Markets Made Simple

Chan and Brown Wealth Management

Wealth Management
Dominion Securities

FOURTH QUARTER REPORT – DECEMBER 31ST, 2022

The economy is getting worst, why not wait until it gets better?

THE UNEXPECTED

My first year of university was a year of discovery, exploring a new world around me and all its wonders, including dating. I met a girl at the gym and we were on our first date, having a great time, joking, laughing, exploring the city, and enjoying each other's company. My date suggested we get something to eat and her favorite sushi spot was nearby. I had never had sushi or knew much about it but wanting to impress her and show how cultured I was, I told her, "You read my mind, sushi was exactly what I was thinking of."

We arrived at the restaurant and the waitress came by to take our orders. Being a gentleman, and because I had no idea what to order, I let her go first and wisely ordered the same thing. Our food came and we were provided with two sticks as cutlery. While I considered how I could best spear my food with these blunt sticks, my date wielded her chopsticks like a Kendo Master. I looked at my plate for easiest thing I could pick up without using my hands, and there it was, a large piece of soft, healthy looking, green paté. I tried my first bite of 'sushi' and found myself with a mouth full of wasabi. Apparently we had also ordered extra.

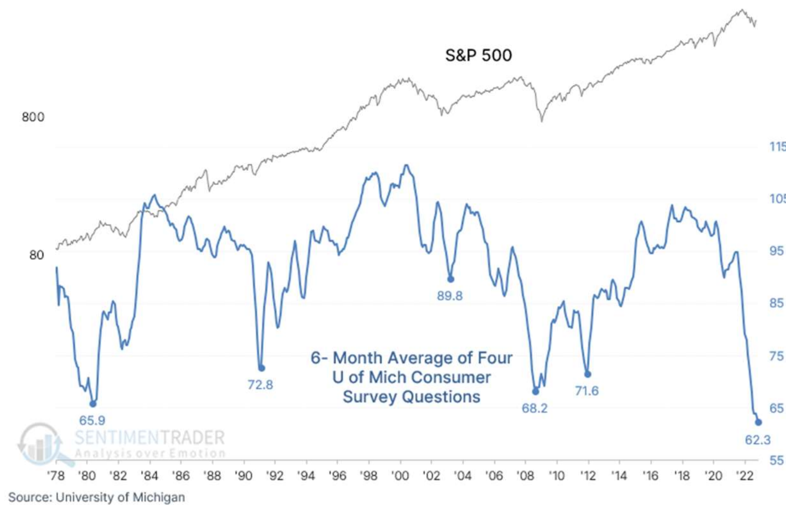
With tears running down my face and the clearest sinuses I had ever had, I told my date between coughing fits that the sushi was really good here. My first experience with 'sushi', like the past year in the financial markets, was an unexpected surprise.

The Unexpected Year in 2022

The economy was hit with a hurricane in 2022. Interest rates rose at the fastest pace in 50 years. Variable mortgages started the year 0.85% and finished the year at over 5%. Housing affordability dropped to the worst levels in history[1]. Inflation climbed to a four decade high of almost 10%. Stocks, bonds and real estate values fell, most by double digits, and some of the largest companies in the world saw their values get cut by half or more. It was a rough year for the economy, consumers, and investors, and many got caught by surprise, like eating a mouth full of wasabi.

As the landscape around investors quickly changed, rising inflation caused interest rates to increase and the economy to deteriorate, investments to fall, and investors to turn negative. Over the year, investors became more and more discouraged, resulting in the most negative investor outlook in over 30 years[2]. With cost of living increasing, mortgage costs skyrocketing, companies laying off workers, and the economy slowing, consumers have also turned negative, with consumer sentiment reaching their lowest levels ever recorded[3].

[1] https://thoughtleadership.rbc.com/homebuyer-blues-dreadful-affordability-gets-worse-in-canada/
[2] https://www.aaii.com/latest/article/16975-aaii-sentiment-survey-lowest-optimism-in-nearly-30-years
[3] https://www.bloomberg.com/news/articles/2022-06-10/us-consumer-sentiment-slumps-to-record-low-on-inflation-woes

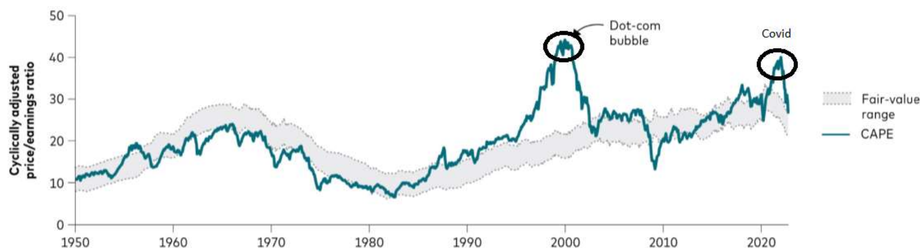


The Party

COVID helped unleash the biggest party we had ever seen. Governments gave away money to anyone that needed it, and then decided to give away it to those that didn't need it. Our government borrowed more money in one year than in the last 154 years…combined[4]. Central banks found the game plan they used for fighting off a depression in 2008, supersized it, and then supersized again. The US FED pumped three times more money into the economy in less than a quarter of the time compared to the 2008-09 financial crisis[5]. A tidal wave of stimulus was unleased, turning empty party halls to full capacity, with line-ups as long as for lost baggage at YVR just to get in.

With all this free, new money, investors came from everywhere flooding the markets and pouring everything they had into them, pushing prices up of everything from stocks and bonds to real estate and crypto currencies. *Investors poured more into global stocks in 2021 than the last 20 years, combined[6].* Funds flowed into some of the most speculative areas of the markets, such as Bit Digital, a car rental company that one day the CEO woke up and decided to change the company from renting cars to mining bitcoins. The stock went from $0.40 in 2020, to $25 in 2021. As investments rose in value, so did investors' expectations that the party would never end. In 2021, the average investor expected to make 17.5% annually above inflation[7]. That's 250% more than the actual annual market returns over the past 200 years. I remember speaking with a prospective client in the summer of 2021. He wanted to make 10%, every week. If he was able to do that, after a few years he would have been the richest person, to walk the face of the earth. I couldn't help him.

Investors partied and poured so much money into markets that prices were bid up to some of the highest levels ever seen.



Notes: The U.S. fair-value cyclically adjusted price/earnings ratio (CAPE) is based on a statistical model that corrects CAPE measures for the level of inflation and interest rates. The statistical model specification is a three-variable vector error correction model including equity-earnings yields, 10-year trailing inflation, and 10-year U.S. Treasury yields estimated from January 1940 to September 30, 2022. Details were published in Davis (2017). A declining fair-value CAPE suggests that higher equity-risk premium (ERP) compensation is required, whereas a rising fair-value CAPE suggests that the ERP is compressing.

Sources: Vanguard calculations, based on data from Robert Shiller's website, at aida.wss.yale.edu/~shiller/data.htm, the U.S. Bureau of Labor Statistics, the Federal Reserve Board, Refinitiv, FTSE Russell, FactSet, Barclays Live, and Global Financial Data, as of September 30, 2022.

[4] Department of Finance, Canada
[5] https://fred.stlouisfed.org/series/M2
[6] https://www.marketwatch.com/story/the-1-trillion-that-has-flowed-to-global-stocks-in-2021-is-bigger-than-the-last-20-years-combined-11631273525
[7] https://www.cnbc.com/2021/06/23/wealthy-investors-expect-to-earn-average-annual-returns-of-17point5percent.html

In the past 100 years, there has only been one other time the US stock markets were more expensive and that was in 2000, after which the NASDAQ would lose 80% of its value. Last year bonds also rose to the most expensive valuation in the last 100 years. The most popular bond funds in Canada would go on to lose 8% for every 1% increase in interest rates. Interest rates for 5-Year Canadian Government Bonds started 2022 at 1.4% and hit a high of almost 4% during the year. The hangover was going to be ugly.

Inflation Hits

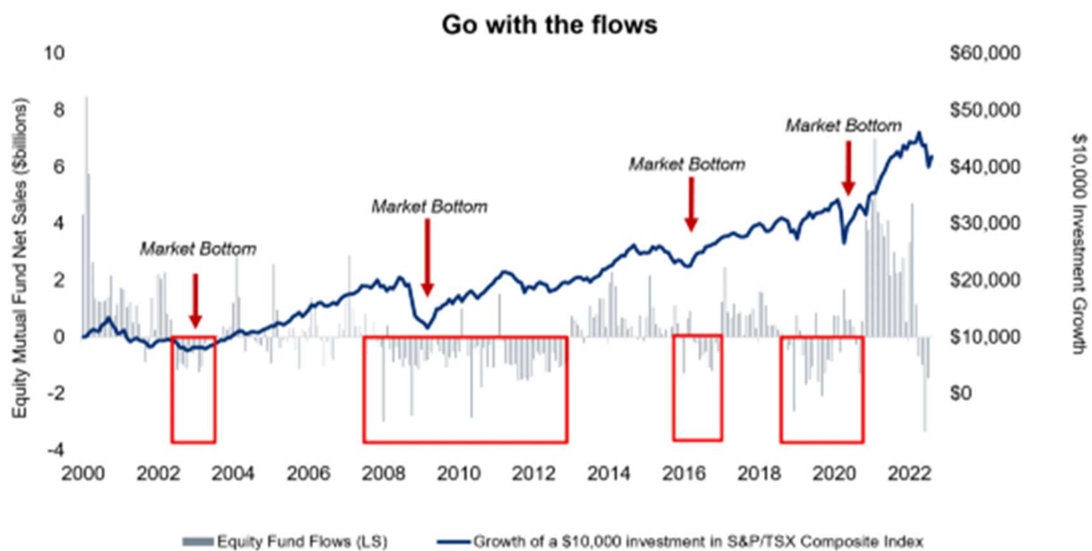
This massive party came at a cost. Inflation. First asset prices rise, from stocks to bonds and real estate, and then everything else follows, from gas and groceries to haircuts and pet food. Who knew printing and handing out records amounts of money would come bad consequences? If Jim was given a million dollars, what would he do? Save some, buy a new condo, a new car, maybe go on a nice vacation? But if everyone was also given a million dollars, and they all decided to do the same things Jim was doing, with everyone bidding on the same things at the same time, prices would rise. This is why prices rose so much in 2021-2022 causing inflation to reach heights we haven't seen in decades.

Central banks now faced their worst nightmare, uncontrollable inflation at 40 year highs. Out of control inflation can lead to economic collapses. From Germany after World War I, to Argentina in the early 2000's, the longer inflation is left unchecked the harder it is to stop. Central banks had to quickly pivot to deal with inflation by raising interest rates, slowing the economy, and scaring investors.

Fund Flows

As inflation rose, scared investors went running for the hills faster than the wasabi raced up my nostrils, and not caring about the investments they left behind. After record amounts of money went into the markets in 2021, records amounts are coming back out. The end of 2022 recorded the largest ever weekly stock market outflow, ever[8].

From record buying, to record selling in 2022, investors don't know what to do, like me using chopsticks.



The chart above shows investors buying and selling since 2000. There have been four main periods when investors sold significant amounts of stock, 2003, 2008, 2016 and 2020. Each time things looked bleak. Investors ran from the tech crash, selling their investments in 2003 and missed the US stock market rally of almost 50% from 2003 to 2007. Investors ran from the financial crisis, selling their investments in 2008 and missed the US stock market rally of almost 120% to 2016. Investors ran from the China slowdown in 2015 and missed the market rally of 80% to 2020. Investors sold after COVID in 2020 and missed the market rally of 80% to the end of 2021. Investors seem to be good at running away from making money.

[8] https://www.bloomberg.com/news/articles/2022-12-23/record-weekly-outflows-cap-worst-year-for-equities-since-2008

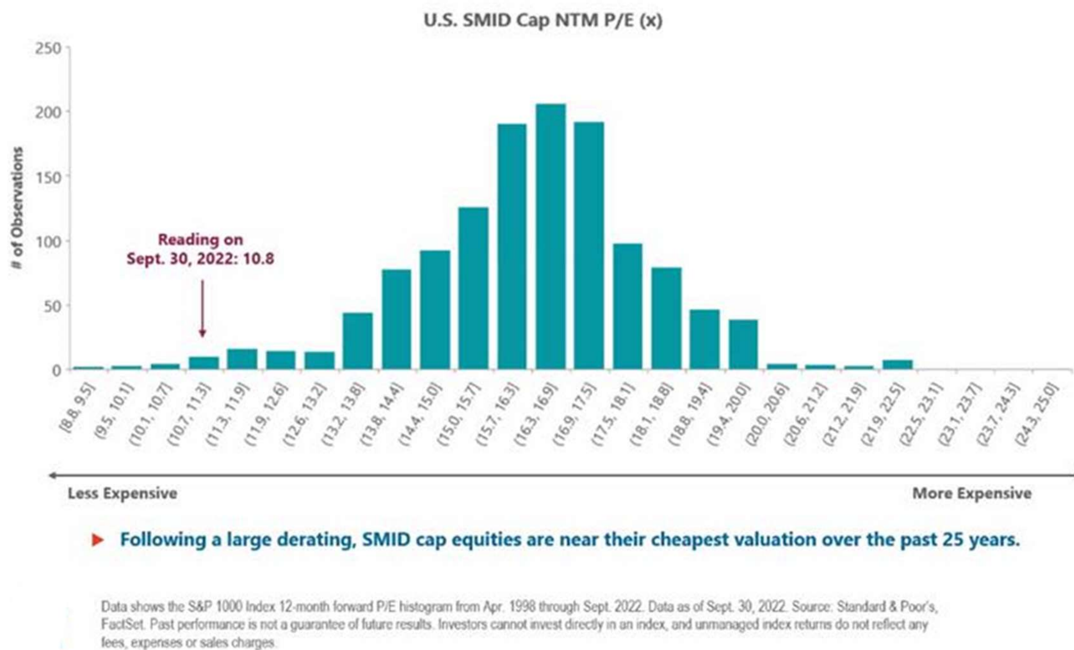
Our Friend, Volatility

Investors hate volatility. We don't…we like it. The more volatile markets are, the more scared investors become. The more scared investors are, the cheaper they are willing to part with their investments. The cheaper we acquire their investments, the better our clients' future returns. As investors left behind their investments scattered like a yard sale while running for the hills, we have been able to find amazing value with what they left behind.

One area investors left as they sell everything are preferred shares. In addition to yields that are much higher than GIC's, preferreds pay approximately 20% less taxes on the dividends received than regular interest income. A good example are Enbridge preferreds that are currently paying 7.6% over the next 5 years. These preferreds also reset their dividend every five years based on the Government of Canada 5 Year bond yield. Rising rates means we will receive higher dividends and protection against inflation. To receive the same after tax return from a GIC, we would need to find one paying over 10% which would be defined as a 'unicorn', a mythical beast that does not exist. The best bank GIC rates are half that. I called my bank asking if they have any 5 year GIC yielding 10%. They told me I was 33 years too late, I should have called in the 90's when I was too busy spending my money on Reebok Pumps and Nike Air shoes.

Another example are Fairfax preferreds offering us a 5.5% dividend yield for the next two years, the equivalent of a 7.5% GIC rate after tax. However, after two years, if the current 5 year of Canada bond rate stays where it is, the yield will almost double rising to 10%. We would need to find a GIC paying over 13.5%. Unless you think GIC rates will reach 13.5% by 2025, these preferred are incredible value[9]. There are only a few times in history preferreds have been this attractive.

US small and midcap stocks are also trading at some of the lowest valuations in the past 25 years. We have been increasing our exposure to small and midcap stocks with our exposure to US small cap stocks now having an earnings yield of over 10%, double the highest yielding GIC's, and our Canadian small cap exposure having an earnings yield of over 13%.



Other unique opportunities we found during the past quarter include a structured note based on the 6 biggest Canadian banks. If the Canadian banks finish positive (even by just one penny) over the next 7 years, we earn an annual return of 13%.

Market volatility and scared investors allow us to pick up these investments at substantial discounts.

Inflation

Inflation has been the driving force for the increase in interest rates this year. So where is it heading?

[9] https://www.ratehub.ca/blog/the-history-of-gic-rates/

Central banks want to see signs that inflation is under control before they can stop raising rates. After the US inflation rate rose to 9.1% this summer, it has started dropping, falling to 7.1%. In Canada, after hitting a peak of 8.1%, inflation fell back to 6.8%. Inflation is still not where we want it to be, but it is heading in the right direction. The economy will continue to cool. The interest rate increases in 2022 can take anywhere from 12-18 months to be fully felt. As rate hikes cool the economy, inflation will also continue to slow.

Stock Market ≠ Economy

But the economy is getting worst, why not wait until it gets better?

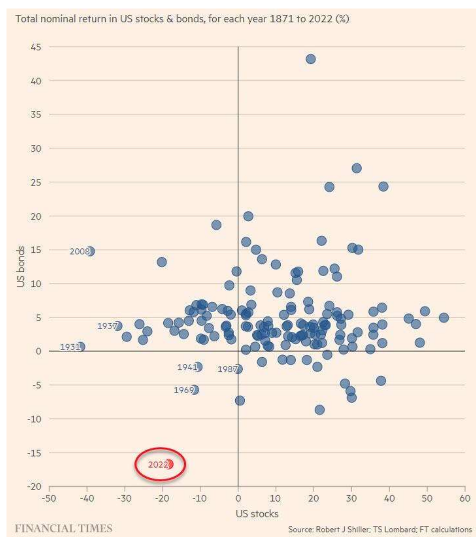
Investors are in hiding in the hills, deep in the caves. They are selling investments and waiting for the economy to get better. The problem with this strategy is that it causes investors to miss out on stock market recoveries, which they have done with surprising regularity over past business cycles. The economy and stock markets do not move together. The economy can continue to get worse while the stock market climbs upward. The stock markets look into the future, while investors focus on what is happening right now or in the recent past.

During the Financial Crisis, March 9th, 2009 was the bottom of the markets. Over the next 8 months, unemployment climbed and economic data continued to deteriorate. During the same time, the Dow Jones Industrial Average rose by 60%. The market bottom during COVID was on March 23rd, 2020 while US GDP and economic data took 9 months to recover. The S&P500 rose 75% during the same time.

The average investor significantly underperforms the markets. Why? Investors buy and sell at the wrong times. Over the past 30 years, the average stock investor has returned 7.1%. Going to sleep and just leaving their money in the S&P500 would have returned 10.7% per year. For every $100,000 invested, that is the difference between having $782,000, or $2,100,000[10].

What are We Doing?

In 2021, we were concerned about the risks in the markets, such as the high stock and bond market valuations. Inflation and higher interest rates were on the horizon. We focused on protecting clients from these risks, such as having bonds and fixed income that would be better insulated from rising rates through floating rate and short-term bonds than the popular bond funds investors were flocking to with large downside risks. We also focused on companies that had strong and growing cash flows that were selling products that would be less affected by inflation and interest rates with attractive valuations. We avoided stocks that were expensive, such as Telsa that investors loved and bid up to astronomical levels. Telsa was down close to 70% in 2022 and global bonds had their worst draw down ever, with the Bloomberg Barclays Global Bond Aggregate down by 20% in the first 10 months of 2022[11]. The typical balanced portfolio that we warned investors about in 2021 had its worst return in 90 years.



[10] "Quantitative Analysis of Investor Behavior, 2022", DALBAR, Inc. Returns as at December 31, 2021 in US$
[11] https://am.jpmorgan.com/fi/en/asset-management/per/insights/market-insights/investment-outlook/fixed-income-reset/

Insulating portfolios from these risks helped our clients weather the storm better in 2022 compared with many other investors. Now we are also in a position to take advantage of the opportunities while other investors panic and run away. Extra cash balances are being put to work, preferred shares have been added and we increased our exposure to small cap US and Canadian stocks. We still see risks in certain areas of the markets and we are being careful to avoid them.

We are very excited with the opportunities being presented today and we are selectively buying and adding to positions at prices we haven't seem for a long time.

Back in university, I needed help on my date. A wingman educating me on what sushi actually is and how to navigate small wooden sticks. Investors need a wingman too, helping them avoid overpriced investments from stocks, bonds, and bitcoin in 2021, to marijuana stocks in 2018 and all the future investment fads that will come and go. Our job is to guide our clients with the appropriate investments to reach their long-term goals, while avoiding the green paté on our plates along the way.

<u>Our Journey with Clients</u>

Dennis Chan and Scott Ross joined to form the Chan Ross Wealth Management team at RBC Dominion Securities 18 years ago. They have been on a journey together with their clients, helping them navigate different market cycles and storms from the 2008 financial crisis, to the global shut-down during COVID, and advising on everything from minimizing taxes, structuring the sale of a business to helping clients create a legacy for their loved ones.

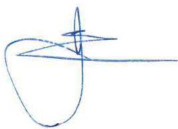
Their unique combined past experiences, and strengths allowed them to take even better care of clients than they could do individually. They also spent decades continuing to improve the level of service to clients and assembled an experienced, highly professional team (Vashti, Matthew and Vanessa) to ensure a high level of service and responsiveness to their clients.

In 2022, Scott made the decision to retire and pursue some of his other passions. He will always be grateful for the opportunity to take care of clients, protecting their money when times are bad, providing long-term growth to meet client goals, and finding opportunities to enhance their returns.

A mentor who was well acquainted with Scott, Dennis and myself, saw the similarities in our businesses, from our core values, commitment to client service to our investment philosophy and wealth management approach which was why he chose to connect us. Over months of discussion in early 2022, we saw the tremendous similarities and the opportunity to combine our strengths to ensure continuity and consistency in the management of our client's funds, especially after Scott's retirement, by partnering together. As he did with Scott, Dennis looks to combine his decades of expertise in wealth management planning with my passion and expertise in investment management, and portfolio construction to look after clients, together as a team.

We are now the Chan and Brown Wealth Management team, different name, same tradition of diligent investment management and quality financial advice. We look forward to taking care of our clients and helping them have a secure and confident financial future.

-Kind regards,



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