Manulife Securities

ELAINE’S NEWS & VIEWS

Jan 2020- PART 2

The topics in this newsletter addendum are:

- some of the takeaways from many of Canada’s top economists
- investing insights and myths that should be de-bunked
- cautionary information on travel insurance through your credit cards, and
- reminders to register for our upcoming seminars, including a newly announced Master Class.

TOP ECONOMISTS’ PROGNOSES

Every January, either Jordan or I get up at some horrific hour to get to downtown Toronto for the Economics Club of Canada’s early breakfast Economics Forum where they host the chief economists of the 5, or now 6, top Canadian banks, who give their forecasts on the Canadian dollar, stock markets, the economy etc. Then we go to a second meeting right after to hear fund managers and listen to Manulife Investments’ chief economist, Philip Petursson, give us their views. (Peterssun, by the way, was touted last week by the Globe and Mail as the only chief economist to predict the Canadian stock market correctly last year.) Those meetings came after I’d written the newsletter that I already sent you this month. There were some interesting things at those meetings that slightly change our views towards the occasional Canadian bank or resource stock that may pop up in our favourite funds. So here’s Part 2 of our January newsletter. (The chief economists who presented the following views on Jan 8 at the Economics Forum were Avery Shenfeld, CIBC Capital Markets, Craig Wright, RBC Royal Bank, Beata Caranci, TD Bank Group, Douglas Porter, BMO Financial Group, Jean-François Perrault, Scotiabank, and Stefane Marion, National Bank of Canada).

The bank economists agreed that the Canadian dollar (CAD) would stay in the range of $0.77 US. Petursson speculated that if the Middle East problems persist and the US factors in the political cost of using non-North American oil, then Canadian oil could be in demand and the CAD could get up to $0.82.

In the US Manufacturing is in a recession now, but since manufacturing has become such a small component (7%) of the US economy, it hasn’t stopped the economy from doing well. 3 out of 5 leading indicators of a recession still show the US economy is in expansion mode. Employment is still very high in the US and Canada. New jobs in Canada are not particularly well-paid jobs though. Technology may disrupt as many as 25% of jobs in the next decade. There will be a transition to high paying jobs, but will there be enough highly educated/skilled people for these jobs? The panel didn’t think there would be unless there is a country-wide push to educate people in the right areas. And 70% of the current high-tech jobs and the expected growth in jobs is centred in only 5 Canadian cities. Even though employment is strong, and inflation is tame, no one expects strong earnings growth. So, stocks will be lucky to rise by 5-7% in 2020. Still no recession is expected. As oft-quoted American Leon Cooperman said, “Bull markets do not die of old age, they die of excesses such as accelerating and above-trend economic growth, rapidly rising inflation, and interest-rate hikes from a hostile Federal Reserve.” What he said after that seems true today too, “Those excesses are simply not with us today, nor do I expect their arrival anytime soon.”

Because European stocks are cheaper than American ones, and Emerging Markets are even cheaper, most expect that Europe and Far Eastern markets will outperform the American market. China’s manufacturing index, which was down, has already recovered. Some expect that Canadian resource companies will be the big gainers in 2020, because they are at historic cheap levels. Others pointed out that there is no huge demand for resources now, so we’re not likely to have a repeat of the 2001-2006 outperformance of Canadian resource stocks, and that there is a 50% chance of a recession in Canada in 2020. The economists weren’t too concerned about Canadian banks, because they get so much of their revenue these days from outside the country and they have lots of loan loss reserves in place (and keep adding more each quarter). No one was predicting a global recession, or a general recession in the US.

The trade deal with China was not really substantive. It just allowed the US to put the breaks on tariffs on Chinese imports, without admitting that the tariffs would really just be a tax on American consumers. The tension between the US and China is expected to persist for a decade. (According to Invesco on Jan 13, even the highest tariffs threatened so far would only hurt US GDP by .6% and Chinese GDP by .2%.)

Gold could spike up to $1950 in 2021, but they reminded us that spikes are often short-lived and gold often tumbles after the initial panic over geopolitical situations settle down.

There was a huge difference of opinion over whether the US or Canada could bounce back faster from a recession. All agreed that the Canadian consumer is so indebted that they can’t spend enough to keep the economy going, but some felt the Canadian government debt is so low relative to the rest of the world, that the government could spend enough to stimulate the market into recovery. Others felt that the American consumer has their debt so in control that they could save the US economy, and even though the US government debt is at record highs, the world loves the US dollar so much, that the US can continue to rack up more debt to stimulate the economy if it needs it.

Based on the facts and figures from the economists and their projections, and everything else we have been hearing from fund managers and newspapers, we aren’t going to try to increase Canadian content in our portfolios, but we won’t worry if we see the occasional bank or resource stock in the holdings of our favourite managers. Those 2 sectors might have some potential winners. We might also balance the international and US exposure a bit more, rather than overweighting the US so much. And, while Jordan still isn’t so keen on emerging market exposure, while emerging market stocks are so cheap, I still think there is adequate potential there to be worth having a small exposure there. When emerging markets spike higher, they generally have strong runs for quite a period.

INVESTMENT INSIGHTS AND MYTHS

On Jan 10, 2020, we received a newsletter from Edgepoint portfolio manager, Andrew Pastor, who had some interesting insights we wanted to share. He started out relating how he didn’t have much success playing chess in high school, when he was following all the same, traditional strategies as his opponents. When he realized that, he started trying new strategies and started winning. He relates that to investing. He had to unlearn the traditional investing wisdom he had practiced in order to start getting great results. He shares with us 5 investment myths he had to unlearn to start being a better investor.

The first myth is that everything returns to the mean. It reminds me of when I did my MBA in the early 80s and we had to study a book I had no use for, "A Random Walk Down Wall Street" by Burton G. Malkiel. It claimed that a company or its stock might outperform for a while, but then it would be sure to underperform, because all companies will only perform at an average level over the long-term, because market competition and pricing are soooo perfectly efficient. Try telling that to Microsoft or Warren Buffett's Berkshire Hathaway, which has outperformed most years since 1964. My feelings that Malkiel was all wet were academically supported early this century. That's when I read a study by a Harvard and a Yale professor that showed, that when a fund has significantly outperformed for at least 5 years, the chances are that it will continue to outperform, because there must have been an actual difference and advantage that led to the outperformance in the first place. And that advantage could persist to bring further outperformance. Edgepoint's Pastor quotes a study from Credit Suisse that was new to me. It looked at 1985-2013 and found that good businesses continue to outperform 79% of the time and weak businesses remain below average 83% of the time. So, it makes no sense to buy losers just because you expect that their luck has run out and it's their ***turn*** to return to the mean (the average performance of their peers), and to do so they would have to turn around their performance and start excelling. Chances are that loser is just going to continue to underperform.

Myth number 2 is that one can only judge whether a company is selling cheaper than what it's worth by looking for companies selling for low multiples of their earnings. Cheap Price to Earnings ratios (P/E) are the easiest and most used measure of "value". It's interesting that one of the legends of value investing, Warren Buffett, never talks about cheap P/E ratios, and his second largest holding is Apple, which is trading at an above average P/E. Buffett always looks at projected future earnings, based on his estimate of a company's probable growth, to determine what is a reasonable price to pay for those future earnings. So, when he wants to underpay for a stock, to have his famous "margin of safety", it's really just underpaying for the level of expected earnings growth. That's what makes it so hard to know just from P/E numbers whether an individual stock is a good value or is expensive. As Buffett says, price is what you pay, but value is what a stock is worth.

People have long seen the wisdom in "averaging down". If the price of a stock they have bought drops, they buy more so that their average purchase cost is lower and potential profits could be higher. That strategy still makes sense if the market panics and a good quality stock goes on sale. What is hard, is buying more of a stock after the price has risen. Pastor says our initial purchase price shouldn't matter. If there is more good growth to come, then the stock could be worth the higher price. It makes sense. Whether you should buy more of a stock should not depend on what price you may already have bought some at. It's like the wisdom for holding or selling a stock. If you wouldn't buy more of it at its current price, then why continue to hold what you do hold of it at that price. Only continue to hold what is a good buy and worth buying again at today's price.

Buffett says to avoid "turn-around" stocks because their situation rarely improves. However, Buffett did put big money into the Canadian GIC issuer Home Capital when it was on the verge of bankruptcy. It was a fundamentally good company that had run into an unexpected and temporary liquidity problem, which Buffett's cash infusion fixed. Pastor points out that there are lots of exceptions to Buffett's admonishment not to buy turn-around stocks. Pastor has had experience with fundamentally good companies who suffered from poor management, but then changed their management for the better, or who made a misstep but recognized their mistake and got back on track. Sobey's parent company, Empire, might be a good example of that. It went off the rails after it bought Safeway and did a poor job of integrating the two companies. It takes in depth research to know if a successful course correction is underway though. So, turn-around stocks could hold great potential or be very risky.

Lastly Pastor quotes Warren Buffett who says that, "Diversification is protection against ignorance. It makes little sense if you know what you are doing." Apparently, Buffett's partner, Charlie Munger, said that one only needs 3 stocks to be sufficiently diversified. Pastor quips that greater diversification is protection against not being either Buffett of Munger. And let's face it, there are very few other investors as brilliant as they are. Pastor also points out that even companies like Coca Cola and Gillette (which Buffett holds) don't always maintain or improve their market domination forever, so if you could only have 3 stocks and counted on those 2, you could suffer lacklustre performance. And heaven help you if you only hold 3 stocks, and one turns out to be a Nortel, RIM or Valeant. So, Pastor recommends diversification by business idea. Most of our top fund managers like to hold 24-40 holdings to be diversified, without being over-diversified. And we like to have 6-10 different fund managers per investment time frame to protect against any one manager making a big strategic mistake. And we often diversify a bit from our core strategy, Buffett's Growth At A Reasonable Price (GARP) strategy, to add some deep value or low volatility strategy or value-momentum style or even dividend grower strategy. Value/Growth At A Reasonable Price may continue to be the best long-term performer, but it can be hard to endure its long-periods of being out of favour. So, adding some complementary strategies can smooth out the ride. Some investors add the opposite strategies of pure growth or momentum, but that is too risky for us and I'll show you why.

The following chart shows you 3 yrs of hypothetical returns for 4 portfolios which all average out to 10% annual returns.

	Steady Returns	Irregular Returns with no Losses	Big Losses then big Gains	Big Gains followed by big loss
Year 1	10%	5%	-30%	40%
Year 2	10%	25%	-20%	30%
Year 3	10%	0%	80%	-40%
Simple Average	10%	10%	10%	10%
Compound Return	10%	9.49%	0.27%	3%
Growth of $100	$133.10	$131.25	$100.80	$109.20

For Illustration Purposes Only

The fourth portfolio above resembles some of the growthiest strategies. You get great gains, but then you can suffer huge drops with the end result that you don't end up making much money. For the high volatility portfolio, the compound returns are awful, less than a third as much as for the steady, dull portfolio. That is why we won't risk buying funds that don't hold reasonably priced, quality stocks. Even those stocks and funds can drop in price when investors get scared and the market falls. But, when there is real value in the stocks, someone eventually notices and pays a fair price. So, then there is no permanent loss. Contrast this with the dot.com bubble companies which didn't have profits or sometimes even a product or business strategy. When investors realized they were paying lots for nothing substantial, the prices fell 95% and the price of most companies didn't ever bounce back.

So, if the coast clear to keep investing in the stock market? Will it be clear sailing for economies and companies or stormy seas? We don't know. It looks like there is no imminent storm, but there are no guarantees. So, we try to head where the seas look most inviting, but we never go without life jackets to save us, just in case. That is why we try to invest in funds which do huge fundamental research to find companies that:

- Make a lot of profit for each dollar of investors' capital (money) they have (and don't need to reinvest much of the profit in equipment renewal, like with a telephone company)
- Have resilient cash flow. That is, they can make money almost all economic conditions (like a funeral home chain)
- Have a long future. Maybe they have what Buffett calls a "moat" around them, so their business can't be disrupted, or so a competitor would have a hard time entering the market. Let's look at some examples. Visa and Microsoft have so much market share, that it's unlikely they'll be displaced soon. Most retail chains though are declining because of internet purchasing, like Blockbuster was replaced by the Internet. And, buggy whip makers were driven out of the market by automobiles. Their moat was breached.
- Are selling for less than their intrinsic value. This is our margin of safety. If we buy something that is 30% cheaper than what we calculate it's worth, then even if we have misjudged some factor determining its value, or the worst possible thing happens to the company, then it still may be worth the amount we paid for it and we might not lose money. And if we underpay by 30% for some dull, utterly stable and predictable company making 5% profit a year, we could make 12.8% compound returns over 5 yrs, if the company starts selling for a fair price.

TRAVEL INSURANCE ON CREDIT CARDS

Someone recently told me they didn't need out of country travel insurance because they were covered through their credit cards. Rob Carrick wrote about credit card medical coverage on Oct 31, 2019 on the Globe and Mail website. He pointed out two main things. First, he wrote that coverage ends or is reduced for cardholders at certain ages, especially 65. If you aren't aware of this, you might think you have coverage when you don't have it or think that you have coverage for a longer trip out of country than you are actually covered for. Secondly, he points out that credit card out of country medical coverage is like mortgage insurance. That is, it doesn't get underwritten until you try to claim on it. At that point, the company will investigate whether you had pre-existing conditions, have changed medications recently, had recent treatments or symptoms, etc., all of which could preclude you from qualifying for any coverage. And of course, all this investigation into your medical history takes time, which means you would have to pay first and hope to get reimbursed later. So, make sure you are really covered, and your children too, if you leave the country. Bills can mount up to $100,000's very quickly out of country.

Also note that if there is a life insurance component to your travel insurance, the cost of it may not qualify for a tax deduction as a medical expense.

SEMINAR INVITATIONS

The fifth session of our **Estate Planning Seminar will be on Tues, Jan 28 from 7-9 p.m**. We know that several of you wanted to come before, but the sessions were either full or at a time you couldn't make. Hope you can make it to this one. It's not on what to put in your will, but rather on the myriad of other preparations you should make so that your loved ones can easily manage things when you are gone and on the planning you need to do so your estate can pay less in taxes . You may also want to come to find out what information you need to ask your family to make sure their wishes are done, their taxes will be minimized and you won't be faced with a big challenge after they pass.

On **Sat, Jan 25 from 10-noon, we'll cover Converting your Savings into an Income Stream**. This is especially for pre-retirees who want to know what needs to happen when they retire. If you are already getting an income from your savings, this might be a good refresher on how your income is produced.

Also, on **Sat, Jan 25, from 1-3 p.m. we will run an Investing Basics course**. This is completely revamped from when we last ran it, a couple of years ago. It's a more holistic view of how money and investments work in our society.

Lastly, we are adding a new session, for the first time. It is a **Master Class on investing on Sat, Feb 29 from 10 a.m. – noon**. It doesn't mean you have to be an expert to attend, but you need to know the basics of investing, to understand it. We'll be talking about terms you may not understand or have run across, why some strategies work better in certain years, how Buffett invests etc. There will be a chance to ask about things that have always puzzled you. If people are interested in learning more in depth about investing, we might regularly run master classes on a semi-annual basis and each class would be different, because the economic situation is always changing, there's always new research and there is an endless amount to learn, so we can always cover new topics.

Register for any of the seminars by calling or emailing Sarah on our regular office number or her e-mail, listed at the end of this newsletter. Come out and see our new, bigger boardroom on the 3rd floor, still at 1685 Main St W, Hamilton, suite 303. The dogs don't work on Saturdays. So, they won't be joining us at the seminars.

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