Goodreid
INVESTMENT COUNSEL

87 Front Street East
2nd Floor
Toronto, ON M5E 1B8

T. 416 364 0890
TF. 1 888 466 3734
goodreid.com

The Goodreid Gauge

Fall 2019

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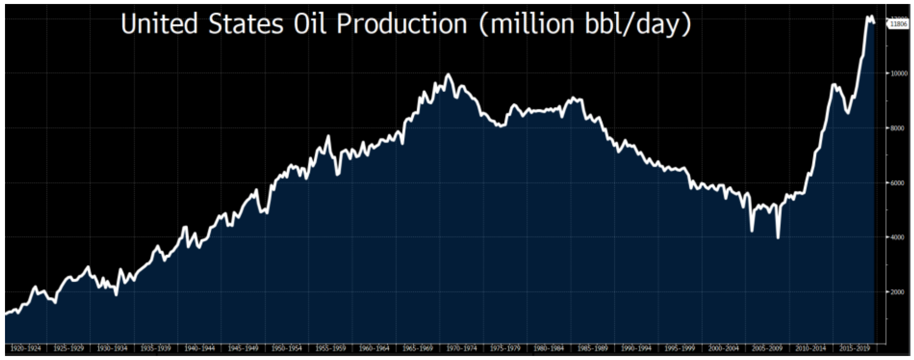
North American stock markets chalked up modest gains this quarter, with the S&P/TSX Composite Index recording a 2.5% gain and the S&P 500 index earning 1.7% in US$ or 3% in CAD$ terms. Fixed income returns were muted with the FTSE Canada Short Term bond index appreciating by 0.3% while the Solactive Laddered Canadian Preferred Share Index inched up 0.1%. Year to date, Canadian stocks as measured by the S&P/TSX Composite index are up a solid 19.1%, U.S. stocks represented by the S&P 500 index are up 20.6% (16.9% in CAD$), the FTSE Canada Short Term bond index is up 3% and preferred shares as measured by the Solactive Laddered Canadian Preferred Share Index are down 2%.

In general, the quarter was a fairly routine one, and investors were spared any serious volatility in stock markets. To illustrate we note that markets traded within a very narrow range with just 6% separating the high-water mark and the low-water mark during the quarter for Canadian stocks, and 7% separating the intra-quarter highs and lows for U.S. stocks. During the quarter some clients raised the issue of the current Presidential impeachment turmoil gripping the United States, and at the risk of sounding dismissive, we have to characterize these concerns as "much ado about nothing", for several reasons. Firstly, risk is the product of probability and severity, and with Republicans controlling the Senate and very little evidence of bi-partisan co-operation on anything, let alone an issue as divisive as Presidential impeachment, we think the likelihood of America's 45th President being convicted by the Senate and removed from office is very low. That said, given that the Democrats control the House it is probable that that body will vote for impeachment. We note the historical precedent of Richard Nixon's and Bill Clinton's brushes with impeachment. Nixon's troubles occurred during a brutal recession in 1974 and saw the S&P 500 Index fall by 11% over a six-month period from February to August of that year. Clinton's troubles occurred during the late stages of a long economic expansion and were coincidental with the S&P 500 Index rising 29% between October 1998 and February 1999. The point, of course, is that too much is made by investors of the political drama of the day and not enough weight is given to the (far more important) economic backdrop, and accordingly we judge that any impeachment proceedings in the United States may at the margin boost the earnings prospects for a few media outlets, but will almost certainly be simply a passing event for the equity markets.

What is in fact important though within the macroeconomic and geopolitical realm, away from the company specific fundamentals that we spend our days following, researching and studying is the ongoing tug of war between trade policy and interest rate policy in the United States. It is undeniable that trade policy - both the actual tariffs and the uncertainty around future tariffs and trade policy - is having a negative effect on global and U.S. domestic growth. We can see this in objective indicators as diverse as rail freight volumes, purchasing manager surveys, manufacturing capacity utilization and even overall job growth. We can also hear it more colorfully and anecdotally from the CEOs of Canada's and America's companies when we listen to their quarterly conference calls, as they lament the policy fog and defer major hiring and investment decisions pending greater clarity. There are perhaps two economists on the planet who believe the fairy tale that trade wars are good and easy to win, and both of them are working in the White House. Accordingly, the Federal Reserve in serving its dual mandate of price stability and full employment has had to correct its course set late last year, away from higher interest rates and towards a more accommodative monetary policy stance to lean into these headwinds that the trade war has brought to bear upon the U.S. economy. The Fed has cut rates twice this year, and markets expect another rate cut before year end. This has



had significant implications for the performance of sectors and styles within stock markets as well as for the performance of other asset classes, most notably long government bonds and gold, both of which we have exposure to. We have had exposure to gold in balanced accounts mainly via our ownership of Canada's pioneering royalty/streaming company, Franco Nevada, for several years now both because we like its unique business model and because it offers us low risk leverage to a rising gold price. Gold is sometimes thought of as a store of value, being one of the most ancient forms of money, but unlike other more modern forms of money and stores of value (bank deposits, GICs, government bonds, etc.) gold pays no interest, and so it incurs an opportunity cost against these alternatives when interest rates are high or rising. The opposite is true when interest rates are low (or negative, as is the case in some countries) and falling as they now are, and accordingly Franco Nevada has performed well. We also introduced a 30-year Government of Canada bond into balanced portfolios early this quarter, understanding that as global interest rates fall, the appeal of earlier issued, higher coupon government bonds increase, as does their trading price. Moreover, there is an international scramble for high (or at least positive) yields in a global debt market awash in $15 trillion of bonds with negative yields, and Canadian long-dated government bonds with their higher yields are attracting some of these marginal buyers. Corporate bonds continue to form the core of our bond portfolios, and we are drawn to them for their generally higher yields versus government bonds, but long-dated Canadian government bonds tend to move more inversely to stock markets and are thus a useful diversifier and dampener of equity market risk in balanced accounts.

Oil remains the global lubricant of economic activity, both literally and figuratively, and investors were abruptly reminded of this in mid-September as multiple rockets struck the largest oil processing facility in the world, taking nearly 6m barrels/day of Saudi Arabian oil off the market. Brent blend oil prices rose 15% when markets reopened on the Monday after the attacks, in one of the biggest one day moves in oil prices in decades, but by the end the quarter, oil prices had fallen back to pre-attack levels. The market was reassured by the Saudi's rapid repair of the damage but it's also apparent that part of the reason for the rebound is grounded in the surge of American production dominance within the world's oil scene. Geophysicist Marion King Hubbert in 1956 first posited, in what is now known as "Hubbert's Peak Oil theory", that oil production in a given region over time would follow a bell shaped pattern…first rising, before peaking and then falling inexorably. The theory was validated by the data and became accepted as orthodoxy over the ensuing five decades as American oil production peaked in 1970 around 10m barrels/day and fell relentlessly to just 4m barrels/day in 2009. But the discovery of unconventional oil in shale fields, coupled with advanced well completion and fracking techniques has made America a born again energy superpower, producing some 12m barrels of oil per day…. more oil than any other country in the world, Saudi Arabia included. America's gain has unfortunately been at least to some extent, Canada's loss. No longer captive to Canadian and foreign crude oil, America's newfound energy riches have brought about a decade of pain for Western Canadian energy producers, who find themselves at "the end of the pipe"…distant to consuming regions in the Midwest, the Northeast and most importantly, distant from the massive Gulf Coast refining complex. Compounding the problem, Canadian and various provincial governments have been unable to find the political will to build critical pipeline infrastructure to ports and to refineries in Eastern Canada, leaving western producers no choice but to move crude at great expense and environmental risk by rail and to sell their oil at a steep discount to international benchmark prices. A decade of disinterest and policy error has left the oil patch, which used to be the beating heart of Canada's most entrepreneurial province, on its knees. Five oil producers were removed from the Canadian TSX Composite in September and the remaining sixteen exploration and production companies in Canada are now a mere rounding error on the TSX Composite, comprising a scant 3.3% combined index weight (i.e. combined they are valued less than a single railway - CN Rail), versus their mid-teens weighting a decade ago.

While it may be cold comfort to long suffering shareholders, investing is about making decisions today about where value will be surfaced tomorrow, and on that score the median oil stock is trading at just 0.54x of its book value – a 20 year low. We have been deliberately cautious and selective in our approach to energy, owning either businesses that supply the oil producers, like Halliburton, or owning best-of-breed, financially strong producers like Canadian Natural Resources and Parex Resources, or integrated refiner/producers like Suncor. We are increasingly confident though that the private market values of many of Canada's energy producers exceeds their share price and expect a catalyst to expose this value in the coming years, perhaps in tandem with a broader rotation out of growth/momentum leadership companies and into value/cyclical businesses, which have seen some tentative stirrings of interest in recent weeks.

Start	End	Russell 1000 Value Index	Russell 1000 Growth Index
13-Sep-93	09-Mar-00	138%	340%
09-Mar-00	08-Aug-06	67%	-40%
08-Aug-06	30-Sep-19	140%	298%

On that last topic, we have observed, over the past few years, a narrowing of market leadership, with investors clamoring for the biggest and strongest names with the longest and steadiest uptrends in price. In Canada, stocks like Shopify, Waste Connections and Brookfield Asset Management exemplify this phenomenon, and in the United States the FAANG stocks (i.e. Facebook, Amazon, Apple, Netflix, Google) have been the momentum darlings. These types of market environments can be challenging for active managers, ourselves included. That is to say, those who undertake a disciplined study of the market and strive to build a diverse portfolio of the "best" companies, as opposed to just buying the whole market via an ETF or an index fund can be confounded for brief or sometimes frustratingly long periods of time over the markets' seemingly blinkered, singular and unwavering focus on the leadership group of the day. The mechanical construction of indices like the S&P/TSX Composite and the S&P 500 is such that larger, more highly valued companies carry greater weight in the index, so each dollar uptick in the favoured leadership group sees their weight and influence upon the index increase, compounding the frustration of the active manager. In effect, this growth and momentum chasing, and the knock-on effect that the proliferation of ETFs and passive investing has on it increases the overall riskiness of markets towards the late stages of a cycle. But we've been through cycles like this before, most notably in 1999 when Canadian investors bid up the shares of Nortel Networks to such an extent that at its peak, it alone comprised 35% of the S&P/TSX Composite. At the time, many active managers felt such tremendous pressure to keep up with the meteoric rise of the index that they bought Nortel despite their deep suspicions that it was overvalued and fragile. We didn't chase then and are resolved not to chase the growth and momentum leadership group of today. We concede that in the short term this may incur an opportunity cost, but in the long run avoiding undue portfolio concentration in the most over-loved, overvalued, high expectation growth/momentum leadership group is the best way to avoid catastrophic losses of capital of the Nortel variety. Conversely, turning over stones in some of the under-loved and better valued corners of the market, in our view, affords us a better risk/reward proposition. We are actively researching these sorts of opportunities in an attempt to capitalize on a broadening out of market leadership, beyond growth and momentum stocks and favouring value stocks, which will inevitably occur. When it does, we expect it will be a powerful and multiyear phenomenon, just as it was from 2000 to 2006.

Another year is quickly fading. We have been reminded yet again that the only constant is change and that the most successful investment strategy practices balance, incorporates hedges at every level, and favours portfolios instead of making bets. Sometimes we're early when taking a position and need the belief to stay with it. Sometimes we're wrong and need the humility and confidence to admit it and move on. Regardless, we always give our full effort and are confident that, over time, it will yield financial success.