The Future of Investing - Post Covid-19

An Overview by Arthur Heinmaa, CFA - Chief Investment Officer

April 2, 2020

Objective: Describe and explain a framework for investing in a crisis and provide a sense of future opportunities for investors.

History demonstrates that panicking is costly when it comes to investing. The market is impacted by emotion and moving investments to cash has not been proven to be an effective strategy in the long run.

Comparing Covid-19 to the Financial Crisis of 2008-2009:

- At its core, COVID-19 is a health crisis whereas the global financial crisis was systemic.
- The global financial crisis centred around illiquidity in the market and was incremental; new problems were constantly being uncovered. At the time, it was fairly challenging for individuals to understand the grave concern and magnitude of events. The financial system itself was in peril, trading was disrupted and banks did not even want to trade with each other.
- Today, we are in the midst of a health crisis. From the outset, individuals could easily understand and imagine the worst case scenarios in fairly short order. As such, we saw the market drop precipitously, based on those scenarios.
- Today, for example, the White House discussed war-like death tolls and some of the worst unemployment numbers in history, and yet the market took it largely in stride and continued an upward trend. It is clear that markets are pricing in this bad news.

Investing Through the Crisis:

How are we valuing companies and incorporating this uncertainty into our investment process? We need to have a framework to look at companies across different scenarios. Cidel's investment process uses a model that discounts the future cash flows of businesses over the short, medium and long term to determine a range of valuations. This allows us to compare our outcomes to the current market and determine if there is value in purchasing or holding a given investment. The focus remains, as it always has been, on companies with sustainable business models, strong balance sheets, strong cash flows throughout the business cycle, and the ability to return cash flow to investors over time. If, for example, we were to sell a position today, it would imply that our framework showed that the company is worth far more at today's market price than the value of its future cash flows.

This process provides some rationality to an otherwise emotional situation and, by using this framework in conjunction with other tools, we are able to reduce the emotion and noise from the headline news and refocus our efforts to seek out opportunities.

At this juncture, it is important to remember that the COVID-19 crisis will eventually end and we will emerge on the other side. Thus, looking ahead, the following list outlines some areas where we think opportunities may present themselves, post COVID-19:

Technology

- We expect to see spending on technology to increase. During this crisis, many companies and governments will have learned that they need better technology and stronger networks to cope with remote working situations and other stresses. Organizations that found themselves without enough laptops and companies did not have adequate bandwidth in their networks to support the new normal will all have to increase their technological capacity.

Preparedness

- Governments and companies will be focused on being better prepared. This could positively impact healthcare companies and medical device manufacturers, for example.

Cashless Society

- Many businesses were moving to cashless operations prior to the COVID-19 crisis, but we now have a heightened awareness of the dangers and health risks associated with handling and transferring cash. In the midst of the crisis, many businesses have either banned cash payments or strongly discouraged them for health reasons. Will this impact future payment trends?

Travel & Tourism

- Will business travel patterns be permanently influenced by the pandemic? Perhaps the term "non-essential travel" will be more widely encompassing and discouraged.
- How will the real estate industry change for hotels, Air BnB and those that finance these properties?
- What jurisdictions and companies will see material changes in the years to come from potential changes?
- In general, we anticipate this industry being relatively slow to recover from the crisis.

Telework

- Having been thrust into remote work, will this become the new normal? It is likely that companies will see the value in having employees work from home a few days each week through reduced office rent and other expenses, and less strain on physical office space limiting staff count.

Consumer Spending

- As consumer spending accounts for almost 70% of U.S. GDP, changes in how Americans react will be highly impactful on this sector of the economy. Will individuals begin to save more to prepare for future shocks? Will certain industries be slower to bounce back than others?
- As an example, if working from home becomes the new normal, how will spending on work attire and transportation change?

Climate Change

- Will society demand a better response to climate change? If so, this response will likely entail significant spending in new areas of the economy, such as infrastructure.

Central Banks and Government Responses

- These institutions have reacted with quick and large monetary responses via increasing liquidity and enacting mechanisms to support the financial system.

We would like to leave you with some notes of optimism

- We have seen the largest insider buying in a decade. As such, company executives and directors believe in the future of their companies enough to be dedicating more of their personal wealth to share ownership - a positive sign.
- Public pessimism in markets is very high. This is often a contra-indicator of future positive returns.
- The world is united in fighting one thing. We can all gain some comfort in seeing the world's "best and brightest" working diligently to end this crisis.

Q&A Summary

Our thanks to clients and friends who sent us questions as a follow-up to our presentation on April 2nd, 2020. The following summary presents the most popular questions and answers that we hope you will find insightful.

Q: Arthur, in your example using discounted cash flows, you showed that cash flows are much lower for one year, then improve for two years at levels above the base case to make up for pent up demand, thereafter resuming back to the base case. What if this all takes longer than we expect and would the result be the same for all companies?

A: The discounted cash flow example is designed to demonstrate one of the key principles we use to evaluate companies since, as a shareholder, you own a portion of those cash flows. The aim is to exhibit that if you sell in a panic, you may well be accepting that a company is going to have either zero or very little positive cash flow for a long time. In some cases, that emotional reaction creates opportunities for buyers. On the other hand, it can be a mistake for investors who fall into a wave of selling by those who simply need liquidity immediately to meet margin calls or who are taking on exceptionally bleak outlooks.

Our modelling is not universal across companies or even industries. Rather, we adapt our base framework accordingly. There could be companies or industries that do not see a full recovery after the pandemic is over. Alternatively, there may be others that perform even stronger during or following the current situation. For example, energy will have different price, margin and cost of capital assumptions than consumer staples and our ranges of projections will reflect these differences. Cidel also uses a valuation technique that includes multi-scenarios to give us a more comprehensive view on potential outcomes when variables differ. This helps us manage downside risk in client portfolios.

Q: What is Cidel doing on the asset allocation front? Are changes being made in the portfolios?

A: Our asset allocation team continues to meet regularly and weigh the potential benefits of changes to client portfolios. The Wealth Consultant team plays a critical role in this process as they are working directly with our clients to assess their needs and objectives. One of the key challenges our team faces currently relates to the large change in interest rates which has altered the relative potential return between bonds and cash.

In our individual strategies, we have been quite active. Using our Global Equity strategy to illustrate, we were able to purchase names that we have liked and monitored for months but that we believed were simply too expensive pre-crisis. What is important to us at Cidel is that we keep using our framework to value businesses and asset classes so we can make prudent and evidence-based decisions. Indeed, it is times like these where I believe our approach can really shine over the coming months and years.

Q: Arthur, do you think individual stock selection will matter more in the coming while than it has in the past?

A: Yes. There has been a huge inflow of money to index strategies - they are inexpensive, easy to purchase and have performed well in many markets for years. However, when investors sell the index to generate liquidity, they are selling everything irrespective of the impact the pandemic or other factors will have on an individual company. This essentially assumes Exxon Mobil and Microsoft, as examples, will be impacted in similar ways which we do not believe to be the case. Therefore, we are confident in Cidel's approach across all of our portfolios.

Q: Arthur, you briefly spoke on the government response and the magnitude of borrowing that has taken place. What do you sense will be the ramifications down the road?

A: This is an important topic and one that we can cover in more detail as we learn more about government and central bank responses from around the world. With the sheer numbers of individuals unemployed, it was clear that much support was needed to ensure families and individuals could cope in buying necessities and making rent or mortgage payments. In fact, this intervention is key to preventing a health crisis from turning into a financial crisis. One advantage our governments have now is the ability to borrow at exceptionally low rates and the presence of a strong market for their bonds.