ODLUM BROWN REPORT

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ODLUM BROWN
Investing for Generations®

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The Devil's in the Details: Quality is Paramount

Looking back, 2021 was a great year for the economy and many stocks. After contracting in 2020, the global economy expanded by an estimated 5.6% last year, while the MSCI World Index produced a total return, including dividends, of 21.2%.[1] The main Canadian and U.S. equity benchmarks led the world's major markets with returns of 25.3% and 27.5%, respectively.

While the overall global economy is back on its pre-pandemic expansion track, many markets are still struggling. In particular, stocks in developing countries have lagged, with the MSCI Emerging Markets Index producing a loss of 3.4% in 2021. The Organisation for Economic Co-operation and Development (OECD) believes that lower-income economies, particularly those where vaccination rates are low, are at risk of being left behind.

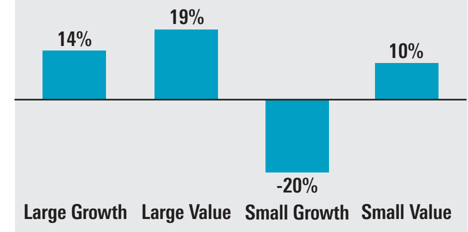
The OECD predicts that global growth will moderate to 4.5% in 2022 and 3.2% in 2023, and cites inflation as the greatest risk to the economic outlook. If elevated inflationary pressures prove to be persistent, central banks might have to raise interest rates sooner and by more than expected.

The prospect of slower economic growth and higher interest rates has made investors nervous. Consequently, equity market volatility has recently intensified. While the major stock market averages are holding fairly close to their highs, there have been notable shifts in which stocks are leading and considerable drawdowns in parts of the market.

Many of the popular stocks in the first half of the pandemic have fallen hard, while those that initially lagged have recently performed remarkably well. Growth stocks in general, and small growth stocks in particular, were the early winners, but it's the smaller growth stocks that have fallen the hardest.

SMALL GROWTH STOCKS OUT OF FASHION

($Cdn Total Return: Feb. 9, 2021 - Jan. 15, 2022)*



* Based on Russell Growth and Value Indices
Source: Odlum Brown, Bloomberg

In fact, since peaking in the second week of February 2021, a little less than a year ago, and through to January 15, 2022, the Russell 2000 Growth Index of smaller stocks is down about 20%. Since that time, large growth stocks are up roughly 14%, while large and small value stocks are up 19% and 10%, respectively.

Let's look at one exchange-traded fund (ETF) that is illustrative of this trend. Cathie Wood, CEO of ARK Invest, was the star investment manager in 2020, but her success peaked around the same time that small growth stocks were hitting their highs. Since its peak in February 2021, Wood's ARK Innovation ETF is down about 50%, paralleling the decline in the Goldman Sachs Non-Profitable Tech Index. While the businesses in the fund have exciting long-term prospects, many have yet to earn a profit. Large holdings in the fund, such as Teladoc Health, Zoom Video Communications, Roku Inc., Spotify Technology, Block Inc. (formerly Square Inc.) and Shopify have suffered major declines.

What's noteworthy is that since the pre-pandemic market peak on February 20, 2020, and through to mid-January 2022, the ARK ETF has underperformed the broad U.S. market and some big value names.

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Odlum Brown is proud to support Hope Air as a sponsor of Give Hope Wings, a round-trip flying expedition between British Columbia and Manitoba to raise awareness and funding for Hope Air.

Hope Air is Canada's national charity providing flights and accommodations for those in need of support when travelling for vital medical care far from home.

Last year's Give Hope Wings expedition met and exceeded its $400,000 fundraising goal – enough for Hope Air to provide more than 1,200 flights for patients in need. It also raised awareness of Hope Air and general aviation, and the enormous good they accomplish together to bridge the gap between home and hospital.

For more information, visit hopeair.ca.

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Over the near 23-month period, the ARK ETF returned 30% versus 35% for the S&P 500 Index, 35% for Warren Buffett's Berkshire Hathaway and 47% for The Royal Bank of Canada.

Why are small growth and non-profitable tech stocks performing so poorly relative to other stocks? We believe it is because they were overhyped and overpriced. These stocks were major beneficiaries of the massive fiscal and monetary support provided by the authorities. Now that fiscal programs are abating and central banks are tapering their bond-buying programs and preparing to raise interest rates, the hot, hyper-growth stocks are losing their appeal and support. Market liquidity is still ample, but the general expectation is that it will deteriorate as the year progresses. The market is forward looking, and stock valuations are starting to matter more to investors as they look ahead to a time when financial conditions and liquidity won't be as favourable.

We think 2022 will be a tougher year for the economy and for stocks. As such, we believe investors should moderate their return expectations and be prepared for increased market volatility.

Many pundits are arguing that value-type stocks, like banks and energy firms, will continue to perform better than growth-oriented stocks, like Google and Microsoft. Their view is underpinned by the mathematical reality that higher interest rates weigh more heavily on the valuations of businesses that produce greater earnings further into the future. Yet, it's also true that growth stocks tend to outshine value stocks when economic growth slows, as investors are usually inclined to pay a bigger premium for the narrower group of businesses that can deliver growth in a slower-growth world.

In general, we expect large-cap stocks – the big and familiar companies that dominate our clients' portfolios – to do better than small-cap stocks in 2022. This is typically the case when investors start to get nervous late in an investment cycle. Because central banks are expected to raise interest rates to fight inflation and since growth stocks are considerably pricier than their value counterparts, it's tempting to favour value stocks over growth. While that is a logical conclusion, we think it is too broad a generalization. The correct posture will likely prove to be more nuanced, in our opinion.

We think quality will override growth and value as the most important factor this year, and we believe both growth and value stocks with strong fundamentals will perform well in an environment with slower economic growth and tighter monetary policy. Larger, higher-quality growth businesses with deep economic moats and reasonable valuations should be favoured over more speculative, higher-growth businesses. Accordingly, we favour the FAANGM group of businesses (Facebook, Apple, Amazon, Netflix, Google and Microsoft) and other large growth stocks like Visa and Starbucks over the speculative, higher-growth businesses promoted by Ms. Wood and featured in the ARK ETF.

With many of the former market darlings down considerably from their highs, some investors see bargains and opportunity. While there are certain to be proverbial "babies thrown out with the bathwater," we caution against the idea of using discounts to peak values as a barometer. Peak valuations achieved during a liquidity-driven speculative craze are seldom good yardsticks to measure value. In many cases, the prices of the former darlings are still higher than their pre-pandemic levels and rich relative to their underlying fundamentals. If the fall-out from the dot-com bubble is a guide, it could be a long time before speculative growth stocks shine again.

Higher-quality value firms – both large and small – with solid and enduring business models and strong balance sheets should be favoured over lower-quality value businesses. Canadian Banks, Utilities, Telcos, Consumer Staples and Health Care are among the value-oriented industries that we think will outperform in 2022. While we are generally less enthusiastic about economically sensitive businesses, we remain constructive on Energy firms, as oil and gas prices will likely be supported by the lack of investment in the sector in recent years.

Above all else, we believe it's important to be diversified. While our top-down views on the economic outlook have some influence on our bottom-up, company-by-company analysis and recommendations, it's important to appreciate that economic forecasts can be wrong. Consequently, it's most important to focus on where businesses will be three to five years down the road and make sure portfolios hold a diverse collection of high-quality businesses that will endure and thrive in the long run.

MURRAY LEITH, CFA
Executive Vice President and Director, Investment Research
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[1] All return figures in this article are in Canadian dollars and include reinvested dividends.

Odlum Brown's 28th Annual Address

We are pleased to invite you and your guests to Odlum Brown's signature investment presentation, our Annual Address.

Join us for this virtual event, featuring a conversation with President and CEO **Debra Doucette** and Executive Vice President, Director, Investment Research, **Murray Leith**, moderated by Vice President, Director, Odlum Brown Financial Services Limited, **Michael Erez**. Debra and Murray will share their perspectives on the challenges and trends shaping our world today, as well as how Odlum Brown's business has evolved as we approach our 100th anniversary as a firm in 2023.

Murray will then explain why the path ahead is more nuanced than ever and how we are advising clients to navigate the increasingly complex investment landscape. Following Murray's presentation, our trusted team of Equity Analysts will join the conversation to discuss the obstacles and opportunities we see ahead.

When: **Wednesday, March 2 at 3 PM (PST)**
Where: **Virtual – Meeting link to be provided ahead of the event**
How: **Register at odlumbrown.com/rsvp**

We hope you will join us! Register today, or contact your Odlum Brown Investment Advisor or Portfolio Manager for more information.

ODLUM BROWN FINANCIAL SERVICES LIMITED

How to Interpret Your 2021 RRSP Deduction Limit Statement

After filing your income tax return each year, the Canada Revenue Agency (CRA) issues a Notice of Assessment (NOA) that includes your RRSP Deduction Limit Statement. Your RRSP limit is also available online through CRA's *My Account* and the *MyCRA* mobile app.

The statement shows how much you are entitled to contribute and deduct for the upcoming tax year and whether you may have over-contributed. Let's look at an example statement for 2021 that an individual taxpayer received with their 2020 NOA if they earned income of $138,889 and belonged to a registered pension plan.

2021 RRSP Deduction Limit Statement

RRSP deduction limit for 2020		$30,000	
Minus: Employer's PRPP contributions for 2020		-	
Minus: Allowable RRSP contributions deducted in 2020		($16,000)	
Unused RRSP deduction limit at the end of 2020		$14,000	
Plus: 18% (to a maximum $27,830) of 2020 earned income ($138,889)	$25,000		
Minus: 2020 pension adjustment	($12,000)	$13,000	
		$27,000	
Minus: 2021 net past service pension adjustment		-	
Plus: 2021 pension adjustment reversal		-	
2021 RRSP DEDUCTION limit		**$27,000**	**(A)**
Minus: Unused RRSP contributions previously reported and available to deduct for 2021		($ 7,000)	(B)
Available CONTRIBUTION room for 2021		**$20,000**	

The RRSP contribution deadline for the 2021 tax year is March 1, 2022.

How much can I CONTRIBUTE to my RRSP?

Your maximum contribution = [RRSP deduction limit for the year **(A)**] – [Unused RRSP contributions **(B)**]. Contribution room you do not use in 2021 can be carried forward to use in any future year, if contribution age limits are met. If **(A) – (B)** is negative (an amount shown in brackets), then you have no 2021 RRSP contribution room and may have an over-contribution. Negative amounts that cannot reasonably be expected

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to be deducted in future years or that exceed $2,000 (or exceed $8,000, if arising from a past service pension adjustment) at any time in the year may be subject to a penalty of 1% per month until withdrawn.[i]

Using the example above, the taxpayer could **contribute** up to **$22,000** ($20,000 + $2,000 over-contribution) for the 2021 tax year without penalty. The $2,000 grace amount for over-contributions is not immediately tax-deductible and will be included as unused RRSP contributions **(B)** on the next RRSP limit statement.

What are unused RRSP contributions?

Unused RRSP contributions, denoted as **(B)** above, are **contributions** made in previous years that have **not** been **deducted** on your income tax return. You may contribute amounts within your contribution limit, but choose not to deduct your contribution in a given year, if you:

- have excess funds available;
- would like to defer tax on income earned within the RRSP as soon as possible; and
- expect higher taxable income in future years, against which an RRSP deduction may be more advantageous.

In the example above, the taxpayer made $7,000 worth of contributions in previous years that have not yet been deducted from income.

How much can I DEDUCT on my tax return?

Your RRSP deduction limit for 2021 is the maximum amount that you can **deduct** on your 2021 tax return, referenced as **(A)** on your statement.

Using the example above, the taxpayer could **deduct** a maximum of **$27,000 (A).** They could do this by deducting all $7,000 of their unused previous years' contributions **(B),** as well as making and deducting a new $20,000 contribution.

Company Pension Plans

Contributions to a pension plan give rise to a **pension adjustment (PA),** which reduces your RRSP deduction limit for the **following year.** In our example, the PA from 2020 reduces the deduction limit for 2021.

Certain other pension transactions reduce or increase your **current year's** deduction limit. A past service pension adjustment (PSPA) in 2021 will reduce your 2021 limit, and a pension adjustment reversal (PAR) in 2021 will increase your 2021 deduction limit.

Group RRSPs and Pooled Retirement Pension Plans (PRPPs)

All contributions to group RRSPs or PRPPs by you or your employer will reduce your RRSP deduction limit for the **current year.** Be careful to consider all employer and personal contributions to group RRSPs, PRPPs and personal RRSPs to avoid over-contributing in the current year. Employer group RRSP contributions are included in your income, but can be offset by tax deductions available on contributions. Employer PRPP contributions do not impact your taxable income for the tax year, since they are neither included nor deducted from taxable income. Your own group RRSP and PRPP contributions are deductible from taxable income.

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MICHAEL EREZ, CPA, CGA, CFP®
Vice President, Director
Odlum Brown Financial Services Limited

[i] For information about the treatment of excess contributions, including voluntary disclosure and taxpayer relief provisions, please visit https://www.canada.ca/en/revenue-agency/services/tax/individuals/topics/rrsps-related-plans/contributing-a-rrsp-prpp/what-happens-you-over-your-rrsp-prpp-deduction-limit.html.

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