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FOURTH QUARTER 2020 – LETTER

If you had the good fortune last January to take a year-long sabbatical in the South Pacific, cutting yourself off from the world, you would be arriving back on an empty flight, landing into quarantine and economic lockdown. After checking in with your family and friends about their health, you might be emailing or calling Avenue to see how bad a global pandemic is for your investment returns. Remarkably, Avenue's equity portfolio was up a bit for 2020, after having a good year in 2019. Avenue's bond portfolio also had a good year in spite of a continuing low interest rate environment. As an added plus, your sojourn abroad would have ensured you avoided the gut-wrenching experience of global market selloff and subsequent recovery.

Looking at the year ahead, we will try and make sense of what seems like major contractions in financial markets. Markets are progressively more fragile, yet we believe it is a greater risk not to be invested. While many stocks are expensive, we have built a portfolio of high-quality businesses that trade at much fairer valuations. Also, we would like to celebrate financial innovation at Avenue in 2020 with the introduction of our Tail Hedge Portfolio to protect our wealth against future systemic shocks.

The impact of low interest rates

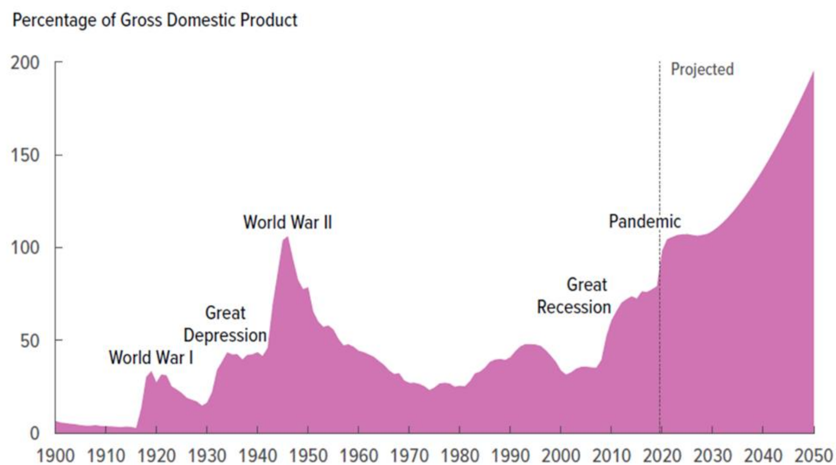
In previous letters, we have termed this current era of financial markets "the great distortion". This term describes the transformative effect on all assets prices from low interest rates. The US central bank is committed to maintain a low interest policy for the next few years until the economy has recovered from the loss inflicted by the pandemic. However, growth will accelerate during 2021 with the global rollout of vaccinations. But as supply bottlenecks continue, there will be higher consumer price inflation for the first time in a decade. We are already seeing 10-year and 30-year interest rates rising, but arguably from a very low base.

In addition to low interest rates, corporate bond spreads have fallen to very low levels. The corporate bond spread is the amount of extra return you get above what a similar government bond would return. For example, if a 10-year Canadian government bond is yielding 1% and a 10-year Bell Canada bond is yielding 2.5% then the added yield for taking on the risk of Bell Canada is 1.5% more than owning a similar term government of Canada bond. Avenue's bond portfolio invests in Canadian corporate bonds as a core part of the strategy.

Because of the risk of increasing consumer price inflation and the fact that the absolute level of corporate bonds is so low, Avenue's bond portfolio is again defensively positioned. We have a higher level of cash and the average term to maturity of the bonds in the portfolio is 3.5 years. While we do not anticipate that the last two years of favourable returns will continue, the bond portfolio continues to serve the important role of diversification and stability for many clients. We also have the flexibility to take advantage of any opportunity to reinvest at higher rates.

Avenue's view of the stock market in January 2021 is very similar to where we were in 2020. Asset prices and valuations are priced as if central bank zero interest rate policy will continue indefinitely. As well, liquidity continues to be added to the financial system. The term liquidity is financial jargon for cash being available or added to the overall market either through suppressing interest rates or issuing more government bonds.

In the short term, if we can agree that there is a fixed amount of assets in the economy, when you add money that needs to be invested then the price of existing assets will be driven up. Last year the rough amount of new money added to help North America get through the pandemic was roughly $7 trillion for an economy that is slightly bigger than $20 trillion. With the Democratic party elected to all three federal branches of government in the US, the expectation is that the stimulus in the first half of 2021 may be up to an additional $3.0 trillion.

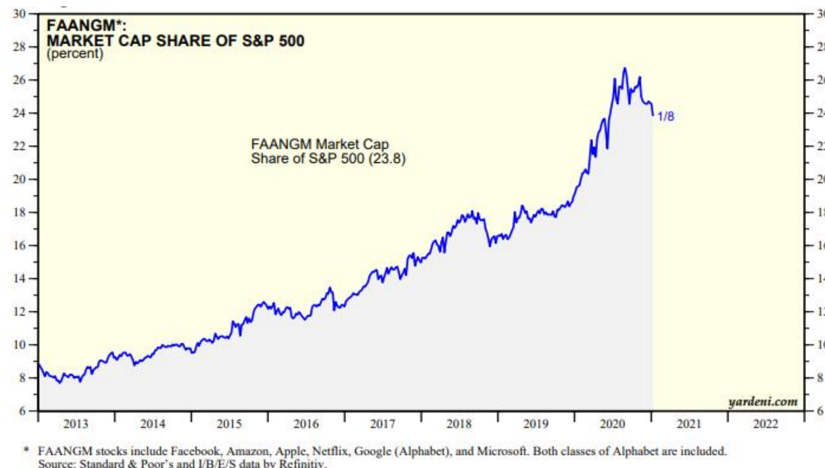


Source: CBO: The 2020 Long Term Budget Outlook

Further to this sum, many businesses listed on the stock market have been very profitable during the pandemic. A good example is Walmart which has thrived while corner hardware stores have been forced to close. But at the same time Walmart is not using their cash, it is just accumulating money until the economy fully opens again. The total cash held by the 3,000 most valuable non-financial businesses globally has gone up this year from $5.7 trillion to $7.6 trillion. Most of this money will be recirculated into the financial market as the global economy is restored to normal.

Then there is the global bond market which is valued at about $300 trillion. With interest rates so low it is hard to get a satisfying absolute rate of return investing in bonds. Each day there are more investors moving money out of the bond market and into the stock market in search of higher returns.

Finally, we need to acknowledge and understand the magnitude of index driven stock market investors and historic retail participation. The majority of new stock market investors are buying index funds which do not distinguish between relative valuation or weigh an individual stock's future prospect. Buying a stock index drives up all stock with the most money going to the biggest stocks. The largest 6 stocks in the US SP500 index now comprise over 25% of the total value of the index.



Source: Yardeni Research

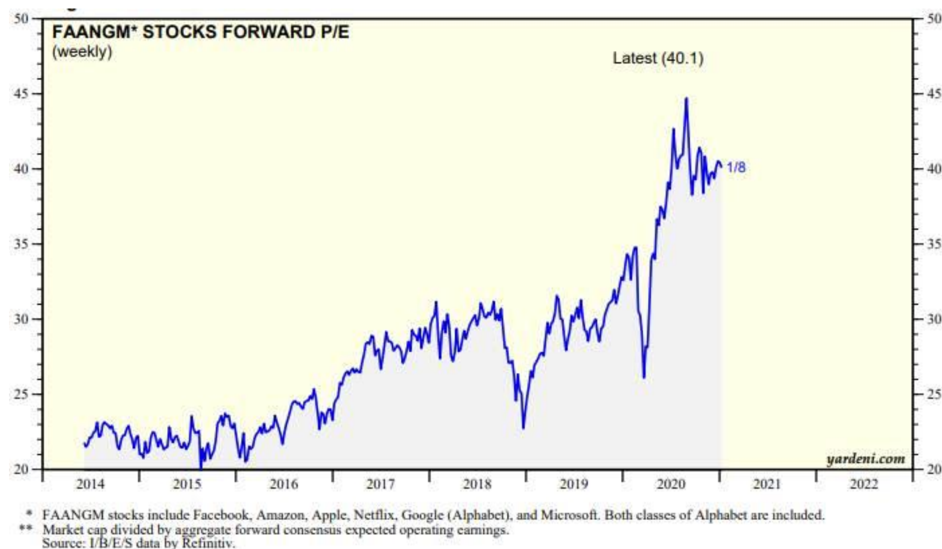
As we look to the coming year, a sustained low interest rate policy with waves of additional money will continue to drive up asset prices. But as prices go higher, the more vulnerable and fragile the market becomes. Any rise in interest rates or any future contraction of liquidity would ultimately cause a big reversal in financial markets.

Moving to the sideline and waiting out a potential mania is not really a solution either. First off, we do not know how long current liquidity conditions will last. Also, as we have discussed for most of this past year, because the government has so much debt, there will be real pressure to devalue the currency over the coming decades. Sitting on cash is actually the dangerous place to be, longer term. And there is not really one currency that appears better than the others.

Our conclusion is that the best strategy to protect and yet still grow our wealth is to make sure we stay invested and sidestep the obviously frothy, or overvalued, stocks. Because of the fragility of the market, you can understand the importance of having Avenue's new Tail Hedge Portfolio which is a complementary strategy when combined with the equity portfolio.

What we own in the stock market is also very important. We believe the safest portfolio is a broad mix of businesses with representation from all 10 major sectors of the economy. All our companies are profitable today, we have not paid too much for them, and we can understand why they will be more valuable in the future. This protects us from sector concentration or the risk from individual companies where profits fail to materialize.

Investments in technology are an important part of the portfolio but this is the sector where some of the stock market mania is materializing. Technology stock outperformance has driven index returns for some time. However, as we have seen in the second half of 2020, what were already expensive stocks are now very expensive stocks. The risk is that all the future growth of profits is already in today's price. One of the most extreme examples is Tesla. The stock trades at a multiple of 1,600 times earnings compared to the comparative stock market index that trades at 22 times earnings. Today's valuation of $700 billion is discounting that the company will have a 30% share of the global electric vehicle market in a few years' time. In this case there is a lot of execution risk on behalf of management to deliver what investors are expecting.



Source: Yardeni Research

We will try and stay away from stocks that are in the spotlight. Doing so gives us a better chance of finding and being invested in high quality businesses but where the risk reward is much more in our favour. Protecting against losses is just as important as the potential upside in any investment. And it may be more important now, given the fragility of the stock market.