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What Matters Most in This Crisis

Current media headlines feature the effects of the COVID-19 global pandemic on our personal lives and our portfolios. In addition, the Saudi Arabian decision to initiate an oil price war has unsettled financial markets. With all the coverage of these events, we will skip repeating the basics and jump to what matters most.

In recent weeks, price declines across multiple asset classes have been rapid and severe. Major North American equity indices fell over 20% during the quarter. Fortunately, we entered this environment with somewhat conservative holdings, as we believed that equity valuations, in particular, were a bit high. Our portfolios have held up better than the broad market indexes. That said, even with our focus on high-quality companies and our higher than normal weightings in cash and fixed-income, the current environment has been difficult. We have therefore taken some steps to further reduce risk in certain portfolios.

An economic recession and difficult investment environment in the coming months appear to be inevitable. While we welcome the opportunity to buy deeply discounted investments, we plan to act cautiously. Patience will likely be beneficial. Historically, recessions and equity bear markets (which involve declines of 20% or more from peak prices) often last around 6 to 18 months. Rapidly deploying all of our excess cash in client portfolios may not be the best strategy.

Ultimately, our purpose is to be of service to you through all market conditions. If any of your personal financial circumstances have changed significantly, we need to know. This includes changes in job security, income, spending plans, and real estate plans. Understanding any changes to your financial circumstances, goals and risk tolerance is absolutely essential in this environment.

COVID-19

We have no expertise regarding pandemics, but our understanding is that a COVID-19 vaccine could take 12 months or more to become widely available. Both the public and private sectors around the world are devoting unprecedented levels of resources to solving this problem. Even so, we must base our thinking on realistic timelines for COVID-19 resolution. Having a successful vaccine candidate is not the end of the process, as it has to achieve regulatory approval and be widely distributed.

Regardless of vaccine availability, it does not seem possible to keep the world economy in lockdown for the rest of 2020. The economic costs will be intolerable, and there will be severe physical and mental health costs that are unrelated to the risks of COVID-19. We are therefore anticipating a gradual reopening of many businesses around the world in the coming 2-6 months.

We do not take this lightly, as balancing potentially greater loss of life due to COVID-19 against economic concerns is a daunting moral question. Small and medium sized businesses are huge employers in North

America, and they do not have the financial resources of many larger companies. It will be hard to watch people lose viable businesses and jobs that they have built up over decades of work.

Policy Intervention

Political factors will be crucial during this crisis. The largest government bailouts of all time will happen around the world. Politicians and unelected central bankers will decide who gets money and who doesn't. Unemployment is already rising fast, and the political pressure to act is enormous. Governments in Canada and the United States will immediately provide assistance to affected workers. Government assistance for affected businesses will be more controversial and uneven. Policy makers are making decisions under time pressure, and their biases will cause huge unfairness.

The bad aftertaste of political decisions made during the 2008-2009 global financial crisis still lingers. There were valid questions about why some were given government assistance but not others. There will be fresh debates about today's bailouts in the coming months. This crisis will further divide political opinion in North America between those who want more government involvement in the economy and those who want more economic freedom. This will likely be an issue in the 2020 U.S. election, along with the question of how to pay for today's bailouts.

Impact of the Crisis and the Response

We cannot simply look at the current crisis and conclude it is bad for the economy and asset prices. That is true in the short-run, but we also have to consider the response, which will be an unprecedented amount of government intervention.

In other words, there could be a serious recession in the short-run, which increases the value of cash. Then, over a multi-year period, as economic activity recovers, the huge amounts of new money that will be injected into the global economy by governments and central banks could cause inflation. Assets will fare far better than cash in those circumstances.

We have nothing against holding some cash in client portfolios over shorter periods of time, and we have done quite a bit of that in recent years. We just have to remember that over long periods of time, assets, including equities, bonds, real estate and commodities, have outperformed cash by huge margins. Therefore, holding a high portfolio weighting in cash is only a short-term strategy.

Equity Markets - Massive Opportunities to Come

Historically, severe negative events in North American equity markets have led to exceptional buying opportunities. This time will probably be no different. That said, we are proceeding cautiously. This is not a normal bear market, as the COVID-19 pandemic is leading to nearly complete economic lockdown in many countries. Complicating matters is the fact that most equities were trading at very high valuations before their recent declines. This means that investors were incorrectly anticipating a bright future for corporate earnings and economic growth, and those expectations were built into market prices.

We should also mention that share buybacks will decline. Companies have been repurchasing their own shares for years, which has contributed to strong equity markets. Now, many companies will have to hold more cash or repay debt.

When researching new purchases, we are looking primarily at high-quality companies with strong balance sheets. We need to ensure that we are looking at companies that can survive a bad-case scenario. Interestingly, we are seeing the shares of some great companies trade down to prices that we haven't seen for years. One positive result of this difficult environment could be some new holdings in client portfolios that we could never before consider buying due to their elevated valuations.

The energy sector of the equity markets has been especially impacted in recent weeks, along with travel-related companies. The Saudi decision to initiate an oil price war caught us by surprise. On Monday, March 9, oil prices fell around 30% in a day. Fortunately, our portfolios are not particularly heavy in energy, and the energy companies that we do hold are high-quality with strong balance sheets.

As mentioned above, recessions and equity bear markets often last around 6 to 18 months, so patience may be beneficial. Rapidly deploying all of our excess cash in client portfolios may not be the best strategy. That said, at some point, we will want to look past the economic gloom towards better times and raise equity weightings. Equity markets do tend to anticipate better times months in advance.

In the Total Return Portfolio and High Yield Portfolio, our strategy may simply involve moving cash and fixed-income holdings into more equities in stages until our equity weightings approach 100%. In the Balanced Portfolio, we may also adjust our asset allocation in stages. Our asset allocation may move towards a 70% allocation to equities and a 30% fixed-income allocation. The stages of taking on more risk with the intention of raising our 3-5 year returns will likely coincide with the dissipation of the COVID-19 pandemic and the associated economic problems.

Fixed-Income Markets – A Time of Transition

In difficult times, there is often a flight of capital towards the highest-quality bonds and away from any bonds with significant risk of default. We have always focused on high-quality fixed-income investments and avoided high-risk holdings. Even so, we have taken incremental steps to reduce our fixed-income risk by selling some corporate bonds. In the Balanced Portfolio, where fixed-income is the most prominent, we do not anticipate making any further large changes to our fixed-income holdings in the coming months.

Commodity Markets – Wild Swings

Oil has been in focus in recent weeks. The Saudis decided to increase oil production and create a supply glut, likely in an attempt to drive higher-cost producers out of business. We do not know when the oil price war will end.

The return potential of other commodities is also changing. Precious metals may have extra appeal in this environment, with the money supply increasing around the world. That said, mining stocks are not the same as precious metals. Mining is a difficult business, and there are many times more mining stocks than high-quality mines. We are evaluating our options to further diversify client portfolios.

U.S. – China Trade

On top of everything else, the U.S. and China continue to engage in a trade dispute that may prove difficult to fully resolve to the satisfaction of both countries. We continue to view this trade dispute as significant to the global economy and to equity markets. COVID-19 is already having a significant impact on the U.S. – China trade relationship, particularly in relation to critical medical supplies. U.S. (and Canadian) policy makers have been exposed for being underprepared for a pandemic and overly-reliant on China for the critical supplies needed by front-line medical workers. There are already many calls to repatriate large portions of supply chain for pharmaceuticals and other critical medical products.

Conclusion

In this environment, we will need to balance the desire to minimize short-term portfolio declines with the longer-term objective of earning solid investment returns.

Today we are facing exceptional uncertainty, and it is foolish to pretend otherwise. Even so, market prices have already declined substantially, and it's likely that there will be major long-term opportunities available in the coming months.

At this moment, we believe that clients are positioned appropriately based on their investment objectives and risk tolerance. As mentioned above, if any of your personal financial circumstances have changed significantly, we need to know, so we can change course in your accounts if justified. For some clients this could mean reducing risk, and for others it could mean increasing risk and potential return. Thank you for reading our First Quarter Newsletter. We look forward to serving you during the rest of 2020 and beyond.

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APPENDIX "A"

DISCRETIONARY MODEL PORFOLIOS

We encourage clients to contact us for more information regarding our three fully discretionary model portfolios, namely the Total Return Portfolio, the High Yield Portfolio and the Balanced Portfolio. Our research efforts are now primarily devoted to finding investment ideas that will suit the criteria established for these portfolios and contribute to their returns.

1) Our Total Return Portfolio is focused on providing clients with an average annual return of around 8-10%, consisting mainly of capital gains and dividends.

2) Our High Yield Portfolio is focused on providing income-seeking clients with an average yield of 4%, plus around 2-3% of annual capital growth.

3) Our Balanced Portfolio is a more conservative portfolio that typically consists of approximately 50% fixed income investments and 50% equity investments.

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