ROSEDALE
FAMILY OFFICE

The Emperors New Clothes - The Love Letter

March, 2021

Optimism for the future abounds: the pace of vaccinations is accelerating, signs of Spring are everywhere, and exuberant equity markets are at all-time highs. For much of the past 12 months we have had a positive outlook on markets as the combination of attractive valuation and improving outlook encouraged an increased allocation to equities within our asset allocation model. While the economic outlook remains bright, the valuation pendulum has swung decidedly toward fully valued territory. Most segments of the market appear to have shaken off the pandemic shock of 2020 and are pricing in a strong economic and earnings recovery ahead. Meanwhile, some sectors, fueled by equal parts monetary stimulus and speculation, appear to have become detached from fundamental reality. Our fundamental, valuation-focused investment approach has prompted us to shift to a neutral position in the short-term.

In theory, the price of a stock is based on the present value of its cumulative future earnings. Macro, industry, and company-specific developments are continuously influencing the likely path of future earnings. Since a dollar of earnings today is worth more than a dollar of earnings in the future (i.e. the time value of money) the level of interest rates are another key determinant of value, with lower interest rates increasing the present value of future earnings and vice versa. Behavioural finance has taught us that a third variable, investor sentiment, is also at work in the determination of stock prices.

At the outset of the pandemic, the future path of earnings became opaque, investor sentiment sank, and central banks responded by slashing interest rates. For value-oriented investors like us, the alignment of these variables presented a buying opportunity. Twelve months later, as the positive outlook becomes widespread, we find that two of these variables have moved or are moving in a direction that make the equity market less appealing in the short-term. Namely, long-term interest rates are rising, and investor sentiment has swung from pessimism to euphoria. As a short-term tactical strategy, we are reducing equity exposure modestly in client portfolios as the near-term risk/reward relationship has become less favourable.

At the beginning of this year we highlighted that rising long-term interest rates were the primary risk to capital markets in 2021. This concern has come to fruition as the 10-year U.S. Treasury bond yield, the benchmark for equity valuation models, has increased from 0.92% at the beginning of the year to 1.72% currently. The increase in bond yields is a result of an improving economic outlook and rising inflation expectations. Over the

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past four weeks, higher bond yields have become a headwind, particularly in sectors of the market where there are little or no current earnings and rising bond yields are like kryptonite to the present value of future earnings. A high concentration of these companies is in the technology and consumer discretionary sectors, where we have an underweight position.

To be clear, we are not averse to investing in growth companies. It is the high valuation that many of them trade at that makes them unattractive to us. The year-to-date underperformance of the technology-centric Nasdaq Composite Index (+0.9% in CAD terms as of March 19) versus the broad-based Dow Jones Industrial Index (+4.9% in CAD terms) is evidence that higher bond yields are starting to weigh on the valuation and appetite for the former. We expect this relative underperformance to continue in coming months so long as bond yields remain upwardly biased.

Indeed, we continue to be baffled at the extremely rich valuations being afforded to many of these “new economy” companies. Just as “price-to-eyeballs” became a popular justification for exorbitant valuations during the dot-com period 20 years ago, a metric that has become popular in recent months is “price-to-story”. By definition, “story stocks” are companies that are years away from meaningful revenue or earnings, but trade at massive valuations because investors believe that their product or service may become dominant in the future. Out of this group some may emerge to be successful, while many will likely not. Investors’ willingness to value something so greatly that hasn’t materialized yet reminds us of the lesson in Hans Christian Andersen’s fable *The Emperor’s New Clothes* (see below for an abbreviated version for those that missed reading the story in their younger years). In the context of capital markets, what we have learned is that price doesn’t necessarily define a company’s true worth. Price is simply what the consensus thinks it’s worth at a particular point in time. Like the child in the story, there are pockets of the market where we have no hesitation in stating that the Emperor has no clothes.

The Emperor's New Clothes (by Hans Christian Andersen)

Two con artists arrive in a kingdom of an Emperor who is obsessed with his own vanity. Posing as weavers, they offer to create magnificent clothes for the Emperor that are invisible to those who are unintelligent or incompetent. The Emperor hires them, and they set up looms in the castle and begin working. For raw materials, the con artists request large quantities of gold thread and the finest silk. The Emperor's top officials, and then the Emperor himself, visit the weavers to monitor their progress. Each sees that the looms are empty but pretends otherwise to avoid being thought a fool. Finally, the weavers announce that the Emperor's new clothes are finished. They mime dressing him and he sets off in a parade before the whole kingdom. Not wanting to appear inept or stupid, the spectators go along with the pretense, until a child calls out that the Emperor is wearing nothing at all. The people and the Emperor then realize that everyone has been fooled.

We continue to actively adjust our managed portfolios to reflect evolving market conditions. In recent weeks, we have made the following portfolio changes in our primary managed portfolio. Please contact us to discuss any of these transactions in greater detail or if you have any questions regarding your portfolio.

Buy: Costco (COST) – We have initiated a 2.0% portfolio position in this world-class retailer. Clients may recall that we had added Costco to our portfolio in mid-2020 and then exited with a meaningful gain a few months later when valuation was no longer attractive. Following weaker than expected Q2 results (due mainly to higher pandemic-related costs) and ongoing sector rotation, Costco is again trading at an attractive valuation. While we expect same-stores sales to decelerate from the pandemic-induced boom, we think retailers like Costco will be beneficiaries of rising consumer confidence and high personal savings rate.

Buy: Citigroup (C) – We have added 1.0% to our Citigroup position, bringing the portfolio weighting to 4.0%. Financial services, and banks in particular, are among the

few beneficiaries of rising bond yields as net interest margins are enhanced. As we have been expecting, recent quarterly results have revealed that provisions taken in 2020 for potential loan losses have started to be reversed and should enhance earnings in 2021. While share prices and valuation for several banks have rebounded to pre-pandemic levels (see Bank of Montreal and Bank of Nova Scotia below), we consider Citigroup's valuation to be attractive compared with peers.

Buy: Nintendo (NTDOY) – We have initiated a 2.0% portfolio position in this Japan-based videogame and console maker. With an extensive library of proprietary brands, the company is increasingly leveraging these brands by adding new revenue streams such as theme parks and video content, both of which serve to reinforce sales of its gaming consoles and game software. At the current 18x price/earnings level, Nintendo trades at an attractive valuation relative to peers and the broad market.

Buy: Restaurant Brands International (QSR) – We have initiated a 2.0% portfolio position in Restaurant Brands International, the parent company of Tim Hortons, Burger King, and Popeyes. QSR has lagged other foodservice and hospitality peers within the broader economic "re-opening" theme. We attribute this to underperformance at the Tim Hortons brand, whose Canada-centric footprint has been subject to greater restrictions. We expect earnings to begin rebounding in the second half of 2021.

Buy: Shaw Communications (SJR.b) – We have added 1.0% to our Shaw position, bringing the portfolio weighting to 3.0%. Our original investment thesis for Shaw was based on rising market share of its wireless segment (Freedom Mobile), attractive valuation relative to peers and above-average dividend yield. On March 15, Rogers Communications announced a friendly bid to acquire Shaw at $40.50/share. While the takeover offer has resulted in a marked increase in the value of our existing Shaw position, Shaw is trading at a significant discount to the proposed takeover price due to regulatory approval uncertainty. While regulatory review may take up to 12 months, we consider the risk/reward of increasing our Shaw position as attractive.

Buy: SL Green Realty (SLG) – We have initiated a 2.0% portfolio position in SL Green Realty, one of New York City's largest office landlords. Although the company reported

relatively stable results throughout 2020, the pandemic has materially impacted investor sentiment toward the office segment of the real estate sector. While the passage of time will dictate whether demand for office space and investor sentiment will recover, SL Green's prime real estate portfolio is trading at a steep discount to pre-pandemic levels and presents an attractive risk/reward opportunity. We note that vaccine breakthroughs announced in November have triggered a gradual recovery in investor sentiment, and the loosening of restrictions in the region has started gradual "return to the office" intentions by major employers.

Buy: Zoetis (ZTS) – We have initiated a 2.0% portfolio position in Zoetis, a leading international animal healthcare firm that was formerly a wholly-owned division of Pfizer. The company researches, develops, manufactures, and commercializes animal health medicines and vaccines, with a focus on livestock and companion animals. The company has established a track record of organic growth complemented by acquisitions, resulting in global market share leadership. A large research/development budget (relative to sales) which drives new products, increased incidence of pet ownership, and steady growth of its livestock segment allow for a high degree of earnings visibility.

Sell: Dynamic Precious Metals Fund – We have exited our remaining 4.0% position in this gold-focused fund. With the worst of the economic crisis now behind us and a nascent recovery underway, the defensive qualities of gold are less needed, and we have reallocated funds to economically sensitive sectors.

Sell: Bank of Montreal (BMO) – We have exited a 2.0% portfolio position in Bank of Montreal. Our investment thesis on Canadian banks has almost come full circle. Our portfolio started 2020 with no bank exposure and we grew it aggressively after the pandemic triggered a broad equity market sell-off in March 2020. Our thesis was built on high capital ratios, material discount to book value, and high likelihood of dividend sustainability. Twelve months later, we note that valuation and share prices for most Canadian banks have rebounded sharply and are now above pre-pandemic levels, reducing their attractiveness relative to other opportunities.

Sell: Bank of Nova Scotia (BNS) – We have reduced our Bank of Nova Scotia position by 2.0% and continue to hold a 2.0% portfolio weight. Similar to Bank of Montreal, we are reducing our Canadian bank exposure after valuation and share prices appear to have fully recovered from the effects of the pandemic.

Sell: Mackenzie U.S. Mid-Cap Growth Fund – We have reduced our position by 2.0% and continue to hold a 2.0% portfolio weight in this fund. While the fund has performed well since we added it in mid-2020, our objective to tactically reduce equity exposure in the near-term has triggered a partial reduction in this position.

Sell: Southwest Airlines (LUV) – We have exited a 2.0% portfolio position in Southwest Airlines, crystalizing a sizable gain. We added economic "re-opening" exposure to the portfolio in the latter months of 2020 with the expectation that vaccine rollouts would reverse investor sentiment for these segments. Rising enthusiasm for airline stocks has resulted in Southwest shares trading above pre-pandemic levels, even though consensus estimates suggest it may take until late-2023 for earnings to recover to pre-pandemic levels.