Cidel
Asset Management

Looking Forward

Time to Retake the Pledge

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The first quarter of 2021 saw decent but unremarkable returns, with major equity markets up between 4% and 8% and fixed income dropping by about 3%. What is remarkable, however, has been the change from one year ago. For the 12 months ended March 2021, major equity markets have had stellar returns, around 40%. As pessimistic as investors were last year, investors are now equally optimistic. This time last year, investors could only imagine a collapsing economy with no hope for recovery any time soon. Today, investors are growing increasingly optimistic about the expected boom in the economy as people leave their homes and unleash a torrent of consumer savings on all the foregone restaurant meals, vacations and concerts. The returns seem to be almost guaranteed and so close that you can already see them credited to your account.

Reflecting on the last year, it all seemed very easy - buy the riskiest asset, whether it be Bitcoin or more speculative companies with weak balance sheets, and wait a short while to see the profits in your account. I vividly recall last March when my hands were shaking as I pressed the buy button in our portfolio management system, worried that prices would just continue to collapse. Now, as I rebalance portfolios, I enter the trades with much less emotion. Even our memory plays tricks on us as everyone seems to have foreseen last year's rally and no one admitting to going or considering going to a heavy cash weight. It is precisely when it feels easy and the future seems guaranteed that you must revisit the fundamental tenets of investing that have produced time-tested returns and kept investors out of trouble.

Stocks represent a fractional ownership of the company and the cash flows that it produces. As the old saying goes, price is what you pay and value is what you get. Once you buy shares, you earn the cash flows from the business for the duration you hold the investment. As the cash flows accumulate, the value of your investment increases and should be reflected in the price that another investor is willing to pay for those cash flows. As a side note, this is one of our biggest concerns with an investment like Bitcoin. If you buy Bitcoin or most other crypto currencies and hold it for a year, what do you get? No dividends, no cash flow, no intellectual property, and not even any aesthetic benefits – so, how do you value the investment? Simply, you can't; it is only worth what someone else is willing to pay for it. From our perspective, you should not decide what to invest in by the direction of the price graph, but by the value earned from your fractional ownership of the business.

We begin from the concept of semi-efficient markets, which explains that prices incorporate most, if not all, of publicly available information. The question that our team must answer is what do we see in an equity that is not yet incorporated into the price? It is not as simple as buying a stock because it has a low P/E multiple. If there is anything we can count on being captured in equity prices, it is that there will be a big rebound in economic activity once the majority of the population is vaccinated and the economy opens up. Even my mother talks optimistically about how much activity there will be in the Fall, with people eating in restaurants and taking cruises again. Thus, this expectation and its link to strong equity market performance should be probed with a degree of skepticism.

First, will the recovery be as robust as everyone expects? A stronger or weaker economy will have a short-run impact on individual stock prices as they either beat or trail analyst estimates and will provide fodder for the financial reporting industry. However, the long-term performance of a company is not determined solely by one or two quarters of earnings. Indeed, if the economic recovery is better than expected, investors and speculators alike will extrapolate this trend and drive stocks to even loftier levels. But eventually, the second question described below will come into focus and might be a

rude awakening for those speculators who have emphasized the price appreciation of an equity while ignoring the growth, or absence of growth, in the underlying businesses.

Second, what will the economic trajectory be after this initial burst of activity? Remember that a stock price is related to the earnings and cash flows that a company produces over many years. Yes, a great year can have a big impact on equity prices but the long-term returns will be linked to its long-term growth prospects, not simply the next quarter's earnings. It is in the prospects for long-term growth that we remain cautious and, accordingly, are not overweight in our equity exposure. A rough approximation of what an economy will grow by is equal to the population growth plus the productivity growth. With the U.S. economy still short 10 million jobs from 2019 levels, there is quite a bit of ground to be made up on the labour front. Moreover, the labour participation rate (percent of people working in the economy) is up slightly but has yet to fully recover. Without significant immigration or a massive uptick in productivity, the U.S. economy will likely return to the growth rates that we saw just before the COVID-19 pandemic. Thus, the growth will start to look more like 2019 than a continuation of the economic growth that we will see this year. This could result in disappointing equity returns as long term return expectations are reset.

We are as excited as everyone else at the prospect of returning to a more normal rhythm in our lives. Long summer evenings surrounded by friends and family, a brief kiss hello or goodbye, even a smile that is not behind a mask – it all sounds wonderful and just around the corner. However, our optimism about the future should not colour our views of the value of our investments. More so now than in the past, we need to continue to pledge to focus on fundamental investing principles and not be swayed by emotion or pretty investment vehicle price graphs.