History Doesn't Repeat Itself, But…

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The first six months of 2020 have been a roller coaster in capital markets unlike many others. The implications of COVID-19 and the economic shutdown cascaded sharply through global fixed income and equity markets in the first quarter. We have seen an equally sharp reaction to unprecedented fiscal and monetary stimulus which has been the dominant factor in the last three months. In North America, we have seen the effect of massive government spending to support consumption, employment and assistance with lending programs. The monetary support has been equally dramatic with central banks lowering rates and buying bonds to inject liquidity and support to capital markets.

Investors have reacted swiftly to the changes and as a result, led by technology stocks, the Nasdaq Composite, which represents large technology companies, has risen 31% in the last three months alone. The S&P 500 Index, which represents 500 of the largest public companies in the United States also rose by 20% in the quarter (its biggest quarterly jump since 1998). The technology sector was generally the biggest contributor as earnings from large technology companies are perceived to be more resilient in this uncertain economic environment. In Canada the S&P/TSX Composite Index rose 16%, led by the gold companies, as gold prices have risen on investor demand for the precious metal. For many equity securities, this bounce back hasn't erased the losses overall from the first quarter (on average), but most have climbed the proverbial 'wall of worry' amidst the current carnage in the real economy.

The corporate fixed income market has also improved dramatically this quarter as central banking support has alleviated the fear from illiquidity. Hence, we have seen many companies refinance their obligations coming due and bond pricing has strengthened as a result. In the table below one can see sovereign yields in North America are well below 1%. In Canada and the United States, we will likely see short term rates anchored near zero for several years. Notably, Canada did lose its AAA credit rating from one of the main rating agencies (Fitch Ratings Inc.) in the quarter, as higher debt leaves our government with less fiscal flexibility in the future. This did not affect near term yields but reflects the increased debt taken on by the federal government.

Government of Canada Bond yields as of July 1st, 2020

2-Year	0.29%
5-Year	0.36%
10-Year	0.51%
30-Year	0.99%

United States Treasury Bond yields as of July 1st, 2020

2-Year	0.16%
5-Year	0.28%
10-Year	0.64%
30-Year	1.39%

Looking forward, we anticipate monetary stimulus to continue being very supportive of capital markets. That should be positive for fixed income prices and will continue to push yields lower for corporate bonds. With accompanying sovereign rates so low, valuation multiples of many equities may continue to expand, provided the recovery outlook remains in place. The trickier part will be the handoff later this year as governments will eventually stop sending out cheques and the real economy will need to generate the jobs and spending that has been lost. With close to 20 million lost jobs in the United States and over 2 million in Canada, businesses are likely to be tentative in their rehiring, extending the recovery. There is also an election south of the border later this year, which will be impactful to the broad market and certain sectors, however it is decided.

While the current focus is justifiably on the COVID-19 pandemic along with the tentative economy recovery, there will be other obstacles in the future that our companies will need to overcome. We focus on building portfolios to be resilient, and while values have fluctuated tremendously in the first half of the year, the businesses we own continue to generate attractive dividends which are anticipated to rise with a recovering economy. The yields in corporate fixed income continue to remain attractive relative to government bond yields. In this uncertain environment, we continue to remain focused on the future. Though the pace and shape of the anticipated economic recovery are unknown at present, we remain confident our portfolios will survive and thrive into the future.

The Rebound

James McInnis, CFA
Portfolio Manager

The Canadian Equity and United States Equity indices rebounded more quickly than many had expected this past quarter, and liquidity in the Canadian bond market improved to near normal conditions. Given all the news reports since the beginning of the year, the year-to-date performance for the markets is closer to "normal", although the world does not seem anywhere close to normal. Our Canadian equity portfolio has a dividend yield near 5%, and our United States equity portfolio is near 3%. Our fixed income portfolio has a yield-to-maturity that is in the 4-5% range, which is highly attractive relative to government bonds yielding less than 1%.

The North American Equity market appears quite bifurcated. Technology companies, represented by the Nasdaq index, are hitting all-time highs, while the majority of businesses have a longer road to recovery, particularly smaller firms outside the technology or healthcare sectors. Some of our faster growing businesses with lower dividend yields have snapped back quickly to hit all-time highs and remain quite insulated from the job losses and reduced spending affecting the more economically sensitive sectors. Our higher dividend yielding companies that are tied more closely to main street (e.g. financials) have been slower to rebound, but they continue to provide tax-efficient dividend income. For the businesses in the latter category, we expect a slow, steady improvement as economies emerge from the economic downturn.

Throughout this volatile period, we've been managing your portfolio within the constraints of your Investment Policy Statement. During the quarter we sold fixed income that performed relatively well and added to equities where it made sense, which increased income, made that income more tax efficient and allowed for greater potential upside. We also exited several positions to improve the quality of our portfolios and generate an improved risk-adjusted rate of return. Furthermore, we continued our research on existing holdings by communicating with management teams to get updates on their businesses while also looking for new investment ideas. In fact, we added a new name to our model in Q2 that is less economically sensitive and provides stability given it is an essential service. This business has good pricing power (often being the sole service provider) and can grow organically via acquisitions given the fragmented nature of the North American industry. It's market events like this that allow a value-investor, such as

BCV, to crystalize gains where investment theses have come to fruition and redeploy that capital into the next opportunistic investment.

Where do we go from here as we enter the third quarter of 2020? Investors are wondering when some of these investments will recover, given the current state of uncertainty. We think it is less a matter of when, but that the probability of a recovery over your investment horizon is extremely high. If you don't need to redeem securities to raise capital, then the timing or a recovery is of less importance. If you do need funds in the near term, it is highly likely that you have fixed income which is generating steady flow of interest income. If your portfolio does not contain any fixed income, it is likely that you have a high allocation to equities because: (1) you have a longer time horizon, or (2) you are living off the dividends on your equity holdings making price volatility less of a concern. Despite many dividend cuts that have occurred across many market sectors, we have not had any equity holdings reduce their shareholder payouts – a testament to the quality of the portfolio. But if you must sell stock to fund your lifestyle requirements, take comfort in knowing that not all equities are down in value by the same relative amount – many are at all time highs.

Our goal is to provide peace of mind for our clients by managing your portfolio in line with your long-term investment objectives. If you are a younger investor or capital needs are not required in the near term, depressed market prices for solid, well managed companies with a strong dividend record are an opportunity to add capital to ride an upward trending market. If you are closer to retirement or newly retired, take comfort that your income from your portfolio has remained intact, if not enhanced, as many of the companies within your portfolio have continued to increase their dividends. We continue to believe in our process and philosophy to drive income and growth over your investment time horizon.