2nd Quarter 2020 (Q2) Market Commentary for The Dividend Value Discipline™

The Big Picture

Q2 2020 can be summed up as "better than we could have ever hoped for", given that we started the quarter a mere seven trading days from the bottom of the COVID-19 induced bear market that saw the S&P 500 correct from its intraday high of 3394 on February 19, 2020, to its intraday bottom of 2192 on March 23, 2020. By that measure, a correction of -35%. As you are no doubt aware, the markets have recovered in spectacular fashion and given the news flow, the most common question I get is, "Chris, how can that be?".

Below are what I believe to be the big three to explain the recovery in stocks, and following that we address "where to from here" as we look to the months ahead:

1. Let's start with the economy. In line with the truism that the market only cares about better or worse, not the absolutes of good or bad, the economy is clearly recovering in a big way. To wit, the services side of the economy went on an absolute tear last month – the ISM non-manufacturing index jumped to 57.1 (above 50 represents expansion). The global manufacturing PMIs (purchasing managers' index) put on a similar show, rebounding in June with a magnitude not seen since the first half of 2009. I recall then being scared to death that it would not last, and yet it did – it seems to echo. Our best leading indicators, copper and the semiconductor index ($SOX), are hitting and exceeding pre-COVID highs.

Charts courtesy of StockCharts.com

2. The COVID-19 deaths are nowhere near as extreme as what was generally accepted as fact, during the March market implosion. Even with the current news flow on the exploding cases stateside, it is not nearly as scary as one might think. To that end, First Trust has done a magnificent job of bringing the current reality into perspective.

3. By far the most important factor has been the two-fold effect of central interest rate policies and government spending. On interest rates, prior to this crisis the 10-year US Treasury yield (arguably the global benchmark by which all other investment decisions are measured against) was at ~1.52% (January 31), whereas on June 30, it closed at 0.65%. It is not hard to see why an investor might be willing to pay more for a company like Johnson & Johnson, where the current dividend yield is roughly 2.75% (and they have increased that dividend for the last 56 years), in a 0.65% interest rate environment as opposed to at 1.50% environment. On the fiscal front (government spending), there has been a "no holes barred" approach to this crisis unlike anything we have ever seen. The chart below illustrates it best.

   Bottom line, if you print enough money it will inflate something somewhere – stocks and gold are attracting at least some of it.

Fiscal response to COVID-19 vs. Global Financial Crisis

Fiscal policy response

Economy	**COVID-19**	**% of GDP (2019)**	**Global Financial Crisis**	**% of GDP (2009)**
U.S.	Congress has passed $2.8 trillion in stimulus, including CARES act and PPP.	13.1	$939 billion in direct stimulus via tax rebates and investment for businesses	6.5
China	Discretionary spending of 3.6 trillion yuan, which includes increased health spending and unemployment insurance.	3.5	4 trillion yuan plan focused on infrastructure and direct support	11.5
Japan	Emergency Economic Package Against COVID-19 worth 117.1 trillion yen, followed by a supplementary package of the same amount.	42.0	15.4 trillion yen in consumer and business support	3.1
Germany	913 billion euros in direct aid to businesses and consumers and loan guarantees.	28.9	82 billion euros in tax cuts, consumer support, and infrastructure	3.4
France	110 billion euros in direct support for businesses and consumers and 315 billion euros in loan guarantees.	19.0	26 billion euros in infrastructure and investment	1.3
Italy	80 billion euros in direct support and 400 billion euros in loan guarantees.	29.7	9 billion in consumer support and tax rebates	0.6
Canada	205 billion Canadian dollars in healthcare spending and direct support to businesses and consumers.	9.8	45 billion in consumer support and infrastructure	2.9
South Korea	29 trillion won in direct support for businesses and consumers, with additional measures waiting for approval.	1.5	69 trillion yuan in infrastructure and tax breaks	5.7
Australia	162 billion Australian dollars in direct support for businesses and consumers.	8.3	52 billion Australian dollars for consumer and business support	4.1

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To address “where to from here”, we still feel it is important not to get too far over our skis. Yes, things are getting better, but notwithstanding all that encouraging news we can still be subject to setbacks. Certainly, the exploding case load in the US is worrisome. Couple a significant second wave with the potential for further economic curtailments and it is not hard to conjecture another selloff. That said, it doesn’t have to happen. Let’s remember, the most important thing is to set ourselves up so we can never be precisely wrong. Accordingly, we have some dry powder (cash) in the hopper and will only be deploying it when we are convinced bargains are at hand.

The Dividend Value Discipline™

Our core strategy has held up remarkably well – most accounts in our “balanced” version saw net year-to-date returns for the six months ended June 30, 2020 peg in at the -4% to -5% range (recall the 2019 numbers were in the +14% to +15% range). And, for the second quarter in a row, the all equity version did even better, pegging in at the -1% to -2% range (2019 numbers were in the +17% to 18% range). The latter points to the lack of exposure in the fixed income space during the spectacular recovery.

As you know, cash inflows, outflows, and different start dates means that no two accounts are exactly alike. You will find your individual results in your personal reporting package.

Our objectives remain unchanged, with a caveat:

- Invest in companies that evidence superior corporate culture and are disrupting/reinventing 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.
- 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.

Last quarter I wrote, “some of our investee companies lost their competitive edge this past quarter, and we are adjusting accordingly”. We now see those adjustments as largely complete and accordingly there is an abundance of new names as we exited Q2. Throughout the quarter we took up or reinitiated new positions in:

➢ Dollarama – a previous holding where we see tailwinds of tight COVID induced household budgets and a large supply of cheap real estate coming their way.
➢ Tractor Supply – “the largest rural lifestyle retailer in the US” that is benefiting from first time hobby farmers/gardeners as Zoom and other remote technologies plus the COVID induced lockdown are translating to a move “back to the land”, especially amongst tech workers who have money and know how to spend it.

- Lamb Weston – a previous holding and the supplier of choice for the most profitable line item on any restaurant, french fries – the number of restaurant closures has peaked – it gets better from here.
- MasterCard – a fintech company that facilitates e-commerce and the cashless society – both have gained market share as a result of COVID.
- Cintas – a "keep it clean" supplier of uniforms, linens and complete hygiene/training systems and a company that we have wanted to own for a very long time – an obvious beneficiary of the new protocols.
- CAE – a well known Canadian name in the simulator training business serving the aviation and healthcare sectors – our take is the bad news gives way to good news and the company has the management talent to pivot into new markets.

What about those rent cheques? Understandably, the increases have slowed down in this environment. That said, there were a few companies that did up their dividend in Q2; namely Johnson & Johnson up 6.3% and Enghouse up 1.2%. The table below reflects where we landed in terms of companies owned at the end of the quarter.

The Dividend Value Discipline™

Rent Cheque increases in the past 12 months as at June 30, 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	2.24%	13.9%	27.0%	3	9	A new store in China every 15 hours where coffee consumption is growing at 16% per year
2	CINTAS CORP	Aggregator	$ 2.55	0.95%	24.4%	24.2%	3	27	A uniform rental and cleaning services company - primed to benefit from COVID
3	NORTHERN TRUST CORP	Disruptor	$ 2.80	3.67%	16.7%	22.6%	3	9	The go-to private bank for Fortune 500 families - leads in blockchain security
4	MASTERCARD INCORPORATED	Aggregator	$ 1.60	0.54%	21.2%	22.1%	3	13	A major player in the global payments industry that needs no introduction
5	MARKETAXESS HOLDINGS INC	Disruptor	$ 2.40	0.44%	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	0.69%	28.6%	21.6%	4	11	A mission-critical software provider and lifetime aggregator
7	A. O. SMITH CORP	Aggregator	$ 0.96	2.02%	45.5%	19.7%	4	14	Providers of the high quality hot water systems and accessing China and India consumers
8	INTUIT INC	Disruptor	$ 2.12	0.69%	12.8%	19.6%	4	9	Creator of TurboTax/QuickBooks, dominant in small business & now cloud subscriptions
9	NIKE INC	Disruptor	$ 0.98	1.01%	7.7%	14.1%	5	30	A marquee designer/innovator in sports apparel
10	THERMO FISHER SCIENTIFIC INC	Aggregator	$ 0.88	0.23%	15.8%	13.6%	5	2	A science enabler through lab systems, software and services
11	CAE INC***	Aggregator	$ 0.44	2.13%	10.0%	12.4%	6	15	A leader in flight simulators and training with strong long-term tailwinds
12	STERIS PLC	Aggregator	$ 1.48	0.99%	4.2%	11.8%	6	14	A sterilization systems provider to the global healthcare industry
13	CANADIAN NATIONAL RAILWAY	Disruptor	$ 2.30	1.91%	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	1.94%	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	0.95%	10.9%	11.5%	6	16	Culture transformer under Satya Nadella, exploiting cloud and MS Office subscriptions
16	ANALOG DEVICES INC	Both	$ 2.48	2.00%	14.8%	11.3%	6	16	Transforming sound, pressure, light, and temperature to data, fueling our digital world
17	DANAHER CORPORATION	Aggregator	$ 0.72	0.39%	5.9%	8.7%	8	26	Science enabler for the medical research, environment and diagnostics industries
18	3M COMPANY	Aggregator	$ 5.88	3.89%	2.1%	7.8%	9	61	Globally diversified - incredibly innovative, loved by employees.
19	LAMB WESTON HOLDINGS INC	Aggregator	$ 0.92	1.53%	15.0%	7.0%	10	2	North America's largest producer of frozen french fries and potato products
20	JOHNSON AND JOHNSON	Aggregator	$ 4.04	2.83%	6.3%	6.8%	11	57	Fantastic culture, huge insider ownership base and well diversified products stream
21	GIBSON ENERGY INC.	Neither	$ 1.36	6.55%	3.0%	1.0%	70	8	Toll booth to North American energy producers with a driven executive suite
	Median			**1.53%**	**12.77%**	**12.38%**	**5.9**	**14**	

*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
***CAE INC has temporarily suspended their dividend as of March 12, 2020

In Summary

We are weathering the storm rather well at this point, and we have sold a number of companies that are clearly going to struggle in the post-COVID world while upping our exposure to those that will benefit from COVID tailwinds. Akin to the way I started this missive, investors don't care about the absolutes of good and bad, rather if things are getting better or worse – when we apply that adage to our stocks, things are getting better. Yes, it will be surprising if we do not get some hiccups. Those are to be expected – longer term, we believe our current roster has the wind in their sails.

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