July 2020

Volatility is the price we pay to earn more than 0% …

Living with Volatility

Dear Investor,

The second quarter of 2020 will probably go down as one of the stranger periods in market history.

Was it only three months ago that investors were panicking and selling equities?
It feels like a lot longer than that, as so much has transpired. The recent market rebound is the fastest recovery on record, as markets appear to have decoupled from the economy.

The major reasons for the sudden turnaround are threefold:

1. Fiscal stimulus.
2. Monetary stimulus.
3. Medical advances in COVID-19 vaccine development.

Faced with possibly the worst economic outlook since the Depression, most governments responded quickly with massive **fiscal stimulus** -- essentially paying people to stay home, while providing loans and other relief to businesses. These policies have buffered the impact of the recession, providing some level of income stability, as economies start to open up.

At the same time, the Federal Reserve (followed by other central banks) announced that they would provide unlimited **monetary stimulus** (quantitative easing) to support the economy, and keep markets functioning. This included the purchase of government and mortgage bonds, and for the first time, the Fed is buying corporate and high yield debt. The corporate bond market, which had fallen sharply in March, rebounded after the Fed's announcement, and corporate debt issuance in the first half of this year is at a record high.

Finally, Wall Street is betting that the efforts of so many pharmaceutical companies will pay off with a **vaccine** by 2021 and that the world will gradually return to a level of "normalcy" within the next 12-24 months.

Where is the money coming from?

The support by governments has resulted in record budget deficits, many times greater than in past recessions. For fiscal 2020, the U.S. budget deficit is expected to rise to $3.7 trillion (up from about $1 trillion in 2019) while the Debt-to-GDP ratio will exceed 100% by the end of the year. With the need for fiscal stimulus expected to continue into 2021, this ratio may surpass the previous high set at the end of WWII.

Most other countries, including Canada, are in the same boat.

Where is the money coming from to finance this debt?

Simple. It is being printed by central banks, whose balance sheets have expanded well beyond the levels experienced during the financial crisis. By supporting government deficits and the corporate bond market, central banks have continued to drive down bond yields to **near-zero** levels. This means that the deficit spending is being financed at such low rates (the 30-year U.S. Treasury yields 1.3%) that the interest expense on this debt is more manageable than in past debt expansion cycles.

What is the impact of these record deficits and expansion of the money supply? This is one of the many unknowns that investors are grappling with. One risk is that these policies will eventually result in higher inflation, which would lead to increased interest rates, but the range of possible outcomes is simply too wide to assume anything.

100-year bond anyone?

As governments pile on debt, many are also extending maturities to lock in low borrowing rates.

The Government of Austria recently issued a 100-year bond at a yield of less than 1% (88 basis points to be exact). Such is the state of the world that this issue was ten times oversubscribed! A number of investors are flocking to long-dated debt to pick up a bit more yield. However, long-term government bonds come with their own set of risks - especially if inflation and/or interest rates rise. These risks are in addition to earning next to nothing in coupon yield for a couple of decades … or generations.

So, where does that leave investors? In a world of zero rates, investors seeking yield have little choice but to buy dividend-paying stocks, high yield bonds and other asset classes, and accept the inevitable volatility.

Value investing

In March of this year, we added Alphabet (Google's parent company) to our portfolio. The question arose as to whether this was a value stock, and we thought it would be useful to provide a brief answer to such a sensible question.

To begin with, we are of the opinion that something got lost along the way when the investment industry split the universe into two types of investors -- growth and value. The reality is that valuation is obviously ***dependent*** on the growth rate of a company.

We describe ourselves as value investors, with "value" defined as buying financially sound business at prices below what we believe them to be worth.

Let's compare Alphabet to another one of our investments, Cisco. The former, is often viewed as a growth stock, while the latter better fits the definition of a classic value stock.

We own both and consider them to have a comparable attraction to us as investors. Both have extremely strong balance sheets (one of our core criteria) and, in fact, both companies have net cash positions.

Cisco is a slower growth entity and is unlikely to see much more than 3% sales growth, on average, over the next several years. Alphabet, by contrast, may well grow revenues at a double-digit annual rate for many years to come.

Profit margins are expected to remain reasonably stable for Cisco, but migrate marginally upwards for Alphabet. Both companies generate significant free cash flow. While Alphabet invests a greater proportion of its cash flow toward growing its business, Cisco uses more of its free cash flow to buy back its own shares. Thus, the benefits of share buybacks is disproportionately higher for Cisco shareholders than it is for Alphabet's. This is reflected in the earnings per share growth rate, where the gap between the two narrows somewhat.

With Cisco, we also get a 3% dividend yield, which is growing steadily, whereas Alphabet shareholders receive none. The final piece of the jigsaw is to ascertain what valuation a business should command in time, based on its economic moat, growth prospects, free cash flow generation, returns on investment, etc. Given the respective future earnings multiples we deem appropriate, both Cisco and Alphabet offer us about a 12% potential annualized return over the next five years, making both stocks extremely attractive "value" investments.

Berkshire Hathaway, Tesla and the markets

	Price Dec. 31, 2017	**Price June 30, 2020**	**Return**
Berkshire Hathaway "B"	**$198**	**$178**	**- 9.9%**

Over the past 2½ years, shares of Berkshire Hathaway and many other excellent companies (including the Canadian banks) have declined in value, as the markets have been driven by an increasingly narrow group of technology companies whose share prices have soared.

Microsoft has been our best performer over this period. However, the stock market has been focused on "story-stocks" such as Tesla whose shares have rocketed skyward, with scant attention paid to valuation.

Tesla has achieved outstanding success in building electric vehicles that its customers love to drive, however, the company is generating minimal cash flow and is presently valued at 150 times its estimated 2021 earnings. In addition, after years of having the market to itself, every major auto manufacturer, from Mercedes to Toyota, will be releasing a slew of electric vehicles over the next few years, providing intense competition for Tesla, whose sales growth is already showing signs of slowing.

By contrast, we recently added Berkshire Hathaway to our portfolio, trading at its lowest valuation in years. Berkshire investors have the opportunity to buy a diverse group of private and public companies at a compelling price that offers a good margin of safety and the potential for long-term capital appreciation.

If you ask us whether we think long-term investors will do better buying Berkshire Hathaway versus Tesla, the answer should be obvious.

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 wild gyrations of global stock markets over the past few months have caused more than a bit of stress for many investors.

In past periods of uncertainty, many investors would gravitate to the safety of government bonds and wait out the storm. However, in a world of zero interest rates, buying long-term bonds with no yield carries risks of its own -- and won't even preserve capital over the long-term.

As investors, we accept volatility in exchange for some meaningful yield over and above the "risk free rate" and equivalents. Said differently, volatility is the price we pay to earn more than 0% these days. However, volatility should not concern the long-term investor holding a well-diversified portfolio of strong, robust businesses -- especially those that are trading at a discount to their fair value.

We remain, as always, focused on owning quality businesses that will survive and thrive long after Covid-19 is a distant memory.

We wish you and your families peace and good health through these difficult times.

Sincerely,

Lorne Steinberg

Lorne Steinberg
President