BMO Nesbitt Burns

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Let's connect

Miatello Investment Management
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A Messy First Quarter

The year started with much enthusiasm as equity markets pushed to new highs. Notable value investor, the redoubtable Jeremy Grantham, wrote about the possibility of a "melt-up" in the equity markets, the opposite of a melt-down that everyone understands. January saw the reversal of the 30 year bull market in bonds. That is, prices started to decline as yields rose above key resistance levels. This signaled that the markets had abandoned the possibility of deflation and were now solely concerned with the inflation threat. This is a very favourable development.

On February 2nd, a very strong US labour report further weakened bond prices while they were in an uncertain precarious phase. Equity markets fell off a cliff, yet credit markets remained relatively stable. As markets gyrated, volatility spiked dramatically. Unfortunately, there were substantial funds placed into instruments betting that volatility would never return. As these players were forced to reverse and cover their positions, it caused serious negative consequences in the underlying main markets which absorbed the shock. It became a toxic stew as algorithmic (computer) strategies kept all markets tightly linked and then the momentum traders joined the action to push prices down further.

There was some reversal of these actions later in the quarter. However, the underlying macro trends remain intact. That is: strengthening economies that will cause inflation; central banks in the novel situation of continuing to unwind massive balance sheets expanded over eight years to get us to this point; new financial instruments and investment strategies that are untested when they are jointly put into stress mode; large financial institutions that are stronger companies, but also weakened in certain trading capabilities where they would normally serve as shock absorbers for the markets.

The complacency of 2017 is gone and turmoil remains.

In The Spotlight

STARBUCKS

“Vente, non-fat, no foam, five shot latte.” That’s my wife’s drink of choice. It is one of thousands of customizable combinations that can be ordered. She orders it on her mobile through the app so it is ready as soon as she appears at the Starbucks counter. All the baristas know her. The payment is already processed through the app. The store is the closest to her office although she passes by two others on the walk. I walk by five locations on the way to my office. Starbucks has displaced the Toronto downtown core competition, Timothy’s and 2nd Cup. Remnants are Tim Horton’s, a brand on the wane, and inconsequential small start-ups. In the USA, Starbucks dwarfs Dunkin Donuts, Caribou and Peet’s.

The company has over 27,000 global locations, 74% in the U.S. and 1.5% in Canada. China remains a major opportunity where it has 3,100 stores and a longer term target of over 10,000. India has a longer term target of 1000 stores. In Japan, the company has bought out its partner which will enable more focused growth. Global target stores by 2021 are 37,000. Matthew Ryan, the company’s global chief strategy officer, thinks opening a store is a “no brainer” as US stores pay back in 16 months. Gross store expansion is compelling on its own, but the company has numerous strategies to increase same store sales. New store formats, expanded food offerings, daypart expansion, greater peak hour capacity through digitization and increased mobile order and pay allow for significant growth. In the new store concept area, the company plans flagship roasteries worldwide and 1,000 reserve stores. Reserve coffee will be priced about $10 a cup. In 2019, Starbucks will open a four story cathedral of coffee in Chicago and many more are expected in major urban locations.

Channel development includes association with major retailers allowing in-store shops and distribution of products through them. Starbucks has expanded to restaurant chains, airlines, hotels, universities, and offices. The company has a refreshed K-Cup relationship with Keuring Green Mountain which offers the company a multitude of distributional advantages .

As you might expect the company has a strong growth history. Earnings per share have grown 17% per year over the last four years. Starbucks has a recent market cap of US$83 billion. Analyst consensus 2019 earnings are $2.80 per share.

There is of course more determined competition and execution risk in Starbucks multi-faceted approach to high growth.

We own a position in Starbucks.

Utopia for Investors; How do we get there?

It is worth repeating that the renewed market volatility is the normal state of affairs throughout history. Nonetheless, there are several key macro trends that we would like to see continued toward our journey to the Promised Land.

Geopolitical risks with hostile parties should not spin out of control and result in wars. The market can only face discontinuities in the face of these types of events as there is no way to gradually adjust prices. As an aside, we should acknowledge that war is sometimes necessary as it addresses national strategies longer than the market is willing to consider.

President Trump's style is to bluster then seek more reasonable accommodation. He or his ghost writer has outlined the strategy very clearly. So on the trade front, focus of this week's market angst; all parties should eventually realize an acceptable compromise. The political consensus is that China needs to be reined in and it will be. Highly placed Chinese officials have stated that they do not want a trade war. It would run counter to the country's very long term plans.

Global growth should continue apace. Global central bank strategy has worked brilliantly since 2009 in enabling worldwide economic recovery. They are now performing their most difficult operation in unwinding the Quantitative Easing that stimulated the economies while at the same time carefully gauging the correct discount rates to allow just the appropriate amount of inflation in the system.

The market volatility exposes the financial system to stresses and possible shock. The regime that we exited in 2017 allowed excessive risk-taking to build in the last decade and new financial instruments and trading mechanisms were introduced. We do not know how they will interact when stressed. We need the system to survive the unwinding of the excesses. The large money center banks are very strong now and will survive a nuclear assault. Smaller players may not, and those banks (i.e., J.P. Morgan) will not rescue them as its CEO has just stated.

In conclusion, there will be stormy weather, but the ship will not sink.

What Would Brian Do?

Dear Brian,

In considering options for investing my RSPs I am leaning in the direction of etfs. I recognize you may have a biased opinion but I am willing to entertain your thoughts.

Regards,
Alex

Dear Alex:

That's grand of you. Thanks for the opportunity to share my convictions.

First let's quantify the discussion. I will assume a 1.25% fee differential between the passive method and active management. Over ten years that amounts to an end wealth difference of 13.2 percent.

The first point is whether it is valid to assume the same gross investment returns. I would say no, for a couple of reasons, not that they would both necessarily apply to you.

It is well known, evidenced by many studies that retail investors on their own to not achieve market index results. The main reason is that their view of the prospects for the markets is mis-timed. Another way of saying this is that they sell when they should buy, and buy when they should sell. This would apply to etfs or individual stocks. In my view, this will always be the case, as it is almost impossible to avoid not being influenced by consensus market psychology and pervasive media advice. Investment TV channel talking heads are compelling only to the non-professional investor.

Asset allocation is a problem for retail investors. If there is an allocation of x dollars and five choices, the most likely response is to place 20 % of x in each option. Obviously, this is suboptimal. I have seen this many times in practice. One of the most persistent crazy recommendations is a significant allocation to cash in RRSP accounts for middle age investors whose accounts are considered to be growth style.

So I submit that the same gross returns would not be achieved.

The second point is that the current most used indices via etfs have been distorted over the last few years. In the US, the IT sector has become overly popular and heavily weighted in the benchmarks. Is it wise to own Netflix, Amazon and Facebook at current levels, as you would in an etf, when at least one of them is facing an existential threat? Does it make sense to own a resource exposed Canadian etf?

Third, the proliferation of etfs has reached a point where there are now more etfs than the underlying securities that comprise them. Amongst that group there are many nuances on the original concept of what they were intended to do. Some of the new formulations are in fact dangerous. One must be careful to avoid adding a product where the risk undertaken does not have the proper reward profile.

Fourth, self-management, even by etfs, is inherently anxiety producing. Was the correct buy decision made? If so, perhaps it should have been more? Or perhaps it should have been less? Who really knows? It can lead to self-doubt and “trigger finger.” Online brokers make it easy to change your mind and trade. Fifth, self-management requires you to gather, consume, and analyze information, then to execute. Most people just can’t do this. The hours add up quickly and I am sure you could better employ your time and skills developing your business.

Investment management is not as simple as portrayed by etf purveyors. The reason they are attracting business is that the retail buyers don’t understand the true costs.

But now you do Alex.

Sources: Financial Times, Morningstar, J.P. Morgan, Barron’s, Wall Street Journal

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