1st Quarter 2020 (Q1) Market Commentary for The Dividend Value Discipline™

The Big Picture

As you are only too aware, Q1 2020 saw the fastest stock market collapse in history. Unlike previous bear markets which are normally born of excesses, the current bear market was brought on by "orders in chief" - our global political leaders' decisions to close whole swaths of the global economy. Our leaders made some very tough calls and with obvious good intent. Whether or not future historians give us a passing grade on how we responded to COVID-19 remains to be seen. For now, it is a moot point - what matters in the present day, is where to go from here?

The top three big picture observations as we see them are:

1. The economic damage is surreal – we are in a recession, it just hasn't been declared yet. To wit, the U.S.'s National Federation of Independent Business (NFIB) Small Business Optimism Index March 2020 survey revealed that participants expect a steep decline in real sales over the next three months. Consumer demand has been shattered and their plan is to run down inventories through spring and summer. Capex plans have been shelved. Almost half of the small employers said they can survive for no more than two months under the current business conditions. The chart and commentary below reflects a similar story – a drop in the global Purchasing Managers' Index not seen since the global financial crisis (GFC) of 2008/09.

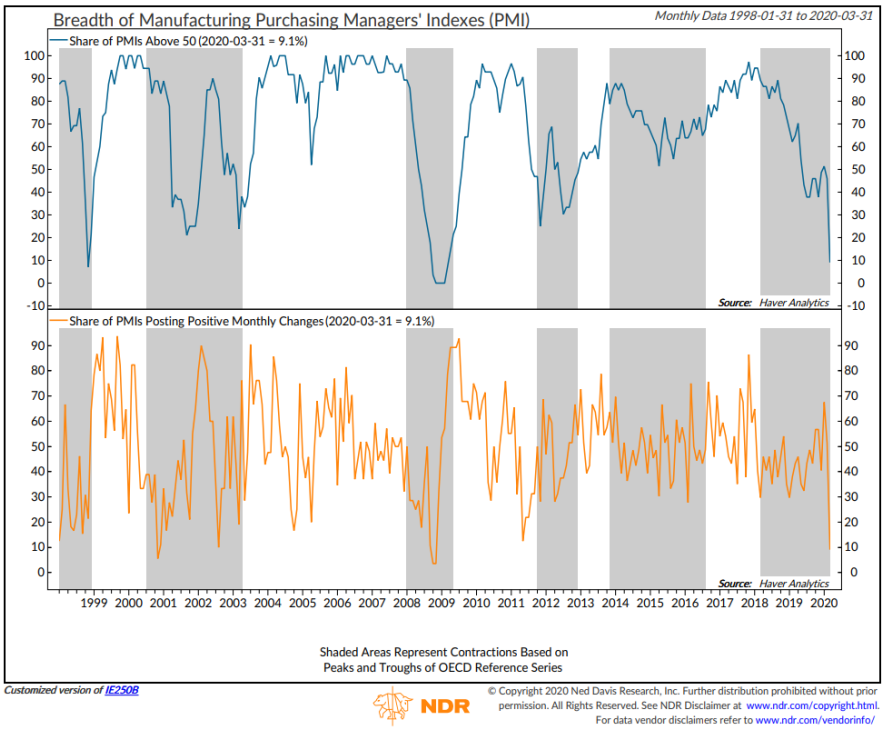
Breadth deteriorates

The spread of COVID-19 saw economic activity tumble in almost every part of the world.

As shown in the chart at right, the share of economies with expanding manufacturing industries plummeted to just 9.4%, the lowest since March 2009. The only other times that this breadth measure has been so low was during the GFC and after 9/11. This confirms our view that the global economy is in a severe global recession.

Furthermore, the share of economies that posted month-to-month deterioration in their PMIs was over 90%. The only other time we saw such broad-based deterioration was right after Lehman collapsed in 2008.

Broadest deterioration since GFC



Separately, unemployment claims for the week ended March 27, 2020 jumped more than tenfold to 6.6 million individuals from its pre-corona run rate of less than 0.5 million per week. When we recall that small businesses are the largest employer in our economies, a quick recovery on Main Street seems highly unlikely.

2. Central bankers and global political leaders are embracing "helicopter drops" - essentially sending cash to households who have had their livelihoods absconded as a result of the economic shutdown. The objective - contain the economic damage and stave off a depression. Thankfully, most of the money is being directed at individual households and small businesses. While such actions are necessary and welcome, it seems unreasonable to think such programs can rescue us all.

3. There is a dearth of historical precedents of shutting down the global economies for weeks/months at a time, and it is unclear what the knock-on effects may be. For example, I am hearing first hand accounts of retail workers being asked to be laid off because they can make more money on the government assistance programs than actually working. The law of unintended consequences applies – even if we were to reopen the economy tomorrow, those workers have far less incentive to return to work until the government assistance runs out. In our view, the absence of precedents calls for an extra note of caution. The price of being too aggressive and perhaps wrong, seems very high.

To address the "where to from here" as per our March 27, 2020 missive, historically speaking, waterfall declines of this magnitude (the S&P 500 fell by some 35% from the February 19, 2020 high to the March 23, 2020 low) are usually followed by snapback rallies. In the ensuing months, not weeks, there is a lot of back and forth and we often see another new low. Such was the case for the S&P 500 between the low of October 2008 and the March 2009 bottom. The December 2018 market rout was the exception to the norm. After that waterfall decline, we never got a retest of the low. That's very rare. While there are some who believe that is due to the algorithmic trading/artificial intelligence applied to today's market functions, and thus postulating that it will be the same this time around, that is not a position I am willing to bet on. Here's why – there were good reasons for the market to rally strongly post-Christmas Eve 2018. The U.S. Fed admitted its mistake and quickly reversed course on interest rates, we started to make progress on the international trade disputes, and we were nowhere near a recession. I just find most of those positives absent in today's environment.

To conclude the big picture comments, we will get through this – we always do. That said, the speed of the recovery remains very opaque. We proceed with caution and a higher than normal cash position.

The Dividend Value Discipline™

Notwithstanding COVID-19, our objectives remain unchanged, with a caveat:

- Invest in companies that evidence superior corporate culture and are disrupting/re-inventing the way business is done and/or aggregating (purchasing smaller competitors) their way to sustainable double-digit earnings and dividend growth.
- To hold such companies through the inevitable market downturns by focusing on their competitive advantage and thereby, the long-term earnings/dividend growth, as opposed to the euphoria and dysphoria of the stock market. Admittedly, some of our investee companies lost their competitive edge this past quarter, and we are adjusting accordingly.
- To generate a consistently growing income and absolute returns of 8%+ per annum over any investment cycle, i.e. peak to peak or trough to trough.

Most accounts in our "balanced" version saw net returns for the quarter in the -16% to -17% range and somewhat surprisingly the "all equity" version was roughly the same. You would normally expect the balanced version to outperform in this environment, so what gives? The balanced program has a large swath of Canadian preferred share exposure which is largely a retail focused market. To us, the preferred

share market is undergoing a strong case of selling begetting selling as retail investors throw the baby out with the bath water. With tax-preferred dividend yields from investment grade companies in the 6% to 7% range, we expect buyers to return to the space…soon.

As the magnitude of the economic disruption increased throughout March, it became clear to us that a few of our investee companies were going to struggle in the post-corona environment. Conversely, there were a number of names that we had previously studied that look increasingly more attractive in the post-corona environment. What follows are the "sell all" decisions and the new additions to the program for the quarter.

The **Bank of Nova Scotia** was sold in early March. We chose to sell due to leadership concerns and macro headwinds for the Canadian banking sector, e.g. high personal debt loads, and the prospect of further deterioration in Canada's competitive landscape just meant the negatives kept building. We prefer tailwinds.

MTY Food Group Inc. was sold in late March as it became painfully apparent that its 7,300+ largely franchised restaurants were rapidly being shuttered and would not be opening anytime soon. In a nutshell, cash flow all but stopped, turning MTY into a broken business model. We saw no alternative than to sell and move on. The prospect of business failure was just too high.

The last sell all decision was that of **Charles Schwab Corp.** and admittedly, the toughest call for the quarter. While we will not know with certainty whether or not it was a good call for say, another 6 to 12 months, the story has changed a lot during the time we have owned it. At initiation, we had the tailwinds of rising interest rates (they earn most of their money on cash in client accounts), and robust asset growth due to a unique value proposition/technological edge for both individuals and advisor teams. With interest rates basically going to zero, and a price war on trading fees which saw same go to zero, much of the tailwind story blew out and we felt our money was better placed elsewhere.

Turning to elsewhere, we initiated/re-initiated positions in the following companies throughout the quarter:

- **Steris Plc** – a sterilization systems provider to the global healthcare industry.
- **Nike Inc.** – their growing online presence gives them an edge in a shuttered retail environment.
- **Thermo Fisher Scientific Inc.** – a science enabler: lab instruments, software, and services including a test system for COVID-19 just approved in Europe on March 26, 2020.
- **Danaher Corporation** – another science enabler focused on medical research, environmental solutions and diagnostics.
- **Nvidia Corporation** – a strong competitor in the virtual world of computing which has obvious tailwinds.
- **Enghouse Systems** – a mission critical software provider/developer, serving call/chat/email based client service centres, telecom/utility with their online billing, and the private transportation industry to deal with things like dispatch and timekeeping.

While space will not allow me to detail each company, please rest assured that they do meet our rigorous requirements for superior corporate culture and strong economic moats with growing rent cheques, aka: dividends.

Speaking of dividends, the chart below details all of the stocks we own that have upped their rent cheques over the last 12 months. As difficult as it may be at times like this, we encourage you to focus on the rent cheque growth as opposed to what the market is trying to tell you your companies are worth. As per our March 12 missive, "Canada's TSX is down more than 10% on the day and it appears to me that investors have lost their minds. For example, one of our well known holdings, 3M Company is being bought and sold

at ~$131 USD per share. At that price, the buyer gets a dividend yield of ~4.5% and that rent cheque has increased every year for the last 61 years. The seller is moving to cash and/or more likely, 10-year government bonds which will yield 0.7% per annum for the next 10 years. In others words, the seller is giving up an income stream more than 6X greater for the perceived safety of the government bond. Which side of the trade would you rather be on? I will take 3M all day long. While the stock price may be anything but stable, the income stream has been stable and growing for decades and ultimately, it is the income we are going to spend."

The Dividend Value Discipline™

Rent Cheque Increases Past 12 Months as at March 31, 2020

	Company	Aggregator/ Disruptor?	Annual Rent Cheque	Current Yield	Last Dividend Change*	3-Year Dividend CAGR	Years to Double Rent Cheque**	Years of Consecutive Increases	Comments
1	STARBUCKS CORP	Both	$ 1.64	2.22%	13.9%	27.0%	3	9	A new store in China every 15 hours where coffee consumption is growing at 16% per year
2	TJX COMPANIES INC	Both	$ 0.92	1.88%	17.9%	22.9%	3	23	An autonomous culture that "out-retails" their competitors
3	NORTHERN TRUST CORP	Disruptor	$ 2.80	3.30%	16.7%	22.6%	3	9	The go-to private bank for Fortune 500 families - leads in blockchain security
4	UNITEDHEALTH GROUP INC	Aggregator	$ 4.32	1.64%	20.0%	22.1%	3	10	Innovative health care provider that helps people live healthier while driving down costs.
5	MARKETAXESS HOLDINGS INC	Disruptor	$ 2.40	0.60%	17.6%	22.1%	3	9	Quickly becoming the global standard platform for bond traders - a market that dwarfs stocks.
6	ENGHOUSE SYSTEMS LTD	Aggregator	$ 0.54	1.11%	28.6%	21.6%	4	11	A mission-critical software provider and lifetime aggregator
7	LOWES COMPANIES INC	Aggregator	$ 2.20	2.31%	14.6%	20.4%	4	57	New CEO joined in July 2018 who learned at HD - improvements in strategy/culture are clear
8	A. O. SMITH CORP	Aggregator	$ 0.96	2.39%	45.5%	19.7%	4	14	Providers of the high quality hot water systems and accessing China and India consumers
9	INTUIT INC	Disruptor	$ 2.12	0.84%	12.8%	19.6%	4	9	Creator of TurboTax/QuickBooks, dominant in small business & now cloud subscriptions
10	NIKE INC	Disruptor	$ 0.98	1.13%	7.7%	14.1%	5	30	A marquee designer/innovator in sports apparel
11	THERMO FISHER SCIENTIFIC INC	Aggregator	$ 0.88	0.28%	15.8%	13.6%	5	2	A science enabler through lab systems, software and services
12	STERIS PLC	Aggregator	$ 1.48	0.97%	4.2%	11.8%	6	14	A sterilization systems provider to the global healthcare industry
13	CANADIAN NATIONAL RAILWAY	Disruptor	$ 2.30	2.07%	7.0%	11.7%	6	20	Unmatched USMCA wide rail network and willing to innovate - watch for bitumen "pucks"
14	ROCKWELL AUTOMATION INC	Disruptor	$ 4.08	2.43%	5.2%	11.6%	6	23	Helping the world become more productive - faster, cheaper, better - great free cash flow
15	MICROSOFT CORP	Both	$ 2.04	1.24%	10.9%	11.5%	6	16	Culture transformer under Satya Nadella, exploiting cloud and MS Office subscriptions
16	ANALOG DEVICES INC	Both	$ 2.48	2.51%	14.8%	11.3%	6	16	Transforming sound, pressure, light, and temperature to data, fueling our digital world
17	DANAHER CORPORATION	Aggregator	$ 0.72	0.49%	5.9%	8.7%	8	26	Science enabler for the medical research, environment and diagnostics industries
18	3M COMPANY	Aggregator	$ 5.88	3.98%	2.1%	7.8%	9	61	Globally diversified - incredibly innovative, loved by employees.
19	JOHNSON AND JOHNSON	Aggregator	$ 3.80	2.69%	5.6%	6.5%	11	57	Fantastic culture, huge insider ownership base and well diversified products stream
20	GIBSON ENERGY INC.	Neither	$ 1.36	7.61%	3.0%	1.0%	70	8	Toll booth to North American energy producers with a driven executive suite
	Median			**1.98%**	**13.33%**	**13.85%**	**5.3**	**15**	

*Annualized. 0% if no change to annual dividend in the last 12 months.
**Based on 3-year Dividend CAGR (Compound Annual Growth Rate) - as of August 21, 2019
***Constellation Software declared a special dividend of $20 US per share on February 13, 2019. This is not taken into account in annual rent cheque or any CAGR calculations.
***Constellation Software's dividend rate is in USD ($1.00 per quarter), but the payments are made in CAD and therefore vary with currency fluctuations

The Global Active Macro ETF (GAME) Strategy – for those of you participating in the GAME mandate, please be advised that returns for Q1 in most accounts pegged in at -9% for the CAD version and -13% for the USD version. This rules-based approach demanded a 60% cash/fixed income position when we made our early April monthly adjustments. You will receive a full commentary in your Q1 reporting package.

In Summary

In our view, the unprecedented nature of this economic collapse calls for an extra layer of conservatism, even if we give some of the upside away. The exception to that stance would be with those people who are still in accumulation mode, say five or more years away from withdrawal mode and have the intestinal fortitude to withstand further down markets. In a nutshell, your strategy needs to be as unique as you are. If you have any doubt about your personal program, please reach out to our relationship mangers, Erika, Larissa and Ryan as the first step. They will get me involved as required. We remain fully operational, albeit in virtual fashion, and remain eager to help.

Please forward this along to your family/friends if you believe we can help them and/or they can subscribe to these missives at http://www.chrisraper.com/contact-us.aspx.

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