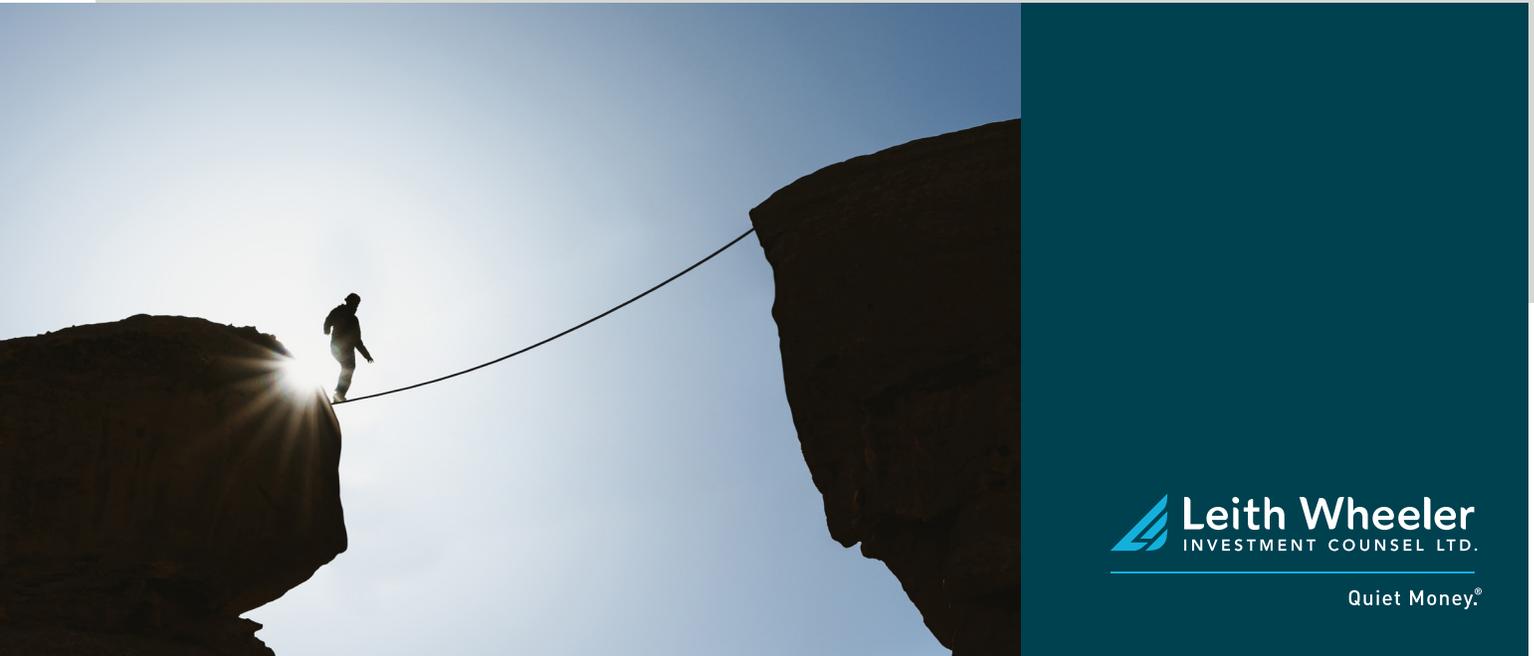


Quiet Counsel

Winter 2020
Investment Outlook



 **Leith Wheeler**
INVESTMENT COUNSEL LTD.

Quiet Money.®

Combating the Cost of Fear

Back in early 2019, we published our annual outlook edition of *Quiet Counsel* in which we made the case that market corrections such as what occurred in December 2018 are in fact a relatively common phenomenon. We suggested support from central banks through lower interest rates would reduce the near-term risks of recession, and that it was a good time to “lean in” to a more pro-cyclical portfolio.

The ensuing year has given us strong equity markets – with returns in excess of 20% in some regions and relatively low downside volatility (the biggest peak-to-trough move for the Canadian stock market during the year was less than 5%). Fixed income was also particularly strong with the broad Canadian bond market returning close to 7%, as a decline in interest rates helped

stabilize some of the previously weakening parts of the economy (such as manufacturing and automobiles).

It would be unreasonable, however, to look at the performance of portfolios in 2019 and extrapolate these returns into the future, for several reasons. In this outlook for the coming year, we take the pulse of the current investment markets and argue that value does remain, but it is keeping company with some large, tempting-but-expensive swathes of the market. We also offer observations about some simple (and perhaps surprisingly minor) ways to increase the expected returns from your portfolio.

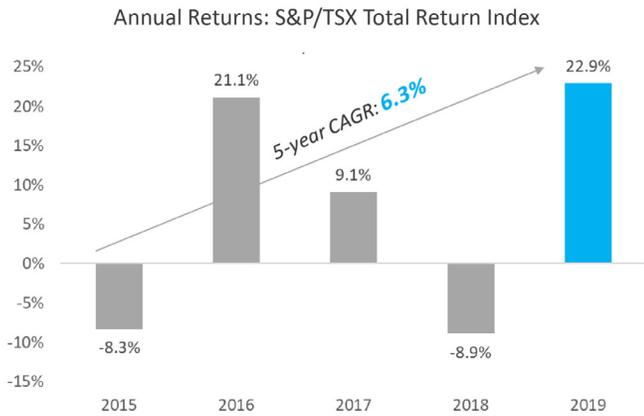
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Canadian Equities

Canadian equity market returns in 2019 appear outsized partly because of the low base on which the S&P/TSX Total Return Index started the year. While the Index returned 22.9% in 2019, compounded annual returns over the past five years were a more typical 6.3%.

Figure 1: Canadian stock returns – surprisingly mediocre over the medium-term

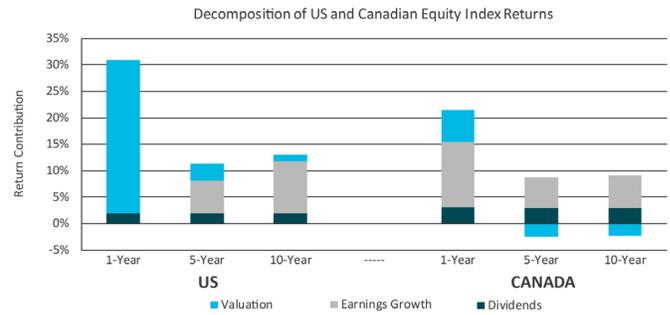


At a broad level, the composition of returns in Canadian equity markets is encouraging. With earnings multiples (a measure of the market’s valuation of stocks) remaining broadly unchanged compared with five years ago, the total return earned by investors in Canadian equity has been the result of more sustainable drivers including earnings growth and dividend yield.

The bright blue bars to the right of Figure 2 show that while earnings multiple expansion (i.e., higher valuations) did help Canadian stocks in 2019, it has still been a drag on returns over the past decade. Over the long run, earnings multiple expansion is mean reverting, so Canadian equities as a whole – with earnings growth

currently close to zero – have become more expensive over the past year. However, we are less worried about valuations in Canada than in other parts of the world, especially the United States. A glance at the left side of Figure 2 tells this story clearly: 2019 was all about rising prices.

Figure 2: The role of valuation, earnings growth, and dividends in Canadian stock returns

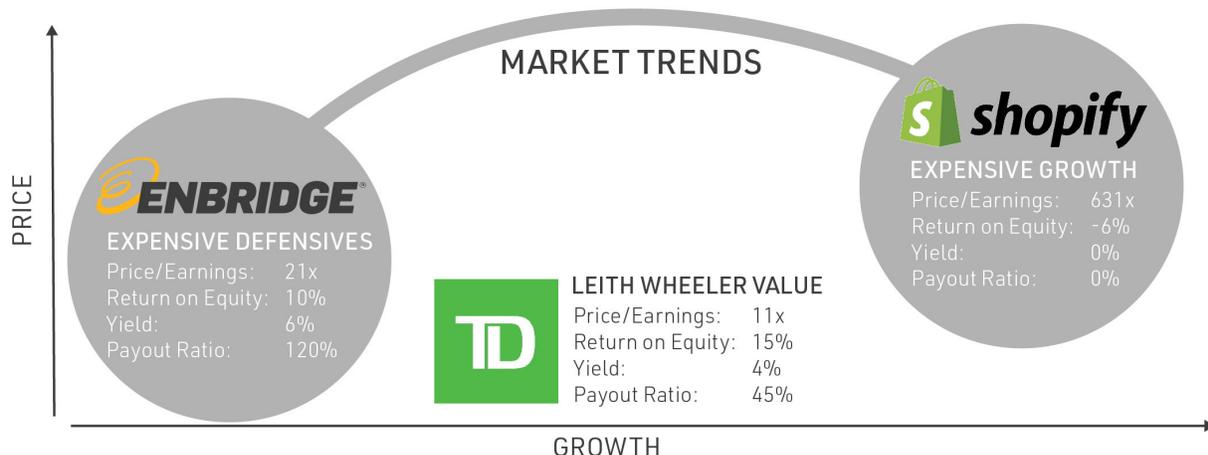


Source: Bloomberg, Leith Wheeler Investment Counsel

Gains in Canadian equities were also concentrated in parts of the market where valuations are most at risk: a barbell of high-growth stocks and low-volatility, low-growth stocks (see Figure 3, below). The Information Technology sector in Canada (where Shopify now occupies almost 50% of the sector weight) returned 64% in 2019. While Shopify has grown its revenues, the company has never made a profit, so we cannot even calculate its multiple of trailing earnings. At current valuations, Shopify trades at over 600x forward earnings estimates.

Similarly, the ongoing decline in interest rates continues to push income-seeking investors towards stocks that pay high dividends, such as companies in the Utilities sector. Unlike the broader market, utility companies have seen their valuations rise as investors demand dividend

Figure 3: The barbell of high valuations among Canadian stocks



certainty. However, this ignores the risk that paying a higher price for a stock (as a multiple of future earnings) increases the chance of a permanent impairment of capital – especially so when you’re buying into regulated industries that have a structurally constrained ability to grow those earnings. This risk is particularly acute for investors if bond yields should rise.

The key in markets like these is maintaining your investment discipline – and avoiding the heavy ends of the barbell. With our value investing, bottom-up style, we tend to live in the more reasonably valued middle.

Fixed Income

The nearly 7% returns from the broad Canadian fixed income market in 2019 are not mathematically repeatable going forward, unless the Bank of Canada cuts interest rates and/or accelerating demand for risk-free bonds were to push Canada’s bond market into negative-bond-yield territory, alongside Europe and Japan. The yield on the broad market, which was at approximately 2.3% at the end of 2019, would have to decline by approximately 0.6% each year to generate bond returns in the 7% range. While not impossible in the short-term (the strong performance in fixed income in January 2020 has pushed bond yields down almost half the distance), as discussed in [our previous writing on the topic](#), we just do not think a persistent shift for the entire bond market (including corporate bonds) into negative yields is likely.

We typically recommend considering the yield of a fixed income portfolio as a good starting point for estimating future returns, particularly over the long-term.¹ For context, five years ago the starting yield of the broad bond market was broadly similar to year-end 2019, at 2.2%, and returns over the subsequent five years were 3.2% per year. Our expectations for future returns have not changed significantly, aside from some caution around potential increases in credit spreads.

Last year ended with both investment-grade and high yield credit premiums at levels at or approaching multi-year lows (see Figure 4, below). In fixed income markets, a low “spread,” or premium yield you would expect to earn above that of a risk-free bond issued by the Government of Canada, signals a more expensive valuation. We believe

spreads are low currently partly as a function of low overall interest rates, which both fuel easier lending conditions as well as push investors towards lower quality debt in search of yield. However, credit spreads are somewhat mean reverting, meaning that if or when they increase again, corporate, provincial, and agency bond performances will suffer. Our expectations for overall fixed income returns over the next five years are therefore likely to be slightly lower than over the past five years, as the previous tailwind to bond portfolios from spread compression is unlikely to be repeated.

Figure 4: Trailing Canadian bond returns relative to prevailing yield to maturity five years prior (FTSE Canada Universe Bond Index)



Source: Bloomberg.

As in the equity markets, the high price being paid for certainty equally applies to fixed income.

It's Time to Take Some Intelligent Risk

While we all have a fundamental human desire for certainty, certainty is not free. In the short-run, owning a company for the perceived guarantee of its near-term dividends might seem reasonable, but paying too much could impair your ability to meet your ultimate investment objectives. Over the long-run, we firmly believe that the best investment strategy is to own good quality companies, purchased at reasonable or discounted valuations, and sometimes, like at the present, you need to continue to hold your courage in taking measured risk.

Investors looking at 2.3% go-forward yields against the backdrop of an 11-year bull market in stocks can be

¹ Due primarily to the decline in interest rates since the 1970s, bond portfolios have tended to earn slightly more than their starting yield over this timeframe. A technical phenomenon called “rolldown” has also contributed to it.

forgiven for balking at the idea of adding risk. But given the premium being paid now for certainty, it is actually a prudent time to do so. And the good news is that the amount of additional risk required may be less than you think.

Fifteen years ago, the expected real return (after inflation) from a balanced portfolio of 60% US stocks and 40% fixed income was about 4.5%.² Today we estimate those expected returns to be about 4.0%. If your ability and willingness to incur some additional risk permits, there are a couple of simple ways to increase this number.

By adding as little as 5% to the equity allocation (taking it to 65/35), an investor can increase the expected real return for their portfolio to 4.3%. Alternatively, by broadening the types of fixed income tools permitted in the bond component, the expected return of a 60/40 portfolio can rise to 4.4%. Also, owning an *actively managed* portfolio of stocks and bonds which seeks to screen out overvalued segments can help offset the overall risk posed by exposure to the broad market indices (and the ETF products modeled on them) if and when a correction in valuations arrives.

² Estimated returns calculated as follows:
Bond portion = prevailing yield on Real Return Treasury Bonds.
Equity portion = earnings yield of S&P 500 plus expected growth in earnings, minus expected inflation.

Conclusion

Given the frothiness in parts of the markets, it is more important than ever for investors to exercise discipline in their investment process. For Leith Wheeler, that has always meant bringing to bear an abundance of patience and a dispassionate, critical assessment of the *true underlying quality* of businesses and their leaders, and just as importantly, *the price being asked* to buy into those businesses. Put simply, investors that permit emotion to influence their decisions – whether that’s some extreme of fear or greed – are at most risk of paying too much. You also can’t give an arbitrary benchmark a vote in deciding what’s worth owning. That means being willing to concentrate your holdings more when the opportunities are compelling and avoiding the “hot” and invariably overvalued parts of the market. Humility is one of the most under-rated qualities among investors. At Leith Wheeler, we try to celebrate our wins, but admit our mistakes and learn from them. Adhering to these fundamentals has served our clients well for nearly 40 years. Whether applying them at a cyclical high or low, they will not lead you astray over the long term.

IMPORTANT NOTE: This article is not intended to provide advice, recommendations or offers to buy or sell any product or service. The information provided is compiled from our own research that we believe to be reasonable and accurate at the time of writing, but is subject to change without notice. Forward looking statements are based on our assumptions, results could differ materially.

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