MARKET COMMENTARY

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"Kingwest's success can be attributed to three principles that the firm has abided by for over 35 years: put the client first, think sensibly, be patient."
- Richard Fogler, CIO

Investment Manager Profile

Kingwest has been investing capital in Canadian and US securities markets through 7 market cycles with one consistent investment process and we have been earning returns well above what the market indices have delivered over a comparable time frame.

We manage $1.7 billion on behalf of institutional and high net worth clients.

Kingwest has grown under stable employee ownership since 1982. Long-term thinking drives our approach to investing, building client relationships and growing our business.

Investment Philosophy

We believe an actively managed, value based approach, using clearly defined and consistently applied thinking offers investors the best opportunity for long- term outperformance.

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Lessons from the past

Richard Fogler, Chief Investment Officer
Tim Regan, Managing Director

A year ago, few of us could have imagined this outcome. In the 33 days between February 19th and March 23rd, 2020, the S&P/TSX Composite index dropped by 37%. And the US market was almost exactly comparable. This was the steepest extended decline on record. The near future looked bleak indeed!

The 2020 crash occurred because we all worried about the coronavirus sweeping across the land. On March 11, the World Health Organization (WHO) declared the disease a pandemic. The economy of Canada, the US, and much of the developed world shut down. If we look at our own circumstances, life over the ensuing twelve months has been even worse than we might have expected due to fear from the disease and multiple lockdowns in most jurisdictions.

The natural reaction to this devastation last March would have been to sell. After all, back a year ago, uncertainty was rampant as deaths were mounting, and there was no end in sight to the health scare.

But that would have been the worst thing you could have done — just look at what happened since the end of March last year. The stock market rose 44% in Canada, and even more in the US. And our portfolios did considerably better than the market averages on both sides of the border.

There is a very important lesson in this. Attempting to forecast the future is a daunting and generally a costly mistake. Yes, you might have sold before the bottom, thus thwarting a serious decline. But would you have bought back at the end of March as the market started to climb? We doubt it. And once missing the initial move would you have bought in as the market moved higher? Again, we doubt it. Remember the pandemic news continued getting worse, and the medical gurus kept painting even more dire pictures every chance they spoke, which was often.

So, what is the lesson of the February — March 2020 plunge in the stock market?

Attempting to gauge the direction of the economy or the stock market in the near term can be disastrous to your wealth. As Tim repeats ad infinitum, quoting the renowned Canadian economist John Kenneth Galbraith, “The only function of economic forecasting is to make astrology look respectable. “

At Kingwest, we do not make forecasts of the economy or of the market — macro stuff. While it sometimes causes our clients to question what we are doing, especially when times look dire and the stock market looks particularly vulnerable, we believe strongly that is the most sensible method and the one that over time will protect capital and realize the best long-term results.

Why? For information to be valuable, it must be both important and knowable. Knowing what will happen in the future is clearly important. But the future is unpredictable — it is unknowable. As Benjamin Disraeli noted “What we anticipate seldom occurs, what we least expect generally happens”

It is not that these macro factors do not matter, but rather that they are virtually impossible to predict with any accuracy on a consistent basis. And remember, you have to make two right calls, one alone is not enough. You must not only decide when to sell, but also when to buy back in. If either of these are off, it will have been of no value, or perhaps very costly, to have sold.

It is for this reason that macro forecasts are of little help in achieving investing success. They are weak pylons on which to build your financial future.

Every investor, unless you are a speculative day trader, is buying assets where the value of those assets is based on the present value of the cash they can generate to the owner over their lifetime. This is true whether it is a real estate asset or whether it is a corporate asset. And it is imperative that the financial position of an asset is strong enough to enable it to survive the storm, which inevitably will come at some point.

The value of a business is not materially affected by a year of underperformance; it is just one year removed from the financial model. The average multiple of earnings in the US market today is 16 times, or stated differently, 6.25% of the market value of the company is represented by the next year's earnings. If that number goes down, is it really that significant to the long-term value of the business (remember that over the next 20 years the market normally would have at least 3 downturns).

This may sound like theory, but it is not. Our experience over 38 years in the investing business has shown it to be true. While we have suffered declines in the past as the market did its thing and dropped, sometimes significantly, we held our investments so long as the value of the businesses we owned greatly exceeded their market price. Sometimes those declines offered wonderful opportunities for us. When you see a brand name product selling at a discount you do not consider it a problem but an opportunity. In a similar fashion, when companies we are confident in are selling at even steeper discounts from their true value, we "back up the truck" — of course within our portfolio construction rules. Historically that has worked well for us, and it did this time as well.

Below we've highlighted what would have happened if a client invested in the Kingwest Avenue Portfolio at the market peak, the worst possible time, before each of the last major selloffs. This illustration tells a simple story. Maintaining your position is the way to increase your wealth, rather than requiring that you make two superhuman decisions. Decisions that if wrong will leave you without the profits the market brings over time.

Additionally, we have included some excerpts of a few of our letters over the years at times of extreme pessimism. Two things you will notice.

First, we are optimists. As Winston Churchill said, "I am an optimist. It does not seem too much use being anything else."

Second, we have consistently emphasized the cheapness and quality of the businesses we own over the prevailing headlines driving security prices lower.

The 2000 Technology bubble

If you had invested in the Kingwest Avenue Portfolio near the peak of the market on June 30, 2000 preceding the bursting of the tech bubble, today the portfolio would be up 528% since that time.

Kingwest Commentary March 2003

"*This bear market's initial fall began around March 2000 with the bursting of the technology bubble and it continued for seventeen months before being exacerbated by the September 11th terrorist disaster. This was not the end yet as it was further compounded by the Afghanistan war and now by the Iraqi war. While our portfolio was able to avoid the devastation that took place during the technology decline, it has suffered along with the market for the last twelve months."*

"The need to ignore short-term fluctuations has never been more important as over the long-term, markets reflect economic conditions and those do not change daily."

"Our style leads us to search for individual companies that meet our investment requirements. Discussing markets is interesting as we review what happened, but our focus is on buying companies that we believe are worth a great deal more than their current trading price."

"While the macro-economic indicators remain ambiguous, we remain optimistic. The economy in North America should provide a relatively stable backdrop against which companies can effectively grow their businesses. When the war worries abate, expect to see a more positive attitude to the stock market, in general, and in particular to those companies that are adding value for their owners."

The 2008 / 2009 Great Recession

If you had invested in the Kingwest Avenue Portfolio near the market peak on July 31,2008 prior to the crash, and suffered through the full extent of the crash, today the portfolio would be up 233% higher.

Kingwest Commentary February 2009

"*The US economy is experiencing its most severe downturn since the Great Depression of the 1930s. The government has already had to inject almost $1 trillion into the banking system in the US and it may require anything up to $2 trillion to restore it to an even keel. The European picture may be even worse."*

"The economy will certainly not be as bad as the 1930's when unemployment hit 25-30%, but unemployment is still likely to approach double figures, similar to other post-war slowdowns. The US federal budget deficit will certainly go over $1 trillion – an unheard of amount. The situation is undeniably very serious."

"Are there reasons to be positive? The world is not ending. The great majority of people will remain employed and make their mortgages payments. Life as we know it will continue. Successful investing always requires keeping things in perspective; this has never been truer than at the current time."

"It is always tempting to wait for the bottom of the market to be reached (as if it would be obvious when it arrived). Such a strategy has proven over the years to be deeply flawed. Historically, little volume transacts at the bottom or on the way back up and competition from other buyers will be much greater when the markets settle down and the economy begins to recover. Moreover, the price recovery from a bottom is normally very swift. Therefore, an investor should put money to work amidst the throes of a bear market, understanding that things may get worse before they get better."

"In summary, our message is a simple one:

1. *The economy will come out of this recession – the best guess is summer/fall 2009.*

The stock market has always acted as a leading indicator and should recover before the recession ends – the lead-time has historically been 4 months (in other words stocks go up when the news is the bleakest).

2. *To get the best out of the recovery stock selection is more important than ever. "*

The pandemic of 2020

If you invested in the Kingwest Avenue Portfolio at the worst possible time at the peak in January 2020 and endured the nearly 40% decline in February and March, nonetheless today the portfolio would have gained 15%.

Kingwest Market Update March 19, 2020

"*During times of crisis, we think it is important to remember what our expertise is and limit our opinions to what we know best. Nobody at Kingwest is an infectious disease specialist. Our opinion on the duration or the magnitude of the economic decline caused by the coronavirus will be no more accurate than your favoured news source."*

"Our expertise is in valuing businesses. We have the historical perspective of how stock market prices and long-term business values have diverged over time, sometimes radically. This is such a time."

"Looking back over the last several decades, the stock market has endured some pretty grim news, and persevered and prospered. One only has to think back to the Russian bond default and the subsequent failure of Long-Term Capital Management in 1998, which nearly brought the entire market to its knees. In 2000, the technology bubble burst followed by the terrorist attack on the World Trade Center. Then Enron collapsed in 2001. In 2008, we had the subprime credit crisis and nearly drove the country into a full-scale depression. It is always something."

"And yet for the last 25-year period through year end 2019, the MSCI World Index rose almost 500%, albeit in a very lumpy pattern. Our portfolios are well positioned with cash. That hurt our returns last year but is comforting now. Investing is about the long term. We have been here before. While uncomfortable, these periods where fear overtakes reason open doors to wonderful opportunities, and we expect this to be no exception. But we are in no rush, calm and common sense in the face irrational behaviour has always served us well. We are confident it will this time as well."

"What Nathan Rothschild is reputed to have said almost 200 years ago is still relevant today "Buy when there is blood in the streets". While markets change, events always differ; the one constant is human behaviour. People have a tendency to overreact to dramatic and unexpected news. This time will prove no exception."

There will continue to be crises and corrections in the future – that is certain. However smart investing and patience will see us through.

We have had 28 corrections — some large, some small — over the last dozen years. The future will bring us more of the same, but it will be these times when the brave buy (or remain the course) and the despondent sell and that makes all the difference to one's wealth.

Bonds can lose money

As everyone is aware interest rates are at the lowest levels in recent history. In the first three months of 2021, the Canada 10-year bond yield went up, causing a 5% decline in the value of these bonds. A similar reaction happened in the US bond market.

Where do bond yields go from here? Some pundits say that the heavy spending from the federal governments in Canada and the US will result in inflation thus pushing bond yields substantially higher, with commensurate losses in bond values. Others, including pronouncements from the heads of the central banks argue that inflation, even with the heavy spending, is well under control.

We do not know the answer to that question, but we do know that it is the wrong question for a bond investor to ask.

The important point about the bond market is in buying a Government bond for a 10-year term in December 2020, at the market low, you receive only a 0.5% return per year — and for individuals that is both taxable at income rates and subject to whatever inflation there might be (inflation in Canada has been running at 1% per annum or a little above).

So, $100,000 nominal value of that 10-year bond will offer negligible annual interest and at the end of 10 years the holder will get back around $90,000 of purchasing power — the lower amount is due to inflation. That does not sound to us like a very good investment, regardless of future inflation.

We will leave you with this one thought on bond investing today:

Bonds promoted as offering risk-free returns, are now priced to deliver return-free risk.

In summary, surprisingly it has been a good year on the investing front. And the strength has continued into this year. We look forward to the balance of 2021 with optimism. As Ted Rogers always said, "The best is yet to come."