TD Wealth

Murdison Minutes

2020 Q4

Defying all odds, 2020 turned out to be another banner year for investors. We are very pleased with how our investment philosophy and strategy execution fared during a year where things went from too bad to believe to too good to be true in a matter of weeks. Staying disciplined and invested throughout was the key to success. As we understand through our analysis and conversations with you, our clients, our diversification across asset classes, geographies, risk factors, strategies and behavioural factors was critical to successfully navigating a tumultuous year.

Typically, Murdison Minutes has discussed high-level, macro topics. Going forward we are going to use this forum to dive a bit deeper into the actual investments that make-up portfolios. This shift is in response to the impressive strategy pieces frequently published by Brad Simpson, Chief Wealth Strategist and his team, Portfolio Advice and Investment Research (PAIR) at TD. We think they do an excellent (dare I say better) job at tackling the macro issues and Brad's unique perspective brings an artistic flare we can't compete with. As long as our investment philosophy is closely aligned with PAIR, we think it will be more valuable to discuss how we apply that philosophy and make specific investment decisions in your portfolio. We'll turn these out quarterly to accompany your quarterly reports.

Bonds

Probably the biggest surprise relative to forecasts from a year ago was the performance of bonds. North American bonds performed especially well as our comparatively high interest rates were slashed by central banks as the Covid-19 pandemic hit our shores. Coupled with the flight to safety that typically takes place during market panic, bond returns were stellar despite their miniscule yield. Many, ourselves included, underestimated the diversification benefits of high-quality, low-yielding government bonds when yields were already so low. That said, few were expecting central banks to cut rates even further than they did post-financial crisis. Although bonds provided a modest offset to losses elsewhere during the early months of the pandemic, that benefit may be short-lived. Although bonds performed well in the first half of 2020, our long-term thesis on bonds is still very much intact. With the yield to maturity on the Canadian bond index now barely above 1%, with a record sensitivity to rising rates, we find it hard to imagine this asset class should be the primary tool for managing portfolio risk or generating income (the two traditional uses of bonds).[1]

Our bond holdings are structured with less sensitivity to rising interest rates and better long-term yield potential (vs. the broad bond market), however, this is at the expense of the short-term return potential during periods of stress. We favour striving for positive returns over the long-term. As populations are vaccinated and economies re-opened, we believe there will be upward pressure on interest rates and that our strategy will fare substantially better than a broad allocation to the bond market.

We learned, regardless of how weak the long-term return potential is, never count out demand for the highest-quality, safest assets during short term periods of stress. However, because of the necessity to generate positive, long-term returns, diversification and risk management needs to extend beyond traditional bonds. Maybe now more than ever.

Credit

Going into the pandemic with near-record tight spreads, corporate bonds (i.e. credit) were priced for perfection. By mid-March the prospects for credit looked dire. Liquidity had dried up and speculation of mass defaults seemed quite reasonable given the circumstances. Then something happened. The Federal Reserve Bank (The Fed), indicated they would start buying corporate bonds in the open market to ensure companies remained solvent. This is a great example of what's known as "adaptive markets". No one expected The Fed to do this because they had never done it before. But facing an unprecedented situation, humans reacted with unprecedented measures. The results—asset prices quickly turned upwards and recovered all losses in record time—to nearly everyone's surprise. The point is, situations change, people change and thus markets change. Trying to figure out all this change before-hand (i.e. predict, forecast, pontificate…) is all but impossible in our opinion (statistics are very much in our favour). Hence, our approach that endorses being fully invested but with broad diversification, with exposure to the safest assets and also even some of the riskier ones. We don't believe we have much ability to figure out when or by how much any asset is going to appreciate (or depreciate). So we focus on the factors we can control.

Although corporate bonds fell in March, the losses were materially less than the stock market and the income stream from those bonds remained in tact. Even the riskiest segment of the credit market, high-yield bonds, only fell about 2/3rds as much as stocks. Then, and now, we like the risk/reward profile of credit. It tends to provide diversification benefits while delivering long-term returns similar to stocks. Going forward, credit has less sensitivity to rising interest rates than government bonds and offers higher yields. Spreads have tightened but are not back to pre-pandemic levels. Given negative real yields on government bonds, the additional yield from credit may compel more money into the market, pushing spreads tighter still.

Credit is tricky business, but we are confident we have invested with some of the best managers available. Indeed, the historical returns of some of our managers clearly indicates their past competence, but as the disclaimer goes, “past performance is not indicative of future returns”. Our work suggests some of our credit strategies still have their best days ahead of them.

Equities

I imagine everyone is aware of the fantastic returns posted by technology stocks. Perhaps of little surprise, companies that sell services and products that enabled remote work thrived in 2020. In fact, most of the big tech companies merely continued the relentless growth they have enjoyed for the past decade or so. To us, the long-term leadership trend of tech companies has been obvious for quite some time. We don’t favour labels—whether that be investment style (growth, value...marketing gimmicks in our view), or industry categories (technology, industrial, telecommunications, consumer discretionary...for many companies, who’s to say the place of best fit). In place of trying to fit companies into tidy buckets, we focus on finding companies demonstrating the highest quality, most dependable growth and often ones that are “changing the game”. As a result, technology has been the largest allocation of any sector in our equity models, for quite sometime. One of our stocks does little more than advise other companies on how to use new technology...that’s a pretty good business these days.

Quite often companies that disrupt traditional businesses and industries are called “tech companies”, but sometimes not. We recently added a wind and solar energy producer that has been benefiting impressively from the lower cost of renewable energy production and increasing political and social support. This company is considered a utility, but very much benefiting from the disruption of traditional industry. Industry labels may be more about marketing objectives than investing.

The U.S. equity market, with it’s abundance of large tech companies was the big winner of 2020. The Canadian market, with banks and insurers representing roughly one third of the index, struggled under low interest rates and continued pressure on oil and gas prices. Considering the 18% return of America’s S&P500, perhaps one of the more surprising facts of 2020 is that the Canadian bond market actually outperformed the Canadian stock market. Once again, concentrating investments in the perceived safety of familiar Canadian companies did not pay off in 2020. The losses were just as painful in the spring as the U.S. stock market, yet the recovery was only a fraction. We have continued to focus equity exposure outside of Canada to gain exposure to the most attractive companies and regional growth potential. We certainly see some great opportunities in the Canadian market, but there are far too few to build a well diversified portfolio.

Alternatives—Arbitrage

The panic and indiscriminate selling in March provided disciplined managers with the best opportunities they have seen in years. The opportunities were especially ripe for our arbitrage managers who had been conservatively positioned going into the pandemic. As a reminder, arbitrage strategies structure trades that benefit from relative changes in prices of various assets, not necessarily absolute changes up or down. In a year full of positive surprises and exceeded expectations, this segment of portfolios was still a shining star. Delivering annual returns that handily beat the tech-heavy S&P500 while hardly giving up any ground in March, we got to have our cake and eat it too. These are amongst the many strategies we utilize to do what traditional bonds can no longer do—manage risk while offering attractive long-term return expectations.

Alternatives—Private Equity

Available to accredited investors only, our private equity investment is a significant (and quite unique) step in our efforts to replicate the allocations of large pension funds and the wealthiest families in the world. Private equity offers two promising attributes 1) exposure to young start-ups that are not listed on stock exchanges but have substantial growth potential and 2) ownership of mature businesses with strong cashflows that public markets may not value appropriately. Although these two types of companies are at polar ends of the equity investment spectrum, they have common threads—neither tend to be valued appropriately by stock markets and yet both are highly attractive investments. Without the distraction of short-term stock price volatility, investors and managers may be better fit to make accretive, long-term business decisions. Of course, we can’t get something for nothing, private equity has it’s costs. The first, well, the costs—it’s expensive to run and thus invest in. Second, liquidity—we can’t buy and sell private companies (or a fund made up of them) anytime we want (like a publicly traded stock). In 2020, we definitely got what we paid for—strong but more importantly, highly stable returns.

Alternatives—Real Assets

To refresh your knowledge of financial jargon, “real assets” in the context of our strategy refers to privately owned real estate and infrastructure. The obvious lightning rod here is office real estate. No question it is down right now, but we are not so sure it should be counted out. Certainly some of the froth of the pre-pandemic office market is gone but these are incredibly valuable assets that generate strong, inflation-protected cash flow.

It is critical to note that our real estate portfolio is incredibly diverse, office real estate is only one of many sub-sectors we own. One sub-sector that has done very well is industrial, specifically logistics. We have about as much exposure here as to office space. Logistics includes assets like e-commerce distribution centers, I’m sure I don’t need to explain the business case.

The disruption to trade, industry and travel caused a pause in the phenomenal growth of infrastructure assets. Opportunity lies in the potential for massive shifts to renewable energy production and government spending on much-needed infrastructure projects. The capital flowing to renewable energy projects has been astounding. Brookfield Asset Management hired Mark Carney to oversee a US$100-billion impact fund with a focus on renewable energy and in early January, Canada Pension Plan Investment Board (CPPIB) committed 245-million Euros to a renewable power investment corporation in Europe. The shift to renewables is very real and our portfolios reflect that change.

In a world where a 10-year Canada bond pays less than 1%, investment income may be scarce for a while to come. With the omnipresent risk of inflation following massive monetary and fiscal stimulus, the inflation protected-characteristics of real assets seems to be an attractive element to own in portfolios.

Environmental, Social & Governance (ESG)

As portfolio managers, we have an obligation to make the best financial decisions on behalf of our clients. For some time, making good investment decisions and doing what was “right” for the environment or society was not always the same thing.

Increasingly we are observing that the best investment decisions also happen to be ones that are likely to benefit the environment and society. In one of our equity strategies, we recently sold out of two pipelines and replaced with two companies that generate renewable energy. This was not out of our desire to market an ESG strategy, the same financial metrics we have always looked at to buy and sell stocks indicated this was a good financial decision. When massive investors like Brookfield and CPPIB are funneling billions to green investments (and out of carbon intensive, polluting ones), the fundamentals and prospects of these companies change. In a symbolic nod to a trade we just made in portfolios, the owners of the Keystone Pipeline, just pledged to only use renewable power in an effort to win over approval from the Biden administration. The Norwegian sovereign wealth fund, the single largest investor in the world has pledged to divest from Canadian oil sands. The irony is not lost on many, nevertheless, money talks—it's hard to build a positive investment thesis around an industry that the largest investors are pledging to avoid.

To be clear, we do not strive to be impact investors (no one seems to be able to define what that is anyway), but we do welcome the trend where our best investment ideas are increasingly ones that may benefit our environment. Embracing change and adapting to it is fundamental to our investment philosophy. There is no greater example of this in action than the gradual change from traditional energy to renewables in our portfolios.

I know many wonder how their portfolio can be doing so well despite all the headwinds in the economy. Despite all the challenges of 2020 we witness impressive appreciation from most bonds, stocks, real estate, commodities and of course, Bitcoin. The simple, and perhaps best, answer for how virtually all assets can go up at the same time during the worst recession since the Great Depression is liquidity. Central banks have poured massive amounts of money into the financial system, some of it is spent but much of it is used to buy assets. The impact of monetary policy on asset prices over the past decade cannot be understated. Considering governments finally seem willing to coordinate easy monetary policy with stimulative fiscal spending, the case for further appreciation of most assets is a strong one. To reiterate, we don't believe trying to predict which asset is going to outperform next year is a reliable strategy, it's too hard to get right and too easy to get wrong. Instead, investing in truly diversified, quality assets helps ensure exposure to the areas of the market that are performing well at any given time. This strategy helped clients stay invested, confident and comfortable during the worst of 2020, so they could capture the benefit of the best.

All the best for 2021. Stay well!

Tom, Galit & Victor

1. All market return data is from Croesus Finansoft Inc.