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 $1.5 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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We are experiencing a period of turbulence in the economy and the securities markets. Inflation dominates the news. It has caused higher borrowing costs and fears of an economic slowdown. This has led to erratic fluctuations of stock markets on both sides of the border.

This market instability is likely to continue so long as inflation remains “the number one, two and three most important data point”. The market is fixated only on inflation, no other economic developments seem to matter in the near term.

In times like this, buyers and sellers have to take a bit of time to re-assess, not react to the news that constantly pummels us all. At Kingwest, we act, or try to act, in a deliberative, thoughtful and patient way. Striving to keep our eye on the prize, focusing on predictable, sustainable business value not fickle stock prices.

The haze of macroeconomic data is exceptionally contradictory, The North American economy, though clearly facing a growing risk of recession, continues to exhibit remarkable strengths. Particularly in the labour market, as illustrated by continued job creation and another drop in the unemployment rate in September in both countries. There are more job openings than there are people interested, or capable, in taking them. As a consequence, wage rates are going up.

In addition, the overall increase in transfer income and the decrease in consumer spending during the pandemic resulted in an extraordinary run-up in household savings. Individuals have excess savings of an estimated $2.5 trillion and about $300 billion in Canada. Consumers have enormous and unprecedented spending capacity.

This would all be good news if it didn’t stoke the fire of inflation. The central banks now seem much more accepting of the risk of causing a recession to dampen inflation. The current constellation of macroeconomic signals is unique, with many signs of strength coexisting with weaknesses. That makes predictions based on historical data very unreliable at best.

Equity prices are down because higher interest rates push down the value of a given level of cash flow, consequently lowering business values. On the other hand, earnings are expected to grow between 5% to 8% for 2022 with further gains to come in 2023. How this will play out over the next few months is anyone's guess.

Joseph Schumpeter's observation has never been more accurate: "Pessimistic views about a thing always seems to the public to be more profound than optimistic ones." Pessimistic views abound now so the prevailing mood is negative.

Going back a couple of years, we became concerned about the prospect of heightened inflation and pivoted our portfolio to respond accordingly. At Kingwest, we consider negative risks first. We would much prefer to miss out on a little extra income than put your capital at risk.

Thus, the term of the fixed income portfolio is very short. The investments include some instruments with floating rates. This works well in an environment where interest rates are rising. While not perfect protection against a declining bond market, our portfolios are down just a few percent in contrast with the double-digit devastation that has broken longer term bond portfolios.

At times like this, when the market is focused on just one thing it pays to take a more comprehensive perspective. Yes, business value has been eroded somewhat by these higher interest rates. But has it been by 30%? – which has been the collapse of some companies and industries. As always, the market throws the baby out with the bath water, particularly in times like now when it focuses on a single data point. Many great opportunities are coming because of these extraordinary and unjustifiable share price declines.

We are confident in our model. We focus on companies building sustainable value. And we take the long view. It takes time, outstanding people, and a superior business model to build companies that really matter.

At present, we are emphasizing resilience. We are looking for companies that will emerge from this slowdown in the economy and securities markets stronger than when the slowdown began. The share price of resilient companies should recover much faster than the market in general. This was our strategy in 2009 and it worked very successfully.

Opinions about the near-term economic outlook are all over the place but the longer-term outlook is excellent. According to a recent survey by KPMG, global CEOs are anticipating a recession in the next 12 months, but more than half of them anticipate it will be "mild and short". More importantly, since the start of the year these business leaders have all been expressing increasing confidence in the growth prospects for the next three years.

Over the longer term whether inflation is high or low, equities are the place to be. The chart below shows that equities outperform over the longer term regardless of the inflationary environment. Companies have the ability to adjust to the rising prices. Our strategy favours companies with pricing power. They have some control over their own destiny. We steer clear of commodity-like businesses that are price takers, meaning the market not their management determines their future.

ANNUALIZED COMPOUNDED RETURNS 1977-2022

	Stocks	Bonds	Cash	Inflation
1977 - 1999	16.0%	8.4%	6.9%	4.8%
2000 - 2022	5.9%	4.1%	1.4%	2.6%

Data: Stocks: S&P500; Bonds: 10-year US Treasury bonds; Cash: 90-day US Treasury Bills
Source. New York University

We have a significant investment in real estate companies. The companies we favour exhibit recurring cash flow from long term rental agreements with credit worthy tenants and make value added investments to increase the asset value per share of the business.

At this moment, public real estate companies are the best way to invest in real estate. Private real estate companies are marking the prices of their properties around where they were prior to any interest rate increase, and in some cases even higher. These companies are ignoring the impact that higher interest rates have on valuation.

The stock market on the other hand has punished real estate stocks because higher interest rates make a given level of cash flow less valuable. Which is right? Time will tell. If the private markets are right, then share prices will rise to align with private market values — a potential increase of 33% or more. On the other hand, if the public markets are right, private market prices will plunge to align with the public market. Either way, real estate in public markets is much better value today than real estate in private markets.

Look at SmartCentres REIT, one of largest REITs in Canada. SmartCentres has one of the highest quality portfolios of real estate in the country with 174 strategically located properties, 114 anchored by Walmart. These properties enjoy stable recurring income with periodic rent escalations. SmartCentres owns $11.3 billion of assets comprising 34 million square feet of income producing value oriented retail space, 97.6% occupied, on 3,500 acres of land.

This stock is very good value. It currently yields 7%. We don't know of any high-quality building or portfolio of buildings that yield anywhere near 7%. In addition, the company has perhaps the best real estate leadership in Canada with an ambitious development schedule building mixed use projects on some of the excess land it owns at essentially zero cost. This development program will drive substantial cash, and therefore value over the next few years.

In the short term we cannot tell you what the stock will do, but when the dust settles, real estate companies like this, with the management skills to build value, will prove very profitable. Meanwhile we are collecting a 7% dividend each year.

We have a large exposure to the exciting potential of 5G: BCE and Telus in Canada along with T-Mobile and Crown Castle International in the United States. Technology is changing the way we live, work, and interact with the world around us. We don't go online anymore. We exist there. Our smartphones and tablets are connected, but we are at the infancy of a great leap forward connecting traffic lights, machines, appliances, and cars. This market called the "Internet of Things" is estimated to be even larger than the personal internet.

We have taken a prudent way to invest in this enormous potential. BCE, Telus, and Crown Castle have long term contracts with customers with the recurring non-cyclical revenue supporting their businesses in good times and bad. They also pay substantial dividends.

T-Mobile has the largest 5G network in the United States. It has at least a two-year head start on its main competitors, AT&T and Verizon. This advantage is playing out as T-Mobile is making strong inroads into government, large enterprise, and rural markets with commensurate financial results. This advantage should continue at least through 2026 while throwing off substantial cash flow not required to be reinvested in its business. These features make T-Mobile a very cheap stock.

One more thing, the Value Gap, an indicator of the potential for our portfolio over the next few years, remains very high, even after we have brought down our company valuations to incorporate the aforementioned impact of higher interest rates. Although your equity portfolio has been volatile recently, the risk of permanent loss is extremely low, and the recovery potential is strong.

We are in a period of market turbulence in both fixed income and equity markets. Near-term the outlook is uncertain. Interest rates do not appear likely to return to the low levels seen in the past few years any time soon. If inflation does come down to the targeted levels, that 2% inflation rate would be consistent with short term interest rates where they are now. The stock market reacted quickly to rising interest rates, and perhaps overreacted.

Long term business prospects remain exceptional. We are taking what we think is a prudent approach and are shifting the portfolio to companies that provide similar returns but with much less risk or offer high potential returns with similar risk. The prospects for equities over the next few years are very attractive as we are acquiring investments and re-aligning the portfolio at dirt cheap prices.