1st Quarter 2021 (Q1) Market Commentary

Introduction

As per our usual course, we start this missive with the macro view of the world as we see it – interest rates, currencies, commodities and stock prices are all interrelated and the one constant is change. They are a reflection of what is going on in the real world – COVID up or down, job growth or lack thereof, trade and trade barriers, political battles won and lost – it is a complex system. If you ever have anyone tell you that they have it all figured out, please run from them as fast as you possibly can.

Post our big picture update, we give the skinny on each of our internally managed mandates, and an update on our current thinking and any noteworthy items that we feel are of value to you.

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

The Big Picture

For those of you who are familiar with our March 9th, 2021 edition of The Opportunity Update, you will recall that the lead track was **Caveat Emptor – The Trend Has Shifted.** Our take was (and continues to be) that last year's winners are unlikely to be the winners of 2021 because we are coming *out* of a COVID induced recession, not entering one. Even if we get some increased shutdowns with the latest variants and rising case loads we are currently witnessing, we now have vaccines, we have treatments, and the future is a whole lot less scary than this time last year. If you put on your investor psychology hat, that means far less likelihood of a panic selloff.

As I write this on Tuesday, April 6th, 2021, the trend continues to roll out as expected – last year's COVID victims are doing exceedingly well and the COVID beneficiaries are struggling in terms of market performance. To wit, note the table to the right – for the quarter ended March 31st, 2021, the top three performing sectors were energy, financials and industrials whereas utilities, technology and consumer staples have struggled.

US Sector Returns for 2020 and Q1 2021

Symbol	Sector Fund Name	2020	Q1 2021
XLE	Energy Sector Fund	-32.7%	30.8%
XLF	Financial Sector Fund	-1.7%	16.0%
XLI	Industrial Sector Fund	10.9%	11.5%
XLB	Materials Sector Fund	20.5%	9.3%
XLRE	Real Estate Sector Fund	-2.2%	9.1%
XLC	Communication Services Sector Fund	26.9%	8.8%
XLY	Consumer Discretionary Sector Fund	29.6%	4.7%
XLV	Health Care Sector Fund	13.3%	3.3%
XLU	Utilities Sector Fund	0.5%	2.9%
XLK	Technology Sector Fund	43.6%	2.4%
XLP	Consumer Staples Sector Fund	10.1%	1.8%

One note of caution - we need to be careful not to paint the technology sector with too broad a brush – yes, we believe there are pockets of overhyped/overvalued technology stocks, most of which do not pay dividends, so we avoid them by default. There are other subsectors within the tech/fintech world where we see great long term value – i.e. the suppliers of “foundry equipment” to the world’s semiconductor manufacturers. Many of their production facilities/ systems are approaching the obsolescence stage, which will necessitate a big capital upgrade to meet the growing demand for chips. Note that the $SOX just hit another all time high as we open Q2.

On the previously referenced recording, I noted that we were seeing a counter trend rally in the U.S. Dollar Index and that I expected it to be short lived. From my perspective, the rally is over – witness the near perfect inverse correlation with copper, which is reflecting a fresh breakout after a month long consolidation. It leans bullish, and the resumption of the $USD Index downtrend is a positive for most things X-USA, including Canada.

Charts courtesy of StockCharts.com

The Dividend Value Discipline™ – Our core strategy has been in existence since the fall of 2002, and I would characterize it as our bellwether mandate – it straddles the need for income and growth, it has no restrictions in terms of industry or geography, but it does have biases – our biggest bias is our preference for acquiring "rent cheque (dividend) growers", for both income and capital gain. Why growers? Please ask me the next time we speak. In short, over long periods of time they do extremely well.

Suffice to say, for Q1 we have had one of the best starts to the year that I can remember. Please take that as your cue to not even think about annualizing the results for the first 90 days! While our base case remains bullish, we are under no illusions – markets will continue to move in a two steps ahead one step back fashion. Periodically, it will be two big strides back, before we start moving ahead again. During those periods, it is our investment behaviour that will determine our lifetime results.

Most balanced accounts (those with a fixed income component) saw the quarter end peg in at the +5.5% to 6% range, whereas accounts in the all equity version were in the +7% to 7.5% range.

As you would expect, our objectives remain unchanged:

- 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.
- 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.
- 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.

In terms of new companies added to the program, we acquired e-commerce provider PayPal because its expanding market presence is translating into copious quantities of free cash flow. They have yet to pay a dividend, but we believe that day is coming…soon. Our take is that their total commitment/focus on the end user will translate to outsized returns for years to come. We also acquired CDW Corp., a technology systems provider/ consulting firm to small and medium sized businesses. Those businesses were hit hard during the lockdowns but they now find themselves in a position where they have to invest to compete – translation, great tailwinds for CDW. The last new addition is a smaller yet acquisitive (i.e. aggregator) U.S. bank, Independent Bank Group (symbol IBTX). We are benefiting from their growing scale and the now higher net interest margins as longer term rates have increased. Between the new additions and our increased allocations to the energy and materials sectors (primarily by way of exchange traded funds (ETFs)), it was necessary to sell some of our long held companies – Starbucks, Johnson & Johnson and TJX were all sold in their entirety. Simply put, we like the prospects/value propositions of the additions better.

Rent cheque (dividend) increases? I am glad you asked:

+ 30%

+ 18%

+ 11%

+ 10%

+ 10%

+ 7%

+ 7%

+ 3%

+ 2%

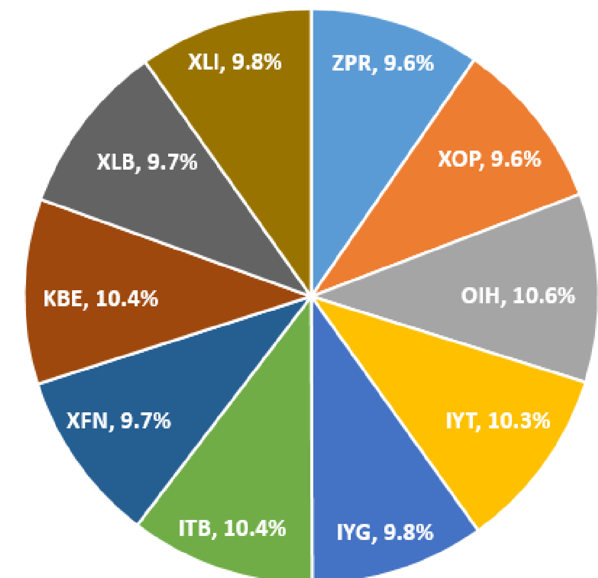
+ $4.60 Special Dividend

Enghouse Systems

Software engineered for results

+ $1.50 Special Dividend

<u>**The Global Active Macro ETF (GAME) Strategy**</u> – This mandate continues to push us to sectors/ regions of the world where money is clearly getting allocated. As participants understand, the process was built to force us to own what is working, regardless of our biases, and push us off what is not working. Throughout the quarter we saw increased allocations to energy, materials and financials, whereas we owned none of those sectors at year end. Most of the Canadian dollar version pegged in with returns of ~+7% on a year-to-date basis.



Where does it fit? The turnover in GAME is fairly high and for that reason, we like to see this mandate within registered accounts (i.e. RSP, RIF, TFSA, IRA). This is a go anywhere strategy an thus is especially appealing to investors that want to move with the market and not get locked into a specific mandate "box", i.e. U.S. equities or emerging markets debt. When I site periods in history where the S&P 500 has actually been negative on a 10-year rolling basis, most people understand why not getting locked in is so important. That is one of the reasons for our generally negative biases towards mutual funds – they have their place, sparingly, in our view.

The Tax Advantaged Preferred Share (TAPS) Strategy – The Canadian preferred share market continues to advance on shrinking supply due to the introduction of limited recourse capital notes (LRCNs) – the result being that many of Canada's financial institutions now have access to cheaper capital and thus are calling in some of their preferred share issues. The complex has also benefited from the increase in the Government of Canada 5-year bonds rates.

PREFERRED SHARES ISSUERS
BCE INC
BANK OF MONTREAL
BANK OF NOVA SCOTIA
BROOKFIELD ASSET MANAGEMENT INC
ENBRIDGE INC
FAIRFAX FINANCIAL HOLDINGS LTD
GREAT-WEST LIFECO INC
MANULIFE FINANCIAL CORPORATION
PEMBINA PIPELINE CORPORATION
POWER CORPORATION OF CANADA
ROYAL BANK OF CANADA
TORONTO-DOMINION BANK

Who is it for? Investors whose primary focus is on income, and they are not concerned with capital growth. This strategy is not appropriate for registered accounts as you would nullify the tax advantages.

This mandate continues to attract capital, especially in light of the dismal return prospects of GICs. The adjacent image shows a snapshot of our current model issuers as of March 31st, 2021. The current portfolio yield is ~4.6%, but recall that the interest equivalent due to the dividend tax credit is north of 6% assuming you are in the highest marginal tax bracket, and if you are not, it only gets better.

The Keep More Income (KMI) Strategy – This mandate was developed for a very specific niche – a resident of Canada, whose primary concern is after tax income yet wants some growth over time. As such, it is only suitable for non-registered/taxable accounts. We continue to be encouraged with the U.S. dollar now resuming its downtrend and what that does for our commodity prices/producers, ergo Canada.

As I noted on the last report, prior to the market meltdown of 2008/09, Canada was the place to be for most of the previous decade, in terms of investment returns. Post that crisis, the U.S. has been the place to be for most of the past 12+ years. Historically speaking, it is extremely unlikely that the U.S. will continue to be the place to be for the next decade. We are already witnessing a weaker U.S. dollar and investors returning to the X-USA space – even Canada's energy patch is attracting U.S. buyers. The best opportunities tend to come from sectors/regions where investors have long given up and thrown in the towel. That certainly describes most of Canada.

For participants, again, please do not even think about annualizing your Q1 returns ☺. For non-participants, because the formalized program has been in existence for less than one year, we cannot make the results public.

The Next Cycle Resource Fund (NCRF) – Like the KMI strategy above, the tenure of this program is insufficient for us to be able to share the results publicly. That said, we continue to benefit from what we see as a secular shift in commodity prices, and thus the investment opportunities in the producers thereof. Our belief is that the weaker U.S. dollar, the COVID induced shelving of commodities production, and now a robust recovery means that we are in for a sustained period of higher prices/better returns. The green agenda only adds additional pressure in that a lot more materials are consumed to produce things like solar panels, wind turbines and Tesla batteries.

Who is it for? Investors with a higher risk tolerance and a specific interest in owning some of Canada's top resource producers. Due to turnover, it is better suited to a non-taxable account or slice thereof.

Conclusion

Q1 has given us a robust start to the year and at times like this, yes, we enjoy the fruits of our labour. We also take time to reflect on the areas of the market that are not doing well as we prepare for the next inevitable downturn. By way of example, at our research meeting on April 6th, 2021, we spent a considerable amount of time debating where to allocate our next efforts – in the sectors that are rewarding us now and where by and large we have lots of exposure/options, or studying the best of the best in say consumer staples, an area where there is little investment news or perceived opportunity. Where are we more likely to find bargains? The answer seems obvious. We trust that demonstrates how we think and why we believe the future will continue to be rewarding, albeit in a lumpy fashion.

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