ODLUM BROWN REPORT

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ODLUM BROWN
Investing for Generations®

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From Hero to Zero and Back Again

The path to legendary investor status is rarely a straight line. It takes gut-wrenching twists and turns. We were reminded of one such legend – Bill Miller – and his famous roller coaster career, when he announced his retirement in early January.

Bill Miller notably outperformed the S&P 500 Index for 15 consecutive years, an unmatched record that ran from 1991 to 2005. Michael Mauboussin, a former colleague of Mr. Miller's, estimated the odds of such a streak at one in 2.3 million!

Miller ran a fund called the Legg Mason Value Trust. Despite the emphasis on value in the fund moniker, Miller invested heavily in technology (growth) stocks. Roughly 29% of his fund was invested in technology in 2000, which was the peak of the dot-com bubble. At that time, technology was considered well outside the purview of any self-respecting value investor. Sounds like a recipe for disaster, right? Well, Miller zigged when the market zagged. He reduced his technology holdings in the first half of 2000 and reinvested the proceeds into less popular and more attractively priced parts of the market.

When the technology sector entered a deep freeze, Miller made another couple of remarkable moves: he bought into the Google IPO in 2004, and he added to his Amazon.com position at depressed prices during the bust.

The sky was sunny for Bill Miller, and his fund grew by leaps and bounds for a few years. Then the Great Financial Crisis happened. This time Miller didn't zig. He dug his heels in and relentlessly bought financial stocks into the 2007-2008 downturn. His stubbornness was so fervent that he was parodied in the 2015 film *The Big Short* as the Bear Stearns investor who ignored the signs that things weren't so rosy.

The Legg Mason Value Trust declined by 55% in 2008. To add insult to injury, the fund's assets shrank from $20.8 billion in 2006 to $2.8 billion in 2011.

Miller split with Legg Mason and became an independent fund manager in 2016, renaming his business Miller Value Partners. Since then, he has climbed back to the top. Over the last 10 years, he has ranked first place in Morningstar's mid-cap blended fund category. Guess what his fund's largest holding is? It's Amazon.com, which he's owned in some fashion or another for the last 20 years.

Holding Amazon.com might seem like a no-brainer, given the company's success. Its shares have appreciated by 25,720%, or 32% compounded annually, over the past 20 years. But to achieve that return, one had to have the guts to hang on through some pretty terrifying corrections. Amazon.com's stock fell by more than 90% during the dot-com bust in the early 2000s. After recovering, it dropped more than 50% during the 2008/09 Great Financial Crisis. If you want to be a legend, you need to have ice in your veins.

We admire Mr. Miller's bold moves, conviction and perseverance. His ability to bounce back and still have an appetite for risk and contrarian stock-picking is unusual. Miller made his share of big mistakes. Still, his ability to evolve and retain conviction in the face of adversity separates him from the average professional investor.

It's nice to see Bill Miller go out on top. Well done!

STEVEN ZICHERMAN, MBA, CFA
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Credit Cards Are Not Going Away

In a recent tweet, Sebastian Siemiatkowski, CEO of buy-now-pay-later (BNPL) specialist Klarna, challenged the "old ways," saying, "We are coming for you… this decade will transform financial services." While the message was playfully adorned with a smiley face emoji, some investors worry that there's a deeper disruption brewing between new payment options and traditional credit cards. Is there really much to fear?

Klarna, which expanded to Canada last month, is a Swedish company that allows ecommerce merchants to offer installment plans to their customers. These plans generally consist of four equal payments without fees or interest, as long as all payments are made on time. BNPL companies generate revenue primarily by charging transaction fees to the merchant. Merchants are usually paid up front and in full, less the fee owing to their BNPL partner. Shoppers open an account on the BNPL platform, where they can see all their plan details and make their installment payments, typically from a debit card or direct bank transfer.

BNPL has surged in popularity, with the total number of users in the U.S. increasing by 300% per year since 2018.[1] This is for good reason. Companies like Klarna allow online shoppers to more effectively bridge the cash-flow gap between spending and their paychecks, thus making their purchases more affordable. On the flip side, merchants benefit from fewer abandoned carts, larger average purchases and stronger customer loyalty. This all happens seamlessly on checkout pages, without the endless paperwork and confusing fine print that comes with traditional purchase financing.

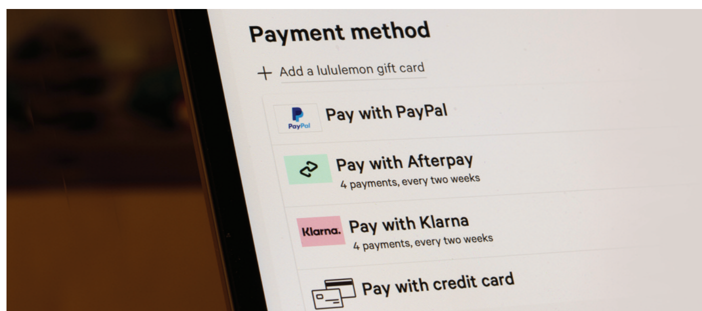
Consequently, the largest BNPL companies have become a powerful force. Klarna achieved a private market valuation of US$45.6 billion in June. Another large BNPL specialist, Australia-based Afterpay, was acquired by Square (now known as Block) for US$29 billion in August. The largest American BNPL company, Affirm Holdings, ended 2021 with a market value of US$28 billion.

Meanwhile, credit card balances have come under pressure during the COVID-19 pandemic. At JP Morgan Chase, the leader among U.S. issuers, credit card loans have declined by 9% over the past two years. Naturally, a narrative has developed that BNPL is replacing credit cards, and many payments companies have seen their share prices come under pressure as a result.

The leaders of BNPL companies have no problem feeding this narrative. Affirm CEO Max Levchin has described credit cards as "a financial service equivalent of a Stone Age hammer: great power, zero elegance or safety."[2] As for Mr. Siemiatkowski, he describes himself in another tweet as "trying my best to be the nightmare of the bank establishment worldwide." There's nothing wrong with ambition.

We believe BNPL has legitimate appeal, and there is certainly much more growth ahead for these companies. However, some of the commentary surrounding BNPL, particularly when it comes to displacing credit cards, has gotten carried away.

When looking at the data, BNPL still only accounts for 2% of ecommerce volume worldwide, and this seems to have largely come from displacing debit transactions, rather than credit.[3] Other data show that BNPL is driven by people with riskier credit profiles. For instance, in a recent study of 1,500 American users, nearly half of respondents said that "poor credit history and usually not being eligible for a credit card" was "one of the main reasons" for using BNPL. In the same study, over half of respondents admitted to using BNPL to spend beyond their means, and more than one third have missed at least one BNPL payment.[4]



Put another way, BNPL companies have been very successful at extending credit to people with more limited alternatives. Yet, when it comes to prying people away from their favourite credit cards, that's a much bigger ask. Credit card users benefit from consolidating their spending in one bill while collecting enticing rewards. Perhaps most importantly, it is very difficult to change people's habits.

As noted earlier, credit card balances have declined in the past two years, but this is due to COVID-19. Credit cards are used quite heavily for travel and entertainment spending, which experienced a falloff in purchase volume at the onset of the pandemic. Then government stimulus programs made it easier for people to pay down their balances. More recently, as the effects of stimulus have worn off, balances have begun to recover.

All the while, the BNPL industry has benefited from strong tailwinds that cannot last forever. Most notable is the benign credit environment; consumers are generally in healthy shape financially, and the BNPL industry has not yet been tested with widespread loan defaults. Also, the regulatory response has been practically nonexistent thus far, although that has started to change. As for the competitive response from banks and other established players, that has only just begun.

The Investment Opportunity

We've seen these types of stories emerge before – for instance, during the rise of PayPal over 20 years ago or the introduction of Apple Pay in 2014. Inevitably there is commentary that makes these contests sound like spectator sports; for every winner, there must be a loser, and if newer entrants achieve breakneck growth, it must mean existing players will suffer.

But this is not like Netflix versus Blockbuster, or Amazon versus Sears – it is very likely that more than one winner will emerge. This is exactly what happened with PayPal and Apple Pay, both of which have grown to be very powerful, but not at the expense of incumbents. We anticipate a similar outcome for BNPL.

In the meantime, we cover three companies in the payments industry, all of which have very profitable business models, high barriers to entry and numerous growth opportunities. Yet each one saw their share price decline in 2021, in part due to growing concern about BNPL. Thus we see an opportunity to own these stocks at very attractive prices, and we can still wish Mr. Siemiatkowski good luck with his audacious goal.

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Equity Analyst
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[1] https://afterpay-corporate.yourcreative.com.au/wp-content/uploads/2021/10/Economic-Impact-of-BNPL-in-the-US-vF.pdf
[2] S&P Capital IQ transcript of Affirm investor presentation, September 2021
[3] https://www.bloomberg.com/news/articles/2022-01-13/buy-now-pay-later-the-credit-card-alternative-to-put-a-twist-on-consumer-debt
[4] Buy Now, Pay Later is surging but consumers overextend their credit | Breeze (meetbreeze.com)

Protecting Retirement Income with Permanent Life Insurance

While purchasing permanent life insurance when younger can support your planning goals throughout your lifetime, it also offers ongoing value as you approach retirement. For example, by retaining a permanent policy into retirement, the policy death benefits could be used to fill income gaps for your beneficiaries should any retirement income reduce or stop after your death. By discussing your potential needs with an insurance specialist early in life, an effective plan can be put in place when premiums are more affordable and when the policy has a longer runway to accumulate potential enhancements.

Why is replacing retirement income an important consideration?

Many individuals view government benefits such as the Canada Pension Plan (CPP) and Old Age Security (OAS) as a "base" of guaranteed retirement income. For some retirees, this guaranteed income may be supplemented by income from employer-sponsored pension plans. Whether these sources will be an important cornerstone of your overall retirement income planning, or a small but steady source of funds to supplement accumulated investments, they can accumulate to meaningful amounts over the course of retirement.

When planning as a couple, it can be helpful to consider not only your individual income sources and expenses while you are both alive, but also what changes could occur when one of you predeceases the other. In particular, if your spouse were to die prematurely, how secure would your financial future look? Would your remaining sources of retirement income be sufficient for your ongoing needs?

It can, for example, be difficult to re-enter the workplace after a period of retirement. While it may be an option to liquidate assets to make up for any lost income, withdrawing larger amounts earlier than planned in retirement may jeopardize the sustainability of your lifestyle.

Example: Peter and Grace

Consider a 65-year-old couple who recently retired. Peter and Grace each receive the maximum available CPP and OAS benefits. Peter also receives a joint life pension from his previous employer, with a 60% income continuance to Grace if he predeceases her. While his pension offered other choices, including 100% income continuance to Grace after his death, that option would have resulted in approximately $200 less in initial monthly income. They decided to take the higher initial income and hope that their current good health and strong family longevity would result in a long and healthy retirement together. **Once selected, their pension choice could not be altered.**

The table below summarizes Peter and Grace's pension income sources, while they are both alive:

PENSION SOURCES WHILE PETER AND GRACE ARE BOTH ALIVE			
	Peter	**Grace**	**Total**
CPP	**$1,254**	**$1,254**	**$2,508**
OAS	**$ 642**	**$ 642**	**$1,284**
Employer Pension	**$4,000**	**-**	**$4,000**
Total Monthly Income	**$5,896**	**$1,896**	**$7,792**

In addition to these pensions, Peter and Grace plan to draw enough income and capital each year from their registered and non-registered accounts to enjoy an annual retirement lifestyle spending of approximately $150,000 (before tax). Since OAS can be clawed back at higher individual income levels, they plan to split their eligible pension income, such as Peter's employer pension and their RRIF withdrawals, on their annual income tax returns.[i]

What would happen to Peter and Grace's income should either of them pass away?

1. **Their household income from government benefits would decline by 50%.** CPP and OAS benefits cease once a recipient passes away. While survivor benefits are sometimes available from OAS, Peter or Grace's income would be too high to qualify for these. In addition, although Peter or Grace could apply for a CPP

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Odlum Brown's 28th Annual Address – Visit Our Website!

Thank you to all of our clients, partners and friends who joined us for our virtual Annual Address on March 2.

If you weren't able to join us, would like to revisit something or wish to share with family and friends, we invite you to visit our website to view the recorded presentation, featuring:

- A conversation between President and CEO Debra Doucette and Executive Vice President, Investment Research, Murray Leith, moderated by Vice President, Odlum Brown Financial Services Limited, Michael Erez;
- A presentation by Mr. Leith on navigating the current investment landscape; and
- A panel discussion with our trusted team of Equity Analysts on the challenges and opportunities they see ahead.

Visit **odlumbrown.com/address22** to view the video.

Please note: This newsletter was written prior to the military escalation in Ukraine.

Visit our Research Department's blog, *Different Makes a Difference,* for up-to-date commentary on global events and the economy at **odlumbrown.com/research-blog.**

survivor benefit, their CPP income would not meaningfully increase since the maximum total combined CPP survivor and retirement benefit is approximately equal to the benefit they each already collect.[ii]

2. **The income from Peter's employer pension would be reduced by 40% following Peter's death, if Grace outlives Peter.**[iii] After Peter's death, Grace would continue receiving just 60% of Peter's monthly pension ($2,400 per month, plus indexing if applicable). This reduction could significantly impact Grace's retirement income and lifestyle, especially if Peter's lifespan ends very prematurely.

As shown in the table below, a 25-45% decline in "core" income could be the cumulative result of these two changes following death. If Peter outlives Grace, the loss of Grace's government benefits will reduce Peter's core income to $5,896 per month, while if Grace outlives Peter, her income after Peter's passing would be $4,296 per month, after the loss of his CPP, OAS and 40% of his employer pension.

	SCENARIO 1 PETER SURVIVES GRACE	SCENARIO 2 GRACE SURVIVES PETER
CPP	**$1,254**	**$1,254**
OAS	**$ 642**	**$ 642**
Employer Pension	**$4,000**	**$2,400**
Total Monthly Income	**$5,896**	**$4,296**

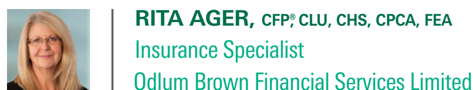
3. **OAS may be clawed back.** Although not illustrated in the table, any OAS clawback could erode Peter or Grace's OAS income shown above. Currently, Peter and Grace enjoy full OAS benefits. However, after either of them passes away, not only are their financial assets likely to be concentrated in just one name (if they leave their estate to each other), but they will no longer be able to income split with each other on their tax returns. The resulting net income for either Peter or Grace might be enough to trigger partial or even full OAS clawback.[i]

Income replacement opportunities for Peter and Grace

If Peter or Grace wanted to replace just 15 years of the $22,750 per year of fully indexed income (the annual equivalent from CPP and OAS in these scenarios), they would need to withdraw an additional $201,000 (today's dollars) from their non-registered savings. If they instead draw upon registered investments, they would need $288,000.[iv]

Another solution to **guarantee** funds after death is having permanent life insurance in place, either as individual policies, or a joint policy that would pay benefits upon the first of these spouses' deaths. Exploring the different life insurance options available with your insurance specialist is the best way to determine which options could best fit your needs and circumstances today and into the future.

If you would like more information on the insurance options available through Odlum Brown Financial Services Limited, contact us through your Odlum Brown Investment Advisor or Portfolio Manager.



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[i] OAS clawback begins when individual net income exceeds $81,761 in 2022 (indexed for future years); the clawback rate is $0.15 of OAS repayment per dollar of individual net income above this threshold. Pension income splitting allows up to 50% of each spouse's eligible "pension" income to be allocated to the other spouse, when filing their annual tax returns.

[ii] Although a surviving spouse should apply for a CPP survivor benefit, the resulting combined CPP retirement/survivor monthly benefit is subject to a maximum amount. In our example, since both Peter and Grace already qualify for the maximum monthly CPP retirement benefit, which is nearly equal to the maximum CPP survivor/retirement benefit, any CPP increase would be negligible. To apply online, visit canada.ca/en/services/benefits/publicpensions/cpp/cpp-survivor-pension.html.

[iii] Although rare, some pension plans may reduce monthly benefits if a spouse pre-deceases the pensioner. This can be confirmed by contacting the pension plan administrator before selecting a pension income option.

[iv] Based on a 2% annual indexing assumption, 4% annual rate of return, 15-year duration and 30% marginal income tax rate on interest income earned in a non-registered account.

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