CIBC

Risky Business

April 2022

While 2021 was a relatively calm year for investors, so far 2022 has been anything but. With the war in Ukraine, increasing inflation and Covid cases on the rise, we've now seen a resurgence of risk and volatility in the marketplace. Our team spends a lot of time thinking about risk, and how we can minimize it, while still providing strong overall returns. The financial markets have been a good source of wealth creation to any long-term participant, but in order to share in this, investors have always had to endure periods of higher risk and volatility. We would like to discuss some of the legitimate risks we see currently and how we are positioned to take advantage of opportunities that may arise.

Russia-Ukraine War Risk

Our hearts go out to everyone affected by this tragedy and we all hope there can soon be peace. Looking at crises like these from a portfolio standpoint, we need to objectively assess what is happening now, where we see things going, and our portfolio's ability to withstand both the probable and less probable outcomes.

We view the most likely outcome being a negotiated peace treaty with some of the current economic sanctions (against Russia) being removed. The longer-term impact to Russia's economy will still be significant, in that Western Europe will likely embark on a strategy to significantly minimize its dependence on Russian natural resources, particularly natural gas and oil.

A negotiated peace treaty in the shorter term would be positive for markets in general and overall portfolio performance - but we would likely give back some gains however in our energy stocks, Nutrien (the world's largest supplier of fertilizer), and in our commodity exposure, within equity ETFs.

We would be remiss to ignore the fact that this war may continue for a long period of time and (regrettably) further worsen. If this occurs, this will be a negative for the broad stock market, with our commodity stocks and fixed income providing support, but likely not enough to avoid overall portfolio declines. Having said this, there are of course many other factors that will affect markets over the months ahead, so a negative outcome here does not definitely mean markets will head lower. One way or another, our highly diversified portfolio approach includes many investments that will perform 'differently from each other' - in order to eliminate as much overall portfolio volatility as we can.

High oil prices, partly as a result of less Russian oil supply due to sanctions, may be with us for a while. During the recent oil price boom, we have seen only 40% of the normal amount of capital spending by oil and gas companies. Surplus energy company cash-flow has instead gone towards increasing dividends and share buybacks. In addition, the large integrated oil and gas firms are pivoting towards renewables in terms of capital investment. As demand for oil and gas is almost back to pre-pandemic levels, lower future supply of oil (due to lack of capital investment) likely means 'sticker shock' at the gas pumps will remain for a while. High oil prices are no longer the 'recession predicator' they used to be though - as energy cost (as a percentage of overall consumer spending) - is a lot lower than years ago.

Interest Rates/Inflation Risk

The war, continued supply chain disruptions, and increasing wage pressures have put central banks between a 'rock and a hard place'. A slightly inverted yield curve (with ten-year interest rates still at a 'lowish' 2.8 %) means though that the bond market is predicting the economy will soften enough to get inflation under control. Engineering a soft landing though without putting the economy in recession will be very challenging and is something central banks have historically had little success doing. However, factors that could enable central banks to achieve control of inflation -without triggering a recession - are very low unemployment levels, record levels of personal net worth/savings, and pent-up consumer demand (which will help the travel, hospitality and service sectors). These positive elements in today's economic environment could mitigate the impact of higher interest rates.

If interest rates increase more than expected, our fixed income (bond investments) will perform okay - as our average maturity in fixed income investments is only about three years. And our variable rate loan ETF and preferred shares will benefit from increasing interest rates.

As of mid 2021, we have had incredibly low interest rates and record low corporate bond spreads. Since then, we have experienced a poor bond market (namely lower bond prices). This is due to increasing interest rates and expanding corporate bond spreads. The silver lining of lower bond prices though is that we now have a heathy 'yield to maturity' of close to 5% (on average) on our reasonably safe fixed income…that's up considerably (from about 3.75% in mid 2021).

PIMCO Monthly Income Fund (down in price of late along with almost all fixed income) looks particularly good from here. Its high quality (on average A- rated) fixed income portfolio has a short duration of about two years - and a high gross yield of 6%.

Covid Risk

Most of the covid risk (economically) is in China right now. Its thus far successful 'Zero Covid Policy' sets up a big challenge going forward as China's low 'herd immunity' and

its use of domestic vaccines (that are not as effective as mRNA vaccines) will challenge China to reopen.

While it looks likely that the worst of Covid is in the rear-view mirror in the western world, we can not rule out future variants that are more dangerous than Omicron.

While the above three ‘known risks’ (war, interest rate increases/inflation and Covid) are the obvious risks these days, we have learned from history that most often, a significant market pull back occurs not due to ‘expected risks’ - but due to an unexpected risk that comes from ‘out of the blue’.

Obviously, no one can ‘predict an unexpected risk’ and on average, significant market downturns caused by ‘unexpected material risks’, occur every ten years, or so. The perpetual irony in our investment business is that we spend lots of time trying to analyze known risks (which are generally already priced into markets), while it’s the unknown risks, not priced into markets, that usually cause the largest declines. The higher markets get, the more the potential downside, which is why we incrementally decrease portfolio risk when markets do well for an extended period. If we see one or two more good performance years, it will be time to implement more de-risking strategies, than are already being used.

How Are Markets Doing and How Are Clients’ Portfolios Doing?

In addition to poor returns in the bond market, technology stocks are down a lot from highs set last year (as of one month back, over 50% of the stocks in the tech-oriented Nasdaq index fell by a whopping 50% or more.) European markets have also had a tough start to the year given their economies are hurt by higher commodity prices and proximity to the war. All major U.S. stock market indices plus Asian and emerging market indices are also down so far this year.

The Canadian stock market has faired better than most, as our stock market has a lot of reasonably priced dividend paying companies plus, of course, has good exposure to commodity stocks. Domestic commercial real estate (through REITs and privately valued commercial real estate) is also performing well.

On an overall basis, our portfolio tilts towards safety, (through privately valued fixed income, good exposure to Canadian dividend paying stocks, underweight to technology, low exposure to riskier fixed income and almost no exposure to longer term bonds) has done well in terms of performance relative to average market returns - combined with portfolio volatility being less than that of the overall market.

Our aversion to richly valued ‘in favor’ companies/industries continues, however a number of ‘high- flyers’ have come down in price enough to get closer to ‘reality’. We generally believe that most of the time, stock prices accurately value (or price in) ‘known information’. However, in the last couple of years, we have seen many stocks trade at valuations that to us, make no sense. In terms of smaller to mid sized stocks, we can understand why mispricing can occur (due to lack of analyst coverage and the high

proportion of retail investors that are attracted sometimes to 'story companies') but one would think that larger capitalized companies, with lots of analyst coverage and significant institutional ownership should be efficiently priced. We question this though - from time to time.

Tesla's share price movement of late is an example of how sometimes a companies share price can disconnect from rational pricing. We are in the camp that Tesla's extremely rich valuation is not justified. While that is our opinion, we may be proven wrong. What makes no sense though is how Tesla's announcement (last month) of an upcoming stock split somehow justifies the company's 'market capitalization' to increase by a massive 84 billion dollars (which is what happened when the Tesla's share price took off based on this one announcement). Tesla finally started making a profit last year, a bit over 7 billion dollars. No one can rationally explain why the stock split announcement is worth well over ten times last years profits. Stock splits do not (in themselves) increase the value of a company, whatsoever.

To Conclude

While we are about to do some trading (annual 'Dogs of the Dow' update, etc.), overall, we feel very comfortable that client portfolios are positioned well to deal with the known risks discussed in our letter ….and if the unknown risk(s) occur, we have enough 'dry powder' to take advantage of opportunities that may arise.

We would more than welcome an opportunity to meet and/or speak with you further about any of the subject matter above - and to also continue to help you with tax, financial and estate planning. For clients who are comfortable meeting in person, we would love to see you in our newly renovated boardroom - at our recently expanded location. For those who prefer to meet virtually or by telephone, we are also happy to accommodate. Please contact Melanie to book an appointment, at your convenience.

Sincerely,
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