BMO Nesbitt Burns

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Let's connect

Miatello Investment Management
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The Way Ahead (same as the way behind)

It is normal at New Year to reflect on the past and consider the future.

The past year, and indeed the last decade, provided numerous economic and geopolitical shocks that threatened to derail the world's economies. There were wars, real and economic; massive political upheavals; income/wealth inequality; countries near bankruptcy; populism ascendant; autocrats elected or more entrenched; and monetary policy worldwide in unchartered territory.

Many thought at various points that the conditions are too dire, that catastrophe awaits. The market just doesn't realize that there is a crash coming. I heard it on the news. SELL! You would have to be an idiot to invest now.

Yet, our job is not to fret about the world's problems, but to invest in the face of the storming seas. That is what we did and we delivered outstanding returns for our clients over the decade.

We are comforted that a recent gathering at the University of Chicago of 40 top US academic economists provided no consensus on 2020 economic conditions. This is hardly surprising as my own crystal ball on future macroeconomic conditions has been consistently cloudy for the last decade. If you can't come to a consensus on the macro, that should be evidence there is little informational content as to investment direction coming from economists. They do tend to be well informed and humorous speakers, so there is some personal utility in reading their thoughts. To the extent their warnings and dire exhortations depress prices, we salute them.

The future flow of the world is essentially unpredictable. So we mostly ignore it in our work. It's a waste of time to spend too long on matters that are irrelevant to the investment decisions required. Time is best spent on company and security analysis. These are two very different things. The former item deals only with the merits of the potential of the business. The latter concerns investors' interpretation of the former. What makes a company suitable for investment given our style preferences? What is the current market judgement of the security?

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Why does the market think that way? Is there a change coming? Is there evidence the market sees it? A lot of time is spent considering how other market competitors are interpreting widely available information. I'll share a secret. No investor knows something that 1,000 other people don't know and haven't already acted on it.

So go about your business, turn off the news, enjoy life, stay healthy, and let the investment professionals do their job.

In the Spotlight: Nutrien Ltd.

Nutrien was formed in 2018 as the merger between Potash Corp. of Saskatchewan and Agrium. Nutrien leads its peers with revenue of over US$20 billion. The company is the world's largest producer of potash with 20 percent market share, shipping about 12 million metric tons annually. The other soil nutrients produced are nitrogen and phosphate. Nutrien is the largest agricultural retailer in North America and Australia with over 1400 stores where they sell proprietary and private label ag products.

For potash, the short term market dynamic pricing mechanism is based off the signed contracts negotiated by India and China with world producers. Major buyers in India recently signed at slightly lower prices compared to the previous year. China likely will follow suit with a very similar price. These signpost prices are indicative of prices to be negotiated everywhere else worldwide by secondary players. Nutrien's share price has been negatively affected by this commodity price reduction for the 2020 year. Hence a buying opportunity presents itself to investors.

Ag fundamentals are improving for corn and soybeans. Recent low prices gave rise to production cutbacks such that inventories are at multi year lows. This tightened supply/demand balance will lead to a 5% increase in corn planted acreage and a 10% soybean planted acreage for 2020. This will lead to higher grower cash margins and certainly more fertilizer purchases. Overall potash capacity utilization will increase as demand grows and insufficient new capacity comes on stream. The same playbook is expected in the nitrogen market as global utilization increases from a current 92% to over 95% by 2023. Exciting times indeed in the commodity ag world over the next few years!

The company expects to invest substantially in the heavily fragmented retail space in their current markets. $4B to $5B will be allocated over the next 5 years in the retail space driving organic growth via digital, supply chain, marketing and financing businesses.

Nutrien has an excellent, highly experienced executive team who are superb capital allocators. Over the next 5 years they expect to generate up to $25 billion in operating cash flow. Up to $14 billion will fund growth plans and additional returns to shareholders.

We own the stock in our portfolios.

Ask Brian

Dear Brian:

I know many people who almost wholly rely on REITs as their investments and, or as, a reliable producer of investment income, all with very low risk. What do you think?

Regards,
Marsha

Dear Marsha:

Perhaps first I would offer some background.

The Canadian REIT industry had its origin in the early 90s with open end real estate mutual funds. These vehicles ultimately failed as their structure made them unable to accommodate market volatility. The emergence of closed end mutual funds for real estate in 1994 found market acceptance so that by May 1998 the market cap of Canadian REITs grew to $4.4 billion. As market conditions changed, legislation regarding REITs adjusted in order to make the industry an important contributor to economic growth with wide market acceptance. Today the size of the public REIT market in Canada is about $92 billion. They are attractive as a proxy, to invest in real estate of various types in small dollar amounts without the hassle of direct property ownership. For public REITs, the almost instant liquidity is also attractive.

Notably, a REIT unit is a security and does not represent ownership of the real estate owned by the REIT. This is a substantial difference. As a point of interest, it is the trustees of the REIT who own the assets of the REIT. This is even quite a difference from a corporation, where a director does not own the assets of the company. The reality of the REIT unit as a security, and for our purposes a publically traded security, means that it can be compared to stocks of companies.

There are some people who think that REITs are bond substitutes. REITs are sometimes described as hybrid securities living between equity and fixed income. The regular income flow from real estate tenancies make them look like bonds. The reality of the REIT as an entity with business risks is similar to equity. The “no maturity date” on a REIT ensures it is not like a bond. The restricted operating environment, tax structure and legal structure ensure it is not equity.

A statistical measure known as correlation has been calculated between the investment returns of equities and REITs in various countries’ markets and across various time periods. The results are in the range of 0.4 to 0.6 which means that they are a good diversifier to be combined with equities. (The correlation is a statistic used in mean-variation optimization which generates an optimal frontier. Including REITs in the optimization analysis push out the curve, meaning that you get the same return at less risk or can reduce risk for a given return.)

Wholesale substitution of REITs for equities is generally not advisable for a few reasons. Some authors maintain that REITS have outperformed the TSX market. That indeed may be true depending on the time periods selected, but the TSX is not, or should not be, the benchmark for investors and it is a flawed comparator given its dominance by cyclical and financial stocks. As well, REIT historical returns were substantially influenced by the small cap factor effect and the high correlation with fixed income markets where we have experienced a multi-decade decline in interest rates. Intuitively it is not clear to me how a restrictive real estate sector could, over a sustained period, outperform a world-wide equity portfolio that can invest in any sector.

In conclusion, on a theoretical level, REITs could be included in a portfolio in circumstances where risk levels allow. They should not be the only risk asset because their risk level, as defined by volatility, is about the same as equities. The impetus for your question likely derives from the very low returns available in the fixed income market. It may be the case that we will be in this environment for a very long time. Japan has been in this situation for thirty years so far.

The practical investment issue is, as above, the necessity to undertake more risk to obtain higher income levels from portfolios, *where this income is necessary*. However, in most cases, the income derived from dividends and interest sources is not essential to the investment objectives of the portfolio.

Sources: Financial Times, BMO Capital Markets, RBC Capital Markets, J.P. Morgan, Barron's, Wall Street Journal, The Globe & Mail, National Post, Factor Research, Nutrien Ltd., REALpac, The Canadian REIT Handbook

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