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Outlook 2020 (Transcript)

Jerry Koonar (00:00:07):

Welcome to the Leith Wheeler 2020 Outlook. My name is Jerry Koonar. I'm a portfolio manager in the Calgary office of Leith Wheeler and I have the pleasure of being your host today. Given the unprecedented times we find ourselves in, we are pleased to be virtually delivering this year's Outlook, and from three locations. I will be hosting from Calgary and I'll be joined by Stephanie Hickmott from our Toronto office, along with Jim Gilliland and David Slater in our Vancouver office.

In March of this year, when the country went into lockdown, our firm successfully transitioned 100% of our employees to virtual home offices. Today, we are slowly returning to the new normal, with our Vancouver offices slowly starting to reopen. And we have taken the appropriate steps to ensure social distancing remains in place and a safe working environment remains in place for those wishing to return to the office.

(00:01:07): Just a couple of quick technology housekeeping items. You'll find at the bottom of your screen, there is a Q&A button. If you have a question, click on that button and you'll get a pop up screen, and in that pop up screen, you can write your question. It's fully anonymous. Once your question is finished, hit submit and we will receive that question on our end.

Now, if there are time constraints and your question goes unaddressed, I encourage you to directly email your portfolio manager to have your question answered. The second housekeeping item is when we get the presentation started, you'll see two panels. One will be the presentation speaker and the other will be the presentation. In between there'll be three squiggly lines. If you toggle your mouse over those squiggly lines, you'll get one solid vertical line that'll allow you to either increase the size of the face of the speaker or the size of the presentation.

(00:02:13): So on that note, at this time I'd like to introduce our first speaker, Jim Gilliland. Jim is President and CEO, and Head of Fixed Income at Leith Wheeler. He'll be reflecting on current market events and what lies ahead for us. Take it away, Jim.

Jim Gilliland: 2020 Reflection and Outlook

(00:02:30): Great. Thank you, Jerry. I just wanted to start off by thanking you for joining us today. This is a different event than we've done in the past. And also thank you for your trust as your investment advisor. The last several months have really been unprecedented in terms of the volatility with significant changes, not just in financial markets, but in terms of our work habits.

As Jerry mentioned, we've successfully transitioned to work from home using our business continuity plan. You can rest assured that with the investments we've made in technology, in business processes, in systems, that we're able to seamlessly transition to working out of the office.

(00:03:14): So just picking up on the financial markets piece of it, I mentioned the last several months we've seen unprecedented volatility. It's not the first time that we've seen a market correction or concerns around a recession. In fact, if you look over the last hundred years, pretty much every five or 10 years, we see something similar to what we've seen in this first quarter.

And probably the two that are most familiar to you are the ones that have occurred over the last 20 years. The dot com collapse, where you had technology and telecom companies that were valued at incredibly high levels, and a significant amount of debt deleveraging from the telecom companies in the early 2000s. And 2008-9, which was the Great Financial Crisis, where you saw excess buildup of mortgage debt...

(00:04:01): ...and you saw financial services companies that were forced into deleveraging. So those tended to be the framing that people use to look towards a path forward for us. And the Mark Twain quote is, "History may not repeat itself, but it rhymes a lot." Now that being said, when we look at this most recent time period, there are some key differences and probably the most important difference is the cause. So when you think of those last two corrections and recessions we talked about, they were because of financial exuberance, where you saw excess debt getting built up. And that [debt] then is forced to get liquidated over time. the time process that it takes to liquidate that debt is why these recessions take so long.

This is a little bit different. This isn't driven by debt deleveraging. This is driven by a public policy decision to halt economic activity. And because of that, it's much more akin to a light switch, where suddenly everything stopped for a time period. And we're now at the point where you're starting to see the dimmer switch slowly resume economic activity.

(00:05:11): When we look at the impact that had on financial markets in the first quarter of that time period between third week of February and third week of March, we saw the most significant decline in equity markets, that quickly. So basically a 35% decline in stock markets in the course of about a month.

It wasn't just equity markets. We also saw pretty severe stress in credit markets. It became very challenging to buy or sell corporate bonds for a time period in the latter part of March. And since that time, you've seen a significant amount of central bank intervention, which has helped support the market. And in fact, if you look at the most recent performance. A significant amount of that has been regained, albeit a little choppier day to day.

But you see that over the course of the last six weeks, a significant amount has come back. And that can seem like a little bit of a disconnect when you're looking forward. The reason being, we're in the midst of what is considered a pretty significant recession. What some people are even calling a depression, yet at the same time financial markets have moved back up to their highs.

(00:06:21): And so does that really make sense? Does that disconnect make sense? And I think to really explore that question, what you need to do is look at the actual economic impact. And probably the best way of understanding the impact that the coronavirus or COVID-19 has had on the economy is through the jobless rate. And what this chart here shows is the unemployment rate in the United States.

Coming into early 2020, we were at a record low in terms of unemployment. So that scale on the left-hand side of 4% means that for every hundred individuals that are looking for work, 96 of them were able to find jobs and only four were actively looking for work. That is an all-time record of the last 50, 60 years in terms of the low level of unemployment.

(00:07:11): In the course of just two months, March and April, we saw that unemployment rate increase to close to 15%. That is by far the most that we've seen since the Great Depression. And because of that, you have a lot of headlines that are talking about, is this the next depression? How are we going to be able to redeploy all of those jobless individuals?

It's important to dig into the data a little bit. In March and April, you saw about a 20 million decline in terms of jobs. Now, what doesn't get well recognized or necessarily reported is that of that 20 million unemployed that were looking for work, 18 million of them were classified as temporarily laid off.

(00:08:00): So those are individuals that were at home, who had jobs, but were being furloughed from their jobs and were expecting to return to work over time. The other aspect is that you can dig in a little bit is in terms of the industries, and try to understand what were the industries that were most affected.

On the right hand side, you can see that leisure and hospitality and retail trade were two areas that had the greatest impact in terms of job declines. And that makes sense. If you're forcing restaurants, hotels, retailers to close their doors, then the individuals that work at those companies are going to be furloughed.

There are also areas that you might not expect, where we saw significant job declines in March-April. One of those is education/health services, and that's primarily hospitals. And you would think in the midst of a pandemic, why would people be being laid off from hospitals? And it's because of the furloughing of elective surgeries.

So as hospitals retracted to focus purely on COVID-19 cases, it meant that a lot of elective surgeries were delayed. And so that's an area similar to manufacturing, that we think will come back pretty quickly. So there is a portion of those jobs that are truly furloughed, that over the next three to six months we do expect to get called back and to be employed again.

(00:09:23): When you go back to that retail trade and to that leisure and hospitality, it's probably going to take longer. In Vancouver, we just recently started reopening restaurants, but they're at half capacity so you're not going to need as many employees as you did prior to it. So it's probably going to be more of a long, drawn-out recovery when it comes to joblessness.

So is this the Great Depression? I said that it's the highest unemployment rate since the great depression. Our view is that it isn't, and it's because of the role that government plays in the economy now, relative to the time period in the late '20s. So for every hundred dollars of economic activity, $12 were generated or spent by the government in the late 1920s.

(00:10:12): Currently, it's around $40. And the reason is, there are far more support programs than there were previously. So think of unemployment insurance, of social security, of banking insurance, of depositor insurance. Medicare, Medicaid were both introduced in the 1960s. All of those programs were developed after [the Depression].

And the reason that's so important is it allows the government to smooth the impact of some of these declines in joblessness and to spread it out over time. So that it isn't felt as severely as it was in the Great Depression. So if we look instead at maybe not necessarily the Great Depression, but let's say a regular recession, like we saw in 2000 or 2008-09. What are the similarities to that?

(00:11:04): Well, one thing that is clearly the same is the panic that we saw in credit markets – that time period in March that I mentioned, where credit markets became very challenging to trade. It's an over-the-counter market and counterparties were reluctant to put pricing on corporate bonds.

In my last 30 years managing institutional money, that's probably one of the toughest environments that I've seen since 2008-09. And really it got solved or got improved through central bank action. And similar to 2008-9, you saw central banks lower interest rates pretty close to zero to provide liquidity, so that individuals would be able to buy and sell corporate bonds again.

And within three or four weeks, you started to see the market improve and gradually begin trading again. What's interesting about this environment is how quickly they moved. So in 2008-9, it would have taken three or six months to have these programs developed and rolled out.

(00:12:04): And what we saw in this most recent crisis is that central banks around the world basically dusted off the old playbook from 10 years ago and implemented it very quickly. And so the timeframe in terms of the damage that was created was much less as central banks were much more aggressive. What is similar is also the damage to consumer psychology.

With the joblessness and with the concerns around COVID-19, you are seeing consumers retract and you are seeing consumer confidence at much lower levels. Even countries such as China that are maybe two or three months ahead of the curve as it relates to gradually reopening, are still seeing that it's challenging for consumers to come back.

Individuals are just going to work and then coming home and aren't necessarily socializing in the same way. And I think probably, the most effective analogy is the airline industry post-September 11th when that tragic event caused all air industry to stop for a couple of weeks. But as the TSA started to reopen activity, you started to see airline travel come back.

(00:13:11): Over the course of six, nine months it had maybe got back to maybe 75-80% of its normal levels. But it took two or three years before the flying public felt fully comfortable flying again. And so in terms of the path forward and thinking through some of the challenges as it relates to the harm to consumer psychology that has been caused through this event, it is most likely going to be a more drawn out process, especially as it relates to the leisure industry.

What's different about this correction and recession relative to others, is that this was induced by an act of public policy. This wasn't financial exuberance. And the reason that's so important is that most recessions get defined by the time it takes to go through the default process. So let's take 2008-9 as an example.

(00:14:01): When you had house prices decline, individuals began to stop making payments on their mortgages. They would go 30, 60, 90 days delinquent, and then eventually default. The bank would need to foreclose, sometimes go to the courts to be able to get control of the title. They would then sell that house, which would then push down prices in neighboring houses, which then created the cycle again.

A very long drawn out process. As I mentioned, this one's quite a bit different. It's driven by public policy, and therefore the timeframe in terms of working through these issues is going to be somewhat different. And probably the most important aspect in terms of why this correction and recession is different than others, is the degree of government intervention to help support it.

And if we look for instance in the States, the latest COVID-19 coronavirus relief bill received a vote of 96 to zero in the senate. I can't recall the last time I saw a senate bill receive 96 to zero votes. But it shows you the bipartisan support to be able to step in and do what it takes, to be able to support the economy and to support individuals that have been affected by it.

(00:15:17): Basically the government is willing to spend what it takes. And it's not just in North America. When you look outside of it, in Japan, in the eurozone, the European Union, Australia, Canada. Pretty much all of them are stepping up and delivering significant fiscal packages that have been designed to smooth the effects that the coronavirus shutdowns have had on the global economy. And probably the question that you're asking and that we get asked quite often is, "Can we afford it?" Any of you who recall the early '90s, in terms of Canada and hitting the fiscal wall... We've had a similar time period in the U.S. in 2010-11 with the rise of the Tea Party. You don't hear a lot of fiscal conservatives today asking, "How are we going to pay for it?"

(00:16:09): And so the question is, can the government afford these higher levels of debt? And I think in terms of debt sustainability, one of the most important things you can consider is the level of interest rates relative to the level of economic activity. So let's go back to that time period of the early '90s in Canada. Interest rates at that time were around seven or eight percent. The economy was only growing about four or five percent. So if you're trying to finance debt at 7-8%, and your tax base is only growing 4-5%, you can see pretty quickly how that can be unsustainable. We're now in an environment of interest rates, where pretty much anything the government of Canada issues is less than 1%. So as long as the nominal economy – so that's inflation as well as productivity – as well as labor force growth is above 1%, these higher levels of debt are sustainable for the short and medium term. Now, that doesn't mean there isn't risk. And there's probably three areas that we look at in terms of what could potentially go wrong.

(00:17:11): The place that you see it first is usually in weakening currency. And so, this applies especially to emerging markets that rely pretty heavily on international buyers to finance their debt. When foreign investors are uncomfortable with the credit quality of an emerging market, they will end up selling that debt and repatriating that currency to their own currency, which causes that currency to weaken.

What's interesting about this time period is that the major currency pairs – so think of Euro/Dollar or Yen/Dollar or CAD/U.S. dollar – every one of those economies are doing the same thing. So if you have one country that is being very profligate and is spending a lot of money and no one else is, then that currency will weaken. When every economy is doing it and things are priced as currency pairs, it's not necessarily clear that you get that same weakening in currency.

(00:18:05): And that's basically what we've seen to date. The other aspect you could see is through significantly higher interest rates. For those of you who remember 1994, that's when the term "bond vigilante" was coined, when we saw bond investors sell bonds to the point where interest rates increased by two full percentage points. That's unlikely to happen today because of central bank intervention.

So basically central banks are going through and setting an upper end in terms of interest rates, and are buying bonds back and printing the currency to ensure that longer-term interest rates don't increase. Again a concern for the longer run, but not necessarily for the short, immediate term

Probably the biggest risk or uncertainty that is incredibly challenging to manage as investors is the impact of a protracted health challenge. So right now, the market is expecting that we'll have some type of vaccine or advanced therapy over the next 12 to 18 months. That would be a record time and pretty much everyone admits that would be a record time.

(00:19:09): If that were extended, if for instance we were forced to shut down economic activity again... Those types of uncertainties are really hard to manage and would definitely have an impact on markets. And in fact, today what you see is with increases in cases in Texas and in other parts of the U.S., the market is concerned now about the potential for a further tightening in restrictions.

And so you have uncertainty that is really hard to price. What is the strategy that you take to be able to manage that uncertainty? What we do is focus on what we do best, which is understanding companies. So we spend our time looking at those company fundamentals in terms of how effectively that company is going to be able to manage a prolonged cashflow interruption.

(00:20:01): And it depends on the industry that that company operates, how much fixed costs they have relative to floating costs. How effectively they can reposition their company to be able to manage it. If they are able to survive a prolonged cashflow interruption.

Then the question is, is the right investment vehicle through the debt or through the equity for that company? And this is where the coordination between our equity and credit teams is so absolutely critical. What I've seen here at Leith Wheeler is that due to the fact that we're all owners, we have a degree of communication and coordination that is unlike any other firm that I've worked at before.

And when you're dealing with an uncertainty, where you have an environment that you need to draw as much insight as possible, bringing together those different viewpoints has been particularly important for us. So we will have our debt investors looking through the loan covenants, looking through the holders of the underlying debt to make sure that the companies we invest in are financially resilient and are going to be able to survive.

(00:21:12): So what types of companies do we invest in? The same type of companies that we've been investing for over the past 38 years. When you look at the types of investments we make on your behalf, first off, they need to be established businesses. And whether you're grappling with COVID-19 or not, you will know that an established business is going to have a product or service that's easy for them to sell, no matter the environment.

"Financially conservative" means that they have the right levels of debt, that they're going to be able to service that debt no matter the economic environment. A quality management team ensures that the company can get repositioned. And most importantly, attractively priced. For us, the price we pay is by far one of the most important components.

(00:22:05): What we've seen in the first quarter is attractive pricing for a lot of these higher quality companies. So Stephanie and David Slater will give you some examples of companies that we've been investing in on your behalf, because of the cloud that's been created because of COVID-19.

What do we not invest in? It tends to be companies that are trading at very large valuations. So if we can't get comfortable with how the market is pricing that type of company, then that will be a company that we wouldn't want to invest in. In the late '90s, early 2000s, there was a company by the name of Northern Telecom. At one point it represented over a third of the total market cap in Canada.

We then saw RIM/BlackBerry. Valeant, which is now Bausch Health Companies, briefly became one of the largest companies in Canada. And then currently, Shopify has had a significant increase in its valuation. Again, a company we can't get comfortable with.

(00:23:13): We would rather invest your hard-earned money in companies like Royal Bank or Toromont, which is one of Canada's largest CAT dealers. Companies that are able to grow through time, where the valuations make sense and we're comfortable we'll be able to deliver the returns that you expect.

The reason those valuations are so important is because of this chart on the left-hand side. When you look at the price that you pay, it has a very, very high correlation to the returns that you can experience over the next 10 years. So when a company is trading at say 20, 25, 30 times earnings, in general, it isn't able to grow fast enough to be able to justify that type of valuation.

And you see returns that tend to be lower. What we're looking for are companies that are more trading in the 10 to 15 times range. Where we're able to get a quality franchise, but be able to buy it at an attractive price. And what we've seen in the marketplace is a very high premium to growth companies.

(00:24:18): So those that have high anticipated earnings growth are trading at the highest level of valuation relative to value companies. So despite this move up in stocks, there's still a lot of companies that we hold on your behalf that are very reasonably priced. And those are the ones that we're looking to continue to hold and to continue to invest your capital in.

How does that work over the long run? This shows the returns for one of our typical balanced funds over the last 20 years. You could see that there's some ups and downs in 2007-09, 2015-16 and most recently. But over the long run, this approach of buying high quality companies at attractive prices has been proven to create the right mix and the right balance for our clients over time.

(00:25:05): So just in conclusion, in our view, a recession is pretty much certain as it's defined as two quarters of negative growth. You could see that in the jobless rate. We think a pretty significant portion of that comes back over the next three to six months, but that the last portion is going to take time. Potentially as long as a year or two for those individuals to get gradually redeployed.

The response from government has been absolutely unprecedented. So in isolation, this recession and slowdown would be very problematic for companies and for the economy, but the government is stepping in and providing support. And as I mentioned, they have the opportunity to be able to do so because of the record low level of interest rates. This type of uncertainty creates opportunities for us, and David Slater and Stephanie will go through some of those.

And probably and most importantly, in conclusion, own a well-constructed, diversified portfolio of these high quality companies that are bought at the right price. We expect to continue to provide that solid performance that you expect over time. So thank you very much, and I'll turn it back to Jerry now.

Jerry Koonar (00:26:18):
Thank you, Jim. Just a quick technology reminder: again, if you have a question, you can find that Q&A button at the bottom of your screen. Just give that a quick click and a pop up screen will appear. You can type in your question, submit it and we'll address it at the end of the presentation. Thanks again, Jim,

for that great outlook.

Before I joined the firm over nine years ago, one of big attractions to me was our independence. Jim touched on that a bit, that our firm is collectively run and owned by our employees. And consensus building is in our DNA. Roughly seven years ago, we recognized that we were missing opportunities in parts of the U.S. equity market, and specifically those parts were U.S. small and mid-sized companies.

(00:27:06): We were fortunate enough to attract two very high quality individuals to build out and lead a small and mid-cap U.S. equity strategy, that now has a successful three year track record and is a part of many of our clients' portfolios. We have one of those individuals today as our next speaker, David Slater. David is a U.S. equity analyst with Leith Wheeler and co-lead of our U.S. small and mid-cap equity strategy. He'll be discussing some attractive opportunities that we're seeing within that space. So over to you, Dave.

David Slater: Small/Mid-Cap US Equities

(00:27:43): Well, thank you very much, Jerry. Good afternoon, everybody and thank you for joining us. I am going to cover four areas today, topics that relate to small and mid-cap stocks. We're going to start just by defining what small and mid-cap is.

(00:28:12): A lot of you may not be familiar with the universe. We'll start there and talk a little bit about the U.S. SMID platform at Leith Wheeler, then move on to something that's really topical, which is just talking about bear markets. And the critical importance of sticking with your investment plan, and if possible putting risk on during bear markets, as difficult as that may be.

Then we'll move on and use that as a bit of a segue way to talk about what we've done in the U.S. SMID portfolio over the last three months, and I'll bring out a couple of examples of new positions that we made about two months ago. And we'll end with a quick report card on how we've done in the last three and a half years since we began. Here we go.

(00:29:05): So to start, I'm just going to help to wrap my arms around what small/mid cap is for all of you out there who don't know what it is. If you think about U.S. stocks as a whole, there are approximately 3,000 companies that account for 98% of the total market cap that's traded in the United States.

Well, most of us are most familiar with the 500 largest. It's where most people are chasing return, and those stocks are for the most part captured in the Standard and Poor's 500. Our universe of SMID stocks (small/mid cap stocks) exists below those 500 companies. It's the 2,500 companies that exists below, and it's actually captured in a benchmark called the Russell 2500. And the 2,500 companies that is our universe, accounts for about 20% of all of the value that's traded in the United States. There are a number of reasons to be interested in small/mid cap stocks, and I'll just hit on a couple of them quickly. The first is that there's a diversification benefit that could be had to adding SMID cap stocks to your portfolio.

(00:30:11): There are lots of niche businesses available with small cap companies that just aren't available in large cap U.S. stocks or in Canada. Another benefit is that small companies just have the great opportunity to grow more quickly than larger companies, just by virtue of being small.

And then the third benefit, which is what I'd like to talk about and what means the most to us as Value investors, is something that I think is best framed by relaying a recent experience I had. Although it's maybe not so recent now, it occurred just before the lockdown began. And I was having a meeting with someone who would come into the office, an insurance analyst. This analyst had been covering life insurance companies and a couple of property casualty companies for about 12 to 15 years, and covered about 20 companies. And the analysts tend to come in and talk about whatever is topical at the time and whatever other investors had been most interested in. But he covered this really interesting little business that I'd followed for about 15 years called Globe Life.

(00:31:19): So I said, "Let's not talk about the other stuff. Let's talk about Globe Life. I've covered this thing forever. It's one of the most fascinating little insurance businesses I've ever come across. So let's start there. I've never spoken with anyone about Globe." And the analyst looked at me cross-eyed and he said, "Wow. I was actually just – after all this time covering it – I was just about to drop coverage of Globe, because I've never in my 12 or 15 years of experience had anyone asking me about that company."

And that brings me full circle back to the third benefit of being interested in small and mid-cap stocks, which is that it's just a less competitive pond for fishing. There are fewer people chasing return amongst the 2,500 stocks. So there are fewer analysts covering companies like Globe Life. They're off the beaten track. And so as a value investor, there's a much greater opportunity to find mispricings.

(00:32:11): And that of course is the nirvana for value investors. So I'm going to back up my little anecdote by showing you a nice little chart here that I think drives the point home a little bit more thoroughly. So here we've got a chart that depicts different categories of stocks, and it highlights the average number of analysts who cover stocks of these various categories.

If you look to the left of your table there, you'll see the FAANG stocks, which of course are Facebook, Amazon, Netflix, Google, and Apple. Probably the most popular businesses and investments today. The average FAANG stock has 51 sell-side analysts covering it. So tremendous coverage, very difficult to get an edge covering and following and trying to invest in those kinds of companies.

If you look at the average Standard and Poor's company, you'll find that only 21 analysts cover it. So still very competitive, but a lot less so than FAANG stocks. As you move into our territory, the 2,500 stocks of the Russell 2500, you'll see that only seven analysts cover the average company. And at our firm, nine analysts.

(00:33:17): So, far less competition, far fewer people seeking return amongst a far greater number of companies. So we started our process of building out our platform for U.S. SMID six years ago. We spent about two and a half years of pre-work, looking for and then hiring myself and my partner, Ray. We spent all our time on U.S. SMID and spent a good chunk of that two and a half years building out our processes and then building our portfolio up stock by stock. And after that two and a half years of pre-work we launched, just over three and a half years ago. And we think we've got a number of things working in our favor.

(00:34:03): First off, we think we've got the right people involved. Because in addition to Raymond and myself, we have a whole team of people who meet formally on U.S. SMID once to twice a week, and who weigh in on every major decision that we make. And our team is comprised of senior individuals from across the firm so we're able to lever and bring in the deep talent pool that we have at Leith Wheeler.

Of course, another advantage we have is that we've got the right clients, which includes all of you. Our clients are long-term. So we get to think about our capital, really like we would think about permanent capital, which in today's world provides us with a distinct edge as we think about and value and invest in businesses. And then finally, we've got the right investment process.

In U.S. SMID, we follow the same value-based investment process that we've been following so successfully here at Leith Wheeler over the last 38 years. Okay, let's move on and talk a little bit about bear markets. Really timely and couldn't have crafted a better bear market day than what we're having today, which for value investors like me keeps me really engaged and interested.

(00:35:14): But I want to talk about bear markets, because it's during bear markets that it's most important to keep a steady hand at the wheel and stick with your investment process. And I'm going to start by just bringing up, I think the most overused investment quote ever. But it's a doozy and it's a great one and it's by of course, Warren Buffet. And that is, that "It's best to be fearful when others are greedy, and greedy when others are fearful." Now that's quite a trite quote now; it's very easy to cite, but it's terribly, terribly difficult to practice. And I can think of many examples over the years of very smart people and wise investors getting off track during deep and tough bear markets. But there's one that comes to mind and it dates back 11 years. I'll just relate it quickly as a segue way into what I'd like to talk about.

(00:36:09): It occurred on Friday, March 6th. I was having lunch with a Goldman Sachs representative. And at the end of the lunch, the gentleman said to me, "Our U.S. bank analyst team at Goldman Sachs thinks that banks are now totally uninvestable. Cannot invest in U.S. banks." Which is quite a proclamation. I'd never heard anything quite like that. Well, easy enough to say now in hindsight.

But the very next trading day, Monday, March 9th, 2009, stocks and pretty much all U.S. banks bottomed and went on a terrific bull market essentially for the next 11 years. So what that little example demonstrates is the extreme difficulty of following Buffet's common wisdom. And in this case, the wisdom is to be greedy when others are fearful. And there are many reasons why it's difficult to follow this wisdom. Stephanie will talk a little bit about some of the reasons.

(00:37:05): And I'll talk maybe a little bit about some of the more visceral reasons. So it's during bear markets where we lose our ability to balance risk and reward. It's where our natural instincts become the greatest threat to building long-term wealth. It's also where the most impactful investor decisions often happen, and where the biggest mistakes happen.

What happens to us from a feeling perspective is that we feel scared. We excessively focus on risk and we lose our ability to think independently or rationally. And as a result, our natural action is to seek safety, just to settle our minds. And it's our instincts that are really compelling us to do so. And this of course, is nothing but the flight mechanism that's hardwired into all of us as human beings.

As a result, many of us succumb to all these pressures and we seek to settle our minds by searching out and at times making very disadvantageous moves into safer investments, like maybe safe stocks or cash or bonds. And it's this behaviour that's most destructive to building wealth. I'm going to help to make my case by showing you really neat graph, that's going to talk about and depict what happens to a couple of different investors over a long period of time.

(00:38:23): So we're going to look at an investor who starts at the end of December, 1979 and invests $10,000 and stays with it. It's all they do. They invest $10,000 and stick with their investment plan through 40 years of ups and downs. At the end of 40 years, that investor ends up with a little over $300,000 and that investor's return has compounded at 8.9%.

Now compare the next investor who misses just the five best days over a 40-year period. Well, that investor compounds at 7.7% and ends up with $190,000 over that 40-year period.

(00:39:07): And then finally, we have an investor who maybe gets really shaky and misses the 10 best days over the 40-year period. Well, that investor compounds at 6.9% and ends up with $140,000. What's most important about this as it relates to this discussion is that all of those best days occurred during bear markets. Since 1929, the average one-year return from a bear market trough is 47%. So what all this tells us is that you have to stay invested through bear markets and to the extent possible put risk into your portfolio, rather than succumbing to all those powerful feelings to do otherwise. And so with that in mind, I'm just going to move on and talk a little bit about what we've done at U.S. SMID over the last three months. And as you can see from this graph, we've been pretty busy.

(00:40:08): I suppose time will tell us if we acted prudently or hastily, but what I do know is I believe that we acted rationally. So we've invested in five new businesses, we've put idle cash to work, and we shifted a significant percentage of the portfolio into our most attractive ideas as valuations changed. In total, we shifted about 30% of our portfolio. And I'll talk about just a couple of those new positions right now.

So the first I'll just mention is a business we invested in called Univar. Univar's a business that started in 1924. It's a global chemical distribution business, distributing chemicals to companies in the agricultural industry, the pharmaceutical industry, the food industry... companies of that nature.

If you think about the business of a distributor in general, and certainly with Univar, you might equate it to a franchise or a royalty collector. For every dollar or pound of chemical that flows through Univar's distribution platform, it collects little royalty. So that's one conceptual way of thinking about this business.

(00:41:15): What really makes us excited about this investment is the growth opportunity in front of Univar. Univar's competing in a $2 trillion global chemical market and there are only two other viable global competitors that do what it does, which is independent distribution. But unlike most other industries, only 10% of chemicals are outsourced to independent distributors like Univar.

That compares to other industries that in some cases have entirely outsourced distribution channels, to others that outsource maybe 30 or 40% of their total product. That template is critical because the 10% is growing, and it's growing because there are increasing advantages to scale in the business. And suppliers have finally realized that there's a major benefit to shifting to an independent distributor who can get your product to a far greater number of customers at a much lower cost. So what that means for you Univar as one or two global competitors, is that the company has an enormous opportunity to get an increasing piece of a growing pie.

(00:42:20): The management team at Univar is outstanding. The business is a little more levered than we'd like. They completed an acquisition in March of last year that raised leverage a little bit. But the company is quickly de-levering and has some very natural buffers that create a resilience that will sail the company through whatever's to come in the next year. It's got excess land it's monetized; it has countercyclical free cash flow production... so a lot of financial resilience in the business.

And of course, we bought Univar at a really attractive price. We were paying between 50 and 75% less than what it recently traded at. And buying Univar less than 10 times normalized earnings for a business that should trade at 15 to 18 times in the coming years.

(00:43:03): So we bought a pretty good business with a lot of growth opportunity at a dirt cheap price. We also bought a little bank in Texas called Prosperity Bank. Prosperity is really interesting, because I've covered Prosperity and wanted to invest in it for years, probably five to seven years. I've just never had the chance, it's never been affordable enough until recently. What we have with Prosperity is we have a case of buying a best-in-class business for fairly dirt cheap price. The bank is Texas based. It's conservatively run; profitable through 2008, 2009; has industry leading credit metrics – had and has today. And the real honey in its businesses, is its low-cost and stable deposit base and its conservative investment or underwriting acumen that it's practiced for decades and through many, many, many cycles.

The management team is excellent, longstanding and heavily invested, including buying shares right through the downturn. And the business is overcapitalized, under-levered, over-deposited and has good resilience as you could imagine in a bank. Like with Univar, we paid very attractive prices. In this case, you're buying shares at 30 to 40% below their high prices, less than nine times normalized earnings. This should trade at 14 to 15 times in the coming years.

(00:44:23): So a couple of really interesting ideas that will give you a flavour for some of the opportunities we've found in the last three months. This is a nice snapshot of the top 10 positions we have in the fund right now. And if you are familiar with the names, you'll realize that there's a really broad mix of industries and exposures that we have here. But my guess is that you won't be familiar with lots of these names. And again, that's because we're looking at smaller companies that are a little off the beaten track, that most people probably haven't heard of.

In conclusion, I'll just wrap up with a quick report card on how we've done. So we launched in September, 2016. We've been doing this now for almost three and three quarter years. And our track record is pretty decent.

(00:45:08): We're pleased with how we started, but what we're most enthused with at this point in time is actually our prospective returns. Valuations in a large swathe of the market are still very attractive and getting more attractive by the day, it would seem. So we're really enthused about prospective returns for our existing and new clients who join us at U.S. SMID. And so with that, Jerry, I'm going to end. I'm going to thank everyone again for joining us, and I'll pass back to you Jerry.

Jerry Koonar (00:45:38):
Thanks, David. So our last speaker of our presentation is Stephanie Hickmott. Stephanie is a portfolio manager in the Toronto office of Leith Wheeler, and she will be addressing a topic that many of us struggle with and many investors struggle with. And that's the dangers of short-term thinking. So Stephanie, over to you.

Stephanie Hickmott: Battling Short Termism

(00:45:59): Thank you, Jerry. Hello everyone. Good afternoon. Some of you may remember from our prior events that understanding your behavioural biases can have a very positive impact on your long-term portfolio results.

(00:46:24): So we thought that given what's been going on year to date in the markets, it would be a good time to focus on this specific behavioural bias of short termism. Short termism refers to an excessive focus on short-term results at the expense of the long-term interests. For investors, this is manifested by focusing and reacting to immediate price changes in market.

The first quarter was a perfect example. As Jim told you, we saw the market decline by 35% from its peak in mid February to late March. Investments were fueled by the uncertainty created by the pandemic to reduce their market exposure. It's normal to feel anxiety and concern when faced with uncertainty. And certainly we had a lot of uncertainty in March, but really was this the best course of action?

(00:47:22): We social distanced ourselves in society, and maybe the best course of action was to social distance from your portfolio. And by this, I mean really just stepping back, looking at the broader perspective and evaluating the best course of action for the longer term. As Dave just explained in his presentation, really the best action was not to sell into the bear market, but in fact to look for opportunities to buy, which is what we did for our clients' portfolios.

So why do investors with long-term horizons battle with short termism? There are three reasons I will go over in the next few slides. The abundance of unhelpful data, an emphasis on short-term performance, and ingrained behavioural biases.

Here you can see news headlines from market corrections dating back from 1929 right up until this year. With every correction, there are concerns. It's normal.

(00:48:31): However, the media takes the opportunity to really play these up, and this is even worse today. It's more intensified because of the way social media is pervasive in our lives. So much of what the media puts out is noise. Noise is very distinct from information, and we need to take this seriously. Information is built on solid evidence. Jim had mentioned that our job here is to dig into the data.

(00:49:02): Noise is really just subjective opinions, which may be supported by some evidence, but it's selective evidence. And unfortunately, this noise often pushes us to react quickly without all of the necessary information at some of the worst possible times. The second cause is the widespread emphasis on short-term performance. So here we have two charts.
The first on the left is the price return of the Toronto Stock Exchange over the past two and a half year period. And you can see many ups and downs. It goes right up until the end of May. It looks like a roller coaster. And then on the right side, we have the total return of the TSX, going back from 1982 right up until the end of May. You can still see the ups and downs, but overall, the trend is positive.

(00:50:00): In fact, the annualized rate of return over this long-term period is 8.8%. Now, which of the two charts presented here gives you the information that you need to evaluate your success in attaining your long-term objectives? Obviously it's the long-term chart. This isn't to say that this shorter-term chart isn't useful, because it is. It can help you understand your tolerance for volatility.

But so much measurement is based on the short-term chart, as opposed to really asking if you are headed in the right direction for achieving your long-term goals.

Here's another quote that's often used by the famous economist and investor Benjamin Graham. He said, "In the short run, the market is a voting machine, but in the long run, it is a weighing machine."

Essentially, this means that stocks are bought and sold over the short-term, much like votes based on popularity, but over the long-term, the stock's true value is properly weighed by the market. And this is what we try to do when we select stocks for your portfolio. And just further to this point on the emphasis on short-term performance, the effect of this really, is we're seeing investors more and more become traders.

(00:51:26): And here you can see that the history of the average holding period for stocks on the New York Stock Exchange. It has fallen dramatically to less than one year. This is as at the end of 2018, but really if we counted right up till today, I'm sure it would be even lower because of the abundance of trading volume that we're seeing. In comparison, Leith Wheeler's average holding period for stocks in our portfolio has been 10 years.

All right. Let's move on to ingrained behavioural biases as the third cause for short termism. Basically, ingrained behavioral biases is people using a series of mental shortcuts, mixed with emotional reactions to make decisions. The biases that I will speak to in the next few slides include herd mentality, recency bias and availability bias. These are quite common for driving short termism behaviour.

(00:52:27): So herd mentality is the tendency to follow what others are doing based on emotion and instinct, rather than independent analysis. There are a multitude of examples to point to in investing, and jumping on the stock-buying bandwagon is certainly one of them. Names like Valeant or BlackBerry or Nortel going back even further; these names come to mind.

But we have an excellent example of herd mentality in society from the first quarter. So here's a photo of people stocking up on paper towels and toilet paper. Let's move to a poll. So I asked Jerry to bring up a question and on your screen, you'll be able to select the answer that best represents your situation. Now, be honest, don't be embarrassed: How much toilet paper do you have in your cupboard?

(00:53:19): I could've just as easily found a photo of real shoppers standing in line at Loblaws or Costco with their trolleys full of paper towels and toilet paper. I won't hesitate to say myself that my linen closet is actually full of toilet paper. So let's see: oh, actually these responses are pretty good. Most of you acted reasonably and you only bought what you need. I thought a lot of you would have more.

But anyway, why do investors behave like this? Why do we herd? Well, humans are wired to be social animals. We're prone to herd because we know by instinct that it is safer and warmer in the middle. In fact, we feel the pain of social exclusion in our brain in the same place in our brain where we feel physical pain.

(00:54:29): So that's why it's so hard to be a contrarian, but being a contrarian is extremely critical to successful investing. And as Dave explained, this essentially means be greedy when others are fearful, fearful when others are greedy.

The next bias that I'll address is recency bias. Recency bias is giving too much weight to information we've seen, heard, read or experienced most recently.

(00:55:01): Now for investors, this can mean evaluating your performance based on your most recent perspective and ignoring the broader, longer term perspective. For example, let's look at 2018. If you were a relatively new investor, let's say you just started to work with a new portfolio manager. You built a diversified balanced portfolio in late 2017 and then late 2018 hits. And your returns were negative, anywhere from negative two to four or five percent, because that's what happened in the market. Some of you may remember. If you used this experience to reach a decision and reach a conclusion that, "Wow, maybe I'm better off in GICs. Maybe I'll just go to GICs," that would be an incorrect conclusion, because you would failed to take into consideration the past five years, 10 years of returns, which is really what you're going for in terms of your longer-term objective. So again, over the past, if you looked at the end of 2018. The five-year return was in the range of 6%, ten-year return was up over 7%.

(00:56:18): And if you had moved to a GIC because of this recent experience and recency bias impacting your decision, you would have missed out on a spectacular year in 2019 when balanced portfolios were up in the range of 15%. So this is how this bias can be extremely detrimental for investors. The next bias that I'd like to like to explain is availability bias. And for this bias, I'd like to use an example from history. Availability bias is focusing on the data that quickly comes to mind or is readily available. Here we see images of World War II bomber planes. So the British Royal Air Force wanted to armor their planes in order to protect them, but they couldn't add heavy armor to the entire plane because it's too heavy, essentially. They asked a statistician to advise them, "Where should we apply armor to our planes?" And they provided this information.

(00:57:24): Essentially, what you see here are where the planes coming back from the front-line had the most damage. So on the right side, the red dots indicate where the bullet holes were on the plane. And this is the data they provided to the statistician. Now let's move to a poll. And Jerry, if you could bring up the poll, that would be great. So based on these diagrams, where would you apply the armor plating to act as protection to this plane?

(00:58:03): And with this example, I learned a new word. Fuselage means the body of the plane, just in looking it up. But, here we go. I can see some of your answers. All right. We stop the polling. Wow. All right. So the majority of you ... Well, 43% of the respondents, of everyone here today, selected around the engine. And that is the correct answer.

A lot of you also selected the body. And that's a logical answer as well, because you can see the most bullet holes, the most damage around the body of the plane. But really the trick here is what you have to consider are the planes that did not make it back. So this data has been provided on the planes that did make it back. So the planes that made it back, they were able to sustain the damage to these areas.

(00:59:06): And that is exactly why you need to consider and be aware of the information that you don't have. So what are some strategies to avoid short termism? I'll go over a few in the next three slides, but really what you'll find is there's an overriding theme to these strategies. And that is to slow down and let your complex mode of thinking take control.

This comes from a book by Daniel Kahneman, one of the more well-known psychologists and economists. His book is entitled Thinking, Fast and Slow and what he describes is two systems of the brain. System One operates quickly and more automatically. System Two operates with more effort and complexity. So the underlying message is: don't let your System One take control.

(01:00:14): Here's some of the things we can do. First of all, block out the noise. Information overload impairs critical thinking. This is proven based on research. I came across Kenny Rogers oddly enough, when searching online for images depicting how to block out the noise. I came across the lyrics for The Gambler, Kenny Rogers' song from the '70s. I'm sure many of you know it, and it's very catchy. And I actually thought, yes, it's appropriate. It's appropriate, because sometimes you need your social media. Okay? You need it. You need to refer to it. It helps you. But many times you need to know when to put it down, put your phone down, put your iPad, whatever you use. Okay? And then other times, when you have to really walk away.

(01:01:13): You have to walk away to keep your sanity and reduce your anxiety. Because according to research, more people are experiencing anxiety today due to the constant news cycle. Fake news, real news, whatever it is. It is actually creating more anxiety. So the message here is, know when to hold them, know when to fold them and know when to walk away.

Another strategy is, and this is very important: to understand your approach. I'll illustrate this with the example of two runners. On the left side, you have a sprinter and on the right side, you have a marathon runner. Both are Olympic runners, and both are competing for the best time in their respective races. But both also have very different skills. Both have very different training and both have very different approaches.

(01:02:13): So if you were to measure your marathon runner based on the speed with which he can do an 800 meter sprint, you probably wouldn't pick the best marathon runner. You'd pick the fastest one, but you wouldn't pick the best one. And this could go on in a number of iterations before you realize that you are not matching the skills of the runner with your objectives.

And this phenomenon, you see this with investors that often switch. So their goal is really long-term, but they're trying to achieve their long-term with a series of short-term sprints. And that just won't work. In fact, it will result in a lot of pain and quite a lot of transition cost.

The next strategy is to be aware of your behavioural biases.

(01:03:11): So we've been speaking about some of these, and unfortunately there's no vaccine to cure behavioural biases. We just have to train ourselves to learn how to work better with them, to trigger that System Two side of the brain and also just to understand their implications. And as Dave showed in his presentation, it's important also to keep in mind that this behaviour can have a significant effect on your fund performance.

He showed us earlier that missing the 10 best days within a bear market can actually detract 2% from your annualized returns over a long-term period. So it sounds like a qualitative piece of advice, but really it has very quantitative implications.

Finally, the last and most important strategy that I'd like to highlight for addressing or dealing with your ingrained biases and combating short termism is the need to develop a suitable plan.

(01:04:23): This really is your investment policy state statement. It is the roadmap to achieving your long-term goals. All right. Here's the components of an investment policy statement: objectives, horizon, risk appetite, asset mix and criteria. These are all very relevant. And most importantly, have a process and a framework for getting you to where you want to go.

Here's a cyclist. I used the image of a cyclist just because there's so many cyclists on the road now as everyone's trying to get out of the house and do something; they've been cooped up for too long. And really, the analogy is a cyclist that is continuously looking at her front wheel is suffering from short termism.

(01:05:07): While it's important to look at the front wheel and notice the bumps along the way, you won't get anywhere if you're not looking ahead. So be the cyclist that looks ahead and stay on your path and your achieve long-term objectives.

Thank you very much for joining us today. And I'll hand it back to you, Jerry.

Q&A

Jerry Koonar (01:05:30):
Thank you, Stephanie. So with that, we will open the floor to Q&A. So I'll start the first question with Jim. And this question says: Jim, I understand that the GDP return will be encouraging. However, the market seems to have discounted the fact there has been a destruction of wealth due to reduced activity. People are not starving due to support payments, but the wealth created by economic activity is permanent. Is there not an important disconnect between the market levels and the true economic value?

Jim Gilliland (01:06:07):
Yeah, that's what we're referring to when we talk about that apparent disconnect in terms of record levels of unemployment, yet having the stock market return to its highs. I think the most important thing to keep in mind is that the stock market is a discounting mechanism, and how forward looking the market is.

So you tend to see that stock markets trough anywhere between six to nine months before the end of a recession. And the reason is that, very near term earnings [are less important]. What affects it over the next six to 12 months is a very small component of the stock price. So think of the current level of stock valuations: 95% of the value is earnings that occur beyond the next 12 months. So as long as the market can start to see a bit of a light at the end of the tunnel, then you'll see that we're going to have market and plus or minus similar levels that we are currently.

(01:07:03): It's when there's concerns that maybe it's going to be extended beyond that, like we're seeing discounted today. That's when you tend to see a market correction. So the vast majority of stock market valuation is based on earnings that are well beyond the next 12 to 18 months. As I said, 90% of it is discounting earnings over the next two years.

Jerry Koonar (01:07:27):
Great. Thanks, Jim. Next question I have is for David. And it says: On U.S. small and mid-cap stocks, what are your thoughts on the recent underperformance versus large cap? How is your portfolio positioned for this? And when do you think this trend will reverse?

David Slater (01:07:46):
So small-cap stocks typically in bear markets decline much more than large cap stocks. Usually, it's sometimes by as much as a factor of one and a half times. So this isn't an unusual period that we're going through. But I think as Jim mentioned in his presentation a little earlier (and I'll highlight it): there are different kinds of stocks that are doing very poorly. One is small-cap stocks, which have underperformed, and then more value-oriented stocks.

(01:08:14): And so to answer the question and get directly at it, there are huge opportunities opening up in small-cap stocks and in value-oriented stocks. And so over time, small-cap stocks and large-cap stocks traded very similar valuation levels. So over time, that difference that's opened up should converge. What we have in front of us from here forward is an outsized opportunity in small and midsize companies.

Jerry Koonar (01:08:43):
Great. Thanks, David. Next question is for Stephanie: How do portfolio managers at Leith Wheeler

guard against short termism?

Stephanie Hickmott (01:08:53):
Thanks, Jerry. I've mentioned the importance of process and we do have an established framework for investing our client portfolios and extracting the best ideas from each other. And also our internal research process. So we do our homework. We look at all information. That's one of the ways.
We also engage in frequent team debate and discussion, in which we challenge each other. Playing devil's advocate and this helps actually make sure that we're accessing both sides of the brain.

Other ways, really we do use social media here and we do our best to use it as effectively as possible. And we do have an internal Slack channel, that again allows us to communicate frequently with each other and make sure that we're getting a broad perspective of opinions.

Jerry Koonar (01:10:03):
Great. Thanks, Stephanie. This question is for Jim, because it's more of a top down macro question: Do you feel that some investors should reconsider their asset allocation, percentage of debt and percentage of equity going forward from COVID?

Jim Gilliland (01:10:20):
I think it really goes back to Stephanie's conclusion slide, which is the need to focus on your statement of investment policy and guidelines and work with your portfolio manager to make sure that the balance between stocks and bonds is appropriate for your longer-term investment goals. Design your statement of investment policy guidelines, not just for normal quiet markets, but for time periods like we've been through over the last three or four months. That's really the North star in terms of your investment process, to make sure that the portfolio that we're pulling together is going to meet your needs over the long run. In time periods like that we saw in the first quarter, the most important aspect that we can deliver on your behalf is effectively rebalancing back to your target goals.

(01:11:07): So let's say you started the beginning of the year at 70% stocks, 30% bonds. Over the course of the first quarter, especially during that February to March, you would have found that the value of that stock had declined to maybe 65% or 63%. And so what we do on your behalf is then liquidate some of those bonds and use that to purchase stocks at a discounted price. And then when you see the market action as we've had over the past couple of months, it ends up going in reverse.

So if we started the second quarter at 70/30, then you would have found that the asset mix had drifted up to maybe 75, 25. And we take that as an opportunity to trim some of those over-value companies and reinvest it in the bonds. And that process of moving into and out of rebalancing is a key portion of the added value that we can provide in these types of markets.

Jerry Koonar (01:12:03):
Great. Thanks, Jim. The next question I have is for David, and this might revisit the process that we have and why we have a SMID portfolio. The question is: It is not clear to me why investing in top 2,500 stocks where not as many experts comment versus top 500 or even FAANG is better or worse. Existence of analysis is not inherently good or bad. It only means more information, which could be both good and bad. Can someone explain the logic please?

David Slater (01:12:37):
Sure. So to summarize that ... Well, let me try and answer, because there's a lot packed in there. I think I'm just going to really go back to what I've said, which is why it is interesting to look at companies where there is less information, less dissemination of views is you have multiple opportunities to get an edge over other people.

(01:13:02): You might have an information edge, or you might have a unique perspective or idea that hasn't been widely disseminated. And if you have those edges, there's a good chance that you can get them in a more timely fashion then and capitalize on them – versus large companies where ideas can come into existence and get disseminated extremely quickly. So, I hope that that answers the question.

I'm trying to think a good analogy for fishing in less competitive pools. And we can even make a fishing analogy, which is that if you're fishing in a stocked lake. I'm not a fisherman, so apologies if I'm off in my terminology here. But if you're fishing in a lake that's been stocked with a certain number of fish – let's say 500 fish, like the Standard and Poor's 500 – and you have 2,000 investors. Your chances of catching a fish are not nearly as good as if you're fishing in a pond with 2,500 fish and a hundred investors. That's one of the reasons why we naturally think there's at times much larger opportunity to be had in smaller cap stocks.

Jerry Koonar (01:14:20):
Excellent, David. Thanks. And so with that, we're at 3:15, Calgary time. So 2:15, Vancouver and 5:15, Toronto time. So we'll wrap that up and bring our 2020 Outlook to a close. But before we do, I want to remind everybody that there'll be a survey that'll pop up once we close off the event. We'd appreciate your feedback. This is the first year that we've tried to virtual Outlook and your feedback on the event and the delivery would be much appreciated.

So on that close, I just want to thank everyone for attending and joining us today. A big thank you to our clients for entrusting us with their hard earned wealth and their loyalty. And we wish you and all your families safe health, and we hope to see you soon physically in person. Take care and thank you.