THIRD QUARTER REPORT – SEPTEMBER 30TH, 2020

Over the last 20 years, the average equity mutual fund returned 8% annually. The average investor returned 4% annually, in those exact same investments. Mistakes are costing investors 4% a year.[1]

WHAT HAS HISTORY TAUGHT US?

I made my first stock market investment when I was still in University. Being a poor student, money was tight. I worked hard and finally saved $12,000. I was rich! It was time to get my money to start working for me. I had friends who were making money in the stock market and it looked like a good place to start. One day while sitting in my Simon Fraser University (SFU) finance class, I decided it was time to start investing my money. With my MacBook open, I looked at some stocks a friend had recommended. I spent a few minutes looking at their past trading prices and invested my savings into three speculative companies. I spent more time picking out my $5 lunch after class than I did with my $12,000 investment. My investment was supposed to double in a few months. I was excited to sit back and watch my money grow.

Over the next six months, that $12,000 turned into $3,000. It isn't easy to lose 75% of your money in half a year. It's not a skill that you brag about at Thanksgiving dinner. But as I reflect on that day at SFU, I am thankful. I learned my first investing lesson. Invest wisely to build your long-term wealth. Investing foolishly, like I had, would destroy it. Learning that lesson when I was older, when I had more money would have cost me much more.

'History doesn't repeat itself, but it often rhymes.' – Mark Twain

We are predictable. We have the same biological make-up as our ancestors, causing us to make the same mistakes as they did. With new generations history is easily forgotten. As we start our lives, we have no experience and have nothing to reference. We rely on our parents and our environment to teach us about the world. Along the way, we make mistakes and that is a part of growing up. As we gain more life experience, we become wiser and have a better understanding of how the world works. Our parents and grandparents will watch us make similar mistakes they had. In turn, we will watch our kids do the same. History is repeated.

With enough time, a new generation of investors will enter the stock market. They are young and inexperienced. They possess little knowledge of the past. Like me, sitting at SFU, making my first investment…The new generation will make the same mistakes their parents did. They will follow what their friends are doing, jumping into speculative investments, chasing the best performing companies, getting caught up in new and exciting investment trends and trying to time the market. They will end up paying much more for investments than they are worth and harm their long-term returns.

Imagine you are 45 years old with $500,000 in your retirement account. Making the same mistakes the average investor makes will cost you 4% per year. Those mistakes will have cost you a million dollars at retirement.

By studying history, we can learn and avoid the mistakes of previous generations.

[1] DALBAR

The Nifty 50.

In the 1970's, a new investment trend emerged. Buy and hold strong, stable Blue-Chip companies. Companies that had a long-term track record of consistent growth. These companies became known as the Nifty 50 and they became the fifty most popular stocks in the 70's.

Investors jumped into these popular stocks. In 1972, investors were buying companies such as Polaroid, Avon Products, and Walt Disney. Based on the prices they were trading at; investors were paying 3-5X more for these companies than they were for the average stock[2]. It was like paying $6.00 for a litre of gas when it was selling for $1.20/litre at other gas stations. Investors didn't care though. These companies were positioned for strong, long-term growth. Investors justified paying more for them.

A few years later these companies started trading at their fair value. Polaroid fell 91%, Avon fell 86%, and Walt Disney fell 84%. Investors lost virtually everything. The 70's taught investors a valuable lesson. Overpaying for a company, no matter how good it was and how bright its future, was a bad strategy.

The Internet Bubble.

Thirty years later, a new generation of investors emerged. The new investment trend of 2000 was the Internet. It was changing the world. Emails replaced mail. We could shop from home in our pajamas. For the first time in human history, we virtually had all information at our fingertips. Investors began selling their slow growing, boring companies to buy exciting, new, and fast-growing internet stocks.

As more investors got excited, they bid up prices of internet stocks to extremely high levels. At its peak, investors in the Nasdaq were paying 13X more than the long-term average price they paid for stocks[3]. Instead of paying$6.00/litre for gas when it is $1.20, investors were paying over $15.00. Investors justified these prices, because they expected tremendous growth from these companies.

Just like in 1972, again investors overpaid for their investments. Some companies would go bankrupt, Pets.com, WorldCom, and Boo.com. Investors lost everything. Others would go on to change the world. Companies like Cisco, Amazon and Apple. But no matter how good these companies were, investors lost a lot of money by overpaying for them. Cisco fell 86%, Amazon 94%, and Apple 62% in a few short years.

2020, the FAANG Stocks.

Today, we have a generation of new investors. They haven't heard of the Nifty 50. They didn't participate in the Internet Boom. They are getting caught up in new investment trends and not paying attention to the inflated prices they are paying for these companies. Instead of buying the largest companies in the 1970's such as Polaroid, Avon and Walt Disney. They are buying the largest and most popular companies today. Apple, Amazon, Microsoft, Google (Alphabet), Netflix and Facebook (the FAANG stocks). Like the Nifty 50, these are some of the most loved stocks and have been the best growing companies.

Investors again have justified the high prices that they pay for these stocks based on their future growth. On average, these stocks trade at 4X more than the historical valuation of the average stock.[4]

Investors in the 1970's and in 2000 can tell you how that turned out. Not well. No matter how good the company, overpaying for them has been a losing strategy.

[2] Price to Earnings (P/E) Ratio for Polaroid 91, Avon Products at 65, and Walt Disney at 86. The average P/E Ratio for a stock in 1972 was 19. https://www.usatoday.com/story/money/business/2014/04/01/ozy-nifty-50-stocks/7156447/

[3] At its peak, the Nasdaq traded at a P/E ratio of over 200, well in excess of the long-term average P/E ratio of the US stock markets of 15 since 1870

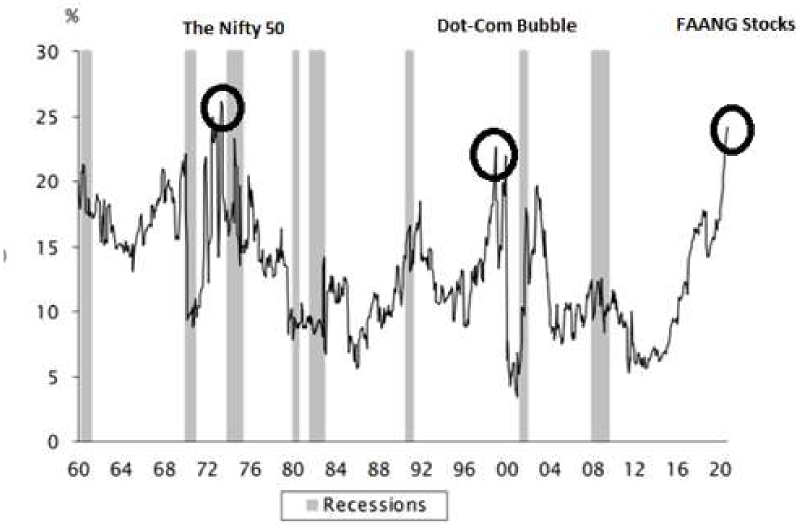
[4] https://www.marketbeat.com/types-of-stock/faang-stocks/

It's worth repeating. 'History doesn't repeat itself, but it often rhymes.' – Mark Twain

In the past, when an investment trend becomes popular, more and more investors pour money into it. The money goes into a few companies, and they become even larger. The market then becomes heavily weighted to just a few companies. Currently, Apple is now worth as much as the all the stocks in Germany, combined.[5]

In the chart below, during 1970 (the Nifty 50), growth companies became close to 25% of the market before they crashed. In the Dot-Com Bubble in 2000, the same thing happened. The FAANG stocks now make up 25% of the US markets. We have seen this before.

Exhibit 12: The Big Growers
Share of Market-Capitalization
1960 Through August 2020



Source: National Bureau of Economic Research, Empirical Research Partners Analysis.

The US Presidential Election

Investors are worried about the US presidential elections. Many investors have opted to sit on the sidelines and hold onto cash until they see things get better.

Biden. Trump. Who will win? Currently the polls and the markets think Biden will win. Regardless of the outcome, US stocks have returned 10.2% in the year following the primaries. This compares to just 5.8% in non-election years. It doesn't matter which party wins; the returns have been evenly distributed between both Democratic and Republican presidents. In the last 80 years, there have only been two negative years during election years. Both can be attributed to asset bubbles, rather than election results. These were in 2008 during the Financial Crisis and 2000 during the Dot-Com boom.[6]

Cash, It Doesn't Pay Much

As I highlighted in my last newsletter, one-third of investors over the age of 65 sold all their stocks around COVID-19 concerns and are sitting on cash. Central banks have driven interest rates to virtually nothing for cash. Investors are still sitting on record cash balances that need to get back to work.

I recently spoke with a friend who lives in the United States. He has $40,000 sitting in a Chase Savings Account. Guess how much interest he earned in the last three months? $1.50. Maybe he can buy a slice of pizza. Retirees who have large amounts of cash sitting in the bank, can't live off the interest. $100,000 would yield $15 of yearly interest.

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[5] Source: Credit Suisse
[6] http://www.capitalgroup.com/content/dam/cgc/tenants/canada/pdf/en/public/Guide_to_investing_in_a_US_election_year_EL.pdf

We are finding many attractive investments out there, yielding anywhere from 3-6%. Not only that, these companies are growing their earnings and dividends over time. This is a much better return than a savings account that pays almost nothing.

In the financial crisis back in 2009, investors sold record amounts of stocks and were sitting on cash, just like today. Low interest rates forced investors back into the stock market. The S&P500 returned over 400% as cash flowed back in the US markets over the next 11 years.

The record cash balances that investors are sitting on will flow into the stock markets to earn higher returns. Recently, we have seen market weakness trigger investor buying; evidence that investors are starting to get cash back to work.

What Should Investors Do?

The stock market performance this year has not been evenly distributed. The largest companies have attracted the most money from investors. These include companies such as Apple and Tesla.

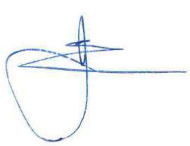
This has made the largest, most familiar companies in the world more expensive. Value companies have been sold and investors have used the funds to buy growth companies. Small companies have seen the most selling. At the end of the second quarter, the difference was striking. The ten largest companies in the S&P500 had close to a 50% difference in performance vs the smallest 50 companies for the first six months of 2020.

This has led to tremendous opportunities in the market right now for investors who do their homework. However, investors need to be very selective in this uncertain environment. Future returns depend on the prices being paid today. Paying too much, as we have learned in the past, will hurt long-term returns. Buying good companies at attractive prices will lead to above average future returns.

Our portfolios are very well positioned for the future. We have increased yields on our fixed income. The valuations for our stocks are well below where they have historically traded. We see strong future returns based on the incredible valuations on our portfolios. We were well prepared and handled the sell-off in March very well. Our alternative and fixed income exposure held up, and we re-balanced within our equity space to capture the extreme mispricing. We are well positioned as cash comes back into the markets.

We hope you and your families are keeping safe and healthy and know we are here for you. Please don’t hesitate to reach out to me if you have any questions relating to your portfolio or the markets.

-Regards,



Joshua Brown, CFA