PRIVATE WEALTH MANAGEMENT

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January 2021

2021 YEAR AHEAD (MAYBE THIS YEAR WILL BE A LITTLE MORE NORMAL)

Last year when we wrote our year ahead letter (titled 'Cautiously Un-Pessimistic'), we would have been somewhat perplexed looking at the photos below. We 'get' them now.

We have been in the business long enough to know that anything can happen, so when discussing potential risks heading into 2020, we wrote that despite the economy doing well at that time, there was always the possibility that some 'unpredictable crisis' may happen. In a sense, we can write these same words in every 'year ahead letter' as there is always a chance that something that is not thought about can occur. As we begin to discuss what we believe has a reasonable probability of occurring going forward, no doubt there will continue to be some surprises along the way. All of us hope though that it will be nothing like Covid -19.

This letter will outline our longer-term strategy and methods we will use to manage both risk and return going forward.

We will also be discussing 'privately valued fixed income' (see attachment) which is an asset class we intend to use more going forward.

What's new

During this past year, we had to significantly re-evaluate all our assumptions and projections based on the new reality of ultra-low interest rates (which appear to be with us for some time going forward) and the fast acceleration of trends in terms of how people purchase things, spend their time - and how and where many do their jobs. As we look ahead, no doubt some of these changes will be permanent while some of our previous habits and ways of doing things will get back to normal (once enough vaccines have been administered).

When it comes to analyzing any new trend (with regards to risks or opportunities), it's always helpful to look at all available information. For example, let's look at online shopping in Canada.

Online sales went from 11% (of total retail spending) to 17% at the peak of early shutdowns. Last month, it was down to 14% [1]. Online shopping may decline a bit further when Covid ends, but from there, this trend will likely resume its normal growth pattern of about 1% (of total retail purchases) per year. Many though have the impression that the growth in online shopping (during the pandemonic) is much more than just 3% of total retail spending. Thus, looking at 'the numbers' puts a better perspective on this issue. Vacancy rates at retail properties are up a bit, just by 1% - and overall occupancy levels are normal. Our take is that 'retail-oriented' REITs with well-located properties and good land value that are still down 20% to 40% (even after a good comeback in price), represent decent value at today's prices. Pension funds such as CPP and Quebec's pension plan are increasing their commercial real estate purchases (they say) due to building values representing good long-term value at today's prices. We agree.

Tax changes coming?

Another potential risk is higher capital gains taxes in future. Significant government spending has increased this risk. Some degree of triggering of capital gains (through our normal trading) mitigates part of this 'higher tax in future risk'. Clients with large untaxed capital gains on a second property, or business, will be particularly concerned about this issue.

Government deficits exploded this past year

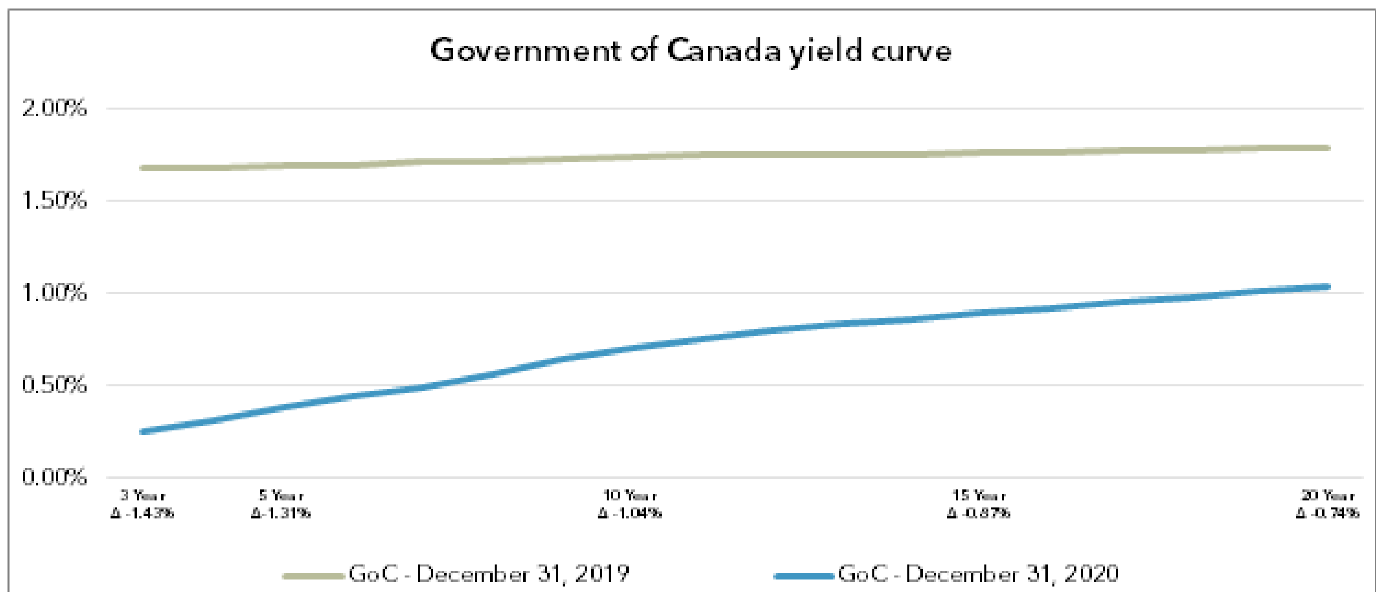
A big concern that many investors have is the huge amount of new government debt that has been issued. While we share some of this concern, the numbers paint a picture that is less concerning. Back in 1994 (when interest rates were much higher than today), Canada was on the verge of a debt crisis. At the time, our federal government's debt-to-GDP ratio was close to today's level; but for every dollar taken in of tax revenue back then, a whopping 70 cents was spent servicing interest payments! Today's much lower interest rates mean that just 12 cents out of every tax dollar is spent paying interest on the debt. This explains why most economists are comfortable with current debt levels, in Canada and most countries around the world. Of course, if interest rates go up, this concern increases. We don't anticipate higher interest rates though until perhaps 2023.

Already low interest rates have gone even lower in 2020

We are having to re-think our traditional method of having close to 60% of client assets in equities and 40% in fixed income. The chart below shows why we must re-evaluate how much bond exposure we use going forward. As you can see, government bond yields have declined to levels as low as they have ever been. And it's not just government bonds that now pay 'next to nothing', even good quality corporate bonds in the 3- to 5-year area yield a paltry (average of) 1.5% right now.

[1] Retail sales exclude auto parts, and gas stations. Source: StatsCan, US Census and CIBC World Markets Inc

Asset allocation and interest rates



Source: Bloomberg

With regards to government bonds, does anyone want a short-term government bond paying 0.25%? Or perhaps a long term 20-year bond at 1% (where if long-term interest rates increase, the value can drop 30% or more)? …anyone? anyone?

How about riskier corporate bonds instead? With yields around 5%, high yield corporate bonds are not paying enough above the risk-free rate of return to justify having very much portfolio exposure.

If we maintain close to a 40% allocation to fixed income, it will be hard to generate a good longer-term portfolio rate of return. We have two ways to deal with the new reality that for all intents and purposes, the bond market will no longer pay any reasonable rate of return - for the foreseeable future.

So, what can we do?

We are continuing to decrease our investment grade corporate bonds (with yields going forward of about 2% or under) by cashing in these bonds prior to the maturity date – at favorable bond prices (which have moved higher in price), and by not investing in similar bonds when these investments mature.

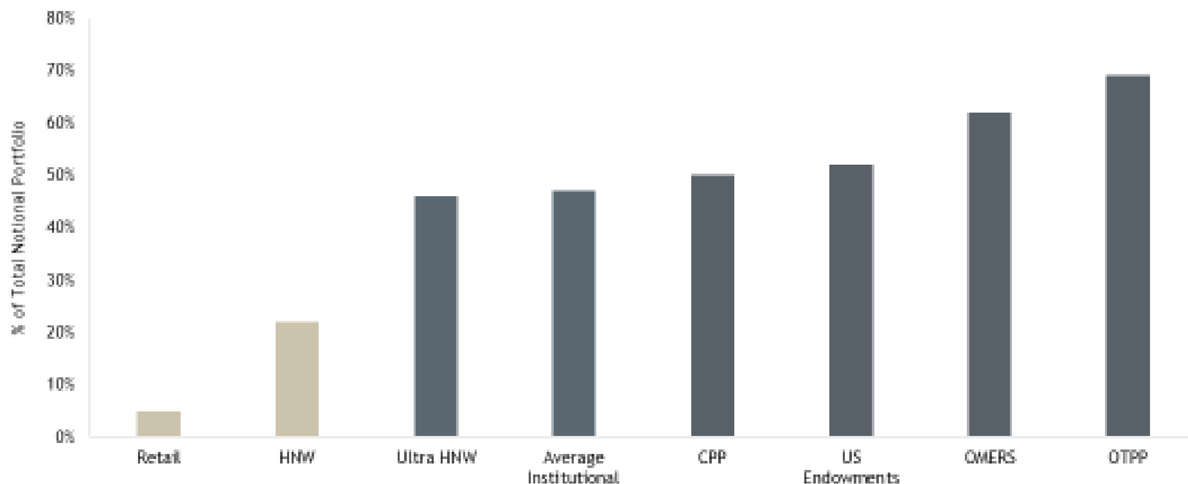
Some of this bond money is being invested in (lower-than-average risk) high dividend paying equities, and a bit is going towards a corporate loan fixed income ETF we use - that currently yields close to 5%.

In addition, as we do not wish 'risk-wise' to significantly increase equities or take on much more credit risk, we also plan to use these funds towards adding to an asset class of mostly fixed income investments which (we anticipate) will continue to provide a steady, reasonably safe, and good yield in the 6% area. This asset class is made up of 'privately valued bonds, loans, mortgages and commercial real estate'. In this sense, we are emulating what most of the largest pension funds in the world (including our Canada Pension Plan) are doing right now with pension fund assets. The chart below shows how much various groups are investing in this area. Retail investors are just now starting shift a bit towards these 'alternate investments' (using hedge funds, private equity and private debt). Our main interest is in what we deem to be the safest privately valued asset class, 'private debt'.

Asset Allocation Trends

Retail Investors Have Only Begun To Embrace Alternatives. Based Upon Institutional Allocation Trends, We Are at the Very Beginning of a Persistent, Sizeable Portfolio Reallocation.

Average Allocation to Alternatives by Investor Type



The information was prepared by CIBC Asset Management Inc. using the following third-party service providers' data: Ninepoint, Blackstone, Global Pension Study 2018, Willis Towers Watson, OTTP, CPP, OMERS. Average Institutional based on data from Preqin (2020).

1

Attached is a report from one of the privately valued pools of investments we currently use, 'Ninepoint Alternative Income'. It will give you a good sense of how this asset class works and why we see good reason to increase our use of this asset class going forward.

Our game plan is to continue to put small amounts of portfolios into various pools of privately valued investments (such as Ninepoint). We typically invest just a small percentage of a portfolio (2% to 3%) into each 'pool'. These funds are very large in size and each fund is highly diversified. And by investing just a small amount into various funds, we can further diversify away as much risk as we possibly can. Both our firm and our team do extensive due diligence on any privately valued investment that may be used in client portfolios.

To expand our use of privately valued investments, we will need to update the 'Investment Policy Statements' and overall account documents for hundreds of clients, so this is a project we will discuss with clients throughout 2021.

Game plan to try and turn 'pain into gain'

Over the years ahead, we will inevitability again need to deal with a 'bad market'. As we did this past March, we will again do our best to try and turn a 'problem into an opportunity'. On average, markets decline in the range of 30% to 40% about every ten years. This magnitude of decline is always caused by either a significant risk/crisis

(that was not anticipated), or a significant economic recession. The higher markets are, the more they tend to fall. As we did on March 24, 2020 (when markets were very low), we plan to again utilize the same type of investment as we did then. We bought an investment that is based on diversified exposure to the TSX 60 stock index called a 'structured product' (with 235% leveraged upside based on how that index performs over a five-year period). In order to obtain this enhanced return, we gave up the cash dividend. We are only prepared to give up the dividend when markets are very low, and we anticipate strong future capital growth from low price levels. Hopefully we don't face a bad market again for a long while but as they say, 'hope is not a strategy'. If this does occur, we can again use a 'structured product' to take advantage of same.

Even though the type of structured product we use is equity oriented, CRA deems the returns to be highly taxed 'interest income', thus we need to have a registered account to tax shelter the resulting interest income. As virtually all clients have either a TFSA, RRSP or RRIF, we buy this investment inside these accounts. Most of our clients are now set up to allow us to trade on a discretionary basis, so we are well-positioned to be able to action this type of trade quickly, efficiently and strategically. As it is almost impossible to call an exact bottom in markets, we will incrementally add perhaps 2% to 3% of portfolios into equity markets (as we did this past March) and be prepared to buy a bit more if markets go down further.

These structured products are created by our firm's corporate finance department and returns are guaranteed by CIBC.

How to manage risk that tends to increase when markets head upwards

The higher markets go, the more we want to do 'de-risk' by using privately valued fixed income and incrementally decrease risk by ensuring lower degrees of publicly traded 'fixed income risk'. In addition, (as we did in 2019) higher markets cause us to increase our focus on areas of the equity market that are traditionally described as 'low volatility'. As you can see, our method of calling where markets may trade going forward has more to do with how low or how high markets are vs. predicting the near term future or projecting how the 'issue of the day' will play out.

How can make we proactively, efficiently and effectively make portfolio changes?

In order to utilize the aforementioned 'privately valued pools of investments' and 'structured products' we need pre-approval. This is included in documentation which is associated with allowing us to trade on a discretionary basis.

Regarding our discretionary trading platform (called 'Advisor Managed Accounts'), we now have four years of experience with this trading method. We are convinced this is the best method we can use. Frankly, it is the only way we can quickly strategically and efficiently take advantage of the inevitability of market volatility.

We (thanks to all you great clients) have a large practice that looks after over 650 families (about 1,100 clients). Bad markets can turn into good markets literally overnight (as we saw this past March.) Thus, we need to be able to action trading without the delay of getting each trade client approved. Four years back, prior to us getting our portfolio manager license (which allows us to trade with discretion), it would take us about two months to do an across the board trade for our clientele.

What countries, industries, companies do we like (factoring in both risk and return)?

Regarding where to focus the portfolios in terms of industry exposure, in our last newsletter in October, we discussed this topic extensively. We would say that for most of our careers to date, it has been best to utilize our 'value-oriented' investment selection method rather than chase higher growth areas that have become popular. We do though ensure some exposure to fast growing industries/companies (in tech, etc.) - provided we are comfortable with valuations/prices and risk (e.g. we added Uber and Aritzia at low prices this past year).

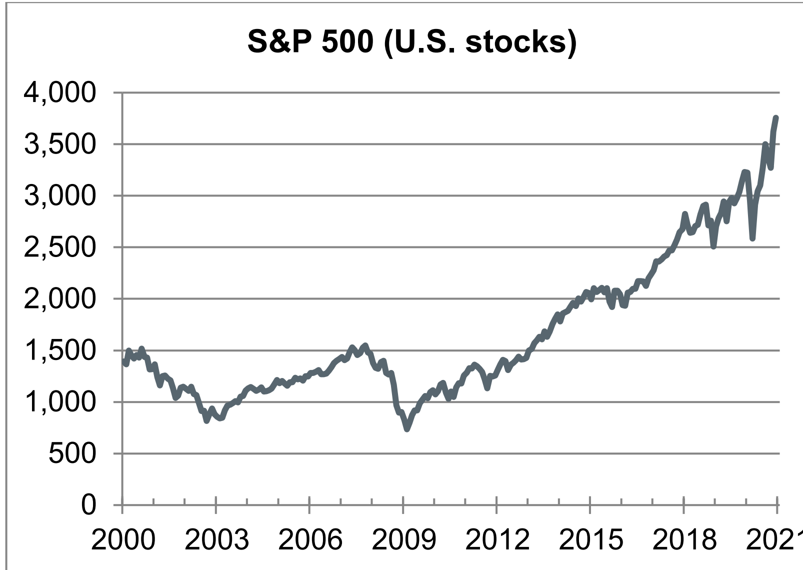
We will continue to look for opportunistic ways to add some 'companies of the future' into portfolios. Our concern right now though is that we see a tremendous amount of 'hot money' going into a number of these companies. As a result, we see signs of overvaluation. For example, newly listed companies (IPOs) in the US are trading at levels which are almost as high as what we saw in the late 1990s, prior to the 'tech crash'. Many growth-oriented stocks (such as Tesla) are being valued at rich levels. At its current share price, Tesla is valued at the same market capitalization as all other car companies in world – combined! Yet Tesla sells just 0.3% of global car sales. Also, previously 'beaten up' Bitcoin is at a price which indicates a lot of speculative interest in markets these days. And how about the crazy situation we just saw with the 'short squeeze' on GameStop?

Much of the interest in tech names is coming from retail investors that normally account for about 15% of total stock trading. This past year, retail trading increased to 20% (assisted by free government money). Throw in speculative trading in call options by retail investors (hitting record levels this past year) and we have a likely explanation of why valuation levels on many of these names look stretched. On the other hand, we continue to see good quality high dividend paying investments trading at very reasonable valuations in Canada, Europe, Asia, and the United States.

As we discussed at the beginning of this letter, we always want to pay close attention to the numbers, not just 'what we are hearing or reading'. An example of how looking at the numbers can be helpful is the topic of 'energy usage'. While the shift towards renewables will continue, overall demand for energy continues to increase, mostly due to increased energy consumption in the emerging economies of the world. So, while renewable energy usage is growing, does that mean that current (inexpensive) conventional energy companies are bad investments, and renewable energy stocks are good investments? Let's look at the numbers to put this in some perspective.

About 80% of the world's energy supply (way back in 1990) came from oil, natural gas, and coal. In the past year, many will be surprised to hear that in 2020, once again, 80% of energy supply came from oil, gas and coal. Thus, while renewable energy supply is increasing, it is not increasing fast enough to gain market share from non-renewables. We are not overly focusing on investing in conventional energy stocks, but this is an example of the 'other side of the coin' that needs to be considered when evaluating new and emerging trends. As we see valuations of renewable stocks as expensive as we have ever seen, for now, we are passing.

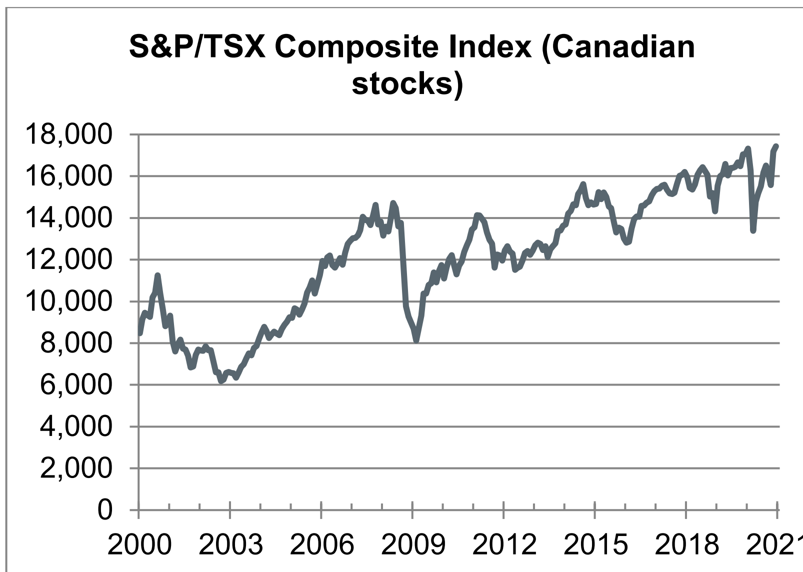
The charts below will give you a sense of where equity markets have been trading in past years and where they sit now.



Source: Thomson One

Trailing PE 37.9

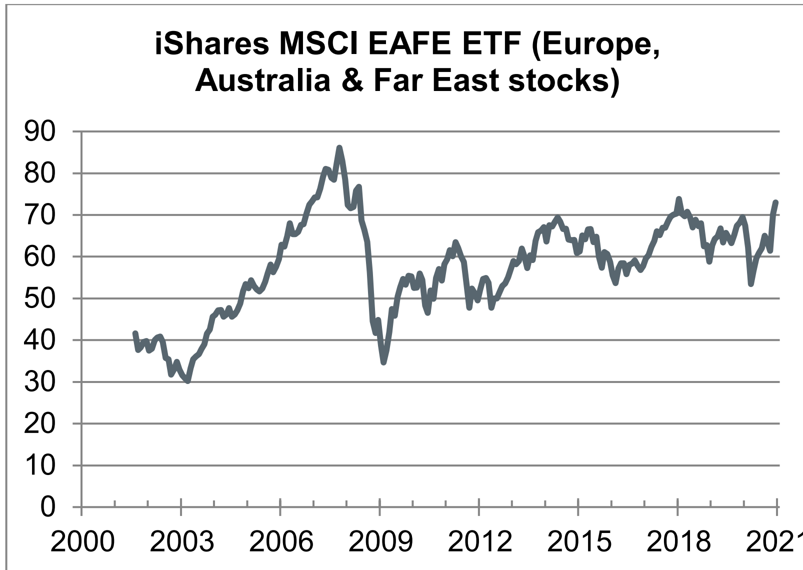
Forward PE 23.2



Source: Thomson One

Trailing PE 18.02

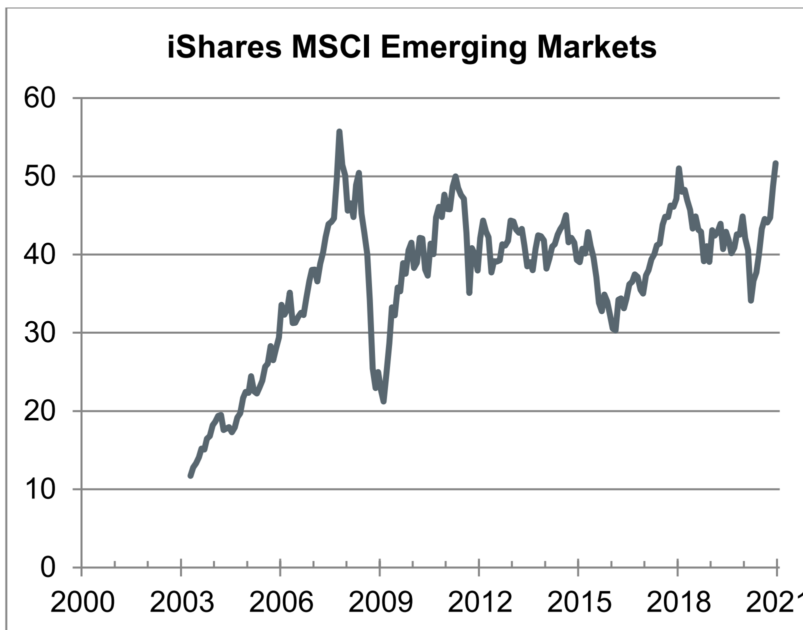
Forward PE 16.04



Trailing PE 23.07

Forward PE 17.7

Source: Thomson One



Trailing PE 18.02

Forward PE 15.9

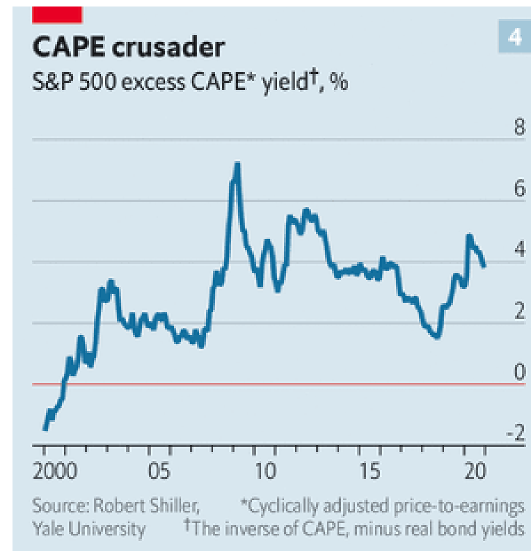
Source: Thomson One

As you can see, the (tech-heavy) US market has significantly outperformed the rest of the world. As a very high 65% of the world's 'stock market capitalization' is now weighted towards the U.S stock market (while the U.S has just 5% of the world's population), we feel a need to be careful with the amount of overall US exposure. And as you see above, valuations (price to earnings ratio's) are more reasonable outside the U.S.

Are stock markets looking expensive?

Warning! (Be prepared to be bored unless you really like to read about finance theories).

Let's first look at valuations on U.S. stocks by using the 'Cyclically Adjusted Price to Earnings' (CAPE) ratio. See the two charts below. The chart on the left-hand side looks at the CAPE ratio, relative to ten-year average -inflation adjusted earnings per share. The CAPE ratio is almost always higher than the current 'price to earnings ratio' - as it compares todays stock prices vs. average (over the past ten-year's) corporate earnings. The ratio has hit a very high level at 33. This ratio has only been higher two previous times in U.S. market history, which is a concern. In contrast, the second chart looks at the CAPE corporate earnings yield - in comparison with today's low interest rates. When one compares the CAPE ratio vs. -very low- ten-year bond yields, suddenly the U.S. market does not look too expensive. Thus, low interest rates may at least somewhat justify todays higher U.S. stock prices.



Interest rates are an import part of stock valuations as analysts value stocks based on the 'present value of future earnings'. This method of stock price valuation is very sensitive the 'discount rate', which is today's (very low) 'risk free interest rate' plus a 'risk premium'. The lower the risk-free interest rate, the higher the discounted present value of the future corporate earnings. Low interest rates therefore explain why equities are being valued more than their historical average. Having said that, U.S. growth stocks (as group) currently trade at very expensive valuations, thus our reason for some caution there. U.S. (value orientated) good dividend paying stocks are much cheaper.

Will Value Investing Come Back?

We hope so, as does the great value investor, Warren Buffet. Starting in November 2020, the market began rotating out of more growth-oriented tech names into safer (and cheaper) value-oriented stocks. We cannot say for certain that this trend will continue but from an overall risk /return standpoint, we want to ensure that we have more of a tilt towards these safer, reasonably valued 'dividend paying' companies. With International and Canadian markets

trading at reasonable valuations (and not nearly as high in price as you can see on the previous stock charts), we are ensuring good exposure to these markets.

Let's sum up the pros and cons

Overall, going forward, there are many positives. Here are some that come to mind:

More predicable leadership in the U.S., (thank goodness!), super low interest rates, more fiscal stimulus to come, significant pent-up consumer demand, record levels of cash in people's bank accounts, advances in robotics and digitizing which will enhance overall growth in productivity; and equities and certain real estate assets attracting investors - due to very low (competing) bond yields.

Reason to have some caution

Almost everyone is saying equities will outperform bonds this year. When 'almost everyone' thinks market will go one way, it often goes the other; speculative trading in some areas of the market indicate too much investor optimism, some tough economic times are in cards for a while yet as we deal with the second wave of Covid; and as said at the beginning of this letter, the perpetual possibility of an 'unforeseen surprise'.

If there is one thing we can say about our world today, it sure is interesting!

Overall, we can assure clients that while we are positing portfolios to generating a decent long-term rate of return, we spend just as much time on trying to mitigate risk.

Bits and Bites

This year's TFSA limit remains at $6,000. For most client situations, we will be investing in one of our model portfolios stocks, Telus.

The 2020 RRSP maximum is $27,230 (deadline end of February). The 2021 maximum RRSP is $27,830. Please check your CRA notice of assessment for your RRSP limit.

As we head towards tax season, please look out for your investment management fee report for non-registered accounts. The fee is tax-deductible.

BC resident children (ages 6 to 9), are eligible for $1,200 (fully BC government funded) towards a 'Registered Educational Savings Plan'. In RESPs we manage here, we track the children's age – and help clients apply for the funds when the child turns six.

In the past year, several new clients have joined our practice. We welcome all of you who have recently joined us! And we very much thank clients for mentioning our practice to your friends, family and colleagues. Our minimum for new clients continues to be $500,000, but as we have always say, any of your children or parents are welcome as clients; and we're always pleased to provide some general advice to anyone- regardless of how much funds they have to invest.

Each year, via our firms' 'Children's Miracle Day' charity, we give a portion of client revenues from the past year to charity. In recent years, the main recipient has been the 'Scientist in Residence Program'. (https://scientistinresidence.ca/) . The program has scientists from UBC working with kids and teachers in inner city schools doing hands on and fun science projects and experiments. The program was on hold of late due to Covid, but we have expanded our support for the next school year by adding additional schools.

We also continue to support Richmond's excellent charity, 'Pathways' (https://pathwaysclubhouse.com/) which supports individuals with mental health challenges by helping them in a variety of ways - including seeking employment.

This past year provided lots of challenges (for clients and us). We got through them and can now see 'some light at the end of the tunnel' -- we hope it's not an oncoming train. Ha-ha.

We have learned some more good lessons that we will try and use as best we can in future. When it comes to market turbulence, which is inevitable in this business, we will draw from experience and do our best to keep portfolios moving forward in the long-term.

We very much appreciate your business and the trust you have put into our team. As always, please call us if we can do anything whatsoever. Here's to a good 2021!

Sincerely,

CIBC Wood Gundy

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Securities

Aritzia Inc.	12,1b,2g,3a,3c

12 The equity securities of this company are subordinate voting shares.

1b CIBC WM Inc. makes a market in the securities of this company.

2g CIBC World Markets Inc. expects to receive or intends to seek compensation for investment banking services from this company in the next 3 months.

3a This company is a client for which a CIBC World Markets company has performed non-investment banking, securities-related services in the past 12 months.

3c CIBC World Markets Inc. has received compensation for non-investment banking, securities-related services from this company in the past 12 months.