices offered an attractive entry point. Below is a brief introduction to some of the recent additions to our portfolio.

Recent investments

In Europe, we were able to purchase two businesses within the food & beverages sector, whose operations have certainly stood the test of time. Dutch-Anglo consumer goods and foods giant, **Unilever**, traces its roots back to the soap-making company founded by the Lever brothers in 1885. With a sales split of roughly 40% from Beauty & Personal Care, 40% in Foods & Refreshment and 20% from Homecare, today they boast a portfolio of over 400 brands, including Dove, Lux, Hellman's, Knorr, and Vaseline. Their products are sold all over the world, including a particularly strong presence in faster-growing Asian markets. They are the world's largest ice cream producer (Ben & Jerry's, Breyers and others), as well as a major force in tea (Lipton, PG Tips, Red Rose). We can anticipate steady organic sales growth over time, as well as a likely continuation of steadily improving profitability.

The other European purchase was **Diageo**, a UK company that boasts of one of the world's best portfolios of spirits businesses, with brands such as Johnnie Walker and Crown Royal in whisky, Smirnoff and Ciroc vodkas, Gordon's gin, Captain Morgan rum, Don Julio tequila and Bailey's, as well as Guinness and Harp in beer. The company has arguably unparalleled global distribution capabilities and has successfully pursued a premiumization strategy in developed markets alongside more of a volume growth / market share strategy in emerging ones. Spirits brands have remarkable longevity. Despite changing consumer tastes and fads that come and go, the vast majority of the 20 top selling liquor brands of today were in existence 100 years ago. As a result, we are now owners of a timeless business that should generate continued solid organic sales and profit growth.

In the U.S., we added three outstanding businesses that were trading at attractive valuations. **Becton, Dickinson and Company** is a global medical devices company whose focus is on disposables and diagnostics. Products include syringes, catheters and infusion pumps, as well as a diagnostic test for COVID-19. End-markets include hospitals, research labs, physicians and pharmaceutical companies, and the company has about a 25% share of the markets in which they operate. The consumable nature of their products effectively means that some 90% of annual sales are deemed recurring revenue. Spending 6% of sales each year on research and development (R&D) also means that they are continually innovating their portfolio and should ensure that they retain their leadership in what are structurally growing end markets.

Alphabet, which as the parent company of Google, in some ways needs little introduction. In addition to its dominant search activities, the Google division also consists of Android, Chrome, Maps, Cloud and YouTube. They also own the Pixel and Nest hardware businesses, while having leading positions in driverless cars (Waymo), quantum computing, artificial intelligence and augmented / virtual reality. Despite its increasing size, Google has continued to deliver annual revenue growth of 20% and, while the growth rate will slow down at some point, still offers a superior sales, margins and profit outlook compared to most of the rest of the market. Combine all of that with a fortress balance sheet, and the result is an extremely high-quality business that we are pleased to add to the portfolio.

Visa is another great business that we now own. Despite what many may think, it should neither be considered a credit-card company nor even a financial business. It is predominantly a payments technology business, supporting the payment processing network that underpins approximately 50% of the digital transactions that take place globally. They earn their revenues principally from transaction volumes that grow with the overall economy, combined with the ongoing shift away from cash to digital. Visa is a company that managed to grow its revenues by double-digit percentages even during the depths of the global financial crisis in 2009. Moreover, they are exceedingly profitable, have negligible debt and boast a very powerful economic moat.

Finally, we purchased **Walt Disney**, whose share price fell due to exposure to theme parks; which, of course, will be negatively impacted in the current environment. Disney makes most of its profits from its Media Networks division, which consists of the various television networks, cable channels, content production and distribution arms, including ABC and a majority stake in ESPN. While box office receipts from movie production will, no doubt, be severely impacted for at least the next several months, their DTC (direct-to-consumer) offerings of Disney+, Hulu and others, will provide a notable offset. Not only that, but in purchasing the stock, we become owners of an arguably unrivalled portfolio of film content, which includes not only Disney itself, but also Marvel, Lucasfilm (Star Wars and Indiana Jones), Pixar, 21st Century Fox, Touchstone and franchises such as The Muppets, Pirates of the Caribbean, Chronicles of Narnia and Winnie the Pooh.

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 market gyrations of the past few weeks are more volatile than most of us have ever witnessed. We find ourselves somewhat surprised by the sudden rebound in share prices, given the strong probability that the second quarter of 2020 will be the weakest on record since the depression of the 1930s. That, combined with the fact that no one understands how quickly the world will get back to “normal,” makes for a level of uncertainty that is novel in and of itself. Therefore, investors should not be surprised if markets take another steep drop as this period of uncertainty continues.

Promises from governments and central banks that they will do “whatever it takes” may make for a comforting soundbite, but the long-term implications of record deficits and money-printing are unknown.

Is this the end of the world as we know it? No. It never is. There is so much money being invested by the best and the brightest in the medical field that, if anything, we may get an upside medical surprise sooner than many expect. The world never comes to an end. One day, we will look back on this moment in history the same way we look back on other crises, and it will be a memory.

As investors, one lesson has always been clear: the best time to invest is when the outlook is ominous, and headlines are filled with worst-case scenarios. As the ‘Great Lockdown’ took shape, we invested some of our cash in March when markets tumbled and windows opened. We will continue to seek out great businesses that offer excellent upside as this situation unfolds.

We wish you and your families peace and good health through this difficult time.

Sincerely,

Lorne Steinberg
President
