BMO Nesbitt Burns
ISSUE #97: WINTER 2020

The Fundamental Investor

A QUARTERLY INVESTMENT NEWSLETTER

BETWEEN A ROCK & A HARD SPOT

As portfolio managers, we are constantly scouring the globe for investment opportunities. It is a constant battle between companies that are doing well but whose stock price appears elevated and others whose price appears reasonable, yet have obvious challenges. Like all managers, we have our discipline or style. For example, some managers look for earnings momentum or growth. We look at stocks as real businesses, we look to buy businesses when they appear reasonably priced and we generally like to hold these companies for an extended period.

The Popular Price to Earnings Ratio
Let's look at perhaps the most basic way to value a company: the price to earnings ratio (P/E). Granted there are several other well known metrics for valuation, however, for simplicity's sake, we can start there. If a stock trades at $100 and the company earns $10 per share annually, it is said that the stock trades at 10 times earnings. That is, the stock's price divided by its earnings. Now let's pretend we are looking to buy this business in its entirety and it has one share outstanding. We pay $100 today, business operations produce $10 per year of profit and thus after 10 years the business is fully paid; all future earnings are ours to keep. In the above example, I have excluded any potential profit growth over the 10 year period, which could shorten the time period required to fully recapture your initial investment of $100. For example, if our newly acquired business were to experience 10 percent annual earnings growth, the recapture period of our initial investment would fall below dramatically to 7 years. So, the question is: what is a reasonable price earnings multiple to pay for any given business? Certainly, it makes sense that companies which are growing faster, should sell for a higher multiple of their earnings, yet still what is a fair price?

No Hard Rules
Market participants have always struggled with this question, because at different times throughout history, investors have been willing to pay different P/E ratios for the same companies. Nobody can say for sure what is a correct multiple to pay. Unfortunately, the market does not follow hard rules like those in science or mathematics, the "rules" are constantly changing and nobody can fully explain them. However, when we think of it in terms of buying the entire company and estimating the number of years of profits required to get our capital back, it makes some of today's market prices rather confounding.

Earnings Payback Period Matters
Putting aside extreme examples like Tesla and other companies with little or no earnings, many of the best known companies leave plenty of room for downside when Mr. Market decides

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FIXED INCOME: Plumbing Problems

Talking about the behind the scenes plumbing of our monetary system makes for neither light nor entertaining reading. However, recent events in the *repo* markets are important and should not be taken lightly, thus we'll venture into the esoterica of our modern monetary system. Repo, is industry jargon for *repurchase agreement*. These are very short term loans, typically one day, done between financial institutions. They are collateral backed agreements between parties to sell and repurchase, at a predetermined price, a security, typically a government bond, with the difference between the buy-sell price representing the interest earned by the lender.

The Fed may engage in repo operations to effect the quantity of money in the banking system, its does so only with *primary dealers,* such as JP Morgan. Non-bank financial institutions, such as mortgage brokers, hedge funds, private equity firms, etc.--collectively and colloquially referred to as *the shadow banking system*--who cannot engage in repo operations directly with the Fed, but who may also have short term funding needs, do so with the primary dealers. This is a large market, the daily repo action averages 2-4 trillion dollars.

The Unexpected Blow Up

Late in September 2019, market participants found themselves waking up to a repo rate which had suddenly spiked from 2% to nearly 10%: a move more than sufficient to cause absolute chaos in the banking system. Of course, rather than leaving the free markets to sort things out and allowing a few over leveraged, cash strapped players to fail, it was central bankers to the rescue. The Fed immediately fired up the printing presses and began buying bonds from primary dealers in order to flush the system with the cash it so desperately desired. Once again, the Fed's balance sheet began to grow by tens of billions of dollars a day. Markets rejoiced at this renewed QE (Quantitative Easing) program, the repo rate fell back down towards the Fed Funds Rate, which it tends to track very closely, and stock markets rallied on a flush of new money. The Fed, of course, went to great lengths to explain how the "*repo event*'" was simply a *technical glitch* and the Fed's intervention would be temporary and should not be considered as a new round of QE, as they were not buying long dated bonds, but rather short term treasury bills. My view: if it walks like a duck and quacks like a duck, it's probably a duck. Whether the Fed is printing money to buy short or long dated government debt securities, it is essentially 1) devaluing the existing stock of money in circulation by printing additional currency 2) interfering (i.e. distorting pricing) in what should otherwise be a free market in private lending 3) facilitating profligate fiscal policy by monetizing government debt.

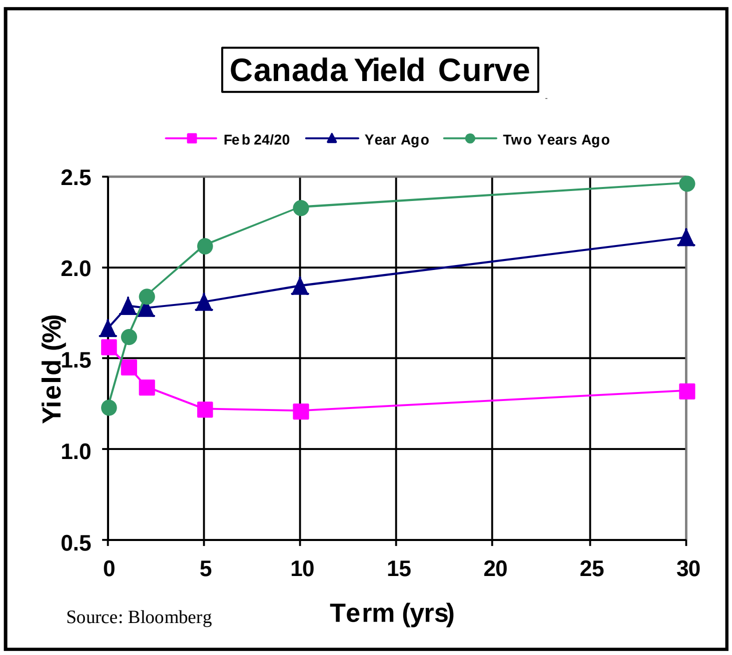
So What Caused the Repo Spike in the Fist Place?

The short answer: nobody really knows, not even the Fed! I have read so many articles on the subject from so called experts and still do not have a clear answer to this important question. One explanation was the large cash need of corporate America to pay quarterly tax installments. Another, was the excessive issuance of debt securities throughout the year by the US Treasury Department, which clogged up the balance sheet of primary dealers, who for the exclusive privilege of being able to buy government bonds at wholesale rates, must bid on and thus must buy all issuances from the treasury. Finally, there was the idea that Dodd-Frank and Basel lll regulatory requirements put quarter ending stress on banks, restricting their ability to lend into the repo market. Some of this makes sense to me, but these are not all of the important factors. The whole story will undoubtedly remain a mystery. Consider that if Federal Reserve data is accurate and commercial banks continue to maintain large amounts of excess reserves, what were banks so afraid of, choosing to pass on such a feast, preferring to sit on their excess reserves earning 2%, rather than lending into the repo market at 10%? Furthermore, the corporate tax and regulatory arguments make no sense to me. Banks know that they face such cash demands at the end of every quarter, how could they be caught offside?

Just Another Monetary Roach Motel Policy

Four months and hundreds of billions dollar later, the Fed is now the repo lender of first resort. So much for "*temporary technical glitch"*. Just like QE and ZIRP (Zero Interest Rate Policy), the Fed will not be able to extricate itself from the repo market. Any effort to do so will result in a convulsive fit by the cheap money addicts and the possibility of something important blowing up, similar to the market's reaction when the Fed tried to shrink its balance sheet and normalize rates in 2018. Leverage to the eyeballs, party on….

When you wake up each morning repeat this mantra, "Central bankers are not my friend". Sincerely, Mark.



PORTFOLIO MANAGER: Crypto Dreams

Bitcoin, What is it?
Frankly, the answer to that question has changed over time to suit the narrative of Bitcoin supporters. Initially, it was supposed to be a currency. One we could use on a daily basis for all transaction types. However, the complexity of block chain--the technology underlying all crypto currencies (digital currencies)--is too heavy to allow for the voluminous transaction processing required for it to function as such. Consider that with relatively good security and very high reliability, a single company like VISA processes roughly 150M transactions per day or about 65,000/sec versus the Bitcoin network, which despite being around for more than eight years now, is still limited to about 430K transactions per day or roughly 5/sec. The serviceability gap remains enormous and looks very difficult to close. Following this failure, the narrative changed to re-brand digital currencies as an asset class, rather than a daily medium of exchange. Thus, we were told, Bitcoin should be considered as digital gold, a store of value, subject to a manageable level of infrequent transactions...the narrative continues to evolve.

The Intention is Good
Of course, as a big believer in free markets, I fully support the concepts behind the development of a currency that is truly physically limited in quantity. A currency that allows for pier-to-pier secure transacting with no intermediaries adding to costs, like the 2-3% fees that credit card companies charge vendors for system access, that must then be passed onto consumers. A trans-national currency that is controlled by nobody, least of all profligate governments and myopic central bankers.

Separating the Technology from the App
I remain convinced that fundamental block chain technology and its myriad of possible applications will revolutionize many sectors, such as *proof of ownership* and *chain of custody,* just to name two. Furthermore, the *open source* nature of the basic code means that it is available, without charge, to all who want to use it: nobody owns the basic block chain technology or holds a patent on it that might restrict its use and/or increase operational costs. Thank you Sitoshi Nakamoto.

Digital Wallets Getting Hacked
You must own a crypto-wallet in order to store your crypto-currencies, such as Bitcoin. Your wallet is secured by a unique encryption key. However, there is no shortage of stories about wallets being hacked or coders including hidden back doors in various wallets. Of course, with no regulated and liable intermediary, there is little to no recourse for those that have lost, forgotten, or had their keys stolen or wallets hacked. So, eliminating intermediaries has its indirect costs. It is important to note that Bitcoin itself or rather the block chain technology underlying Bitcoin has yet to be hacked, and it seems unlikely that it ever will. However, *never-ever* is a very long time, and the first time it does get hacked, this digital currency or asset immediately goes to zero.

Furthermore, public storage vaults (the crypto world's equivalent of banks) have been hacked. Go to Wikipedia to read about the 500 million dollar heist of Bitcoin from Mount Gox's vault, at that time one of the biggest and most trusted Bitcoin dealer/exchange.

Digital Currencies not so Green
It's ironic that the Millennial generation, who are the bedrock cohort underlying society's move towards a greener future, should also be the biggest supporters of Bitcoin, which is probably the biggest environmental disaster of the 2010s. While estimates very wildly, the decentralized computing network that both creates (mines) for new bitcoins and authenticates transactions is estimated to consume the equivalent of Denmark's annual electrical output of 40 terawatts or about 250Kwatts per transaction. Enough to power the average Danish home for a week!

Better Hope the Grid Never Goes Down
The idea that I am totally dependent on electricity (the internet, Wi-Fi-access, a mobile device, etc.) to access any part of my money does not sit well with me. True, we are all, in large part, dependent on the same weaknesses with the current paper fiat system. However, I can get some paper money or gold coins if I want, and store them in a handy location outside of the modern digital banking system. But going 100% digital eliminates this option. One well directed solar flare or one small zombie apocalypse that takes down the grid and I am entirely without a means of exchange, barter aside.

Too Much Power, Privacy Lost
I have no doubt governments are eager to adopt this new technology, moving towards the elimination of paper fiat. With a digital foot print of all our transactions, we would be giving government tremendous power. Any semblance of privacy would be lost. Consider that if you decided to buy an old tractor from your neighbor for $200, government could easily apply GST to this private transaction, debiting your account immediately for the tax. They could also apply a negative interest rate to your bank balance to help stimulate the economy or bail out failing banks—-The Fed recently published a paper on exactly how this might work!! With paper money eliminated, the option to remove our money from the bank and stick it under the mattress is gone. The possibility for financial repression in a digital money only world, controlled by government, is just plain scary.

> *"Permit me to issue and control the money*
> *of a nation and I care not who makes its laws."*
> *Nathan Mayer Rothchild*

One unfortunate consequence of the efforts of incumbents such as VISA and MasterCard and the upstart crypto crowd is that they are all helping to move us in that direction, thus paving the way for government to usurp even greater control over <u>our</u> money, the <u>people's</u> money.

As usual, we must fight for our freedoms. Always fight for sound money and freedom of exchange without surveillance capitalism. Sincerely, Mark.

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current multiples are no longer suitable. This is why I believe it's important to buy companies that pay dividends.

The Dividend Shock Absorber

A dividend, which as long as it is sustainable, acts as downside protection in case the market decides to pay a lower multiple for the stock. For example, if we consider Scotiabank shares, the bank is projected to earn roughly $7.25 per share this year. Currently, it pays $3.66 per share in dividends and the stock trades at $74, thus the company has a P/E ratio of 10 and a dividend yield of 5%. If shares were to drop 20% to the $60 level, the dividend ($3.66) would represent a yield of 6.1%. Furthermore, a drop of 30% to $52 would put the yield at 7.0%. This elevated yield acts as support and helps to put a floor under the stock price, as the further the stock drops, the more enticing it becomes to yield hungry investors.

Conversely, if we examine a company like Costco, currently trading at $315/share, with earnings of $8.60 (P/E = 35x) and $2.78 (0.9%) in dividends, there's not much support from either the dividend or a valuation perspective for a long way down. There is little doubt Costco's business is growing far more rapidly than Scotiabank's. Nonetheless, some quick math will show that when the market decides that 35 times earnings is no longer appropriate, it is difficult to estimate were a floor might immerge for Costco's stock price.

This is the predicament we find ourselves in today's market. There are at least two groups of companies: one whose prospects are good at the moment, but are trading at dangerous valuations; the other group which is muddling along with issues and challenges, but whose valuation and dividends protect on the downside.

Finding Downside Protection

Energy and financials fall in the latter group. Generally speaking, their shares are trading at very reasonable levels by historical metrics, yet each sector faces structural challenges.

Energy shares are caught in a situation were oil prices are soft, due in part to oversupply created by U.S. shale production, a perception that electric vehicles are going to reduce demand and a general dislike from investors who view them as carbon emitters and part of the environmental problem. It would appear that these issues are not going away any time soon. Nonetheless, we view oil stocks as similar to tobacco stocks a few decades ago. That is, despite being hated by the market, they continued to reward investors with generous yields and excellent total returns.

The fact is, oil demand is still going to increase for the foreseeable future, electric vehicles are a long way from becoming viable from a mass market perspective and despite the environmental concerns, the world still needs oil. The cash flows on some of the best oil companies are compelling. The companies are rewarding shareholders by using these cash flows to buy back their depressed shares and pay out juicy dividends. The market may continue to ignore/hate them, but investors can choose to just get paid and wait for sentiment to turn.

Financial stocks are another group whose valuations appear attractive. Since the crisis, many U.S. banks and financial firms have been penalized for being part of the problem and having required a tax payer funded bailout. In addition, the low interest rate environment has pressured their best profit generator, net interest margins (the difference between what they pay on deposits and what they charge for loans). However, banks have found ways to increase profitability by expanding offerings, embracing technology and cutting costs.

The temptation to chase high flying stocks is strong. We see them rising almost everyday and would like to participate, but those of us who lived through the bursting of the tech bubble in 2000 know how things can end badly when valuation and caution are disregarded. To be clear, I do not believe the market is at levels similar to 1999/2000, yet it doesn't take a lot to overpay for an asset that leads to poor returns for years to come. I believe you could buy almost any asset and make money on it, if you buy it at a good price. Conversely, you can certainly lose money or make a poor return by overpaying even for a great asset.

Being careful is never a bad idea, Al.