ROYDS REPORT

Oct 2021

First, here are some one paragraph topics before a comparison of China and the US in more depth.

RESPs- Registered Education Savings Plans: The last time you can contribute to an RESP for it to count as a 2021 contribution is Dec 28. *If you child turned 15 this year, it's your last chance* to make sure there have been $2,000 in contributions before next year or contributions of at least $100 in each of 4 different years before the year your child turns 16, or else your child won't be eligible for government grant money in the years they turn 16 or 17. If your child turned 17 in 2021 and had that $2,000 in their RRSP or 4 years of at least $100 in contributions by the end of the year they turned 15, this is the last chance to contribute to the RESP and still get the 20% free government grant money.

TFSAs – Tax Free Savings Accounts: If you have a TFSA that you want to move to Manulife Securities Incorporated and you don't want to pay a transfer fee to move it, you can take action in December. You can take your money out of the TFSA sometime before Christmas and then in January you get back contribution room equal to the amount of your withdrawal. So no matter how much you have withdrawn, you can re-contribute it in January with no problem. If you've been waiting to move TFSA money for free, don't miss the *great opportunity that comes only in December*.

Tax: One way to pay the least amount of tax on your lifetime earnings is to keep your income levels relatively even. It's better not to have $120,000 income in one year, and $30,000 the next, if you have a choice to change the timing of some income to make your income closer to $75,000 in both years. You could pay almost $36,000 in tax with the uneven income over the 2 years and pay $30,000 with the level income. So, if you plan to sell something in an unregistered account with high capital gains, but you have been hesitating because you don't want more taxable income this year, consider whether you might want to sell half this year and half next year to spread the tax hit over two years. And don't forget that there's a huge chance that tax on capital gains may be raised next year (to help pay for COVID bailouts), by increasing the capital gains inclusion rate. So you might want to trigger capital gains before the next federal budget, or, trigger the capital gains partly in 2021 and partly in Jan or Feb 2022.

Markets this Quarter: July brought modest gains. August markets were up pretty strongly in Canada, the US and globally. There was talk that Canadian resource stocks, which had had a pretty good spring, might be reaching the end of their run, and indeed resource stocks have generally retreated recently. Sept markets were a different matter. There were only a handful of trading days in Sept that were positive. Although people fear October's market volatility, historically Sept is the most likely month to have negative markets. And indeed September did take back most of the July and August gains and leave our portfolios back at July levels, just a smidgeon up from June, but still up. There are pockets of stocks that are expensive, but our managers are also finding pockets of undervalued stocks. And corporate profits have risen so much through the year (with most corporate earnings so far in October exceeding expectations) that many stocks have grown into their prices. (For example, if a company 's

stock would normally trade at 20 times earnings, while earnings were down due to COVID shutdowns, it might have traded at 25 times those lower earnings. Now that earnings are up, the same stock price might only be 20 times the new earnings, and therefore no longer be expensive.) Most expect strong GDP growth (Gross Domestic Product, GDP, measures a country's productivity, and has been running around 2% in most of the developed world for years. GDP is now expected to run at closer to 4%, which is great). That strong GDP growth should fuel stock markets to keep advancing forward. These expectations are based on the fact that there is still so much more demand for goods and services than there is currently supply, and inventories are depleted well below normal operating levels. Companies are trying to replenish inventories. So we can expect the market to keep rising as it has in the past, that is, not in a straight-line fashion. The market is always faced with worries, but the old market saying is the "market climbs a wall of worry". So it seems like business as usual in the world of investing.

How Canada is Faring on a Relative Basis: There is so much bad information out there (much of it spread in election ads!), that it's important for decision making and understanding Canada's place in world economics to look at two measures of Canada's current risk level based on facts. First, let's look at our debt. The IMF (International Monetary Fund) published countries' Debt to GDP ratios as of Aug 31, 2021. It's an important measure of two things: how much debt load the country will have to carry (so will it be at risk of bankruptcy and how much of its budget each year will be spent just servicing debt) and whether a country has further room to borrow should it need to stimulate the economy to stave off a recession or handle some other emergency (like COVID bailouts). Canada's debt/GDP ratio peaked at 118% last year and seems to be down a bit this year. France, Germany and the UK, of the other G7 countries, have lower Debt/GDP ratios (France is just marginally lower), while the US, Japan and Italy have 10-110% higher rates. So Canada, right in the middle of the other G7 countries, is not out of line. And on COVID vaccinations Canada is doing exceptionally well. RBC Global Asset Management found that of the 25 economically largest developed countries in the world, which excludes emerging market China, Canada had, as of Sept 6, 2021), the 3rd highest % of population that were either fully vaccinated or had received at least one dose. Only the UAE and Spain had higher vaccination rates. Vaccination rates have an impact on COVID outbreak rates and therefore what restrictions there are on businesses being open or how they operate. So it is an economic advantage, among other things, for Canada to be doing as well as we are on vaccination rates. (Source: RBC's Fall 2021 Global Investment Outlook)

Electric Vehicles: EVs are caught in the chicken and egg scenario. Many people won't buy them until there are charging stations available everywhere, and charging stations aren't being built until there are enough EV to use them, until now. Shell is building 50,000 EV charging stations in little England and is aiming to control 1/3 of the UK's charging station market within 4 yrs. One of Shell's oil competitors, France's Total, is also branching out into greener energy, putting $2.5 Billion into solar energy. So unlike film companies of old, like Kodak, who saw a future coming in which the use of their products would decline, but who did nothing to prepare for that future, a few of the big oil companies are trying to reposition themselves as big players in the world of the future. That's encouraging for the world, and surely for their shareholders. (Source: The Financial Star Sept 2/21)

SPACs: Special Purpose Acquisition Companies, nicknamed Blank Cheque Companies, were all the rage last year. A shell company would raise money to start up as a publicly traded company, stating that its purpose was to buy or merge with an unknown company within the next two years. The SPAC sponsor would try to find a company that needed to go public and wanted to do so by merging with a SPAC, which would be faster than the normal regulatory process would allow for the company to go public on its own. Then the SPAC investors could get shares in the merged company or get their money back with interest instead. The sponsors who put the deal together would take 20% of the purchased company.

The Jan 1, 2019 to Mar 5, 2021 median returns for the investors in SPACs, that did their merging or folded because they couldn't close a deal within 2 years, was 4% as of Aug 17, 2021. The median returns of the sponsors were 507%, according to JP Morgan, Bloomberg and Dealogic. Is it any wonder that SPACs are no longer so popular with investors?

Another Advantage for the "Big Guys": There are lots of way to analyse the value of a company, so you can compare what it's really worth to what price it's currently selling for. One of the most common ways is to look at Price as a multiple of earnings, in other words, how much are you paying for one dollar of earnings. The problem is what number to use as the earnings of the company. Companies report earnings, that everyday investors see posted on websites, based on GAAP (Generally Accepted Accounting Principals). GAAP is not very good, from an investor's point of view, at accounting for R&D (Research and Development) spending, lease capitalization etc. At both of Berkshire-Hathaway's 2018 and 2019 annual meetings, Warren Buffett talked about how net income reported doesn't really reflect what's happening in a business. Other legendary investors, like Benjamin Graham and Charlie Munger, have also commented on how GAAP does not reflect reality. Unfortunately GAAP is an accounting requirement and it's hard to fix, and Wall Street isn't motivated to get it fixed so the everyday investor can have sound data. Instead what happens is that the big investment firms either make their own adjustments to a company's data or contract with a database that makes the adjustments, perhaps using Uniform accounting or UAFRS metrics. These may make more than 130 adjustments to a company's financial reports. Without those adjustments, we can misjudge companies terribly. Take for example Spotify, Pinterest and Peloton. On Goldman Sachs' new index of "unprofitable" tech companies, it shows the GAAP accounting earnings per share (EPS) for those companies as -$3.1-, -$3.24 and $-.32 respectively. (This index has caused much to be written in the press about how the price of tech companies today is another dot.com bubble in the making, because of negative EPS in the index .) Under Uniform accounting, the earnings show as $1.65, $.29 and $.50. That's a huge difference. Similarly reported Return on Assets can range from -49% under GAAP to +9.2% with Uniform accounting. We would value a company very differently depending on which numbers and which accounting system we were using. The point is, it's hard to assess the true value of a company if you are an individual investor and to therefore know what price to buy or sell it at, and you are competing in the stock market against institutional investors who have much better data on the companies' worth. While the press is talking about how overvalued the market is now and how investors should expect a crash, fund companies and institutions are finding lots to buy at what they feel are reasonable valuations, and many think we are in the early stage of another bull (rising period of the) stock market. We think the sophisticated professional investment firms with the corrected data have a better chance of being right. (Source: Forbes website post of Mar 4, 2021 by Joel Litman of Valens Research)

China: China's phenomenal growth of the last 40 years, together with the size of its population has made it an economic force to be reckoned with and a candidate to overtake the US as the strongest economy in the world, or does it? Here are some points from a Valens Research webinar and Globe and Mail articles on Sept 25 and Sept 28, 2021 that we found fascinating and thought-provoking about China.

From 1978 to 2007, the Chinese economy grew at about 10% per year. Since then it has slowed to about 7% per year, which is still about triple the rate of the Western world. The growth rate is projected to drop to only 2% by 2030. Early growth stemmed from a new tolerance for entrepreneurial enterprises within China. And centralized control and direction from the government could direct resources where they would benefit the country most. For example, the government decided to relocate 400 million people, mostly farm families with 1 acre of land each, to build the biggest hydro

electric project in the world. Another example of the benefits of centralized control and coordination by the Chinese government concerned China's importation of huge amounts of fertilizer. Remember when potash was $2000/ton? That changed when China negotiated a massive potash contract for the entire country, rather than let individual Chinese companies negotiate for themselves. The price of potash dropped to hundreds of dollars per ton, because the whole country together was a mega-client with negotiation clout. This lowered farming costs a lot in China, helped food prices across the country and hurt Canadian potash companies.

More recently, China's focus has been on increasing employment. Some of its initiatives have been building super modern, beautiful, impressive infrastructure. Bridges that reduce transportation costs are infrastructure investments with an economic payback. Building beautiful pedestrian bridges that look like they belong on the Jetson's (a cartoon show about a family living in space well in the future) may have artistic merit well beyond their functionality and building apartments beyond current demand for housing provides employment, but doesn't provide utility beyond that. Getting a return on the money borrowed to pay for these projects wasn't seen as important. Now the companies that got all that money may never be able to pay it back and there may not be economic payback either in terms of increasing China's competitiveness or productivity commensurate with the investment in these projects.

In the news every day for the last few weeks is the second largest property developer in China, Evergrande, a company once ranked by Forbes as the 120th largest company in the world. It grew at break-neck speed on borrowed money. It expanded into a theme park, a sport club, electric vehicles etc, all on the back of debt. In Sept, Evergrande announced that it can't sell the apartments it built fast enough to pay the interest on its debt. In October, they did default on foreign debt payments, even though they had the cash to pay. They did pay all domestic interest owed. The impending failure of such a large company is rocking the Chinese stock market, but maybe it's just the tip of the iceberg. There is concern that the Chinese companies that provide raw materials for construction may be the next companies who run into severe difficulties.

Over the last year China has shown signs that it's fearful of the power of some of its most successful companies, especially ones dominating the internet (with huge power to influence culture and people's opinions) or impacting the education system (which again has the power to transform society). The Chinese government has been reigning in powerful, domestic companies and isn't concerned with whether that hurts economic growth and profitability. That has spooked investors, especially western investors who didn't expect the government to limit companies' options or restrict the areas of their growth, which of course impacts profits. We have seen this impact many emerging market funds this year.

Such action by the government is making it more difficult to invest in China. Regardless, some of the largest, most sophisticated, analyst-heavy institutions in Canada, like Canada Pension Plan (CPPIB), Ontario Municipal Employers (OMERS) and the Teachers' Pension Plan (OTPP) are now allocating 10% of their investments to Asia (which for sure includes Japan, Taiwan, Indonesia, India etc, but which is mostly China.) Fund managers have also been increasing exposure to China in their portfolios. Maybe that's because Emerging Market companies are at 10 year low valuations relative to developed markets.

In 1989 US economic dominance seemed to be threatened by Japan, which had 9 of the 20 largest companies in the world. Now Japan has no companies in the top 20, but China has 3 and the US 13 (none of which are the same as the ones on the 1989 list). The UAE, France, Taiwan and Korea have the others. So some Chinese companies are definitely emerging as world-shaking forces (like Facebook,

Apple, Amazon, Netflix, Google, Tesla, and Microsoft are), but China is facing slower productivity gains, massive debt levels and misallocated capital, that is capital spent on projects and companies which wouldn't even be profitable enough to pay the interest on the money spent on them. China's private and public debt is over 300% of GDP (Gross Domestic Product), whish is almost triple that of Canada. And China is facing huge power shortages and health problems related to its pollution levels. On the other hand, the US is still entrepreneurial, capitalistic, and innovative with a relatively educated population and reasonable infrastructure (compared to much of the rest of the world). Revenue (using GAAP accounting) is growing faster in China than in the US, but free cash flow (something that can't be fudged by accounting) is growing faster in the US. One of the best reasons to keep betting on the US is that it spends more on research and development than the rest of the world combined.

Buffett said "For 240 years it's been a terrible mistake to bet against America,". Maybe the US can hold on for years to come as the world's dominant economy.

Source: Sept 24, 2021 Webinar by Valens Research

A Few Pieces of Good News: To end with good news, let's look at poverty. 9.6% of people in the world live in extreme poverty (that is, they live on less than $1.90/day). "What!", you say. How is that good news? Well, it's a huge, huge improvement from 1990, when nearly 36% or people in the world lived in extreme poverty. (Context is so important, isn't it?) Such improvement is worth acknowledging, even though there is much more to do at home and abroad. Source: WorldVision.org

On a personal note, Jordan had a successful first year racing in the Canadian professional motorcycle championship series this summer, finishing 6th in his rookie year at the professional level, against the best in Canada, who average 10 years more experience at the professional level than Jordan.

You may also notice some initials after Jordan's name that weren't there last quarter. He finished the arduous path to become a Certified Financial Planner.

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