

# The Wealth Letter

December 2019

“God bless you if you’re hoping for a mean reversion to a 16x Shiller  $p/e$ ”  
– *Awsath Damodoran*

2019 has been a vintage year for stock investors, particularly those focussed on U.S. equities.

The broader American market continues to outperform Canada’s on the whole by quite a significant factor. Given a not-so-rosy economic backdrop here and the inescapable fact that U.S. multinationals continue to afford investors greater exposure to international economies as well, this is likely to continue. This year, it seems, will be the 8th during this decade when our stock market trails the U.S.

When reviewing the dynamics of the year to date, it is critical to keep in mind that a general and sharp rebound began for North American equities on January 3rd, the day the U.S. central bank’s Chairman made *dovish* comments, convincing “The Market” that the U.S. Fed was not on a set path to increase its interest rates. The general concern had become that the central bank was on the way to making a “policy mistake”, i.e., setting too restrictive monetary policy and precipitating a recession.

Such a mistake, an exogenous shock such as war (hot, cold, trade) aside, is most often the cause of an economic contraction. I think, as ever, it’s more pertinent to take a longer view to gauge how our holdings are benefiting us.

Since “The Fed” walked back its previously restrictive messaging and rate hikes, it has gone farther, actually now cutting the rate it sets three times. The yield on the ten year U.S. Treasury bond has increased from 1.25% to as high as 1.85% and the U.S. stock market has rallied about 24%. The higher bond yields are a good thing. The lower yield was indicative of apprehension about a faltering Global economy as bond investors rushed to lock in yields they thought would slide with further economic weakness. From late September of ‘18 to early January, the broad U.S. market as measured by the S&P 500 had declined over 16% and with this year’s rally we are now about 7% ahead of the peak 15 months ago.

While the economic outlook remains tepid, at least it seems for now that chances of an outright recession in the next year have receded, from a high of 40% to about 25%, according to Bloomberg’s tracking of the NY Fed’s own predictions. Of course, the current round of U.S.-Sino trade policy machinations, which are having a dampening effect on business confidence and investment, are now



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supposedly coming to a successful conclusion and will definitely be an important part of the economic backdrop in 2020.

I was in New York City in November to attend the CFA Institute's annual Equity Research and Valuation Conference, which had a slate of very interesting presenters, including NYU professor Damodaran. His quote at the top of this piece alludes to Yale professor Robert Shiller's work which is anchored on historical data going back to 1945 to determine at what level the stock market should be. Well, the world sure has changed, just look at trillions of dollars of global sovereign debt with negative yields as a starter.

Another presenter was a partner who oversees Global Macro Balance Sheet and Risk for Kohlberg Kravis Roberts, which manages over \$148 billion U.S. They are using alternative data and analytics in their investment process to find opportunities in what they see as a slower growth world.

Andrea Frazzini, a principal at Greenwich Connecticut-based AQR Capital Management, which manages \$185 billion U.S., delved into Warren Buffett's Alpha. He contends that Buffett is a better stock picker than business manager and attributes a good part of his success to his negative cost of capital (due to the float from Berkshire's insurance business) and the lack of pressure to deliver results in the short term. His patience and high-quality orientation have certainly been significant factors over the years to a track record which has been somewhat front end loaded.

Ryan Murphy, Head of Decision Sciences at Morningstar, delved into cognitive biases and how they can affect our forecasting and decision making. He referenced Nobel Prize winner, Daniel Kahneman's book *"Thinking Fast and Slow"*, as well as Canadian author Phil Tetlock's *"Superforecasting"*, two books which I had read previously and found very interesting. If you are looking for something of a lighter read you might consider *"The Undoing Project"* by Michael Lewis, who is the author of such bestsellers as *"Liar's Poker"*, *"The Blindside"*, *"The Big Short"* and *"Moneyball"*. *"The Undoing Project"* explains the work of behavioural economists Kahneman and Amos Tversky's ground breaking research into cognitive biases and their decades long academic partnership.

If one considers that it is not possible to be sure of data released in the recent past as it is routinely revised even quarters later, making predictions, or depending on those of others is not something I put a lot of emphasis on. Long-time Citigroup Chief U.S. Equity Strategist and former Montrealer Tobias Levkovich, in explaining his almost bang-on S&P 500 target prediction for 2019 said "Luck, it's called luck." Not sure how much of that is based on false humility or enough experience to know he's just as likely to be middle of the pack or less this time next year.

Soo... reading a variety of economic reports and forecasts daily and repeatedly polishing my crystal ball, I guesstimate that in the U.S., GDP will likely grow by 1.75-2% next year. The looming presidential election may contribute to investor reticence. But at least the Central Bank will not be a headwind, as it has just signalled it will likely not change its interest rates in 2020.



In Canada, barring a pronounced rebound in the oil patch (not likely), the indebtedness of consumers, a left leaning minority government, subdued foreign investment and weak productivity growth, I think Canada will struggle to match the U.S. Oh, Canada.

Canadian bank shares, historic stalwarts of our stock market and Canadian investor portfolios have disappointed this year as they provision for losses in good part attributable to the oil industry and indebted consumers, hence depressing their reported earnings. While we have certainly benefited from the longer term performance of our bank stocks, we are currently significantly underweight the banking sector of our stock market, even more so energy and other natural resource stocks, the other major pillar of the Canadian index.

A year ago, in my last newsletter I wrote about a few stocks that I had been active in or showed promise, to my mind. I offer a

minor *mea culpa*. I reported that I had trimmed positions in The Walt Disney Co., overall, by about 40%. My concern had been the ongoing trend of *cord cutting*, as cable service households chose to get their entertainment content via streaming, new-fangled rabbit ears or books!

The good news; at the very beginning of November, I chose to re-emphasize Disney shares as recessionary concerns subsided. Disney now owns 20th Century Fox and the other Fox studios that came along with that \$80 billion+ U.S. \$ acquisition to complement its own Pixar, Marvel, and Lucas Film "brands". Besides all those movies and ESPN, the company also makes its profits from very discretionary cruises and theme park visits. The buy decision pre-dated the launch of its Disney+ streaming by 11 days. Disney shares are up 12% since and once again figure in the top ten holdings across my clientele.



While I had not abandoned The Mouse House, I think this new embracing of its shares underscores a critical element of investing. Recognizing and combatting one's own investor psychology. Oh, the traps we lay for ourselves, beyond investing in the story stocks of the day. "I'll sell it when it gets back to my cost" or more pointedly, "I can't buy that here, it's higher than when I got out" are emblematic of these pitfalls. Hopefully, these do not sound familiar.

Well, the market really doesn't know or care what went on in anyone's account whenever. And neither should we.

I also wrote about CAE, Canada's premier aerospace company, which records about 10% of its sales here and represents about just one third of 1% of the S&P TSX index. The company is my top Canadian holding. This is *active* investing; i.e., differing from the index. Quite acceptable that it is up over 35% in 2019, vs. 18% for the Canadian index. This is not a simulation.

Beyond selecting different securities, the emphasis or weight we place on them is a major contributor to the active share of a portfolio. According to a recent study, as reported by Bloomberg, the

top-performing 1.3% of the global stock market accounted for all the \$44.7 trillion of wealth creation in the world's markets from 1990 to 2018. This is not a new phenomenon that one might be tempted to attribute to the rise of tech stocks. Particular to the U.S., the best performing 4% of listed companies has accounted for all the stock market's gain since 1926. I am reminded of U.S. humorist, cowboy and vaudeville performer Will Rogers' sage advice, "*only buy stocks that go up*". It is entirely possible that the future holds in store a broadening of performance across smaller companies, but I think this historical data serves to make the case for managing concentrated portfolios.

The American conglomerate United Technologies also figured in last December's newsletter. Happily, it is up about 36% in 2019, about 1.5x the market. It is the 5th largest equity holding across my clientele's portfolios. The company will seemingly split into 3 separately traded entities next year. After having added Rockwell Collins to its collection of aerospace companies last year, UTC is set to bulk up further in that industry via a merger with Raytheon first, adopt its name for the Aerospace company and then execute 2 spinoffs of the businesses that comprise its climate and controls products, which includes Carrier air conditioners, and Otis Elevators.

As a measure of the tailwind for aerospace globally consider that, by 2035, it is expected that in China alone, the number of civil airports will grow from 250 to 450. I have also seen very bullish longer term estimates of an increase in air conditioning demand there too, which will likely not come as a surprise. In their 2018 annual letter of The Bill and Melinda Gates Foundation, they write that they expect that the globe will create the equivalent of 11 Manhattans **each year** from now until 2060. Urbanization of this magnitude makes apparent the long term appeal of a company like Otis, despite what might be short term ups and downs. These projections also underscore the importance of arriving at a measure of trade détente between China and the U.S.

Statistically, according to Bloomberg, the year following one of

double digit gains is also likely to be positive but uncertainty remains, of course. In the 74 years since World War Two, the S&P 500 has fallen at least 10% 35 times. Of those, 12 were declines of at least 20%. The worst was the almost 57% decline of 2007-2009. Warren Buffet was about 5 months and 25% early, if we go by his NY Times op-ed of October 2008, when he stated he was going all in on America. Hoping to consistently time for these drawdowns via drastic asset allocation changes is not likely to be a winning strategy.

Our own Chief Investment Strategist maintains his bullish stance. His base case scenario for next year is a price return (before dividends) of about of 8% in the level of the S&P 500, propelled by a rise in the earnings of the companies comprising the index approaching 7%. Most of this year's headway has been due to multiple expansion. He is also positive on the Canadian market and expects a similar rise. He does advise focusing on those Canadian stocks with inherent exposure to the U.S. and beyond. My top Canadian holdings beyond CAE, which include TD Bank and CNR, have this factor in common.

Next year, come what may, I venture to say that our portfolios comprised of no nonsense industry leading companies will, at least on a relative basis, continue to serve us well. The only thing 2020 is hindsight.

I wish you and your family a joyous holiday season and the very best in the New Year!



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Sources: BMO Capital Markets, The Wall Street Journal, Bloomberg, Wikipedia, The Bill and Melinda Gates Foundation, NY Times



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