LorneSteinberg
Wealth Management

QUARTERLY NEWSLETTER

> *"Value stocks are about as exciting as watching grass grow, but have you ever noticed just how much your grass grows in a week?"*
> *- Christopher Browne*

The Death of 60/40… At Least For Now

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PRESIDENT

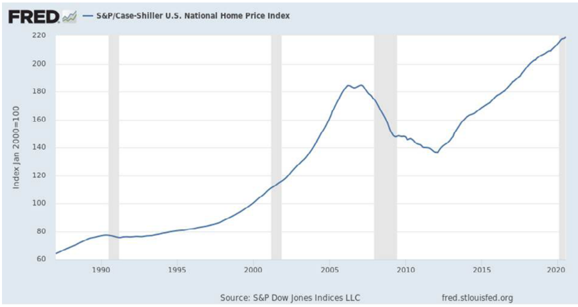
Dear Investor,

As we head into the final quarter of the year, COVID-19 remains omnipresent. The optimism that a vaccine would be announced by the end of this year is fading and attempts to "open up" the economy are resulting in community spread. Most countries have not yet found the right balance between increasing economic activity and controlling the rate of infection, which suggests that the economy will remain under pressure until there is a vaccine or cure.

That being said, the global economy bottomed out in April and has been steadily improving since then, though still nowhere near pre-COVID levels. At the same time, markets have continued to recover despite the recession, and this disconnect is causing confusion to many.

The rebound in markets since April is largely the result of massive monetary and fiscal stimulus. Governments are issuing record amounts of debt as they continue to pay those who have been most impacted by the pandemic. This might normally result in higher interest rates, but central banks have continued to print money to buy up this debt, and the result is lower yields. These policies are boosting both equity and home prices.

The chart below illustrates the gain in housing prices during this recession. The 30-year U.S. mortgage rate has fallen below 3%, while in Canada the 5-year rate is now below 2%.



Of course, this recession is different from others, as the key to returning to sustainable economic recovery is based, in large part, on a medical solution.

With the economy still struggling while the stock market has rebounded, the question arises as to whether there is still value to be found in equities.

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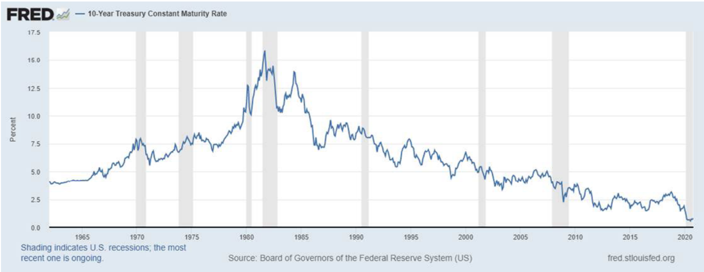
Are stocks expensive?

It depends.

From a valuation perspective, the S&P 500 has traded at a historical average price-earnings (P/E) ratio of 16, meaning that investors have been willing to pay $16 for every $1 of a company's earnings. Today the P/E is about 25, a 50% premium to the long-term average. However, that alone does not make the market expensive.

As can be seen in the chart below, the 10-year U.S. Treasury bond yields have averaged approximately 4% over the past 60 years; and was yielding over 3% as recently as October, 2018.



Bond yields and asset prices generally have an inverse relationship. In other words, as yields rise and investors are afforded the ability to earn a higher risk-free return, the P/E ratio (and thus stock prices) tends to decline. We witnessed the impact of rising rates in the 4th quarter of 2018 when the Federal Reserve indicated that it would be raising interest rates the following year. The market quickly reacted to the news, suffering a 14% decline.

It is also important to note that while the market average P/E is 25, some companies trade at much cheaper valuations and some much higher. A look at the chart below gives an indication of the valuation and other key metrics of our Global Value Equity strategy vs. the S&P 500:

	Price/Earnings	Price/Book	Free Cash Flow Yield %	Dividend Yield %
LSWM Global Value Equity	13	1.3	7	2.3
S&P 500 Index	25	3.9	3	1.6

The death of the 60/40 portfolio?

Since the 1980s, many investors, including large pension funds, have maintained a strategic asset allocation of 60% in stocks and 40% in government and corporate investment-grade bonds. When long-term interest rates were 4%, this made some sense, as bonds provided a stable income and usually held up well during bear markets. This strategy was successful in a declining interest rate environment. However, today, 10-year bonds yield less than 1%, putting fixed-income investors in a risky situation. Those who buy longer-term bonds with minimal yield are betting that inflation will remain benign and that interest rates will decline or remain stable. If that happens, they will earn perhaps 1% on this portion of their portfolio. That is their best-case scenario. A more likely scenario is that when COVID-19 has passed, and central banks stop printing money, interest rates will rise to at least their pre-COVID levels, which would leave these bond investors with significant losses on their fixed income portfolios.

This risk is especially evident for balanced mutual funds. We continue to meet with prospective clients holding such funds, whereby the bond component (which makes up 30-70% of these investments) yields perhaps only a little more than 1%, while the fees associated with these mutual funds are often in excess of 2%. This is not a sound strategy for successful investing.

Many investors seeking income have been increasing the equity weighting of their portfolios, shifting to high dividend-paying stocks for their income needs. It is always important to remember that stocks are not bonds, and that, in the pursuit of income, simply buying the highest dividend-paying stocks does not usually end well. In fact, it is often those equities with the highest dividend yields that are most at risk, as those high yields are often a precursor to dividend cuts. One need only look at the Canadian energy sector or REITs to find a slew of companies (Suncor, Crescent Point, H&R REIT and others) that have been forced to cut dividends. That said, investing in a well diversified portfolio of dividend paying stocks, whereby the dividend is sustainable and growing in tandem with earnings, is an integral part of our portfolio strategy.

The traditional 60/40 asset allocation can no longer meet the needs of most investors because, in a zero-yield world, long-term bonds may end up being the riskiest part of a portfolio should interest rates rise.

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New additions

August saw the addition of **Intel** to our portfolios. The inventor of the microprocessor, Intel today remains one of the world's leading chip designers and manufacturers, with commanding market shares in almost all of their chosen activities.

Approximately, half of their sales come from selling CPUs to the mature and, therefore, low growth PC & notebook markets. The other half is accounted for by its Data Center Group (i.e. selling servers into the enterprise and cloud computing markets, etc.), which continues to enjoy much higher levels of demand growth. Recently, they have suffered from manufacturing issues that will result in rolling out some of their newer products later than previously envisaged. As a result, the shares have fallen to a very attractive level, trading on a mere 11x P/E multiple and providing a 2.5% dividend yield. At Intel, management must now choose to either fix the manufacturing issues themselves or resort to outsourcing such functions to a third party. The latter scenario may result in a modest reduction in profitability, but potentially a major boost to cash flow. As shareholders, we should be very well served from here in either scenario, given the valuation.

We also purchased **Johnson Matthey** during the quarter, a business from the UK that traces its roots back over 200 years. Today, it is a global leader in catalytic technologies and various surface chemistry technologies (used in the control of vehicle exhaust emissions).

The company also operates in complex industrial processes, pharmaceutical active ingredients, and electric vehicle battery materials as part of its sustainable technology division. They are one of only three global companies that operate in the markets for catalysts, and market shares have been stable for years. Global emissions standards are ever-tightening, driving increasingly sophisticated autocat technology demand. Over time, the rise of electric vehicles and the resultant long-term decline of the internal combustion engine in cars will ultimately result in a lower contribution from this area of their business. Today, we are not paying very much, if anything at all, for that division, with the stock trading on only a mid-teens multiple of what may well be trough earnings this year. Autocats will be around for a very long time, and there is much more to like about this company, including its market-leading position in heavy-duty diesel trucks, a cyclical recovery that is taking place in industrial catalysts used in petrochemical processes, a strong pipeline in pharma ingredients, and a potentially very promising seat at the table in electric vehicles.

Having initiated a position earlier on in the summer, we also added substantially to our holding in the French food and beverage entity **Danone**. Although perhaps best known for its household yogurt and probiotic brands, such as Danone and Activia, around a third of sales (but fully half of profits) comes from its Specialized Nutrition division, which focuses on early life and medical nutrition.

In addition, they are also the global market leader in plant-based foods and were one of the pioneers in bringing non-dairy 'milk' to market, introducing its Silk soymilk to customers over 40 years ago. Through the ownership of the Evian and Volvic brands, Danone also has a strong position globally in bottled water. With such a broad and diverse portfolio, and one that is focused on healthier options, the group is very well positioned for evolving customer tastes.

Despite such relatively predictable earnings and cash flows, the stock trades on a sizable discount to its U.S. and global peers, commanding only about a 16x multiple of earnings while giving us around a 4% yield.

Within our Canadian Dividend Growth strategy, we purchased **Saputo**, a Montreal-based, but increasingly global, dairy products manufacturer. Saputo ranks within the top 10 dairy processors in the world with close to half of their business in the US, just over a quarter from Canada, with the UK, Australia and Argentina making up the bulk of the rest. With strong household brands and key distribution capabilities, they are the leader in their domestic market, as well as in the UK and Australia, the number two player in Argentina, and ranked number three in the US. The business offers predictable organic growth, combined with the opportunity to expand inorganically into new markets from time to time. COVID-related weakness in its foodservice client base provided us the opportunity to pick up the shares around a quarter lower than where they were trading not long ago, while enjoying a 2%+ dividend yield.

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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

With lingering uncertainty surrounding COVID-19, the global economy, and various geopolitical issues, we remain focused on ensuring that we own a diversified portfolio of financially sound businesses that are competitively positioned and whose share prices are attractive even if market valuations revert to the mean.

In a world of low rates, many investors have felt compelled to buy stocks and other more volatile assets in search of yield. The retiree, for example, who has $2 million of investments to sustain their retirement, can no longer live off government bonds or bank term deposits. For such an investor, a 1% return would generate $20,000 of income -- not nearly enough to survive. The longer that yields remain at current levels, the more attractive a 2% dividend becomes. With the value of many assets trading at elevated levels, it is hardly surprising that Warren Buffett remarked that he is having a lot of trouble finding attractively priced companies to buy. Berkshire Hathaway continues to hold some cash and wait, as do we.

The quote at the beginning of this letter is from the late Christopher Browne, a well-respected investor whose brokerage clients included prominent value investors such as Warren Buffett and Benjamin Graham. Simply put, the best values are usually found in companies that may not be the "hot stock" at a moment in time, but rather in those that have a history of creating value for shareholders and are trading at reasonable prices.

Investors seeking yield and returns in this very uncertain world with historically low-interest rates, need to maintain a reasonable time horizon, learn to live with volatility, and focus on value in both fixed income and equities. Our portfolios are conservatively positioned, well-diversified, and offer above-market dividend yields at below-market valuations.

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

Sincerely,

Lorne Steinberg

Lorne Steinberg
President

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