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THIRD QUARTER 2020 – LETTER

"In the short run, the market is a voting machine but in the long run, it is a weighing machine."
– **Benjamin Graham**

This pandemic period we are living through has been described as The Great Distortion for financial markets. Central banks are intervening to support the bond market and Government spending is injecting enormous amounts of money into the economy with much of it finding its way into the stock market. We know we must own stocks now more than ever to protect our wealth, given the fragility of the financial system built on too much debt. Avenue's equity strategy allows us to stay invested but avoid stocks that are too expensive. We must also avoid stocks that might be inherently weak. We are continually building a portfolio of high profit margin companies that still trade at a reasonable valuation and do not need to rely on financial markets to raise money.

The frequently used quote above, is attributed to Ben Graham, often referred to as 'the father of value investing'. What he is observing is that in the short term many stock prices will swing wildly as a reaction to the flow of money and perpetuation of fads and tends. However, in the long term all stock prices must reflect the earning power of the underlying business. Substance eventually wins over popularity.

We feel this statement is very relevant today. The pandemic's impact on the economy and the stimulus impact on financial markets, has resulted in pronounced stock price moves. We see stocks trading either well ahead of their fundamentals or at a deep discount to their asset value. As we wrote in our Q2 letter, we are trying to come up the middle and not overpay for the future nor get caught in what is called a value trap, where the stock is cheap but stays cheap.

COVID-19 consensus

Before we go any further, let us weigh in on what we believe is the consensus estimate for the length of time until we have a vaccine. While this changes day to day, it gives us a benchmark for what we believe is priced into the market. Currently the average opinion is that there will be a vaccine and it will be ready by next spring and then available to most people by this time next summer. If that timeline changes for the better or for the worse we can gauge how parts of the market, like banks and energy stocks, will react.

The Economy vs. Financial markets distortion

There is still a general feeling that there is a disconnect between the recovering financial markets and an economy in recession with high unemployment. Since our last Q2 letter we are now able to detail some hard numbers comparing the economic slowdown to the stimulus. In this case we will use US numbers because they highlight the massive scale of what we are talking about.

In the first half of the year, US wages and salaries decreased by $680 billion with a further decline of $175 billion in other types of income. However, US government transfers to individuals totaled $2.4 trillion in this same period. For the first half of the year, the average personal income in the US actually increased by 33% because of government support, while spending declined by 35%. Money that would have been spent on travel, restaurants and other entertainment has gone into home improvements, personal debt repayment and stock market investing.

The US gross domestic product for Q2 was $4.85 trillion and total stimulus spending was $5 trillion. The pandemic has created a massive hole in the economy but between central bank borrowing and deficit spending by the federal government, the hole has been filled, and then some. The numbers in Canada are not quite as dramatic but they are not far behind.

Low interest rates and corporate bond market distortion

Low interest rates are the intention of central bank policy but also the casualty of a low growth environment. With high household and government debt levels, low interest rates are essential for avoiding a deep and painful recession. Also, there is the theory that low rates will encourage people to borrow and build new businesses. But that notion has not held true. The pandemic has instigated a decline in traditional bricks and mortar store front businesses that borrow from a bank. Dynamic new economy technology companies don’t get any advantage from low rates because they can’t borrow from a bank even if they wanted to.

The central bank has borrowed money and given it to the banks to lend. The banks have money to lend but no one to lend it to. We now have more debt but no increase in economic activity, the result being low interest rates that reflect a stagnant economy with no inflation in goods and services.

Too much debt makes our financial system fragile. There is now incentive for the Federal Governments in both Canada and the US to never pay this money back. Our conclusion is that, over time, all currencies will be depreciated. This is why Avenue fundamentally believes owning high quality businesses and hard assets is the best way to protect and grow our wealth in the next decade compared to the alternative of not owning stocks and hard assets. Cash in the bank or under the mattress is the riskier choice.

However, Avenue’s bond portfolio still plays a role for people who need income and can’t take on long-term stock market risk. As we have again experienced, the stock market can swing wildly in the short term. Absolute levels of interest rates are now very low. The 10year Canadian Government Bond yield is 0.55%. At this level many investors feel the pressure to look for higher returns.

The core of Avenue's bond portfolio strategy is to invest in Canadian Corporate Bonds. We were able to take advantage of the sell-off in corporate bonds in the spring and we are having a decent year for returns in a low rate world. But this pressure for higher returns means that money that might have been invested in government bonds has now moved to buy corporate bonds. Canadian Corporate Bond prices have benefitted from money looking for higher returns but now the market is expensive. For example, a 7-year bond issued by Canadian Natural Resource, where you take on the risk of the oil sands, will pay you a 2.2% annual return.

We believe Canada's central bank's coordinated effort to lower interest rates is fully reflected in the bond market. Any surprise move in the bond market will likely come from a rise in longer term interest rates. Therefore, Avenue's bond portfolio is again positioned conservatively while we wait for economic recovery to restore more rational interest rates.

Stock market distortion

Following through on this last point, some of this money that has historically been invested in government bonds is being forced to take on even higher risk found in the stock market. Just knowing that this is the intention of central bank policy should be taken as a warning not to take too much risk. There is always an element of musical chairs in the stock market where the game is chasing returns when there is too much money and only so many seats. Returns are always better when the game has lots of seats and fewer players.

Identifying the excesses in the current stock market is easy to do. Please see this quarter's Case Study on the valuation of Apple. Investors are forced to take on more risk and go into the stock market, but they still want safety. Safe investments in the second half of 2020 are companies with little debt and those that dominate the new tech economy. A new acronym has evolved over the summer: FANG MAN. This acronym stands for Facebook, Apple, Netflix, Google, Microsoft, Amazon and Nvidia. The combined market capitalization of these relatively recently created businesses is $7.5 trillion dollars. Their combined weight in the US's main index, the S&P500, is 27% of an overall valuation of $27 trillion dollars. That is up from 21% when we described this phenomenon in our Q2 letter.

The distortion is caused by the flow of money pushing up valuations based on the perceived safety of these businesses. Back to our Ben Graham quote, current FANG MAN stock prices are reflecting many years of future growth that now must happen to sustain today's price level. We are not predicting that these stocks must fall. But it a riskier bet to say that these companies will continue to compound at the same rate given today's high valuation as a starting point. It is more likely that the stock market returns will broaden out to other parts of the market as the economy slowly recovers over the next year.

We have showed this back of the napkin valuation exercise before. Again, we will use the S&P 500 Index. The two inputs are a rational stock market multiple and an estimate of next year's earnings. Historically the stock market has traded at a multiple of 16 times earnings. However, that was in a higher interest rate world. With lower interest rates we are forced to accept a higher multiple and here we argue that a multiple of 20 is reasonable and in reality, next year, it will likely be higher. The S&P 500 consensus earnings estimate for 2022 is $200 per S&P 500 unit. Embedded in this estimate is that the dominant FANG MAN earnings will be stable, and the broad economy will recover. A multiple of 20 x $200 in earnings = 4,000 units for the S&P 500 Index, which is over 20% higher than today's level.

What do we know that will help us make sound investment decisions? We know we must own stocks because holding cash and sitting on the sidelines is risky. We also have a positive bias for the overall stock market. We know a handful of Mega Cap stocks are overvalued. But we also know many traditional businesses in retail, travel and entertainment are distressed. As we stated at the beginning, we try not to overpay for the future nor get caught in what is called a value trap, where the stock is cheap but stays cheap. This knowledge helps us to build a portfolio of businesses that we have determined to be economically essential and which continue to operate in line with our expectations. We make sure to reduce risk by maintaining balanced exposure, in the best businesses we can find, across the various sectors of the economy.

We have always said that we go into the stock market to look for consistently profitable companies, with a high return on their capital, that trade at a fair valuation. What we find is that companies that fit this description are more mature and have well established businesses which often pay a dividend. We do not intentionally plan to build a portfolio of high dividend companies but often that is the result. For the last few years, the equity portfolio has had a dividend yield of about 3.5 - 4.5%.

With the new investments that we have made over the year the equity portfolio's dividend yield has fallen below 3%. Partially this is due to increasing our gold exposure with companies that pay small or no dividends. But what has changed is that there are many high yield stocks trading in the market and we own a few of them. However, when we dig into the numbers, many high yield stocks are trading that way because their underlying business is distressed. We are finding it is better to invest in healthy businesses that pay a smaller dividend and have a clear path to increasing that dividend over time.

Canadian stock market's negative perception is more distortion?

Is Canada still out of favour? This is still a major investment theme. Canada's image was not helped by the Liberal Government's throne speech on September 23rd. Attracting investment to a 'new and improved' economy is seen as essential as long as your goal is to ***not*** make money. With all that is happening around the world we must recognize that Canadian's are blessed to live in a country such as ours. At the same time, a thriving and prosperous economy is what pays for the things we value such as education, healthcare, and generous social spending.

The green economy is growing but it is not big enough to make an impact and it will not pay the bills for the country. Much needed toll-type infrastructure like pipelines and ports cannot get a building permit. Taxes are high and there is a lot of red tape because of government regulation. On the other hand, there is a big desire for transit or high-speed rail, but these projects do not operate at a profit.

Here is the problem. Canada's electricity sources are already carbon-friendly green from our hydro and nuclear plants. Transportation is still awaiting a revolution because at this time Canada is cold and we live far apart so we are not suited for the current types of electric vehicles.

When we look at Canada's top 10 exports, where Canada makes most of our money, we sell carbon-based energy to the world as well as heavy equipment. Wheat exports do not even make it on the list. Investors' negative perception about Canada is real and it comes from observing a Federal government and a majority of the Canadian voting public that wants to shut down our carbon-based extractive industries before there are substitute industries. If Canada is to succeed in the years ahead we need a more rational and balanced approach.

We find by digging into the Canadian stock market that many dynamic Canadian businesses have evolved to lower their environmental footprint and increase their reach across North America. Companies like Cargojet, CP Rail, and Superior Plus are businesses that are having a great year despite not being widely owned by index investors. Because of investors' antipathy to Canada, these companies trade at a lower valuation to their US peers. This gives Avenue lots of choice for investments in good Canadian companies. We can end this quarter's letter by repeating what we wrote earlier, returns are always better when the game has lots of seats and fewer players.