The Wealth Letter

December 2020

Quality Brings Resilience to Portfolios

I write this on the last Thursday in November as less sunlight will be bestowed upon us each day for the next 3 weeks or so and our American neighbours celebrate their Thanksgiving, just days after their stock market has set a new record. It's not just in the U.S. of course, with the Canadian market up about 11% and the MSCI All-World Index up over 12% this month.

I'd like to say I am writing this in a café in Southern Florida called Fomotina. But I am in truth working from home as most are for the last 9 months and the café doesn't really exist, except as a little place of my creation, which encapsulates two drivers of the stock market for more than a while now. It is an amalgam of the Fear of Missing Out and There is No Alternative.

But Fomotina has served like a double shot of espresso to energize equity investors in the thralls of the global pandemic COVID-19.

Tina had largely been affecting investors calculations even before this virus began to kill people and seize up the global economy. By recent count, according to the Wall Street Journal, there is now over $17 trillion U.S. of sovereign (government) debt offering negative yields. This of course hinges on bond investors' view of a country's fundamentals and the likely trajectory of its currency, if it has one of its own. Germany was perhaps the first country to accommodate lenders by having them pay to accept their loans. China just issued bonds of its own, with the shorter maturities offering negative yields. Ironically, China is the country which has weathered the COVID storm best. Its economy is expected to grow about 8% next year.

In the U.S., the yield on the ten-year government bond is now about 0.80% and has been on the rise of late. As I've said before, that's a good thing. Some economists have predicted just recently that the first quarter of 2021 in the U.S. will see a slight contraction, but the Bloomberg feature I have said I keep handy on my "machine", indicates the chances of a recession are on the decline. Our own chief economist foresees solid growth on both sides of the border next year and BMO's chief investment strategist predicts higher levels for both the U.S. and Canadian stock markets, by-the-way.

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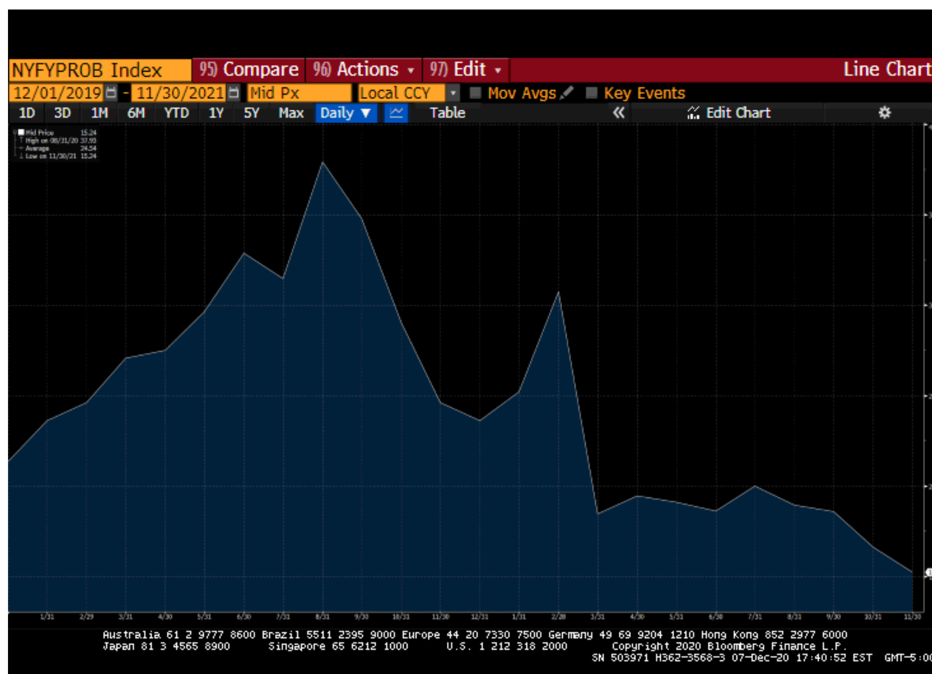

New York Federal Reserve Board's measure of likelihood of US recession in next 12 months.
Sources: Bloomberg

Negative yields of course impact what countries with lesser fundamentals need to pay bond investors and more to the point, affects the profitability of corporations and how investors value those expected profits. That's the crux of Tina.

Bonds have been in a bull market for over a third of a century. This stock bull market is going on 9 months old, the last one having come to a crashing halt in late winter.

The companies with the strongest fundamentals, the ability to post unfailing profitability, and strongest balance sheets have been the best stock performers from day one of this year. Since the birth of this bull on March 23rd, as the U.S. central bank basically had it known that it would do whatever it took to stave off economic calamity, those companies whose survival was most threatened have enjoyed the biggest bounce. Just lately, given news on the vaccine front, the more real re-opening stocks like restaurant chains or airlines have had sharp moves upwards. Herein is found the Fomo.

Not that it is clear sailing yet, but I have to say at this point of this extraordinary year, if back on New Year's Day we knew that we would have come through this crisis as investors as well as we have, I would have been more than happy.

I think that this is attributable to a few factors, beyond the acumen of the monetary and fiscal decision makers here and in the U.S.

One is that our portfolios were diversified and had a very high quality orientation to begin with and were happily populated with just the companies that "the market'" would gravitate to in search of both the where-with-all to survive a crisis and even deliver growth when other pure cyclicals and even more economically sensitive names would be eschewed. Microsoft, Apple and Amazon, for instance, all relatively long standing holdings, fit the bill even more than ever.

Secondly, and modestly, I would suggest that attentiveness and flexibility also served client portfolios well. Here I think of my late January decision to eject from our investment in major holding United Technologies. Having considered the virus news emanating from China I decided to become more liquid across client portfolios generally speaking. UTX shares were a recent but significant holding and in selling, profitably, we raised cash which was deployed later at more advantageous prices, without having an onerous amount of tax to pay.

The sharpest and most significant bear market ever ensued for the next several weeks.

Companies such as Qualcomm and Applied Materials in the semiconductor space were more adventurous names we redeployed into later. Verizon and Coca-Cola were good dividend payers that I invested in as well. I consider their more steady nature to be portfolio stabilizers to a degree. The latter is also something of a bet on a global re-opening, as it derives about half of its sales from outside the home.

Disney, which currently pays no dividend having recently eliminated its payout, is another such bet, with its theme parks and cruise ships,

but it is also investing in its video streaming offerings so there is a burgeoning stay-at-home aspect to its business too.

CNR was a high-quality early summer speculation on the improvement of the North American economy and even increasing trade beyond our shores. I think I was channeling my inner Warren there. And I certainly was when I invested in The Oracle's own company Berkshire Hathaway, just 2 days after the U.S. election.

BRK Class B shares had been a laggard this year, as had many financials. The company has a very substantial insurance business, hence its stupendous balance sheet (cash of $145 billion U.S.- all hail "The Float"!) and as well as its significant portfolio of publicly traded securities, Apple Inc. being the largest, and closely held operating companies such as Burlington Northern railroad, Lubrizol and Precision Cast Parts, which will bring us added economic exposure. Somehow it has taken me a while to invest in Berkshire, just the 36 years of professional investing. But the same could have been said of my initial investment in Microsoft in 2016. May Berkshire shares perform as well. Yes, a quadruple would be highly acceptable. I am reminded of the Chinese proverb "the best time to have planted a tree was 20 years ago. The second best time is today."

In closing, I will touch upon Costco, the U.S. based retailer (they have one store in China, at last look) which is among my top 15 holdings in client portfolios. It recently declared a special dividend to be paid to shareholders in mid-December.

They have a habit of doing so every few years. Since the end of 2012, including the forthcoming one, they will have paid $29 in special dividends and $49 in regular dividends. COST shares closed 2012 under $100 per share. They just made an all-time high at $390. Better to add on dips with such a name, not ring the register. That is my conclusion.

Wishing you and your family a safe and happy holiday season.

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Vice-President & Portfolio Manager
December 2020

Sources: BMO Economics, BMO Capital Markets, Wall Street Journal, Bloomberg, Thomson Reuters, Value Line, Inc.

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