CIBC Wood Gundy | Papau Armstrong Schmidt Financial Group

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Keeping the Focus on High-Quality Companies

Looking back on 2020, aggressive government and central bank intervention plus the return of investor optimism saved the equity markets from a very rough first quarter. Now, in early 2021, many equities again appear to be overvalued, in our opinion. There are lots of speculative companies attracting great attention from investors, many of them new to the markets. We believe that there are still undervalued opportunities in some sectors, mainly involving high-quality companies that have been harmed by the pandemic.

Generally, investors are confident in the vaccine rollout, and are looking ahead to better economic times. Historically high levels of market intervention are likely to continue, both by governments through fiscal spending, and by central banks through interest rate suppression and money printing. Policy makers have made it clear that they want higher levels of economic activity and they want higher inflation. The trend is towards greater intervention in markets with no end in sight.

We will focus this fourth quarter of 2020 (Q4) Newsletter on some of the opportunities and risks that we see for the year ahead.

Opportunities

We tend to find opportunities whenever high-quality companies trade at undervalued prices. In recent months, we have consistently been buyers of these types of companies in our discretionary portfolios, and our cash weightings have come down. Our buying was the most aggressive in Q2, Q3 and early Q4 and has slowed down somewhat since early December.

Many of these companies have multi-decade track records of success, pay dividends, and have remained profitable throughout the pandemic. Our Q3 Newsletter contains several examples. We believe that the rotation towards high quality companies of this description can continue along with the overall economic recovery. We continue to favor these types of companies for our new purchases.

Our financial sector holdings are a good example. There will of course be loan losses for Canadian and U.S. banks as a result of the pandemic, but so far, they appear to be manageable. Signs of economic recovery have pushed interest rates slightly higher in the U.S., but not high enough to cause concern. For U.S. banks, this means they can earn a higher spread between what they receive in interest from loans and what they pay in interest on deposits. For example, J.P. Morgan Chase & Co. (US:JPM) is a significant holding for many of our clients. The company's shares traded below US$100 for much of 2020. More recently, they have recovered to above US$130. Most of the gains occurred since early November.

We have been searching diligently for additional opportunities in the technology sector beyond our current holdings in Apple Inc. (US:AAPL) and Alphabet Inc. (US:GOOGL). Many of the highest-quality companies look

too expensive to us. In late October, we purchased shares of semiconductor capital equipment maker Applied Materials Inc. (US:AMAT) in our Total Return Portfolio at a price of US$60 per share. At that price, the shares looked modestly undervalued, assuming continued growth in the industry. Perhaps aided by current investor sentiment, the shares immediately surged higher. We decided to take profits on November 25, only one month later, at a price of US$81.74 per share, giving clients a gains of roughly 35%, or two to three years of equity-like returns.

The move in the stock was a bit abnormal for a company that has been around for decades and usually trades in a calmer manner. We are mentioning this minor transaction because we want clients to know that we do constantly try to find technology companies that fit our strategy. It has simply been difficult in these markets, as there is so much optimism built into equity pricing in the technology sector, especially companies that are beneficiaries of the pandemic.

Since the year 2000, we have experienced two lengthy periods when technology equities stagnated or declined, so technological innovation is no guarantee of equity price performance. This is hard to understand for newer investors. The historical trading of Microsoft Corp. (US:MSFT), one of the greatest software companies ever, provides a good example. On the first trading day of the year 2000, Microsoft shares closed at US$116.56. The shares then declined sharply in the bear market of 2001-02. Even a full decade later, on January 4, 2010, the shares closed at only US$30.95. Meanwhile, the company continued to innovate, and sales and profits continued to grow. The problem for the year 2000 purchaser of Microsoft shares was that they were trading at a very high valuation. We are not arguing that all technology stocks will face this disappointing outcome 10 years from now. We are simply pointing out that caution can be warranted when there is too much optimism about any one sector of the equity market. At the moment, we are generally seeing better opportunities in high-quality companies outside of the technology sector, but we will continue to search.

Risks

There are no shortage of risks facing the equity markets today, even with the vaccine rollout ongoing. The first risk worth mentioning is that the pandemic could extend well into 2022, suppressing economic activity and causing a selloff in the equity market. The probability of this outcome is declining. Several effective vaccines have already been developed. Uncertainty about the rollout of these vaccines is a far smaller problem than developing the vaccines in the first place. Part of the reason we even mention this risk is that there is uncertainty regarding whether the vaccines will effectively combat every new strain of the virus.

Another risk is that the massive amounts of money creation and policy intervention, combined with pent-up consumer demand and rising commodity prices, could cause an inflation and interest rate scare. It seems likely that we will have to face this scenario within the next 12-18 months. We think this scenario could actually harm the most overpriced companies in the market the most, and we try to avoid those holdings. We also note that higher rates could actually benefit many of our holdings, especially in the financial sector, and we also have some holdings that would benefit from higher commodity prices.

A third risk is that equities are simply overvalued at this point, and markets could perform poorly even if corporate earnings recover along with the economy. We take this risk very seriously. We are likely to face

some version of this scenario within the next 12-18 months, and we believe we are fairly well prepared for it. The particular equities we hold, in our opinion, are not overvalued. Of course they could be dragged lower in an overall market selloff, but we believe they are likely to perform better in that scenario than many of the more speculative companies that have surged during the pandemic.

A fourth risk worth discussing is that investor sentiment is currently extremely optimistic. Historically, extreme optimism has often been followed by periods of weak returns. This makes sense. If most people are optimistic, there are fewer skeptics left over to be converted into equity buyers. If anything goes wrong, there are lots of people who will be caught off guard by bad news and may decide to sell. The excessive optimism about equity markets currently looks like a warning sign. We are managing this risk primarily by staying away from the most speculative companies with frothy valuations, as we believe they carry the most downside risk.

Finally, we must acknowledge that taxes could go way up around the world in order to pay for pandemic spending. So far, it seems that governments are aware that drastic increases could harm the fragile economy. This risk is more of a slow-developing certainty than a near-term risk to equity markets.

Reviewing these risks, we believe that we understand them fairly well. Of course, there are always complete unknowns that are impossible to anticipate. That is one reason why we use a conservative approach to equity investing.

The best outcome for equities would be a strong economic rebound that occurs on-schedule without any economic overheating. Ideally, policy makers would be able to start slowly withdrawing from their interventions as 2021 nears its end. This would be the path to a gain in equity markets in 2021, and it seems to be achievable. Even if things do go well, it seems highly unlikely that we will escape 2021 without significant volatility. We are prepared to identify more investment opportunities as trends unfold.

Conclusion

Our intention is that our overall strategy and the opportunities and risks for the coming year are understandable and clear for clients. Please let us know if you have any questions regarding this Newsletter or any of your portfolio holdings. Thank you for reading our Q4 Newsletter. We look forward to serving you throughout 2021 and beyond.

David W. Papau *BA, CIM, FCSI*
First Vice-President, Portfolio Manager
T: 604 641-4358
david.papau@cibc.ca

Michael H.F. Armstrong *BA, CIM, FCSI*
First Vice-President, Portfolio Manager
T: 604 608-5223
michael.armstrong@cibc.ca

Andrey Schmidt *BA, LLB, CIM*
Investment Advisor
T: 604 608-5224
andrey.schmidt@cibc.ca

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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