Winter 2022

While markets digested information and ongoing developments over the coronavirus over the past twelve months the discussion has now shifted to the war in Ukraine and the concern over rising inflation and interest rates. The Russia/Ukraine war has increased geopolitical risks and have raised the possibility of increased tariffs and trade barriers. This renewed protectionism may cause higher costs and a loss of markets for some businesses. The war has also had an impact on supply chains. The movement of goods and products throughout Europe has been disrupted resulting in delayed manufacturing and production of cars, machinery and equipment.

Ukraine is one of the world's top ten exporter of many natural resources and agricultural products; particularly wheat. As the war rages on Ukrainian exports have largely been reduced. In addition, the sanctions on Russian exports; particularly oil and gas have also added to commodity shortages. As a result, commodity prices have risen dramatically over the past several months.

The war in Ukraine is currently causing short term problems. However, in the longer-term economies and businesses should benefit from the reconstruction that commences once the conflict is resolved.

Rising inflation rates were also a concern during the first quarter. Although the impact of the war in Ukraine has added to inflationary pressures we believe that the root cause of the surge in inflation has been very loose fiscal and monetary policies by governments and central banks around the globe. In addition, higher energy prices, higher commodity prices, supply chain issues and rising wage costs are adding to inflationary pressures. Consequently, it is highly likely that inflation is going to be higher and last longer than most market participants expect. Ultimately these higher levels of inflation will lead to higher interest rates.

While markets were positive over the past twelve months the first quarter of 2022 experienced negative returns. The MSCI (USD) world Index declined approximately 5.0% while the S& P 500 (USD) dropped 4.6%. The S&P/ TSX Composite Index bucked the trend posting a positive return of 3.8%. The Canadian market was helped by the Energy, Materials and Gold sub-sectors as they all recorded double digit gains during the quarter.

During "market hiccups" many commentators suggest that now is the time to invest.

Over the past several years markets have also come to rely on Central Bankers and governments to bail them out. This behaviour has contributed to a "buy the dip" philosophy and causes markets to go up after a decline. As a result, many investors and financial advisors have come to believe that anytime markets go down five to ten per cent it is time to allocate more to equities. Often, they do bounce back in a relatively short period of time.

However, we believe that one must put this strategy in perspective of overall market valuations. We believe that equity market valuations are extremely high. Aggregate market valuation indicators such as the Shiller P/E Ratio and the Market to GDP Capitalization Ratio are at all-time highs as the charts below indicate.

Graph 1
Market Capitalization/GDP

Graph 2
Schiller P/E Ratio

Source: gurufocus.com

These very high valuations and the prospect of higher inflation and interest rates pose a substantial risk to equity investors going forward. As a result, the probability of a serious market decline over a prolonged period is quite high. During these downturns markets might bounce up from time to time but the downward trend is still there.

We strongly believe that it is only appropriate to purchase an equity investment if and only if one has an opportunity to invest in a business or businesses when their share price is undervalued.

However, we find these opportunities few and far between in today's environment. Today's markets need to drop far more than five to ten per cent to get to fair value. Buying on small market declines might work occasionally, but it has been our observation that very few people are able to successfully implement this short-term trading approach on a consistent basis. Buying 'on the dips" without consideration to valuation and fundamental analysis is tantamount to speculation.

Inflation is a major concern, and it is likely here to stay at far higher levels and for much longer than we have experienced in a very long time. Inflation not only erodes consumers purchasing power, but it is a significant headwind for equity markets. It leads to higher interest rates which reduce P/E multiples. Inflation also increases costs that most businesses cannot fully pass on and thus reduces profit margins. The combination of lower valuation multiples and lower profitability creates a "double whammy" that drives equity valuations lower. This scenario is even riskier in an environment where valuations are at extremes as the Market to GDP and Shiller P/E charts above indicate.

In our view the best protection against the corrosive power of inflation is to purchase and hold high quality companies that have a history of maintaining and increasing their dividends. However, these businesses must be purchased at attractive valuations in order to provide an acceptable yield at the purchase price and more importantly to protect against the permanent loss of capital. Purchasing overvalued securities in the hope of outpacing inflation only leads to losses that are far more substantial than the temporary loss of purchasing power while patiently waiting for the opportunity to invest in undervalued securities with the potential for higher-than-average dividend yield and potential capital gains.

Patient Capital's portfolios are well positioned for current market conditions. As of March 31st, 2022, the equity component's dividend yield was 3.5% per cent and the portfolio's valuation statistics are far more attractive than the market. While we will likely experience volatility in the share prices the dividend income stream from the portfolio will continue to grow at a rate that mitigates the impact of inflation.

PCM's portfolios were initially impacted by the pandemic as investors rushed away from value stocks. The stampede into already expensive internet and software companies and panic out of value-based businesses was a "once in a century" event that created unprecedent volatility for value investors. Many questioned

whether a long-term value-based approach such as ours was relevant.

But value works! As our portfolios have illustrated “coming out of the pandemic”, purchasing high quality businesses at deep discounts to their intrinsic value provides satisfactory returns given time and patience. As of March 31st, 2022, our portfolios have not only recovered but have outperformed the TSX over the past one- and two-year periods. As rates rise, we believe that the potential exists for value-based strategies to outperform.

We at PCM thank you for your support and continued confidence.

Vito Maida