PRIVATE WEALTH MANAGEMENT

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OCTOBER NEWSLETTER

During the fall months we notice an increase in client attention to finances. There is no shortage of things to discuss these days, that's for sure. Here are some views on topics and questions that are coming from client discussions.

Does the increase in stock and bond prices make sense given we still face a severe recession and good degree of uncertainty going forward?

While we are experiencing a bit of market weakness due to a lack of agreement on a pre-election fiscal stimulus package in the U.S., and increased Covid cases, we think the comeback (since the lows of March 23rd) makes sense based on the following factors:

- Massive government fiscal support and huge central bank monetary stimulus.
- The potential for a Covid-19 vaccine rollout in the early to mid-part of 2021. During the midst of the huge sell off in March, estimates were that it could take at least two years or more.
- Less pressure on hospitals than was initially anticipated due to good results with therapeutics, better treatment protocols and (in most countries), adequate levels of PPE.
- In Canada, aggregate income (due to government transfers) has increased so much that the 'per capita debt service ratio' has improved significantly - to levels last seen ten years back.
- The recognition that we will likely see ultra low interest rates for years to come, thus money has been flowing into good yielding equities, growth companies and the few remaining fixed income investments that pay a bit of interest.
- There has been a huge improvement in 'investor sentiment' (AKA 'investor emotions') which has seen many investors shift from selling equities and/or raising cash, to instead trying to profit from this downturn by buying into equities (in particular companies that are faring well such as Tesla, Amazon, Facebook, Google, Netflix, Zoom, renewable power companies, and heath care companies with vaccine and/or Covid therapies exposure.)

Should we be buying more technology (or other fast-growing industries) given many of these companies are doing well given the work/play/study from home phenomena we are clearly seeing?

If we could turn back the clock, sure. In this pandemic oriented recession, many of these companies are benefiting.

Prior to the downturn in March, we had been positioning portfolios for a recessionary environment 'at some point' thus we decreased U.S. stock exposure (which had done so well for us for most of the previous decade) to diversify into other areas that had lagged pricewise and had good defensive characteristics.

As many of the world's leading technology companies reside in the U.S., by decreasing our investment exposure there, we ended up 'underweight' technology. As we have seen though, this pandemic led recession is very different from a typical recession. Certain industries (e.g. tech) benefit, while travel, hospitality, and entertainment take a severe hit. Most other industries are 'affected but not too bad'.

While we concur that trends towards work/play/study from home have hugely accelerated of late, we question the extent of the valuation difference between companies

that are currently benefiting from this shift vs. many quality companies that are 'not affected by Covid too much' but are languishing share price wise.

Our cautiousness on adding tech names right now is based largely on the investment process we have used our entire careers, namely we are very 'valuation conscious' when we buy any asset. In the past couple of years, and currently, valuation metrics on many of these tech companies are at levels where we are concerned about downside risk. We recall vividly how many investors in the late 1990's took huge losses on tech stocks by not paying enough attention to 'valuations'.

Technology as a sector lost about 80% of its value in the early 2000's, which caused an overall market selloff close to 50%. We very much avoided that debacle (and many others since) by staying true to what we call our 'value or growth at a reasonable price' investment process. Having said that, share valuations in the tech sector are nowhere near as extremely overvalued as was the case then; and we recognize that certain industry leading tech firms are much stronger today than they were years ago.

Some tech companies will indeed continue to disrupt more traditional industries. This pandemic has caused about 5 years of coming change to happen within a short period of time. Market efficiency theory (that stock prices reflect all current known information) is a very valid theory, so proponents would say that these tech stocks are indeed priced accurately - or as best as anyone can tell.

Hardware oriented tech companies can face significant competitive pressures; but certain dominant software and internet-based tech companies can generate excellent incremental profits (as revenue grows without much incremental variable expense.) Thus, markets generally ascribe expensive valuations to these companies (which typically pay no dividends).

It will be interesting to see if the current focus by the U.S. congress (in terms of investigating monopolistic tendencies of today's leading tech names) becomes a material risk to share prices or not. In addition to this regulatory risk, we see many of the same warning signs we have seen at previous times when investor attention and excitement turns to more growth-oriented names. Evidence of this is smaller (retail) investors piling into many of these companies of late while similarly having little or no interest to industries/sectors that have become 'cheap' from a valuation perspective.

It's amazing how narrow the stock market's recovery has been. For example, the five largest U.S. tech companies now comprise 25% of the U.S. stock market capitalization (at a time that the U.S., which has just 5% of the world's population, now represents a whopping 65% of the global market capitalization.)

To sum up our options, we could: pay about 25-100 times earnings for non-dividend paying tech stocks (in many cases these are indeed good growth companies that are doing very well); or pay 10-20 times earnings for less exciting but good companies with good dividends. Our preference remains to tilt our weightings towards the latter. Our focus on capital preservation and good yielding blue chip companies has worked very well over our careers to date and should continue to do well longer-term.

It is though important to have some exposure to tech from a diversification standpoint, and to ensure we are not too heavily weighted to industries that carry 'disruption risk'. We make good use of broad-based equity ETFs and some reasonably priced tech companies (Cisco and IBM, each trading with low price-to-earnings ratios and paying good dividends); therefore, we will always have some exposure to the tech sector

We are also not averse to adding some degree of low or no dividend paying growth companies provided we can buy them at reasonable valuation/price levels-such as our two most recent buys (UBER and Aritzia). Thus far, they are doing well.

What areas do we like, and what other areas (other than tech) are we cautious on?

Government bonds, GICs (and now even good quality corporate bonds) currently pay 'next to nothing'. Thus, we continue to mostly avoid these investments for new money.

We are starting to trim back our exposure to good quality corporate bonds a bit as 'yields to maturity' going forward (based on current bond prices) are down to a paltry 1.25-1.70% (as bond prices have increased due to lower interest rates.)

We have a bit of exposure to senior corporate loans through Mackenzie Floating Rate Income ETF (MFT), which has a gross yield of 6.5% (and we believe not too much downside risk). Depending on how much each client has, we are either holding or adding to it.

Invesco Fundamental High Yield Corporate Bond ETF (PFH.F) has a gross yield of 4.5%. which is low for this asset class (below investment grade bonds). We are not adding to this name and have ensured that our overall exposure to bonds with some degree of default risk is 'low'. We may sell some or even all our position in this ETF going forward.

We are holding onto to our position in PIMCO Monthly Income Fund as we expect about a 3.5-4.0% return without too much risk going forward.

We are pleased with how our privately valued investments, mostly invested in fixed income, are doing (Ninepoint Alternative Income Fund, Timbercreek Four Quadrant Global Real Estate Trust, and in some client accounts, ACM Commercial Mortgage Fund.) When public markets eventually fully recover, we will get back to adding to this privately valued asset class which can provide good income with less downside risk, compared to similar publicly traded assets.

Regarding preferred shares, we are pleased to see the recovery in share prices; and we think better prices are still to come. The current average dividend yield (of about 5.25%) is still so high that virtually no company is issuing new preferred shares. Less supply than normal means any reasonable demand coming into this space will cause prices to continue to climb. In addition, banks and insurance companies have begun redeeming their high yielding preferred shares in order to issue cheaper (and tax deductible for them) debt instruments instead. This is very good news. Over the next 2 years, we expect 20% of the entire preferred share market to be redeemed. Some of the resulting cash will find its way back into existing preferred shares.

Are we concerned about Real Estate Investment Trust (REIT) exposure and how much exposure do we have in the 'challenged areas' of commercial real estate?

A typical client has about 4% of their portfolio in office and retail-oriented properties (where the market has concern), so we have some exposure to these areas affected by changing trends, but exposure is not excessive.

The pandemic has indeed significantly increased 'work from home' and 'online shopping' which are concerns for these two types of commercial real estate.

In our previous market update reports, we have provided detailed comments on REITs, so we will try to be concise. Firstly, about one-half of our REIT exposure is in apartments, single family homes and industrial properties (no problems there).

Office properties are indeed affected by increased 'work from home'. We think though that this concern is overly discounted in current pricing. Simply put -when comparing the REIT share price vs. the current value of its properties- the publicly traded share price is significantly below the private value (of what the buildings and land are worth.)

The average office company lease has about five years to go so most rent will still be paid (as office leases are contractual obligations.) In addition, as we see things right now, we do not foresee too much in the way of bankruptcy risk – in companies that typically occupy office buildings.

The most 'challenged area' is retail. A lot of our exposure there is in 'high land value open-air malls'. In the longer term, we think these open-air properties will be ok. However, some of our REITs also own enclosed malls, where the challenges are greater. Two examples of enclosed malls that we own through a REIT are the largest malls in Kelowna and Kamloops. We only have about 1% (of overall portfolio exposure) to enclosed malls.

The open-air retail properties are anchored by large national retailers (such as grocery stores, and Walmart) which by and large are doing ok; but enclosed malls have longer term challenges. These include the shift away from large 'one-stop shopping' retailers and exposure to certain apparel companies that (in some cases) have not adapted well to online shopping.

As is the case with office properties, the share prices of retail property REITs are trading well below true land/building value. Over many years now of investing in REITs, whenever we have seen REIT share prices disconnect from the 'true value of properties', we have always seen share prices eventually comeback to the value of what the properties are worth.

There are other positives that we think the market is not focusing enough on. These include:

- Future financing costs within REITs will now be lower than previously expected due to the big decline in interest rates. A typical REIT has about 50% leverage (mostly though commercial mortgages). Lower financing cost improves cashflow.
- Smaller retailers and restaurants will indeed see a higher than normal number of bankruptcies going forward but only about 15% of operating income (within our retail REIT exposure) derives from same.
- We will continue to see condos built (at zero land cost) by retailers as they take advantage of high residential real estate prices and good rental demand.
- We will likely see very little in the way of any new retail or office properties built in the foreseeable future and population levels will grow once again- when immigration returns to normal levels. In the long run, supply will eventually equal demand. Thus, if we indeed have too many office and retail properties, a lack of new supply will eventually fix this issue.

It may take some time, but given REITs provide a nice yield (average 6.5%), we think investors will return to this asset class for income - and some growth potential, perhaps once we get through Covid and investors look for yield in an almost zero interest rate world.

In the early stages of the market recovery, most REIT share prices moved up nicely. Of late, while prices have been flat, REITs continue to generate these good cash distributions.

So much for being concise! I am working on that. Ha-ha.

How about investing in renewable power companies and selling fossil fuel companies?

For the sake of our planet, we very much hope to see good growth in the clean energy sector. From an investment standpoint, here is some data/information that forms the background of our current stance on this sector:

Alternate renewable energy (as a share of U.S. energy production) was 13% in 2017 but surprisingly dropped to only 11% in 2019. The decline is because energy demand is still growing strongly, and renewables have not been able to keep pace with increasing demand.

While energy demand in developed nations (such as the U.S.) continues to increase, demand is increasing much faster in developing nations. This is due to more rapid population and GDP growth in developing countries - which in turn increases energy demand. Fourteen percent of the world's growing population (located in the developing world) have no access to electricity- that eventually will change.

The bottom line is the world's demand for energy will continue to increase in the years ahead, and despite renewable power growth, it will still take some time before renewables supply a large portion of that demand.

It is unlikely that a trip to a grocery store in the lower mainland will not include seeing a Tesla; but in the U.S. for example, out of 280 million vehicles, only 1 million are currently EVs. With improvements in battery technology and decreased battery cost, EVs will eventually become a big factor, but it's going to take a while.

In terms of electricity production, the cost of wind and solar is now very competitive with natural gas, so we do expect to see many new wind and solar projects going forward; but it is going to take a lot of time for this transition to happen. Just as car owners are not going to throw away gas burning cars, we will not see countries de-commissioning natural gas power plants anytime soon.

Regrettably, many nations in the developing world continue to build thermal coal fired power plants. In the developed world though, most countries will continue to decommission them over time (and not build new ones.)

Regarding natural gas, prices are rising of late due to a huge decline in drilling for new oil (as natural gas is a byproduct of this drilling, less gas is being produced). And natural gas heating demand increases in the winter months. This explains why natural gas prices have gone up by a good amount (50% year-to-date).

The building of LNG infrastructure to get Canadian natural gas to foreign markets (which command much better prices) will also increase demand for Canadian natural gas.

Oil demand dropped to 80 million barrels a day in April, from 100 million barrels a day, but rebounded to 95 million barrels a day in August. With end of the summer driving season in many countries, demand has fallen a bit, but once we get through Covid, we will likely see oil demand back to close to previous levels. The only area that will likely lag is 'jet-fuel demand' which is about 6% of total oil demand.

In the meantime, U.S. shale producers and others around the world have slashed capital investment. With Saudi Arabia being the only major oil producer able to quickly bring oil to market, eventually we could see a spike in oil prices that will surprise the market.

Canadian oil and gas companies have a much better environmental record than many around the world and a number of them have had good success in decreasing costs, particularly in the oil sands, where oil can now be produced for as low as $7 (variable cost) per barrel . And with TMX and Enbridge line 3 pipeline projects likely to be completed, we may finally see a decline in the large discount that Canadian oil trades at - versus U.S. WTI prices.

Canada produces a lot of heavy oil which many U.S. refining companies need. Declining production in Mexican heavy oil and the Venezuela oil embargo, bodes well for Canadian producers.

Regarding climate change in general, carbon capture, improved battery storage, government tax incentives/subsidies, carbon taxes, use of hydroelectricity (which BC has in abundance), nuclear power facilities (some risk but they produce no greenhouse gas-China in particular is building many), greener building permit regulations to better deal with the 25% of global greenhouse gas that comes from homes/buildings, better cow feed to mitigate methane (a further 25% of greenhouse gas is methane), more people adopting 'beyond but not impossible' (ha-ha) plant based diets, advances to decrease methane from industries, massive tree planting and other future innovations - will all be needed to address this huge concern.

A big game changer will likely be a new way to use 'fusion', to produce electricity. Based on the use of hydrogen, 'fusion' emits no greenhouse gas whatsoever. And the safety level of powering turbines (to produce electricity) using fusion looks good.

By about 2035, the first experimental 'fusion based power plant', a 35 nation, 20-billion-dollar project being constructed in France, will begin production. From there, costs will have to come down. It estimated that by 2050, fusion generated electricity will be cost competitive. Numerous other clean and safe methods to produce power via fusion are being researched. Some look very promising.

Examples of other early stage but promising technologies are: direct air capture (sucking carbon out of the air), carbon neutral fuels, a method to decrease use of cement in concrete manufacturing (cement-making causes 7% of global greenhouse gas), cloud brightening to shelter us better from sun (it can work but potential downsides from tinkering with nature.)

In the far-off future, renewable's powering the energy grid will be the norm; and it is likely that some of the innovative methods being researched (and to be discovered in future) will work. It looks like it will take a long time though before ever-increasing demand for energy will be met by renewables and new technologies. In addition, while a big increase in EVs is coming, that too will take some time. In the meantime, investors seem to be pricing in a quick movement towards this and away from fossil fuels. Based on the current data and trends, this looks unlikely.

Given rich valuations for renewable power companies (and Tesla), there is a reasonable chance these companies may not be able to meet the high growth estimates the market has priced in.

Valuation wise, a mere one-half of the current market value of Microsoft will buy every energy company in the S&P 500. Thus, the market has such dismal expectations of the conventional energy sector (share price wise), any return to some degree of normalcy in oil and gas demand may see this sector surprise on the upside.

Where are we investment wise?

Fortunately, we do not have much exposure to oil and gas producers. Stock prices for larger oil and gas companies have done very poorly while intermediate and small caps in that sector have seen their share prices decimated. We are starting to add a small amount to our sole (pure) oil and gas producer, Canadian Natural Resources (CNQ) with cash coming into clients' accounts.

We added a bit to the stock market (for clients in our discretionary accounts) on March 24; since then, any additional buying of equities has been based on cash flow coming into client accounts or for clients who have had new money to invest.

We will be doing our annual rebalancing of our 'Dogs of Dow strategy' shortly and since Exxon (an integrated energy company) is no longer in the Dow index, that stock will be sold. Proctor & Gamble, which has done very well, will also be sold as it is no longer a top ten dividend payer in the Dow 30 index. We have used this contrarian, value oriented, high dividend strategy for over 20 years now (for a portion of U.S. equity exposure). While the strategy has been very successful over the years, this past year is the first time we have seen this strategy materially underperform the overall market. This is clearly due to the 'value underperforming growth' theme we have been discussing in this letter- which we feel will eventually shift in the other direction.

We are also adding a bit to our REIT positions, and to companies with high dividends such as Manulife and Nutrien (the world's largest producer of crop nutrients.)

U.S. election risk?

A Biden victory looks likely and it's possible that the Democrats will also take the Senate and retain the House of Representatives. If so, anticipate a return to normal (not low) U.S. corporate tax rates, big fiscal stimulus, increased investments in renewables (that's largely behind the high share prices in same of late), a return to better global cooperation (thankfully), and less ammunition for late night TV comics!

Having never thought Trump could win back in 2016, my track record on election predictions has not been very good, but as they say, 'keep betting on tails and eventually the coin will flip tails' (that's an original! -at least I think so.)

How about inflation as result of all this money printing?

Economic textbooks from years back would have predicted inflation based on the huge increase we are seeing in 'money supply'; but in today's world, it's not happening due to:

- Lack of demand for goods.
- Increased supply of goods (due to advancements in manufactured productivity.)
- Efficiencies gained by increased use of technology.
- Banks which are hesitant to lend.

All the above has been keeping inflation at bay. This is despite the big increase in money supply. If this quantitative easing (QE) was going to create inflation, then Japan (where QE is 100% of one year's GDP), combined with massive fiscal deficit spending (debt now totals 250% of GDP) would have created inflation; but it has not.

The U.S. Federal Reserve has grown money supply to the tune of 20% of GDP which leads many to assume inflation is on the horizon. But Japan's example, plus rock-bottom long-term interest rates (meaning the market in general has low inflation expectations) gives us little concern about inflation.

Having said that, 1-2% inflation combined with say 3% GDP growth is necessary to be able handle the huge increase in government debt during this pandemic. Clearly that is what the central banks are trying to pull off.

Where do we see things going from here?

We have seen a nice recovery since the lows of March 23rd despite higher than usual uncertainty regarding the economy.

We think that quality, higher yielding, somewhat defensive equities will very likely attract more buying once we get through this pandemic… and in the meantime, if the market corrects downward, we are comfortable that our bond related investments, privately valued fixed income investments- and tilt towards

reasonably valued Canadian and International dividend paying equities will provide appropriate downside protection.

Please do not hesitate to call in to review your accounts or to discuss anything whatsoever including tax, estate, and financial planning matters.

Sincerely,

CIBC Wood Gundy

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Securities

Aritzia Inc.	12,1b,2g,3a,3c
Canadian Natural Resources Ltd.	2a,2c,2e,2g,7
Enbridge Inc.	2a,2c,2e,2g,7
Manulife Financial Corp.	2a,2c,2e,2g,7

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