Before Christmas, my fiancée and I got away to Cabo San Lucas for seven days and it was wonderful. It was the first time I'd been away from my boys for a whole week since they lost their mother to cancer seven years ago.

The boys are 16 and 18 now, and it was great to come home and see that the house didn't burn down and nobody starved.

I didn't leave them alone like my oldest wanted. I told them we needed someone to stay and look after the dog, but frankly I'm finding it hard to leave them on their own.

Nonetheless, with the kids getting older, I've been thinking a lot about letting go, protecting less and how best to help the boys mature and grow.

The light bulb really went on in a funny, yet shocking, conversation I had with my oldest son two summers ago.

He was going to a friend's cabin and I told him he should take some steaks and I'd teach him how to cook them. That would help get him invited back and besides, he'd need to cook if he went away to university.

He told me that wouldn’t be necessary because he’d just order from “Skip the Dishes.”

Wow, did I have some re-parenting to do! I guess I modeled ordering food a little too well. That was a big wakeup call and a sign that I needed to set different expectations.

All of us with kids have struggled with the trade-off between protecting and letting go. If we are too protective, kids don’t learn from experiences and mistakes, mature and grow.

In many respects, the balance I'm trying to get right for my boys is similar to the balance between protection and growth that we're looking for in our investment portfolios. Like raising children, it's not easy sometimes.

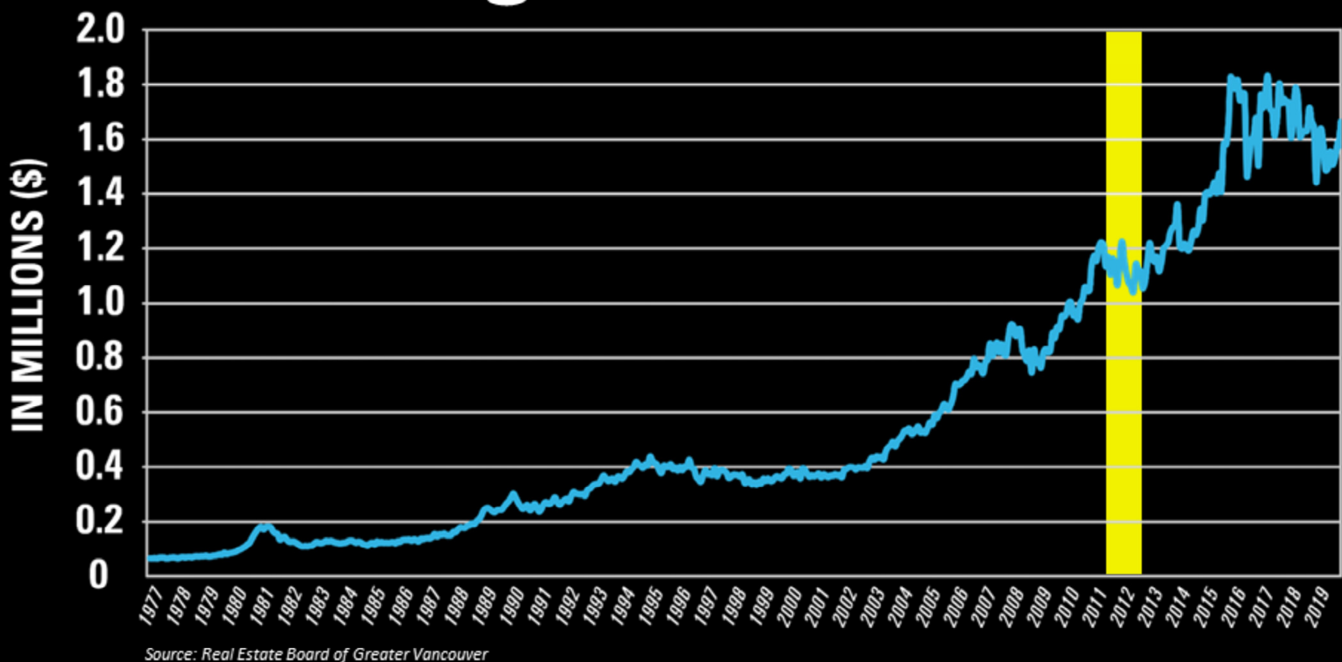
In fact, in my 25 years at Odlum Brown, I don't think it has ever been more challenging to protect and grow wealth.

Let me explain by reflecting on something I shared at the Annual Address in 2012.

On a Friday night in May 2011, I ordered pizza for my boys. When the delivery guy arrived, he asked a very unusual question. He asked if I wanted to sell my house. When I explained that we liked our home and weren't interested, he told me that he had a lot of great contacts in China and that he could get me a very good price.

Legend has it, Joe Kennedy knew it was time to get out of the stock market before the 1929 crash when he received stock tips from a shoe-shine boy. His thinking was that by the time the shoe-shine boy was excited about the stock market there was probably nobody left to buy and drive stocks higher. It turned out he was right.

Similarly, I thought the housing market might be due for a correction when pizza delivery guys were brokering homes.



My theory looked good for a moment in 2012, with the average Vancouver home price falling from a peak of $1.2 million to a little more than $1.0 million.

But, I wasn't right for long. As you can see in the chart, the average Vancouver home is $1.7 million today.

That got me thinking about just how much prices have inflated since I was starting a family 19 years ago.

They have risen more than fourfold, from less than $400,000 to $1.7 million.

I thought housing prices were irrational and out-of-sync with the general level of income when we bought our first home in 2002, and yet the average price has risen at an annual rate of more than 8% since then.

At that rate, the average Vancouver home will be $6 million by the time my oldest is 35 years old, the same age I was when I bought my first house.

The reason I'm telling you this story is twofold.

First, I think there is a lot more inflation in the world than governments want us to believe. There certainly is for the younger generation and those who don't own homes.

Second, I tell this story because I want you to understand why home prices and other financial assets are rising rapidly.

Monetary Policy

It’s due to extremely accommodative monetary policy – ultra-low interest rates, in other words.

Ever since the financial crisis, central banks have been printing money and keeping interest rates low because they are trying to stimulate growth and ensure we don’t have deflation. Deflation and the world’s excessive debt would not mix well, as they could set in motion a deep economic setback. Consequently, central banks err on the side of caution and keep interest rates low.

Low interest rates help stimulate economic growth in a couple of ways. They encourage consumers and businesses to borrow and spend. They also cause asset prices to rise, which, in turn, makes people feel richer and inclined to spend.

The strategy has worked well. Unfortunately, it won’t work forever. There are two major adverse consequences of cheap and easy monetary policies.

Social Unrest

The first, and most worrisome, is that they are fueling inequality and social unrest in the world.

The relatively small group of people who own the majority of the world's financial assets are getting richer and richer, while the rest feel like they are falling further and further behind.

The other major negative consequence of ultra-low interest rates is that they are fueling an even greater buildup of debt in the world. In that sense, we are treating the debt problem with medicine that is slowly killing us. It's not a formula moving the world to a healthier and more stable state.

The central banks are acutely aware of the negative consequences, yet the easy money policies persist. The U.S. Federal Reserve and other central banks tried to raise interest rates and tighten policy in 2018, but after the global economy slowed and stocks had a big correction, they quickly reversed course.

Stocks rose sharply last year because the shift to lower interest rates brightened the near-term economic outlook and put recession fears to rest.

Unfortunately, central banks are like over-protective parents. Their policies make us feel safe in the short term, but they are not setting us up for success in the long term.

The world really needs better government and less easy money, but that is not likely to happen in the near term.

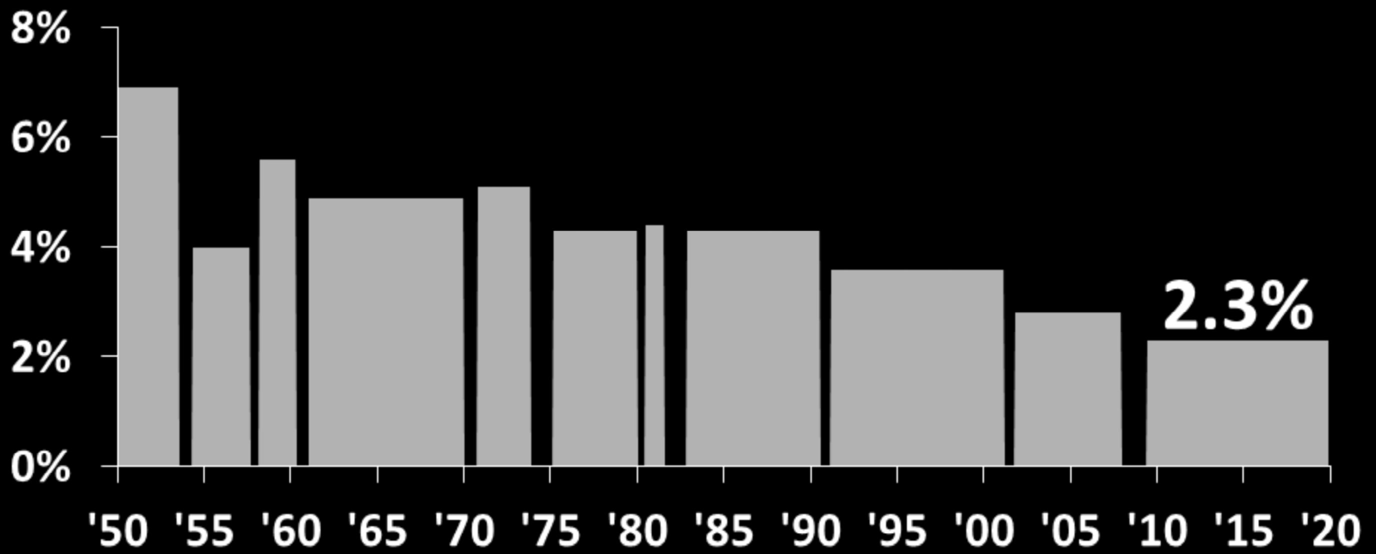
That makes our job tough. On one hand, we should be cautious because the world doesn't have good leadership or a long-term plan to deal with social unrest and excessive debt. Yet on the other hand, there is a good chance central banks will continue to inflate asset prices because they fear deflation more than the long-term consequences.

Despite the feeling that Vancouver housing prices were crazy, I didn't let the pizza guy sell my home eight years ago because I didn't want to take on the risk that easy money policies would further inflate prices. It's still among the reasons why I'm not selling my home today, and I think we should probably have the same attitude about shares in great businesses.

I say "probably" because there are other considerations.

The world is not growing as fast as it used to, and stocks are not cheap.

I'll address the sluggishness of global growth first.



The current U.S. economic expansion has the dual distinction of being the longest and the weakest in postwar history. The point is illustrated in this chart, which compares the current expansion with past cycles. The width of the bars represents the duration of each expansion and the height is the average annual growth over each cycle.

The long and weak characteristics of the current U.S. recovery have been mirrored around the world, and the contributing factors are fairly universal.

The biggest contributing factor to slower global growth is demographics – working age populations are growing a lot slower than they used to, and that will hamper global growth for the foreseeable future.

Excessive debt is also weighing on growth. Not only has overall debt leverage increased in the world, but much of it is not going to productive purposes. For example, many businesses are borrowing to buy back stock. That helps shareholders get richer, but doesn't do much for society. Consequently, it has taken increasing amounts of debt to produce incremental growth in the world.

That's not a good trend.

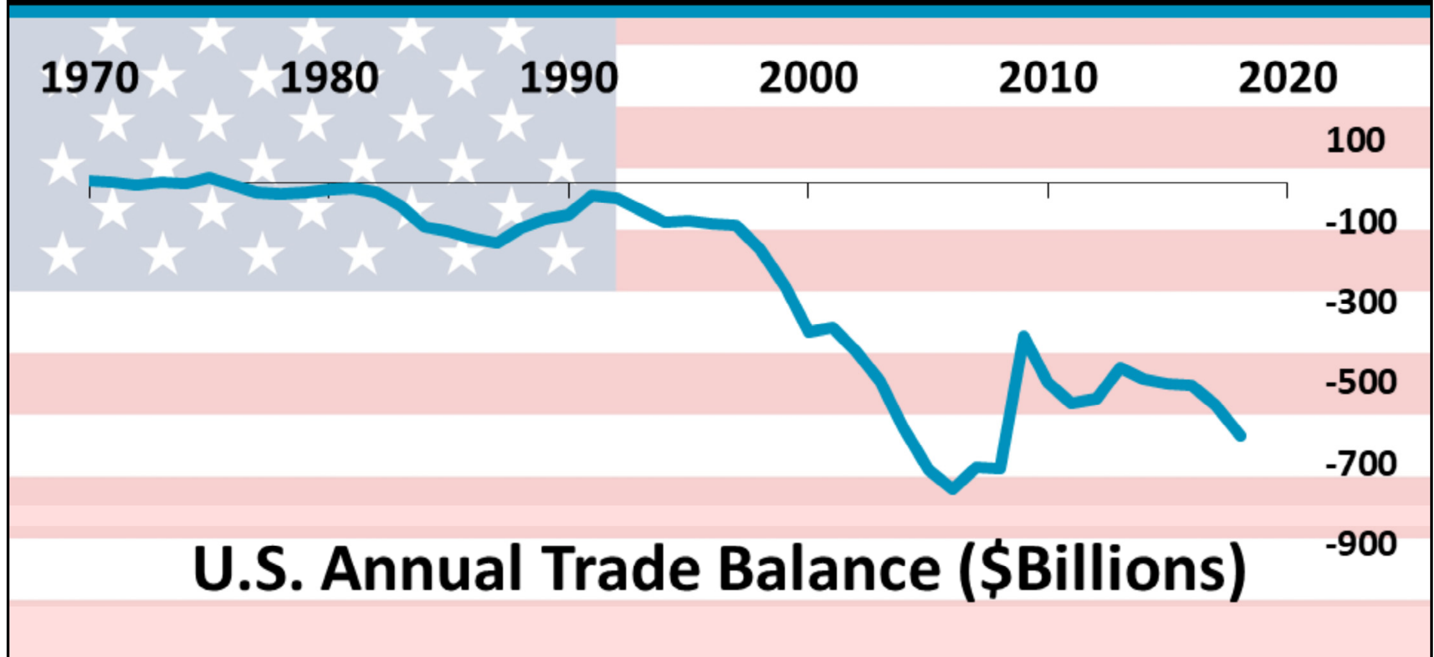
The growth dampener that get the most headlines is protectionist trade policies, principally tariffs.

While there has been some progress on the U.S./China trade war, we think trade friction will continue to be an issue that weighs on global growth and spooks the market from time to time.

The American view on globalization and free trade is changing, and we think it's important to understand why.

In university, we were taught that society benefits from trade because there are more winners than losers. The winners include consumers, who benefit from lower prices and more choice, and entrepreneurs and workers who benefit from selling the products and services in which they have a competitive advantage to the rest of the world. The losers include all those who lose their jobs to cheap overseas labour.

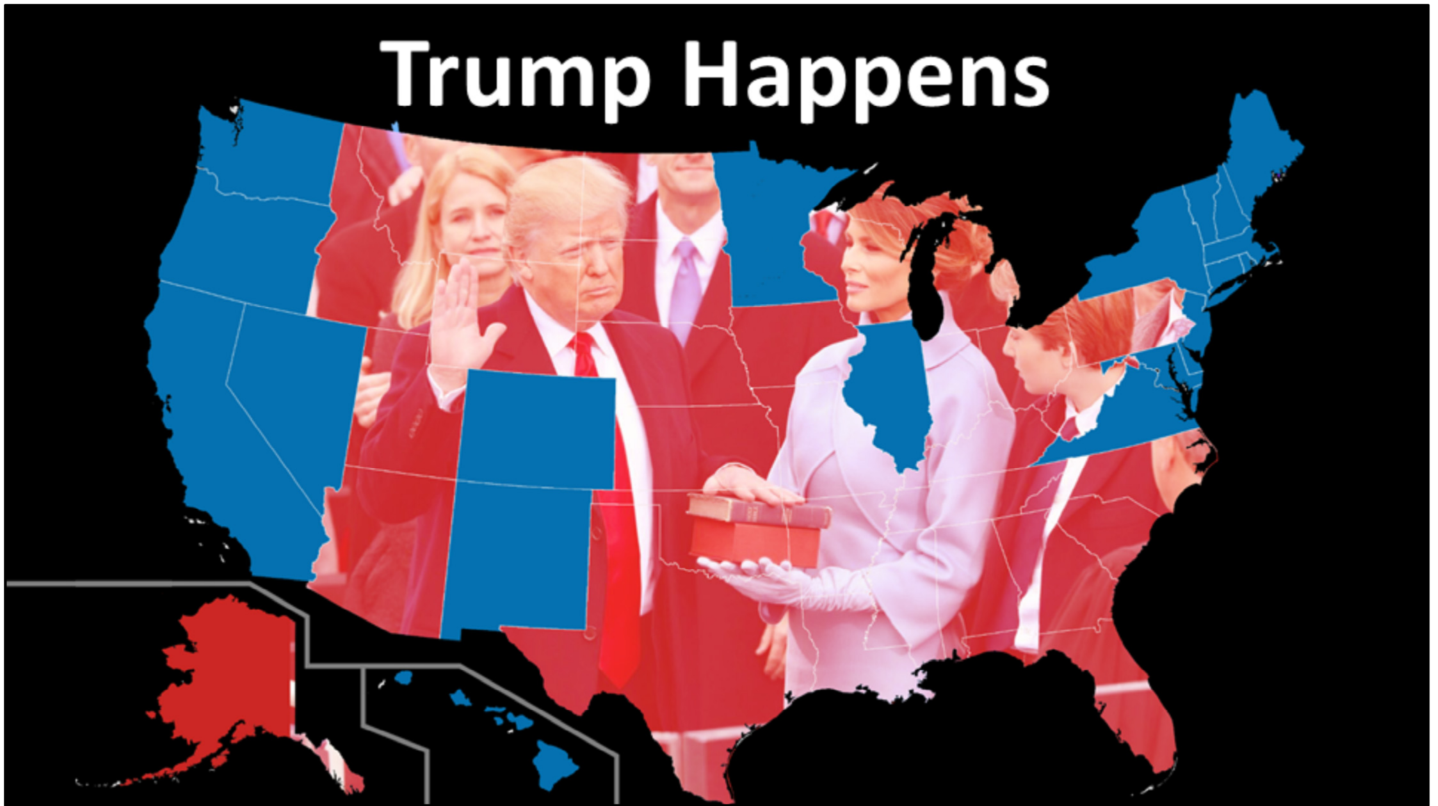
The one thing they didn't tell us in university is that this conclusion is based on a key assumption that trade is balanced. Unfortunately, that is not what has happened in the "real" world.



For 40 years, the United States has had a trade deficit, meaning imports exceeded exports. In the first year, there was small group of losers and a few more over the next couple of years. Not a lot.

But after 40 years, there is a HUGE number of unhappy people who have lost their high-paying manufacturing jobs to cheap foreign labour.

You know what happens when that happens?



Trump happens!

This chart shows the electoral map from the 2016 election.

Hillary Clinton's Democrats won the coasts, but Trump's Republicans won the states in between. That's where all the farmers and manufacturing workers who have suffered from freer trade live.

The industries that have benefited disproportionately from free trade are on the coasts – Silicon Valley and Hollywood in the west and Wall Street and the defense industries in the east.

There are a lot of angry people, and that is driving crazy, polarized politics in the United States and around the world.

The combination of unfavourable demographics, excessive debt and divisiveness will make slower global growth a reality for a long time to come. As a consequence, we should expect corporate profits to also rise at a slower rate over time.

Stocks can rise and have risen at a faster pace than corporate profits in recent years because valuation multiples have expanded as interest rates have fallen.

What happened in 2019 is a case in point. Corporate profits barely increased last year and yet the U.S. and Canadian equity benchmarks rose 32% and 22%, respectively.

While we believe there is still scope for valuation multiples to increase further, it's not realistic to expect double-digit returns from stocks when growth is slow and valuation multiples are already on the higher side of reasonable.

For those reasons, we need to lower our return expectations. We used to expect stocks to generate average returns of 8-10% over the long term, but 5-7% is a more realistic expectation today.

Let me reflect on history to reinforce the point that elevated valuation multiples can have a dampening effect on returns.

Total Returns (1999 - 2019)

199%

S&P/TSX
Index

Compound Annual Returns

6.3%

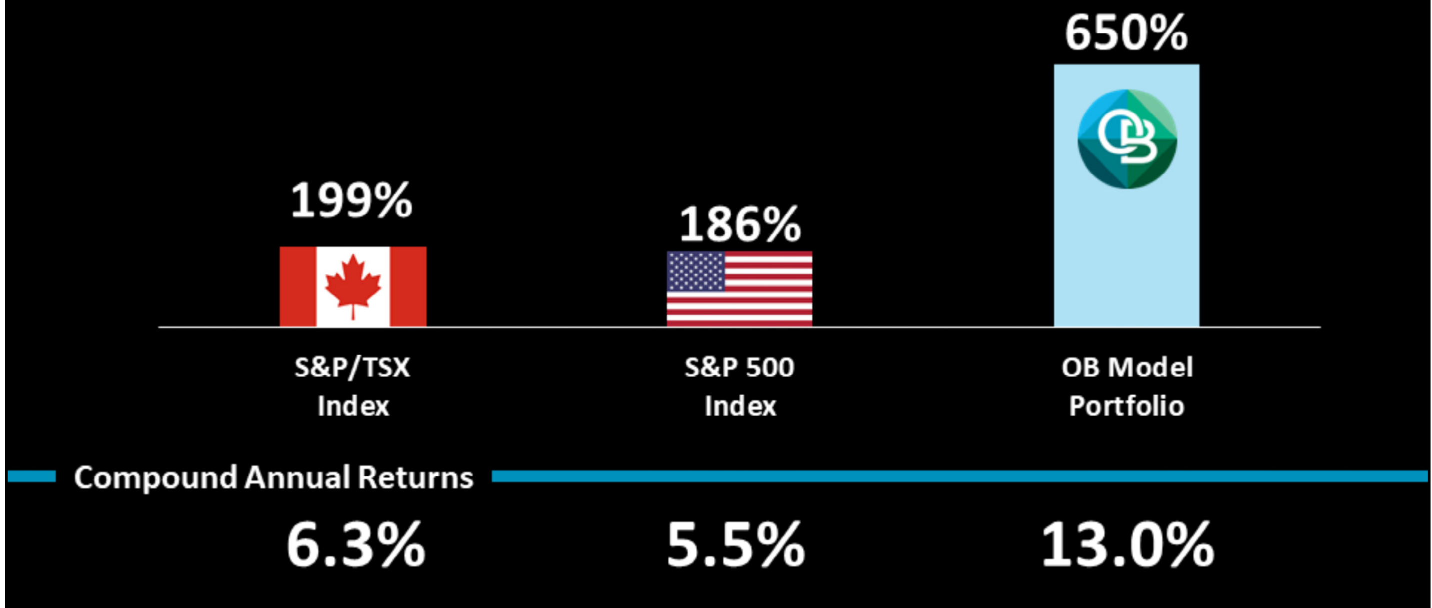
Over the last 20 years, the Canadian stock market has produced a total return, including dividends, of about 200%, or 6.3% compounded annually. That is not terribly inspiring, and that's because the Canadian market was very expensive during the technology mania at the beginning of the 20-year period. Because of the ultimate demise of just one technology stock – Nortel Networks – and the Resource sector boom and bust in the 2000s, our stock market didn't embark on a sustained recovery from its peak in 2000 until 2016.

Total Returns (1999 - 2019)

S&P/TSX Index	S&P 500 Index
199%	186%
Compound Annual Returns	
6.3%	5.5%

Still, you might be surprised that the Canadian market did better than the U.S. market over the last 20 years.

The American market returned 186% in Canadian dollar terms, or 5.5% compounded annually. It performed worse because overvaluation was more significant and widespread in the U.S. in the late 1990s. Not only were technology stocks stupidly priced, but America's biggest and best companies also traded at ridiculous valuations.



The Odlum Brown Model Portfolio has performed considerably better than Canadian and U.S. stock markets over the last two decades for two reasons. First, we didn't own the over-hyped and overpriced stocks during the manias. Second, there were plenty of attractively priced high-quality alternatives during those previous periods.

In the late 1990s, we kept our money in Canada when investors were chasing overpriced American stocks. With the exception of a few technology stocks, there were a lot of attractively priced, high-quality businesses in Canada at the time. In the mid-2000s, during the Resource mania, we shifted money out of Canada and into America, because their biggest and best companies were out of fashion and cheap.

Being different during those two important periods really made a difference. Our Model Portfolio appreciated by 650%, or 13.0% compounded annually, over the last 20 years.

The challenge in the market today is that everyone is chasing the same thing.

The high-quality businesses we like are popular and pricey. Unlike during the mania periods I had mentioned, the crowd's behaviour is fairly rational; investors appreciate the uncertainties and risks in the world and are gravitating toward the businesses that are best positioned to thrive in that environment.

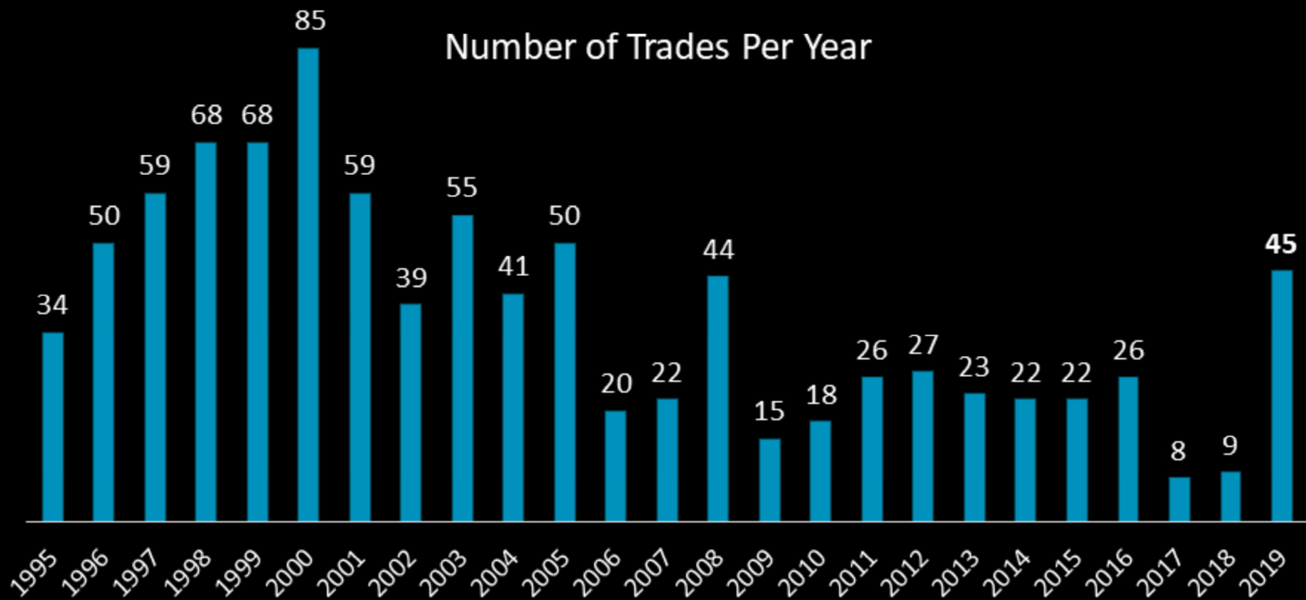
There simply aren't many high-quality businesses trading at great prices.

Most of the cheap stocks are cheap for good reason. They either have too much debt, poor management, operate in challenged industries or have some other problem.

Earlier in my career, you could buy such unpopular stocks and count on a robust economy to lift profits and investor sentiment and drive impressive returns. However, that strategy doesn't work very well in a slow-growth world.

You might be wondering, if the best businesses are somewhat pricey, should you sell? I don't think that's the right thing to do, at least not yet.

My experience and understanding of history and human nature cause me to believe that valuation multiples could be higher, and perhaps a lot higher, before the cycle is over. Over the years I've spent a lot of time studying great businesses, other cycles and the evolution of sentiment and valuations, and I can tell you that trends often run a lot longer than you think. For example, the popular Nifty 50 stocks in the 1970s, which included companies like Polaroid, McDonald's and Disney, traded at much higher multiples than the companies everyone loves today. The same is true of technology and American blue chip stocks in the late 1990s – valuation multiples were much higher back then.



Having said that, it doesn’t mean we are sitting on our hands.

After making fewer than 10 trades in each of 2017 and 2018, we made 45 trades in our Model Portfolio last year. That’s the most trades in 11 years!

This slide highlights the logos of all the stocks in the Portfolio, and I think you'll agree we own a lot a great companies.

The trading we've done recently was about achieving better diversification and balance. We were uncomfortable with the concentration of popular and pricey stocks in the portfolio. As such, we trimmed the winners, liquidated some losers, reduced cyclicality given that we are 11 years into an economic cycle and increased positions in good dividend-paying companies.

We also added three new names in the last six months, including: TC Energy for its dependable dividend, wealth manager Charles Schwab, and Albemarle, the world's largest producer of lithium used in electric vehicle batteries.

In total, our dispositions aggregated to approximately one-third of the Portfolio's value, whereas the stocks we bought represented roughly one-quarter. With more selling than buying, we built up a cash position of about 10%. We subsequently put 3% of the cash into a gold ETF, which owns physical gold bars.

Adding cash and gold to the Portfolio has caused a bit of a stir, and made people wonder if it's a sign that we are expecting a big correction. *We are not!* At least, not any more than usual.

We are always prepared for corrections, as they are something you have to live with if you want to be a good investor. Frankly, we think a market melt-up is more likely than a correction. Still, we added cash and gold for diversification purposes.

I'll explain why.

The big drop in interest rates has pushed up the prices of most assets, including homes, U.S. growth stocks, dividend-paying stocks, REITs, infrastructure, venture capital, bonds, you name it, such that most investors have a lot of exposure to assets that are popular and pricey.

In other words, most of their eggs are in the same basket. They are not well diversified.

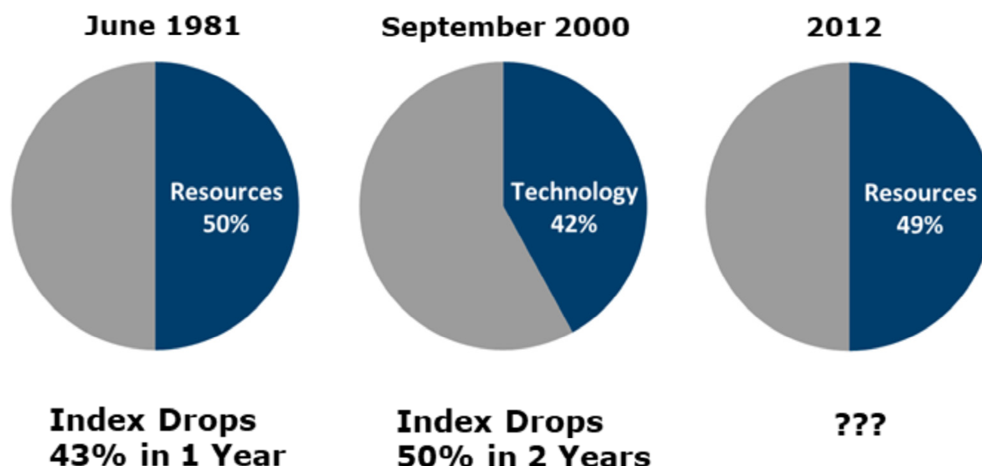
Because we are struggling to find high-quality businesses that are out-of-favour and cheap, we added cash as a buffer for when stocks do poorly.

More recently, we shifted some of that cash into gold, because gold will work even better as a portfolio diversifier.

We continue to own resource stocks, and energy stocks in particular, despite their horrible performance, because they are out of favour and extremely cheap, and also because they provide diversification.

I know everyone's patience is wearing thin on energy stocks, but it's important not to miss the forest for the trees. Being significantly underweight resource stocks is one of the major reasons why our Model Portfolio has appreciated more than three times as much as the Canadian stock market over the last decade.

In fact, the reason I told the Pizza Guy story in 2012 was to encourage clients to diversify outside of Canada and into blue chip American stocks.



This is the slide I used eight years ago to highlight the popular and pricey nature of Canadian resource stocks. The point I was making at the time was that Canadians had enormous exposure to China, with half of our benchmark represented by resource stocks and our home prices also very much influenced by Chinese buyers.

Back then, investors thought the world was running out of cheap oil and other materials.

Now, the worry is that oil reserves will be worthless as the world goes electric.

We think the idea that oil reserves will be worthless will be as wrong as the idea that we were running out of cheap oil. The truth likely lies somewhere between the two extremes.

Now that investors like China and resource stocks a lot less, we think energy stocks have a lot of potential.

But please don't get the wrong impression; we are not telling you to load up. Energy stocks are not without controversy and we don't think it would be prudent to invest too heavily. Energy producers are about 10% of the Portfolio.

My main message today is not about shifting large sums of money from one country to another or to compel you to favour a few sectors over others. Rather, it's more about making sure you don't have too much concentration in assets that are popular and pricey.

If some of the assets in your portfolio aren't causing you some grief or controversy, you are probably not well diversified.

I love my Visa and Apple shares and a lot of other companies that have done well, but in investing it's important not to be too greedy. We should hang on to the great businesses, but we should also diversify our risk. That's what we've done in the Model Portfolio.

We believe the major market indices will appreciate 5-7% over the long term, and we hope to do a bit better than that based on the composition of our portfolio today. Of course, we will be working hard to find opportunities to do better than that. But until those opportunities present themselves, we think it's best to have a more conservative posture.

The best way to protect and grow wealth is to own great businesses and make sure your portfolio is adequately diversified.

If central banks continue with their cheap and easy monetary policies, as we think they will, the price of homes and great businesses will likely continue to go up. If we don't hang on to these financial assets, we risk falling behind.

While great businesses are not immune to market corrections, we can be confident that they will survive adversity and thrive over the long term.

The diversification into cash, gold, energy and other contrarian positions will help reduce volatility along the way.

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Investing for Generations®

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