

Finding Comfort in a Troubled World



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Image credit: Charles M. Schulz

2018 was a tough year for investors. Our Model Portfolio declined 6% in value. That was the fourth time in 24 years that we had a negative return. While that is not a bad record, it's disappointing nonetheless.

I want to tell you about a recent experience I had that I think might help shape the discussion about the economy, the stock market and our approach to investing.



High School Stock Market Contest

My oldest son is in Grade 12 and one of his closest friends – Jacob – asked me to teach him about the stock market. His economics class is running a stock market contest. Groups have \$100,000 of virtual cash that they can use to buy and sell stocks over a 6-month period.

The contest started just in time for the recent correction and the team that is winning so far is the one that hasn't done anything. They are sitting on cash. All the other teams, including Jacob's, have lost money, but nobody is too concerned because they aren't playing with real money.

That is not the case for the rest of us and I know that stock market corrections are unsettling.

The holiday's are normally a fairly calm time for markets, but not this year. From the end of November through to Christmas Eve, the U.S. stock market dropped 15%. Canadian stocks fell 9% over the same period. Although markets have recouped much of those losses, that sort of volatility rattles nerves.



People worry about what might trigger a more significant setback. Lately, the shortlist of concerns includes:

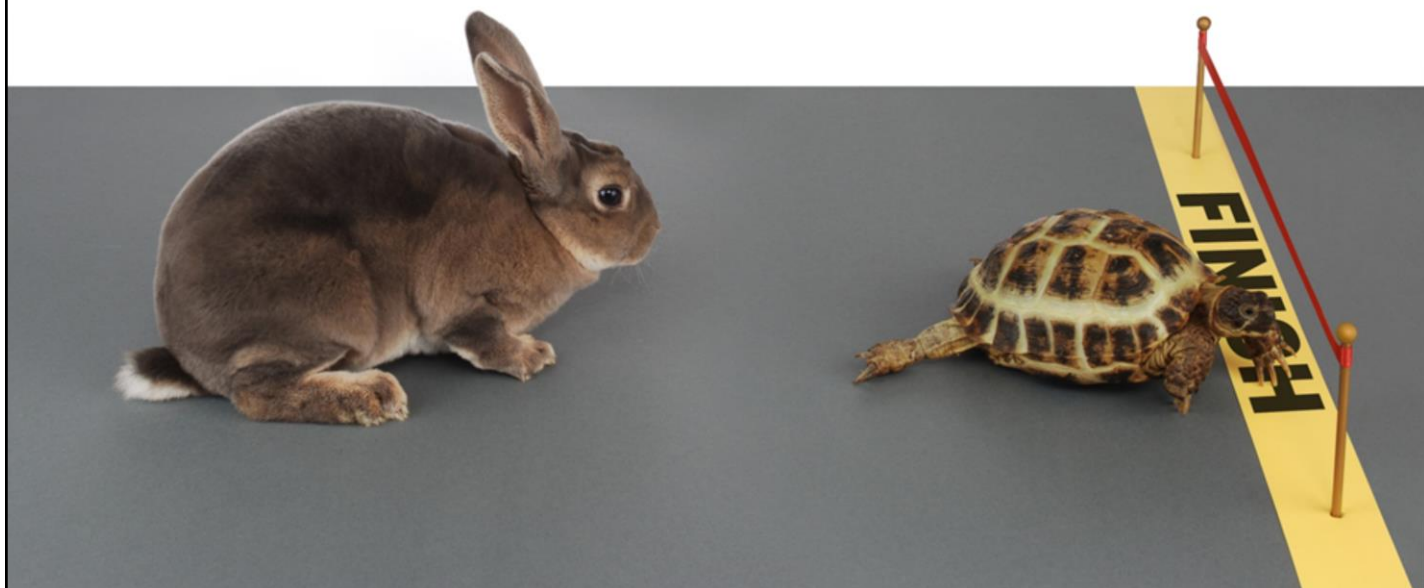
- 1) Trump – his trade war, the U.S. government shutdown and the standoff over the wall;
- 2) Rising interest rates;
- 3) Debt – U.S. debt in particular;
- 4) The economic cycle and
- 5) Stock valuations.

We are in the 10th year of economic expansion since the Financial Crisis, and there is a lot of debate in the media about the timing of the next recession and the risk of a further drop in stocks.

These are all valid concerns and things that we think about when recommending stocks and giving advice on the positioning of portfolios.

Jacob asked similar questions. But, I couldn't answer them until I gave him some context and shared some key lessons about investing. There were eight lessons and I'll touch on each.

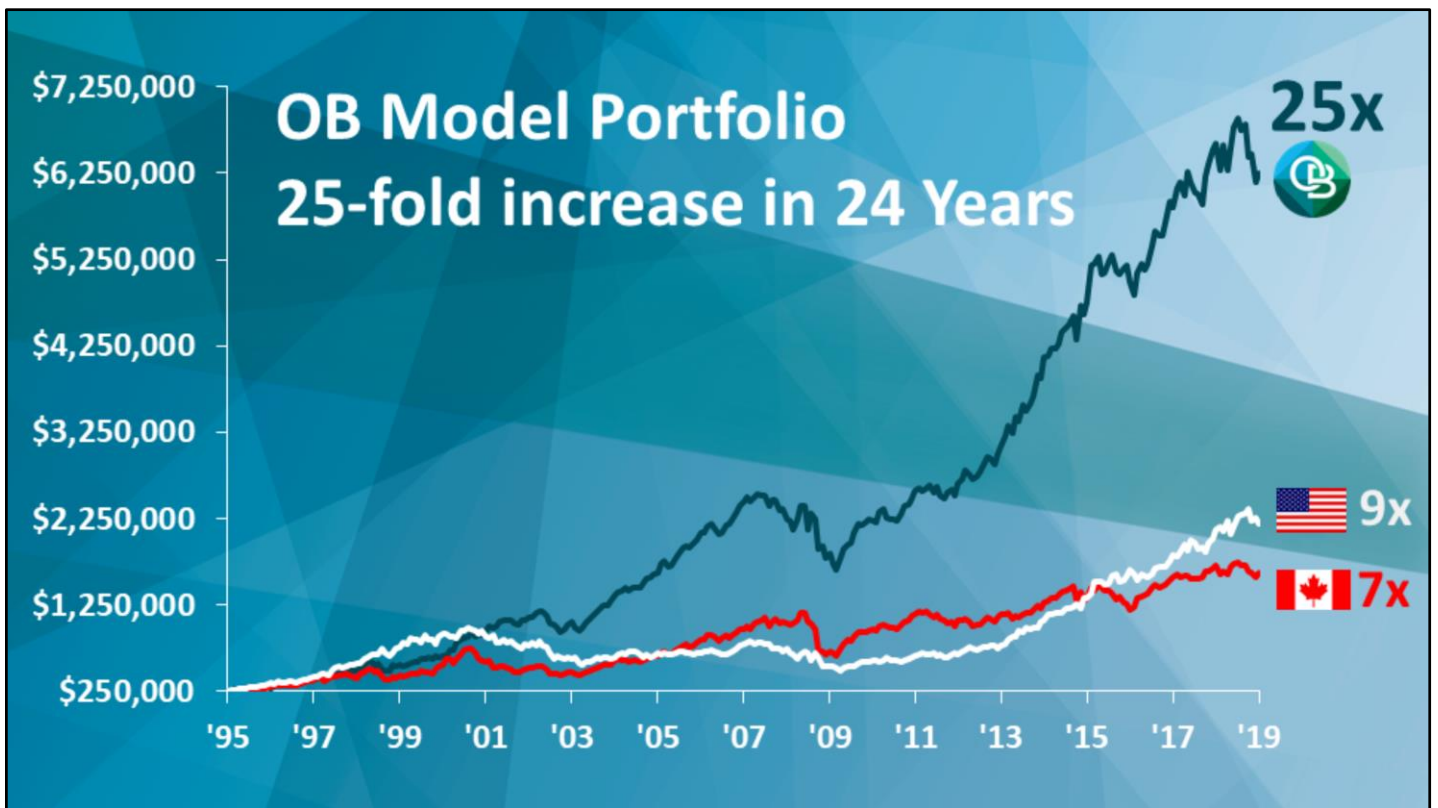
1 Investing is a marathon, not a sprint.



The first lesson is “investing is a marathon, not a sprint.” It’s a long-term endeavour.

If you only have a 6-month time horizon, which is the length of their stock market contest, and you put money in the stock market, it’s called speculating – not investing. Markets are not predictable in the short term; there are countless factors that can cause stocks to behave counterintuitively.

I can teach Jacob how to be a good investor, but most of that advice won’t help him win the contest. I’ve participated in plenty of stock-picking contests over the years and I’ve proven that I’m mediocre, at best, at picking which stocks will win the short-term sprint. We are much better at running marathons and putting together stock portfolios that will do well over the long term.



I told him about our Model Portfolio – a hypothetical all-stock portfolio that holds 40 to 45 businesses across a variety of industries, primarily in North America. This slide highlights the performance of the portfolio since inception. It has risen from \$250,000 at the end of 1994 to about \$6.2 million today, a 25-fold increase in 24 years. You can see that the portfolio has done quite a bit better than the benchmark equity indices in Canada and the U.S.

We have been successful because we have held a diversified portfolio of good businesses through good times and bad.



2 Own Long Term

You don't hear about private business owners selling their business because Trump tweeted something outrageous or because the Dow Jones Industrial Average dropped 500 points.

Business owners are successful because they are in it for the long-term, and you should think the same way about stocks.

Stocks represent partial ownership in businesses. Just like private business owners, you will do well if you commit to owning great businesses for the long term. That's lesson 2.

3 Diversify



Lesson 3 is the importance of owning a diverse group of businesses.

It's very hard to know in advance which stocks will do best. Diversification helps reduce a portfolio's volatility, as stocks typically don't all move in the same direction at the same time. Being well-diversified makes it easier to weather the inevitable ups and downs.

4 Time in the Market



Not Market Timing

I also told Jacob that it's "time in the market, not market timing" that counts.

It's easy to get the impression from the media and the so-called experts that jump in and out of the market is the key to success, but nothing could be further from the truth.

Those who accept market volatility invariably do better than those who try to anticipate it. Not once over the last 24 years have we made a call to get out of the market. If doing so was in our playbook, I'm sure we would have made some good calls; but we would have made mistakes too, because markets are very hard to predict in the short term. Those mistakes would have been costly and would have undermined our long-term results.

5 Sustainable Competitive Advantages



Jacob naturally wanted to know what makes a good business. We talked about companies that are profitable and growing. I told him it's important to think about whether a company has sustainable competitive advantages that will allow it to maintain a high level of profit.

Top of the Class



FORTIS INC.

KraftHeinz

XPO Logistics

ENBRIDGE

[intact]

Google



ROGERS

Brookfield



VISA

CP



amazon

BCE

Johnson + Johnson

CARmax

This slide highlights some of the companies in our portfolio that we believe have sustainable competitive advantages.

Sometimes it's great brands like Starbucks or Apple that sustain high profits. Sometimes a company's success is driven by the power of its networks, which get stronger and more valuable as they grow. Visa and Google are good examples of that. Sometimes companies can sustain a decent level of profitability because they have a monopoly or because there are few competitors, like railroads and telephone companies.

Management can make a big difference too, and there are plenty of examples of businesses in competitive industries that deliver stand-out performance because of great management. My colleague Steve Boland will talk about one a little later.

The key message I gave Jacob is to own companies that he is confident will be bigger and more profitable down the road, because if they are, the odds are very good they will be more valuable too. It's not hard to figure out which are the best companies; most of the time it's common sense. It's the businesses that make the products or offer the services we all want.



But if investing is common sense, Jacob wanted to know why do so many people have a bad experience in the market and struggle to achieve their goals? I told him it is because there are exceptions to every rule, and stock prices don't always behave the way we think they should. Because the stock market is volatile and unpredictable in the short term, it's very easy to be emotional and make mistakes.



Stocks can behave counter-intuitively!



Let me use a couple of high-profile companies – Netflix and Tesla – to explain how confusing the market can be.

In July, Netflix reported a more than 300% increase in second quarter profits and the stock dropped 13% in afterhours trading.

Tesla, on the other hand, announced a horrible second quarter. Their loss doubled from a year earlier; they were burning through money and running out of cash – and yet the stock went up 17% on the news.

Those counterintuitive moves are tricky to explain when you are trying to teach someone about the market. Why did Netflix go down on good news and Tesla go up on bad news?



6 Prices Discount the Future

That is lesson 6: stock prices discount the future, not the past.

The past can provide some clues about where a company might be heading, but it's what investors think about the future that determines whether a stock price rises or falls.

Netflix is no doubt doing well, but the stock probably went down because it wasn't doing as well as investors thought it would. Tesla's shares may have rallied when it reported big losses because the losses weren't as big as investors expected.

Stock prices discount the collective expectations investors have about the future. What matters is whether the company does better or worse than those expectations.

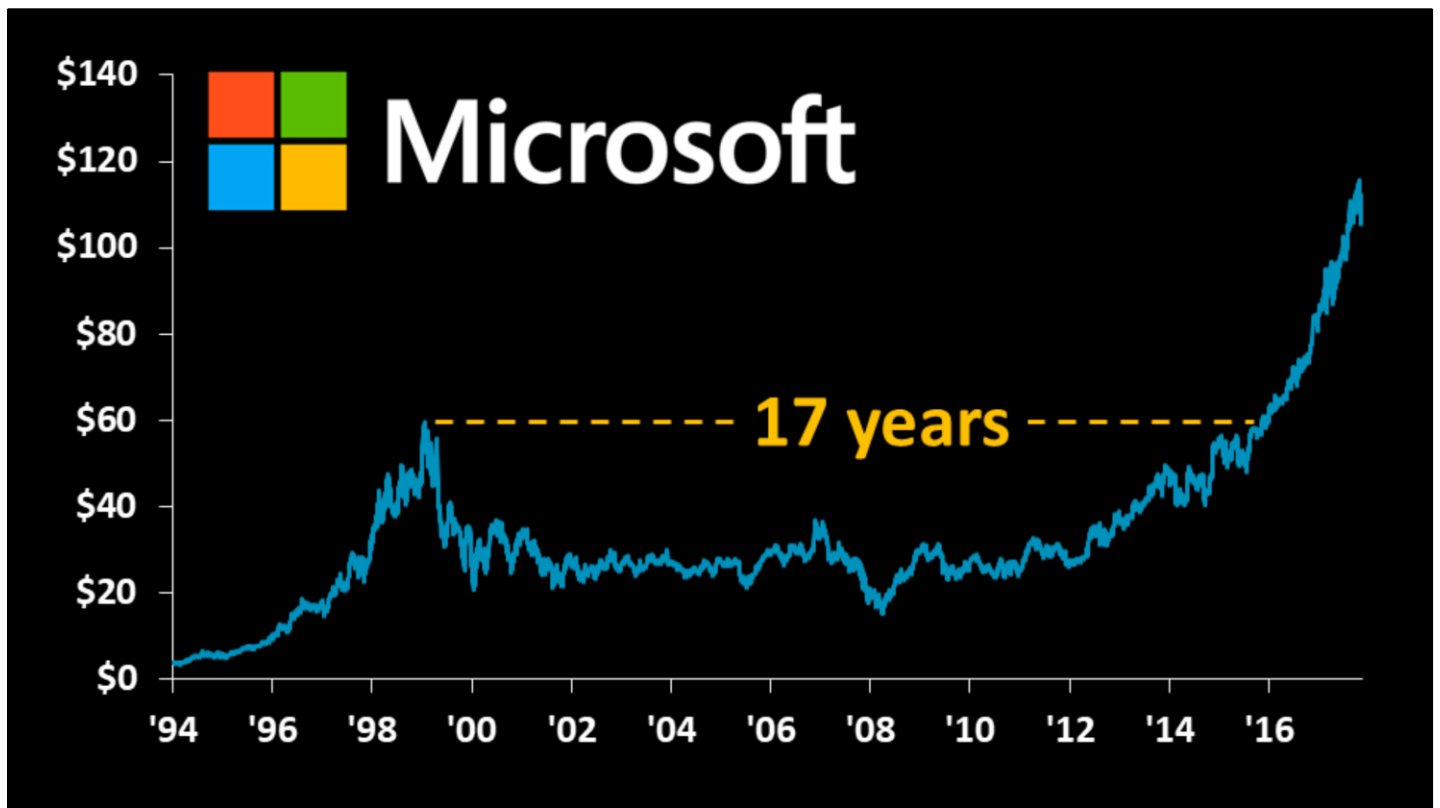
7 Price Matters



That naturally led to the next important lesson: price matters!

If a good business is priced too high, you can lose money. Conversely, you can make money buying out-of-favour companies priced low enough, if you think their futures will be brighter than what is reflected in the current stock price.

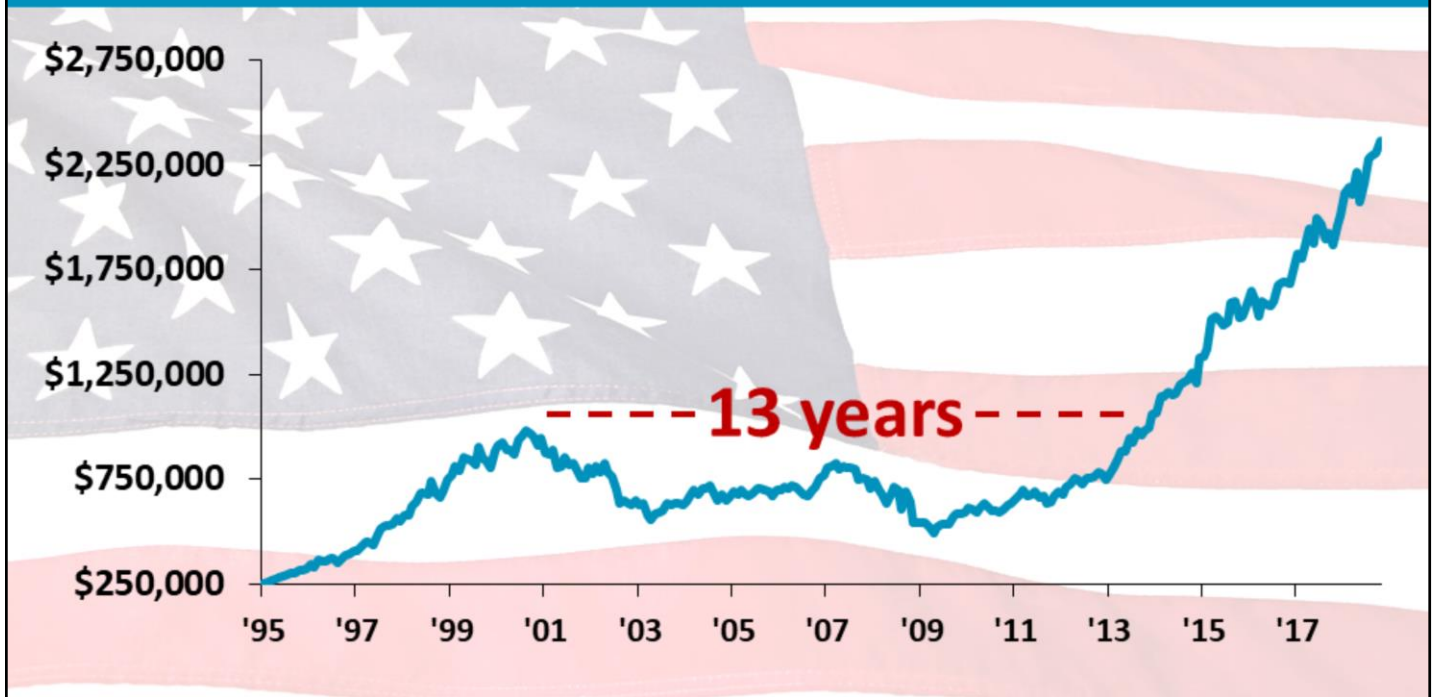
The technology mania in the late 1990s is a great example of the perils of paying too much.



This is a chart of Microsoft’s stock price – it peaked in 1999 and then crashed along with many other technology companies when profits didn’t live up to investors’ lofty expectations. It took a long 17 years for Microsoft to get back to its 1999 peak, and that was despite a more than seven-fold increase in profits per share over the period. Even worse than Microsoft, many dot-com companies didn’t survive at all. Canada’s biggest internet-related stock, Nortel Networks, ultimately went broke.

It wasn’t just the technology companies that were expensive in the late ’90s. The biggest and best U.S. companies were also very expensive. Blue Chip stocks like Johnson & Johnson, Coca-Cola and Wal-Mart were priced at 35 to 50 times earnings, more than double the valuations that would have been appropriate.

S&P 500 Total Return Index (CAD)



The consequence of all the overvaluation, is that it took the U.S. market 13 years to recover from its year 2000 peak, as highlighted in this chart.

8 Beware of Manias



The lesson is to beware of investment manias and be careful not to pay too much for popular stocks, especially those that are in exciting new industries. Excitement attracts capital and competition, and that can have a negative influence on profits.

I told Jacob that our portfolio didn't suffer when the technology bubble burst and U.S. Blue Chip stock valuations came back to earth, because we weren't in those stocks.

Instead, we kept our money in Canada and concentrated our investments in businesses that were not popular. They weren't the fastest growers or in the sexiest industries, but they were much cheaper than they should have been relative to their prospects.



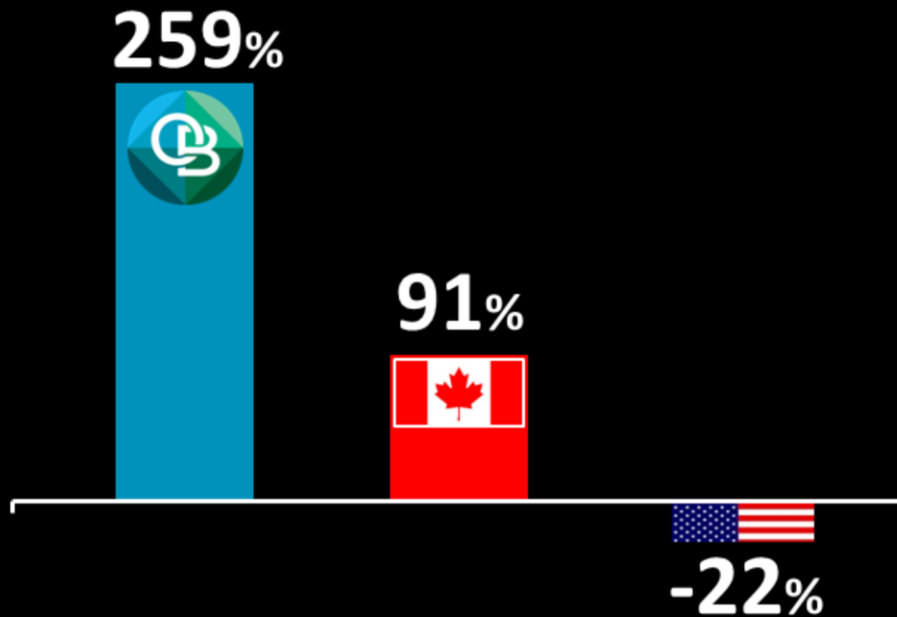
The downside to acting differently than the crowd, is that it is hard on the nerves. It requires patience and faith in our process.

By default, if you don't own the fast rising mania stocks, you are not keeping up with those who do. That causes envy. Worse, you likely own a number of stocks that are out-of-favour and performing poorly. That creates regret.

It's hard on everyone when the investment winds are not blowing our way. I ask our analysts a lot more questions. Our advisors wonder if our Research team has lost its mojo. The conversations that you have with your advisor are not as fun. More time is spent talking about the securities that are not doing well. It's natural to have doubts and to want more of what is going up and less of what is going down. It's natural to feel nervous and uncomfortable.

Many people act on those emotions and make changes at the wrong time. They sell what is not working and buy what is popular and performing better. Unfortunately, doing so sets the stage for poor performance down the road.

Patience Yielded Rewards (2000 – 2007)



Fortunately, patience paid off. Many of the stocks that weighed on our performance in the late 1990s were the ones that drove our returns in the 2000s. Between 2000 and 2007, our Model Portfolio appreciated almost 260%, much better than the 91% gain in the Canadian market and the more than 20% drop in the U.S. benchmark.

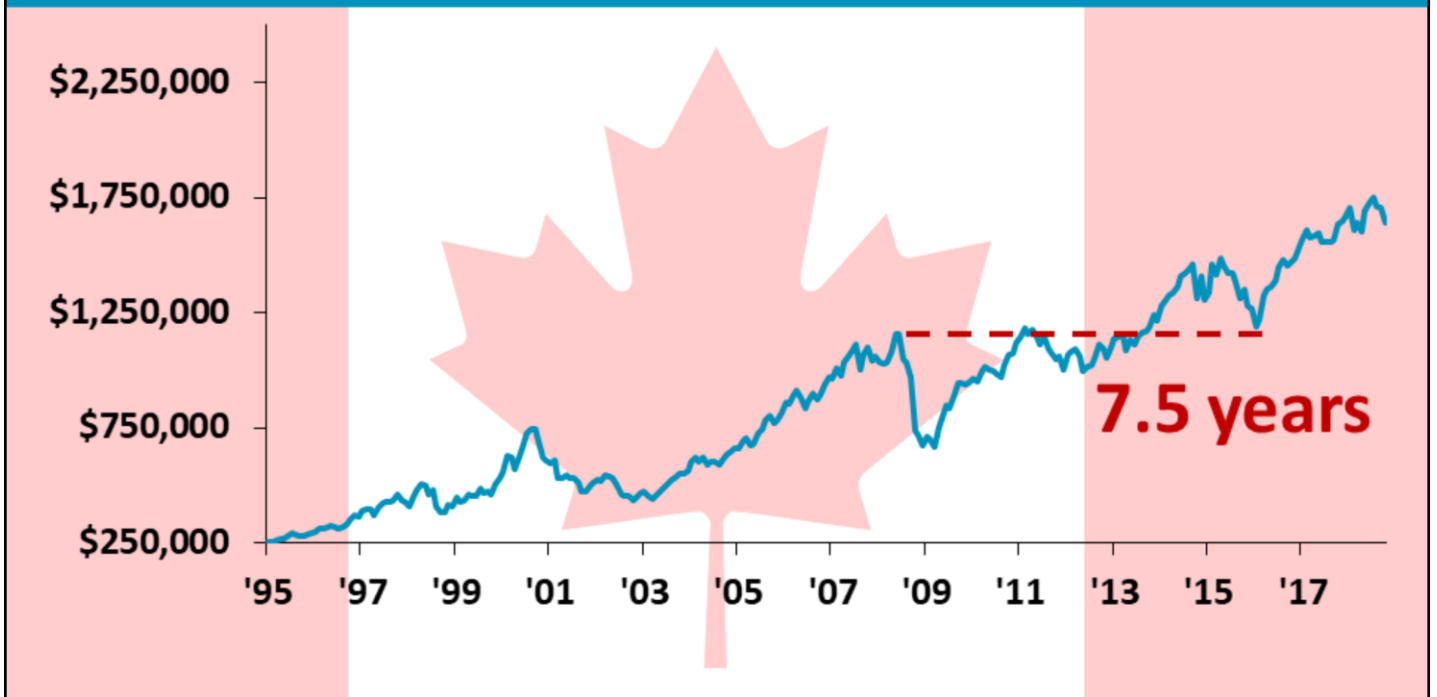
Move Up the Quality Chain



In 2005 and 2006, we saw an opportunity to move up the quality chain and own better businesses. Canadian resource stocks were getting popular and rising in price, while U.S. blue chip valuations were falling to reasonable levels. So, we sold Canadian resource stocks and bought U.S. Blue Chips.

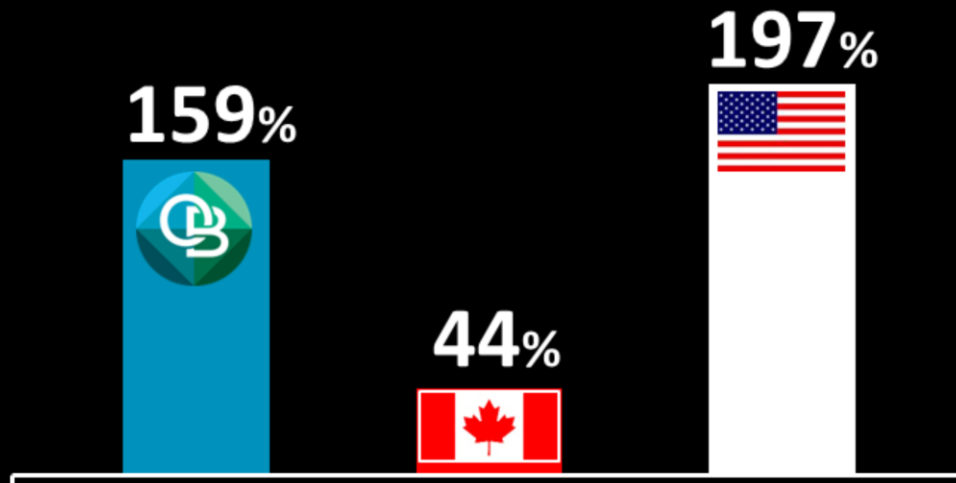
It was a great long-term move, but I can tell you that it once again tried everyone's patience. In 2007, a mania developed toward resource stocks, and many felt that we didn't get it and were missing the resource boat.

S&P/TSX Total Return Index (CAD)



Fortunately for us, investors' love affair with resource stocks didn't last. The epicenter of the 2008/09 Financial Crisis may have been the U.S. housing and banking sectors, but it is the Canadian stock market that has suffered the most. Because resource stocks weren't discounting the possibility of an economic cycle and a slowdown in China, it took 7.5 years for our benchmark stock index to sustain a break above its peak in 2008.

U.S. Blue Chips Served Us Well (2008 – 2018)



Being underexposed to cyclical stocks and owning a decent complement of higher quality U.S. businesses has served us very well. Over the 11 years since the end of 2007, prior to the Financial Crisis, through to the end of 2018, we achieved a total return of almost 160% (159%), roughly 4 times as much as the Canadian stock market benchmark (44%).



Jacob said, “That’s great, but what now? What strategy is going to work best for the next 10 years? What about Trump, trade wars, the wall, rising interest rates and all the debt? There could be a recession and stocks could go down more.” I told him that is possible, but nobody really knows what will happen in the short term.

The more relevant question to ponder, I told him, is whether current stock prices are discounting a future that is too optimistic or too pessimistic? To answer that question, I gave him some context around our view of the world.

A Slower-Growth World



Demographics

Debt

Divisiveness

Those of you who have heard me speak before know that we have been talking about a slower growth world for some time. It's a reality due to demographics, debt and divisiveness.

Population growth helps fuel economic growth, and the world's working-age population is growing at roughly half the rate than it used to, and that is not going to change anytime soon. There is too much debt in the world. With less capacity to increase leverage, that also puts a damper on potential growth. Social unrest is driving protectionist policies around the world. And that, too, is having a modest negative influence on global growth.



We think the global economy will continue to grow at a modest rate, largely because we don't see economic storm clouds on the horizon like we did before the Financial Crisis. This slide and the next are repeats from last year, because our view has not changed.

	THEN	NOW
<i>Monetary Policy</i>	Slam on the Brakes	Tap on the Brakes
<i>Interest Rates</i>	High	Low
<i>Oil</i>	\$140	\$50
<i>U.S. Housing</i>	Unhealthy	Healthy
<i>Banking</i>	Overleveraged	Underleveraged

A decade ago, central banks had slammed on the economic brakes by raising interest rates a ton; they are tapping on the breaks this cycle, with a more modest increase in interest rates.

Interest rates are still a lot lower than they were back then. With so much debt in the world, we don't think central banks will raise interest rates much more.

A decade ago, high and rising oil prices were killing consumers and businesses; oil prices are much lower today.

In 2008, U.S. homes were unaffordable, banks were poorly capitalized and making reckless loans; today U.S. homes are affordable, banks are well-capitalized and lending is prudent.



Trump and the trade war with China is unnerving, but we have seen this movie before. The Reagan administration had similar trade fights with Japan in the 1980s, as Japan, like China today, was seen as a competitive threat. Yet, the economy still expanded and the U.S. stock market tripled in value while Reagan was in office. We think the world will continue to grow despite the trade tensions.

Carrying more debt than ever!



People are forever asking if the level of U.S. debt worries me. My quick answer is not as much as debt in Canada, and other countries around the world. When you add up all the debt – consumer, corporate and government – and compare it to the size of our respective economies, the ratio of debt-to-GDP is roughly the same in Canada as it is in the U.S.

It's the composition of debt in Canada that worries me. Canadian consumers are very leveraged, more than Americans were before the Financial Crisis, and much more than American consumers are today. The U.S. has a lot of government debt and is running a big budget deficit, but government debt is inherently more stable than consumer and corporate debt, as governments can print money.

The theatrics around the wall and U.S. government shutdown are disturbing, for sure, but we also believe that pushback on divisive policies and unnecessary spending is a long-term positive.



**Growth is more likely
than a recession.**

Relative to the rest of the world, the U.S. economy is in pretty good shape.

While we would be happier if there was less overall debt in the world, we are not worried about a financial collapse like the one a decade ago, because the global banking system is a lot healthier.

Bottom line: the world economy is in reasonably decent shape, with continued slow growth more likely than an economic setback.

Besides, we buy businesses, not economies. The more important question we need to answer is “are stocks, in general, pricing in the slow-growth reality?” We think they are. The valuation of the overall market is reasonable and many stocks seem to be discounting a future that is overly pessimistic.

It’s also comforting that we don’t have mania-like valuations. Aside from pot stocks, we don’t think there is an area of the market that looks dangerously speculative and pricey.



So what stocks should Jacob consider for his portfolio? I think there are many good options, which is why we are well-diversified across all areas of the market. I'll generalize by talking about three broad categories:

- 1) **Growth stocks** – typically businesses that are doing well and are popular;
- 2) **Value stocks** – normally businesses that face some near-term challenges and are currently out-of-favour; and
- 3) **Dividend payers** – companies that operate in stable industries, and the pay good dividends.

Let's start with growth stocks, many of which are technology companies.

Some think technology stocks are too popular and too expensive; they believe conditions are similar to the technology bubble at the turn of the century. That's like comparing apples to watermelons, in my opinion, as I lived through that mania and I can tell you that valuations are not as crazy like they were back then.

Take Google, for example. It trades at a small premium to the average stock, yet it is expected to grow three times as fast as the average company. That sounds like a pretty good trade off to me. Growth would have to slow a lot at Google to cause it to appreciate less than the average business over the long term, and I don't think that will happen. In fact, the premiums you have to pay for higher-quality growth stocks are pretty modest compared to history. Growth companies like Amazon and Visa are great businesses for Jacob buy and hold as a young person, as they have the potential to be much bigger and valuable down the road.

At the other end of the spectrum are the so-called value stocks – cyclical businesses, or lower-quality businesses, or businesses that are not executing their business plan well at the moment. They are very much out-of-favour and priced as if an economic recession is around the corner.



We have some dogs in our Model Portfolio – names like Coty, Colfax and ING. Canadian Energy investments have been a huge disappointment as well, with companies like Peyto and Cenovus near multi-year lows. Likewise, U.S. housing-related stocks – homebuilder TRI Pointe Group and timber company Weyerhaeuser, for examples – have weighed on our results.

We wish we owned fewer stocks that have gone down and more stocks like Starbucks and Rogers Communications, which have performed very well, and we know you feel the same way. We know it's frustrating to have the same eyesores in your portfolio quarter after quarter.

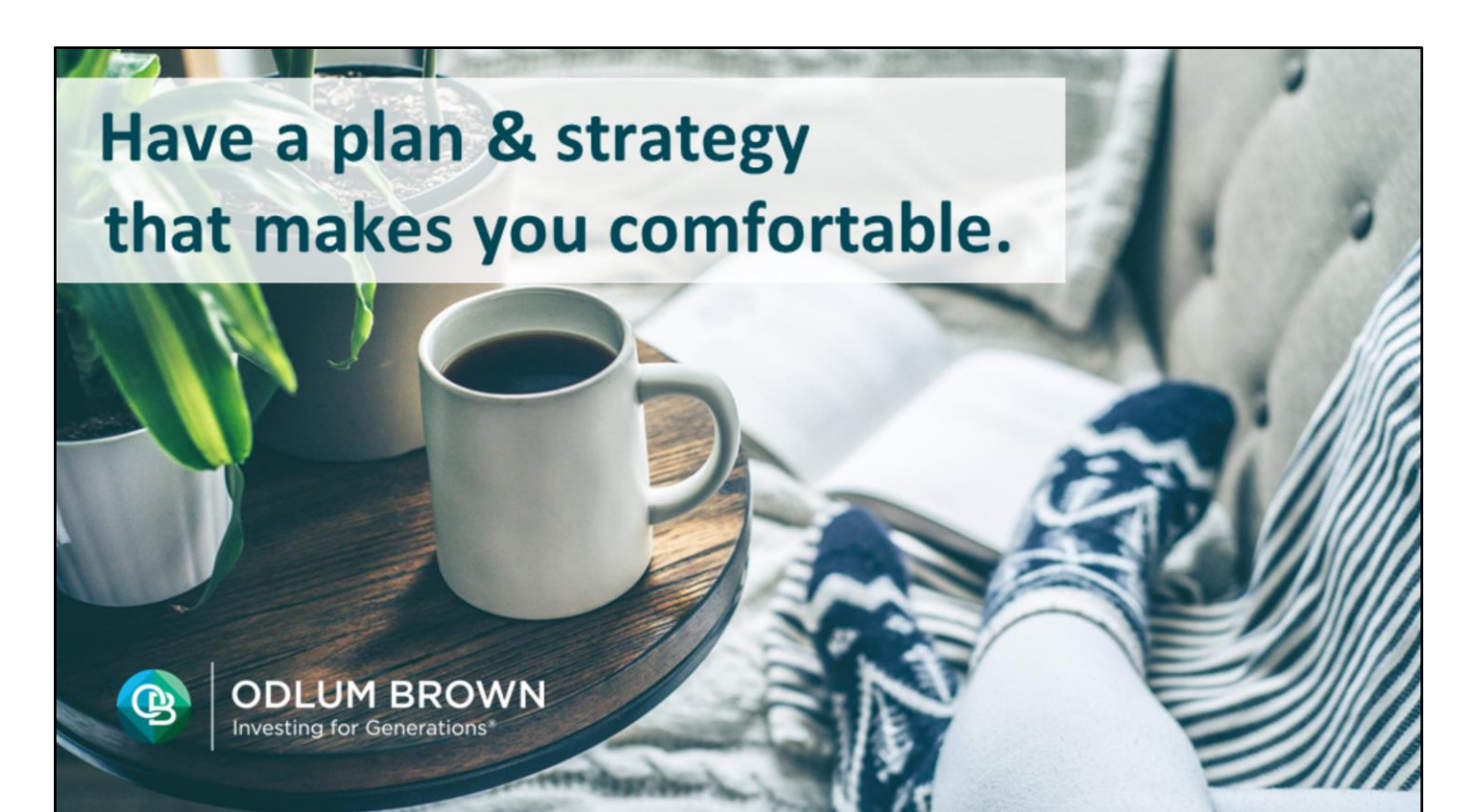
However, we have owned frustrating stocks before, and patience has yielded big rewards. Not all of our dogs will recover and do well, but if history is a guide, the odds are very good that many will be top performers down the road. Jacob should definitely diversify his portfolio with names that are causing investors discomfort.



The last group of stocks that Jacob should consider, are businesses that pay dependable dividends: utilities, telcos and consumer staples. Stocks like BCE, Fortis and Kraft Heinz have languished over the last couple of years, as interest rates have gone up. To some extent, we expect these stocks to underperform as interest rates go up. But we think investors have overreacted. Dividend yields are still very attractive relative to bond yields and the spread between the two is still very high compared to history. Interest rates would have to go up a lot more for these stocks to underperform over the long term, and we don't think that will happen.

People are always asking me for my top stock or favourite sector. I'm sorry to disappoint. I don't have answers for those questions. I don't have strong arguments to favour one area of the market over another.

Our strength is in designing diversified portfolios that will survive the inevitable ups and downs in the market and thrive in the long-run. And, we are optimistic regarding the portfolio of businesses that we own.

A photograph of a person sitting on a light-colored sofa, reading an open book. In the foreground, a white mug of coffee sits on a dark wooden tray. To the left of the tray is a small potted plant with green leaves. The background is softly blurred, showing the person's legs and feet in blue and white striped socks and blue sneakers. A semi-transparent white box with dark blue text is overlaid in the top left corner.

**Have a plan & strategy
that makes you comfortable.**



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The most important thing you can do is ensure you have a long-term plan. Work with your Portfolio Manager to make sure your asset mix between stocks, bonds and cash is suited to your goals and tolerance for volatility. There isn't a one-size fits all answer. Within the equity portion of your portfolio, make sure that you have a good balance between stocks that are doing well now and those that have pent-up potential. If you have strong convictions, by all means, put more emphasis on the stocks you feel most confident about.

The market is volatile and the best way to minimize emotional mistakes is by having a plan and a strategy that makes you comfortable.



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