Manulife Securities

ROYDS REPORT

April 2021

Recent Markets

What a ride this last year has been! Last April we were starting to recover from the monthlong steep drop in the market caused by Covid. Up until November, high tech and other beneficiaries of the lockdown did terrifically in the markets. High tech got pricey and starting in November, the other, older economy companies started to shine on the stock market. Fidelity's Mar 19, 2021 Week in Review email had a concise analysis of how markets usually behave, relating it to the markets of the April to Feb: "the powerful, valuation-driven initial rally in equity markets between March and September last year is typical of the initial "hope" phase of a bull market, which generally begins during a recession when earnings are still falling. This phase is generally followed by what we call the "growth" phase, and is typically characterized by earnings expansion. Often, the transition between the two phases is marked by heightened volatility and a market setback as investors wait for, or being to doubt, the recovery that has been priced in."

Something unexpected changed the normal recovery pattern. At the start of March, bond traders shook up the market. There was a substantial sell off of bonds, lowering bond prices and simultaneously increasing bond yields or interest rates. Some attribute this sell off to optimism about North American economic recovery and others to expectations of rising interest rates. Whatever the reason for it, bond yields rose dramatically. Yields on 10 yr government bonds are now triple (1.5%) what they were last August. (Source: Globe and Mail Apr 3, 2021) This shook up the stock market. Typically rising bond yields have signalled it's time to move into banks and cyclicals like resource companies (oil and gas etc). All the traders who follow such patterns and don't focus on fundamentals, dutifully moved into banks and other cyclicals. High tech or solid non-cyclical companies languished, and banks and resources soared more at a record pace. Banks, oil and gas are areas we have not been invested in, so this was not a help to our portfolios. <u>"This trend, loosely referred to as a "junk rally", rewarded companies with heavy debt loads and negative earnings, while undervaluing those with strong balance sheets and profits." "Stocks are generally valued by discounting their future cash flows to present day, at a rate of discount in line with current interest rates. So it is no surprise that higher bond yields are especially negative for early stage companies whose best days are further off in the future". A "Scotia report … listed its 30 top-ranked Canadian names by quality metrics – a group that has failed to keep pace with the S&P/TSX Composite Index since the bull market began, and has underperformed the group of lowest-quality Canadian stocks by a wide margin over the same timeframe."</u> (Source: Globe and Mail Apr 3, 2021)

One of the most successful investors in Canada, Noah Blackstein (whose funds can be extremely volatile, but who has outstanding long-term returns) described the drastic market change this year as follows:

> "Value Indexes *[which follow the cheapest stocks, and include companies which are cheap because they are of low quality as well as quality companies that are simply out of favour]* are outperforming growth indexes by over 10% so far this year after being decimated in 2020. While banks and energy have been the key drivers, it was the bond bear market (>20% sell-off), that triggered massive factor rotations in the market. According to Bank of America, the bear market in bonds since early August had been one of the deepest of all time. The <u>annualized return on 10-year Treasuries is now close to -30%</u> *[meaning the price of existing Treasury bonds dropped 30% more than the*

interest they earned] from the summer peak. The reasons are obvious – monetary and fiscal policy as well as the implementation of vaccines. As I have often written, the slope of the yield curve is the catalyst for those quants *[quantitative traders who look at trends and ratios and don't look at companies' products, management, prospects, competitors etc]* who trade factors (value, growth, momentum, low beta). To them, an upwardly sloping curve means the economy is getting better and it's time to buy cyclicals. An upwardly sloping yield curve is also considered positive for banks, and both value indexes and small cap indexes are heavily exposed to traditional banks.

Examining this more closely, one will see that **it's not really "value" that's leading, it's junk – low quality stocks. Companies with the worst balance sheets and financial position have completely dominated the market – the lower the quality of the company, the bigger their rally has been…** Bloomberg notes that "**Companies with weak balance sheets are beating those with sturdier accounts by over 20 percentage points so far this quarter**, the biggest gap since at least 2006, according to data compiled by Goldman Sachs Group Inc. and Bloomberg. The list of firms with rickety credit includes Expedia Group Inc., Alaska Air Group Inc. and Carnival Corp. -- a group that doubles as the hardest hit by the coronavirus pandemic." Central bank involvement in the markets has changed the current functioning of the market from price discovery, to capital raising for social reasons. For example, AMC Movie Theatres now trades at twice the price it did pre-pandemic while its share count that has more than doubled. Nearly every day there is another financing for cruise lines or airlines. [Government support of the companies that were most affected by Covid artificially propped them up and made their shares more attractive than their business prospects warranted. Companies that the government decided society needed, like airlines, movie theatres and cruise lines, attracted the government capital as opposed to companies attracting investor capital on the businesses' merit, as is supposed to happen in a capitalist society. Government capital allocation is not known for being smart or efficient!]

One of the best takes on the junk rally came from Bank of America's Communications Infrastructure analyst. The title of his note is "Secular Growth to Cyclical Rotation Has Run Its Course", where he states "Some of the optimism is warranted, in our view, as case counts tick down and a return to near normalcy appears within sight. However, in some cases, **recent stock performance is detached from fundamental underpinnings and reflects a pervasive trade-based market mentality rather than sound analysis…Valuation comparisons now favor secular growers**."'

In other words, the market is off on a tangent. It's pushing up the price for companies that are in bad financial positions without the best growth prospects, and companies with strong growth prospects are out of favour with the market and are trading more cheaply than poor quality companies. So, **the fact that our portfolios did not do well in March may be explained by the fact that the market is not buying quality right now. We never abandon our strategy to follow short-term market trends, like these. Eventually the market will get prices right, and quality and growth will be rewarded**.

The idea that the market rotated from companies with great futures to junk is also supported by statistics on the 2020 Canadian market that CI Investments shared. As you can see below, in the first half of last year, the companies that were selling for the highest prices, as measured by price compared to their free cash flow or net profit, rose in price the most. At the same time, the companies with poor cash flow dropped in value. The lower the price to cash flow [that is, the cheapest companies], the worse the loss in their price. Oil and gas companies and companies in the travel industry would have been amongst those trading cheaply, because they weren't making money and had low growth prospects. Then in the second half of the year, but mostly starting in Nov, the companies making lots of money and therefore having lots of free cash flow only made a bit of money, while the companies without lots of net profits gained a ton, almost 3 times as much as the companies with lots of net profits. That could indicate a rotation to companies with improving prospects, like airlines and hotel chains, which just didn't have profits during Covid, but which could be expected to have great profit improvement when travel resumes. And maybe the companies with lots of profits that had already gone up significantly had gotten fully priced and needed to have slower price growth until their value caught up to their price. You can see that market moods change dramatically and even the best strategies don't work all the time.

	Return Jan - June 2020	Return July - Dec 2020
Most Expensive	16.70%	7.90%
Next Most Expensive	-6.50%	6.00%
Second Cheapest	-12.20%	16.90%
Cheapest	-12.30%	23.20%

For Illustration purposes only

Words from Other Investing Masters

Mark Schmehl is one of the most successful and brilliant stock pickers I know of. He looks for companies that are terrible but improving (so their prices will go from terrible to not-so-bad) or companies that are great, getting even better breaking new ground in the world with tremendous growth which the average investor has not discovered or pushed into too-expensive-territory yet. His funds can be very volatile, so not suitable for most investors, but there are important lessons we can learn from this master anyway. One thing he says is if "I made mistake, sell right away…. Sounds easy but most investors sit on their mistakes…. If you're wrong, move on." It sounds obvious, but it isn't human nature in the world of investing to admit to a mistake, crystallize a loss by selling a loser and buy something else. We see this most when people own individual stocks. We're going to be calling people a lot in the next month about their individual stock holdings to review with them the returns, the profit growth rate, the analysts' expectations, the company's prospects and whether there is a good reason to keep holding the stock. Some people won't want to sell because it could trigger tax on gains made years ago. This can be a very costly mistake. We've watched lots of people hold stocks drop in price year after year rather than pay tax on past gains. The stocks often lose more value than what the tax would have been if they'd been sold, and there was all the lost opportunity for growth in something else as well. So let's take a hard look together at whether any individual stock holdings are really adding to your portfolio growth.

Other gems from Mark's mouth recently are:

- "The environmental trade is a 10-20 year super cycle….we have a huge fundamental problem… with massive political will to make some change… We can fix this problem… We're throwing massive amounts of capital at it… This will make the internet roll-out look small… It reminds me of the cloud… it's coming like a freight train… Europe is ahead on environmental stocks and technology development… European investors don't like growth stocks. They don't know how to value growth whereas Americans will buy anything with a good 10-year track record. Lots of valuation mismatches in Europe

- The market will come flying out of the gates as soon as everyone is getting vaccinated… With a ton of pent up demand and ton of money in the consumer's wallet… It will be a roaring 20s type scenario

- Technology is an enabler of innovation. Let's look at the Cloud, mobile, etc. The first order move was you own the pure play like Microsoft, Apple, Amazon, etc. The technology is now becoming pervasive of the whole ecosystem. Now you want to own the companies that apply the technology to their business in new an innovative ways. You're seeing "old-line" companies apply innovation to their business…. You'll have massive earnings growth in sectors that people haven't owned or talked about in a while."

(Source: Mark Schmehl webinar Mar 24, 2021)

Further to what Mark said about us entering a roaring twenties era of consumption, The Economist magazine put out a chart based on OECD and World Bank numbers that shows Canadians (more than other nationalities) had extra savings, compared to normal non-pandemic times, in the first 9 months of 2020 equal to 6% of GDP (gross domestic product). That's huge. While too many Canadians are struggling financially, those who made more on CERB that they would normally have made, or who kept their jobs but couldn't go out or travel to spend their earnings, have massive amounts of spending money available and are hungry to get out and do things – shop, eat out, travel, etc. This will be very stimulative to the economy.

A legendary investor and mutual fund manager of the latter half of the 1900s, Sir John Templeton, had a few other wise words for us: **"Bull markets are born on pessimism, grow on skepticism, mature on optimism and die on euphoria."** So if you are feeling a little nervous about the economy and the market, that's totally normal, and in no way diminishes the likelihood that we are going to see good markets for 2021.

Elaine

Jordan

L. Elaine Royds, MBA, CFP®

Senior Financial Advisor, Manulife Securities Incorporated
Financial Planner, Manulife Securities Insurance Inc.

Jordan Royds

Financial Advisor, Manulife Securities Incorporated
Life Insurance Agent, Manulife Securities Insurance Inc.

Suite 303 - 1685 Main St W, Hamilton, ON L8S 1G5
Office 905-393-0787 Toll Free 1-855-640-1857 Fax 905-393-0788
Website www.roydsfinancial.com
Associate Advisor: Sarah Breimer – Manulife Securities Incorporated sarah.breimer@manulifesecurities.ca
Administrative Assistant: Trevor Philippe trevorphilippe@manulifesecurities.ca
Administrative Assistant: Alisha Westaway alishawestaway@manulifesecurities.ca