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Investor Strategy

Pandemic, polls & positioning

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Executive Summary

- **Part 1: Market recap – We've hit turbulence**
  - A surprise end to the month and elevated volatility
- **Part 2: Asset allocation – Election, almost there**
  - A look at the big event
- **Part 3: Asset allocation – Pandemic**
  - Two steps forward, one step back
- **Part 4: Asset allocation – Positioning still defensive**
  - But starting to get more interesting
- **Part 6: Equities – Dividend doldrums**
  - Dividend-paying companies continue to lag
- **Part 7: Fixed income –LRCNs, the *new, new* thing**
  - A look at the changing funding sources
- **Part 8: Managed Portfolios – An evolution of style**
  - Styles change over time, so do our style allocations

Market recap – We've hit turbulence

Alexander W. Tjiang

Chart 1: Fall months tends to be bumpy

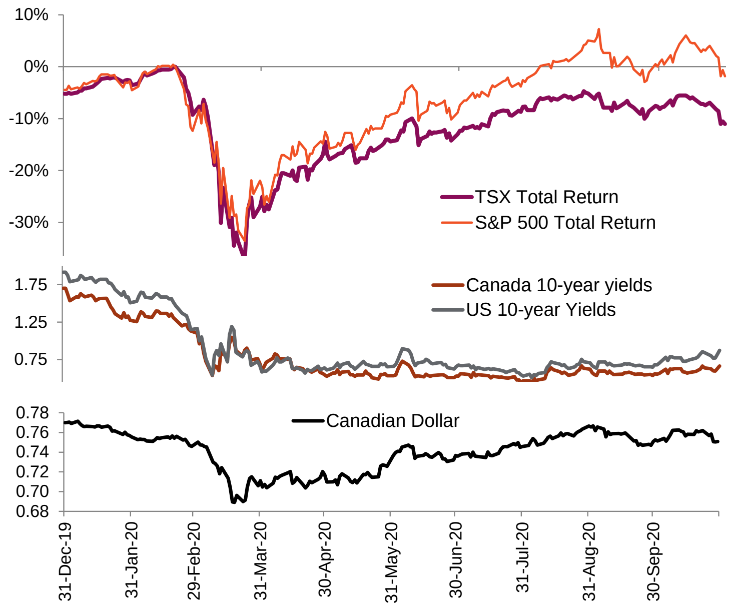
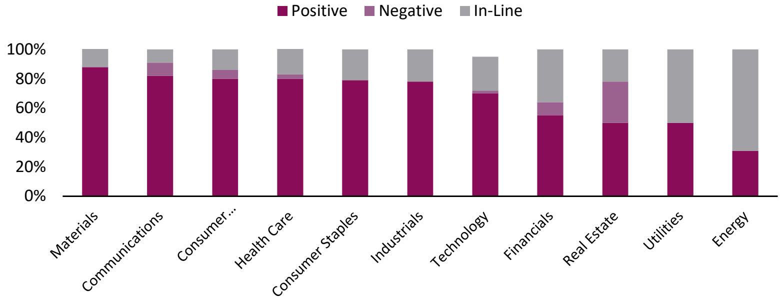


Chart 2: S&P 500 Earnings Standard Deviation Surprises



- October kicked off with a handful of worried optimism. Market strategists were dealt the difficult task of balancing election uncertainty, 3Q20 earnings rollouts, and the economic implications of a second wave of global COVID-19 cases. Yet, despite decent earnings performance and a better-than-expected 3Q20 U.S. GDP, what seemed like a balanced environment took a sharp turn in the last week of the month, with equities contracting, yields whipsawing, and oil prices moving decidedly lower.
- Canadian and U.S. stocks ended up posting monthly returns that were worse than September's, with the S&P 500 and TSX indices down -2.5% and -3.1%, respectively. Global markets also fell, with the MSCI World Index falling -2.8% for the month (international returns are in Canadian dollar terms). The VIX rose considerably too in the last week of the month and now sits elevated at 50.
- Elsewhere, the loonie strengthened then weakened during the month, finishing flat. Shorter-dated U.S. treasuries rallied at the last minute as investors ditched longer-dated notes and bonds in favour of parking cash ahead of election week. The energy complex saw dramatic drawdowns, with WTI Crude futures falling -11% for the month to ~US$36/bbl, marking its largest monthly drop since March as demand recovery concerns took investors by surprise.
- This last-minute asset class volatility was driven in large part by subpar earnings results from big tech companies and a growing number of global coronavirus cases. In the U.S., big tech stocks led losses, with Facebook and Twitter both missing their user growth estimates; by the end of the month, the Nasdaq 100 index was down -2.99% for the month. In Europe, several countries re-instituted full lockdowns to curb the spread of coronavirus, sparking doubts about the true trajectory of a global economic recovery.
- 3Q20 earnings aren't too bad. Three weeks in, 68% of S&P 500 companies have beaten consensus earnings estimates by a standard deviation or more (**Chart 2**). Companies continue to manage through these troubled times better than analysts give them credit. Valuations have come down as prices fell this month and forward expected earnings continue to recover. The P/E ratios based on the next 12-month consensus estimates for the TSX and S&P are 16x and 20x, respectively.
- We are 10 months into the year and uncertainty around the world has only seemed to grow; it goes without saying that these conditions are far from ideal. Undoubtedly, there will be more tumultuous headlines to come. It's certainly worthwhile remembering here, however, that investing shouldn't be a short-sighted endeavor; there is much to be gained by sticking to a process grounded in unemotional reason, long-term thinking, and tactical adaptability.

Election – Almost there

Derek Benedet

Chart 3 : Probability of a blue wave fell in October but has ticked back up

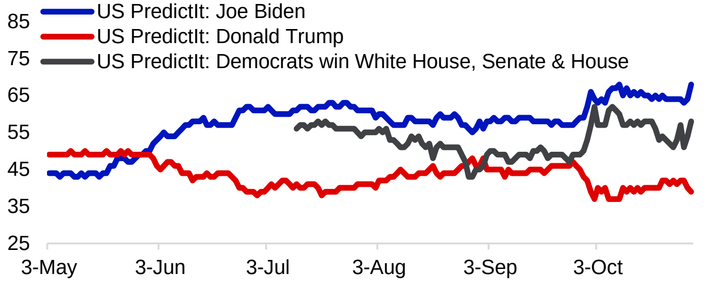


Chart 4: Option market already pricing in elevated volatility for weeks after the election

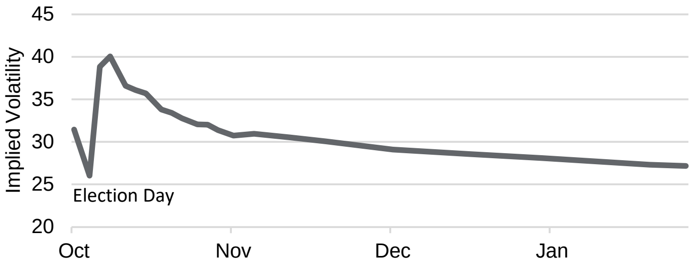
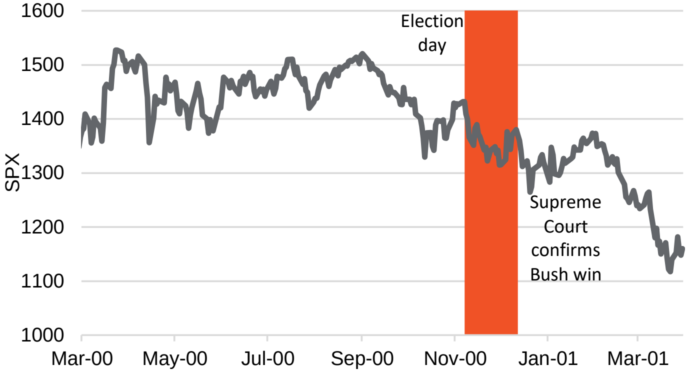


Chart 5: The stock market fell in 2000 when the election result was uncertain but it was already



- The relationship between politics and finance is closely intertwined. Every four years, we have a major convergence when Americans head to the polls and investors try to figure out what it means for their portfolios. Canadians have a vested interest as Canada's economy and a large portion of diversified portfolio's are directly exposed to the U.S. The dreaded word "uncertainty" is used *ad nauseum* in the months preceding it to explain the market's movements. Vanguard did a study going back more than half a century, that showed U.S. equity market volatility in the months preceding and following a presidential election has been lower than experienced during non-election years. So enough with the uncertainty.
- Polls point to a sizeable Biden lead, but market forecasts suggest the outcome is a little closer, with Biden's lead in key swing states narrowing. It's also plausible that we're all suffering from recency bias, when polls got it wrong in 2016. While belief in a Democrat sweep or "blue wave" faltered earlier this month, it has been back on the rise at the time of writing (**Chart 3**). It's impossible to disconnect lower odds of a spend-happy "blue wave" from rising virus fears as the true cause behind the market's current swoon.
- One key to the market uneasiness is the rising prospect of a contested election. Yes, this is a high possibility, but perhaps the market is already pricing it in. Looking at the implied volatility of weekly SPX options, we continue to see a significant uptick in post-election-night risk premium (**Chart 4**). With the prospect of the Supreme Court getting involved, this draws parallels with 2000. It was also a controversial time and there are valid comparisons. As seen in **Chart 5,** the market did sell off during the postponement of a final decision, but context is critical, and the market was already bearish. There is uncertainty, yes, but a large amount is already anticipated. Remember it's the surprises that move the markets, not actually anticipated events.
- The only common ground between the Republican and Democratic parties seems to be big deficits and money printing. Over $3.3 trillion has been printed year to date. How much more stimulus, where it is directed remains key questions for the market and the recovering economy. With a gridlock election result, this becomes less clear.
- Republican or Democrat – does it really matter? While one party has a reputation for being more business friendly, Bill Clinton and Barack Obama have the distinction of being the two presidents who presided over the largest overall percentage gain in the stock market. George W. Bush has the unfortunate status of having the worst market return with the S&P 500 dropping 37% during his eight-year term. We're not saying one party is better than the other, but maybe, just maybe luck plays a large part. Presidents can't control investor enthusiasm, market bubbles and exogenous events such as a global pandemic. If history is any guide, there is little discernable impact on your portfolio based alone on who's governing.

Asset allocation – Pandemic, two steps forward, one step back

Brett Gustafson

Chart 6: 3rd wave is big and widespread

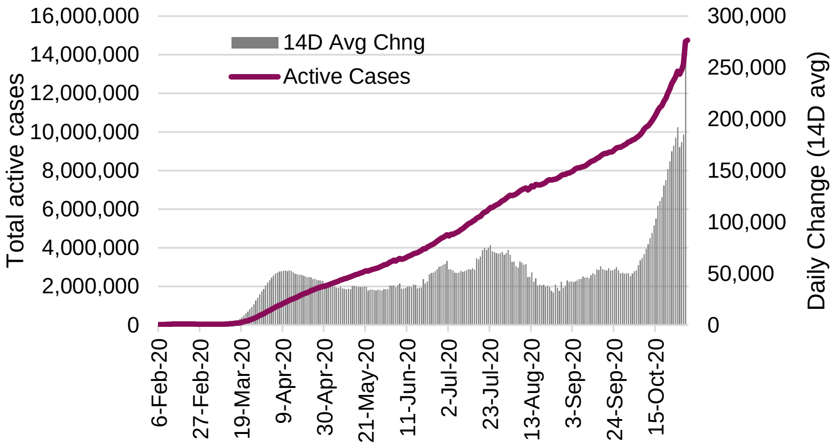
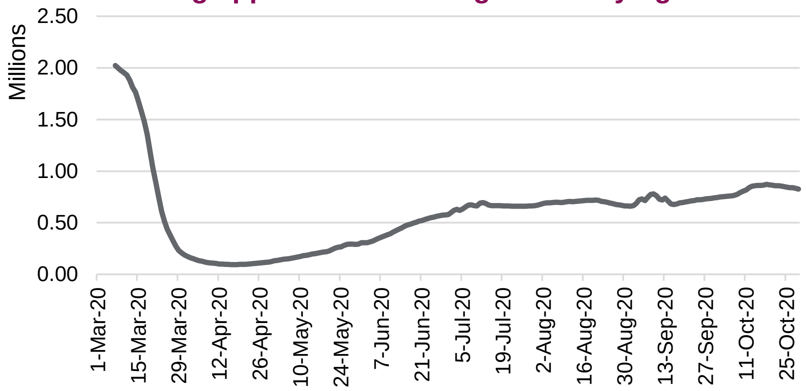


Chart 7: TSA security checkpoint volumes have seen some improvement but a vaccine + rapid testing appears needed to get folks flying



- If there are still any questions about the possibility of a third wave, we believe they have been answered. At the time of writing, global cases of COVID-19 have risen to almost 45 million. 530,000 new global cases were reported on October 28, while back in July and August new daily case numbers were anywhere from 165,000 – 304,000. The virus is on an exponential growth path with no clear end in sight.
- The rapid rise in cases is not specific to just a few countries as it was in the beginning and in the summer. Recall a few months ago it was Brazil, India and the U.S. with rapidly rising cases. Canada and much of Europe were seeing fewer and fewer cases. And even in the U.S., cases were more concentrated in a few states. In the past month, new cases have become more widespread.
- Mounting cases are starting to put pressure on the already expanded health care capacity for dealing with this pandemic. As a result, governments are re-instituting several policies to reduce social interaction. The re-opening process was never going to be a gradual linear path – more likely a two steps forward, one step back. We are clearly stepping back.
- For now, part of the economy will remain dormant requiring continued government stimulus. Many health experts around the globe are expecting infections to increase during the coming winter months. The reason? COVID-19 is a coronavirus and historically other viruses of this nature have spread more during the winter. However, if there are continued and additional lockdowns, one would think that would limit the proliferation. On the other side of the coin, spending more time indoors without sufficient ventilation could mean a higher probability of community spread.
- The equity markets ignored this pandemic for the first few months until cases started showing up outside China, then things really reacted. But since those dire days of March, the market has appeared to be immune to case count data, appearing to have gotten over the virus. This past week, it would appear the market has started to care again as the precautions being instituted will likely curb the pace of economic recovery.
- For the economy, it really comes down to under what circumstances will individuals feel safe to become more economically active. A vaccine would help, but if efficacy is 65% would you for instance hop on a plane? Some would, some wouldn't. What if everyone had a rapid COVID-19 test before boarding? A vaccine won't be a panacea, but it will provide a good shot in the arm to the economy, encouraging many to become more economically active.

Asset allocation – Positioning still defensive

Craig Basinger & Brett Gustafson

Chart 8: Still playing defense

Overall Asset Allocation	Balanced	Baseline	-				+
Equities	46.0%	54.0%		■			
Fixed Income	34.2%	34.2%			■		
Cash	4.0%	1.8%				■	
Alternatives & Real Assets	15.8%	10.0%				■	
Global Equities			**-**				**+**
Canada	18.0%	27.0%		■			
U.S.	11.0%	13.5%		■			
Euro Area	10.0%	6.8%				■	
Japan	7.0%	4.5%				■	
Emerging Markets	2.0%	2.3%			■		
Fixed Income			**-**				**+**
Investment Grade					■		
High Yield				■			
EM Debt			■				
Prefs					■		
Duration				■			
Credit				■			
Currencies			**-**				**+**
CAD Short Term (3m)				■			
CAD Longer Term (1yr)						■	

- Despite the prevailing headlines, there is some good news out there. In Q3 the U.S. economy recovered most of the lost ground from Q2. China's growth recovery remains on track. Renewed lockdown rules will slow parts of the economy, but most economic activity continues.
- Much of the bounce from Q2 was expected based on how quickly parts of the economy shut down. However the bounce has impressed most, including us. Companies have pivoted to continue activities with new safety protocols, many have pivoted to fill new demands prompted by the pandemic. Employment gains have slowed but have already recouped the majority of jobs lost earlier this year. Many employers are hiring again too based on job postings.
- Of course the economic path forward is dependent on the pandemic's path, which does not appear to be relinquishing its grip on humanity. The re-opening pace will be a function of case counts and health facility usage.
- Our current recommendation for a defensive tilt is comprised of an 8% underweight in equities, 2% overweight in cash and 6% overweight in alternatives. This is predicated on the following:
  - The second or third wave of the pandemic does run the risk of impacting equity prices again, which we would view as a buying opportunity. This may have already begun.
  - Guessing on elections or how the markets will react is a mugs game. However, given valuations are elevated, there is likely more downside risk than upside potential in the near term.
  - The market has become very skewed by a few growth names that have done very well this year. This is a risk and could lead to increased volatility before a more balanced market emerges.
  - Given low bond yields and tight spreads, we are leaning more on alternatives and real assets for defense instead of holding more bonds.
- The S&P 500 is down -6.4% over the past two months and the TSX is off -5.1%, including dividends. This does have us getting closer to tactically shifting some of our defensive cash or alternative allocations back to equities in November.

Equities – Dividend doldrums

Chris Kerlow, CFA

Chart 9: TSX companies with biggest dividends have trailed the most

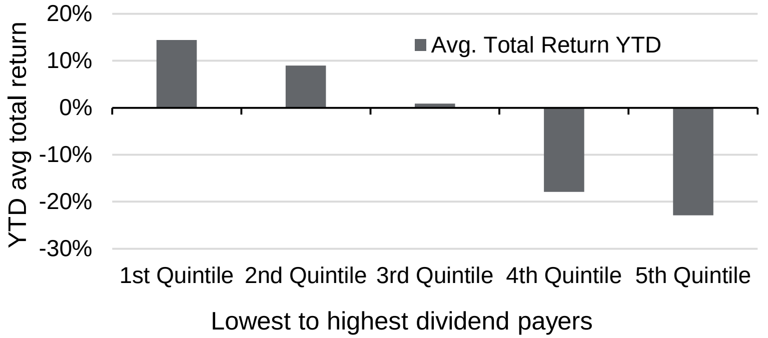
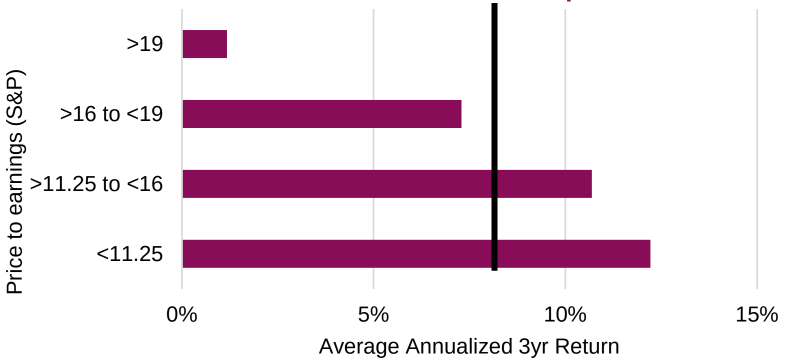


Chart 10: Valuations do matter for subsequent returns



- The S&P 500 is up 25% over the past two years, the TSX has struggled to keep up, advancing 10%. Stocks move higher from two factors: 1. Growing earnings; and 2. How much the market will pay for those earnings (multiple). The advancement of the last two years has been largely supported by multiple expansion as aggregate earnings have been crushed by the pandemic. Price to earnings has expanded to 20x for the S&P 500, up from 14x at the end of 2018 (based on consensus earnings for the next 12-months). The TSX is trading at 16x earnings compared to 12x.
- Those numbers are a reflection of the broader market, but under the hood there is a dichotomy between value and growth, in addition to the dividend payers and the low-to-no dividend payers.
- The S&P TSX Dividend Aristocrat index fell 42% during the pandemic pullback, when the TSX Composite drew down 33%, and it has failed to catch up. As of the time of writing, the Aristocrat index remains down 14.4% year to date and the Composite is only down 6.1%.
- High-paying dividend stocks have been a favourite of retirees and risk-averse investors because of the income and they tend to be in some of the perceived safest sectors such as bank, real estate, telcos and so-called “boring” health care. The problem is those have been some of the poorest performing sectors this year, as the pandemic has increased loan losses, reduced demand for many forms of real estate, eliminated international roaming charges and slowed down a lot of health care services and elective surgery. **Chart 9** shows the average performance of TSX index constituents grouped by their dividend yield. Companies with the lowest dividend yield have performed the best while companies with the highest dividends have performed the worst. Many of the companies that pay higher dividends are more economically sensitive.
- Fear of missing out lives inside all of us and with the rally in high-flying technology names, investors are flocking to the obvious winning trends induced by the pandemic. As it rages on, many are wondering if they should rotate out of the dividend payers into momentum names.
- Valuations have become stretched in many low-dividend momentum sectors leaving some of the most attractive fundamentals in the aforementioned legacy defensive sectors. Investors need to focus on where we are going next and our view is that we will emerge out of this pandemic and recession and when we do the winning trends of today will likely reverse.
- There is also a distinct possibility that the market weakness of late continues in the weeks to come. In that scenario we perceive the valuations as a safety net in some of the higher-yielding sectors
- When looking at valuations, your return expectations tend to be highest the lower the valuation. While **Chart 10 s**pecifically refers to the S&P 500, this valuation rule transgresses borders. This makes it a good time to pick away at some of those dividend value names that have been out of favor for so long.

Fixed Income – LRCNs , the *new, new* thing

Joey Mack

Outstanding LRCN issues

Bank of Montreal 4.30% 26-Nov-2080, callable 26-Oct-2025
Current offer 102.06/3.84% to call
Rated BBB-/BBB(high)
Reset spread +3.938%

Canadian Western Bank 6.00% 26-Nov-2080, callable 26-Oct-2025
Current offer 102.00/5.36% to call
Rated BB(high)
Reset spread +5.621%

CIBC 4.375% 28-Oct-2080, callable 28-Sep-2025
Current offer 101.56/4.02% to call
Rated BB+/BBB(H)
Reset spread +3.998%

National Bank 4.3% 15-Nov-2080, callable 15-Nov-2025
Current offer 100.45/4.20% to call
Rated BB+/BBB
Reset spread +3.943%

Royal Bank 4.5% 24-Nov-2080, callable 24-Oct-2025
Current offer 103.70/3.69% to call
Rated BBB/A(L)
Reset spread +4.137%

Royal Bank 4.0% 24-Feb-2081, callable 24-Jan-2026
Current offer 100.81/3.83% to call
Rated BBB/A(L)
Reset spread +3.617%

- Royal Bank of Canada was the first Canadian bank to issue Limited Recourse Capital Notes (LRCNs) in the domestic market in July. Other issuers were quick to follow, and RBC came back in October and issued a second note.
- The introduction of LRCNs into the domestic bond market followed the approval of the structure as Additional Tier 1 Capital by the Canadian banking regulator, the Office of the Superintendent of Financial Institutions (OSFI).
- Being Tier 1 Capital, and due to the way these notes are created, an LRCN's rank in a bank's capital structure is the same as preferred shares. They rank above common equity, but below all other debt obligations of the issuer.
- The common form of issue is a 60-year term to maturity, with a coupon that re-sets every five years at a predetermined spread over 5-year Government of Canada bonds.
- These issues are callable after 5 years, and every 5 years thereafter, until the final maturity in 60 years.
- Due to the complexity of the structure and the lower ranking in the capital structure, LRCN's can only be issued to accredited investors, and the minimum initial piece is $200,000 par value.
- Also due to the complexity and risk of the structure, these notes do trade at a relatively wide spread versus more senior debt instruments. For investors with a higher risk tolerance, this can make them a very attractive addition to a diversified portfolio.
- Currently these issues all trade on a yield to first call basis. However, investors should be aware that if credit spreads rise for the issuer (due to either negative credit events or due to overall market moves), these could begin to trade with a much lower likelihood of being called, which in turn would have a sharply negative impact on price.

Managed Portfolios – An evolution of style

Chart 11: Value vs Growth over the past two

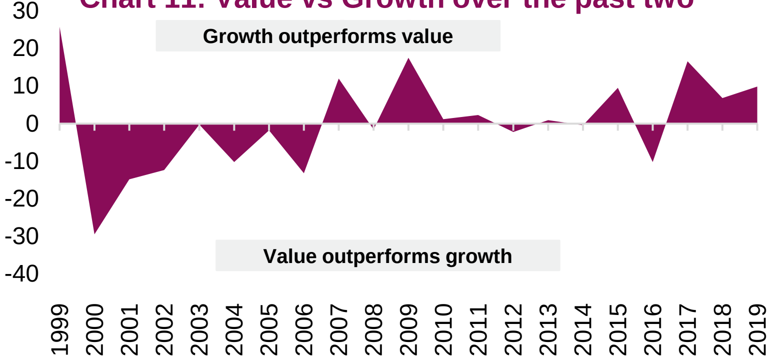


Chart 12: PE Valuation spread between Russell 1000 Growth and Value

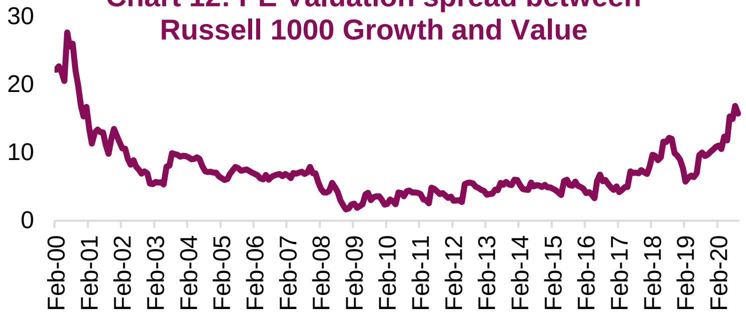
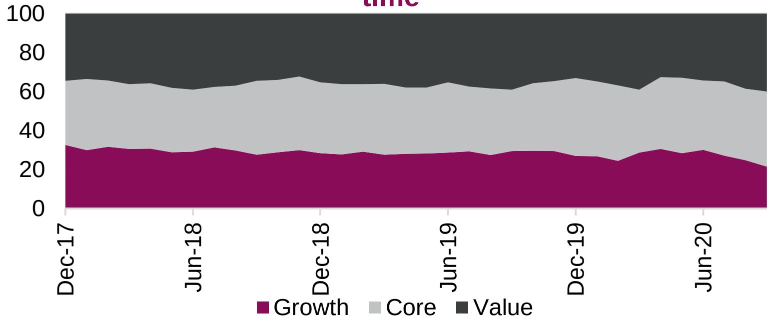


Chart 13: Managed Portfolio equity style over time



Source: Bloomberg

An Nguyen, CFA

- In June's edition of the *Investor Strategy*, we wrote about the well-researched benefits of targeting specific investment attributes, otherwise known as factor investing. We emphasized the importance of diversifying a portfolio across multiple factors to avoid potentially prolonged periods of underperformance since some factors can be out of favour for significant periods of time. While there are six well-known factors, we will focus the following discussion on one of the more prominent, if not topical or controversial factors, the ***style-factor*** (value vs. growth)**.**
- Benjamin Graham, considered the father of value investing, introduced the world to the early concepts of value investing. He introduced us to fundamental ideas such as intrinsic value, and the margin of safety which helped to shape how many investors think about value investing (or investing) today. Eugene Fama, and Kenneth French famously followed up with their own research to show the persistence of the value premium (and other factors) over time.
- However, as **Chart 11** shows, the value style can underperform for significant periods of time, as it has done over the past decade. As of September 30, 2020, the Russell 1000 Value TR Index returned 10% while the Russell 1000 Growth TR Index returned 17% in U.S. dollars annualized. There are no shortage of reasons as to why it is believed the growth style (led by the technology sector) has outperformed the value style and why many investors believe this trend will continue. Some of the reasons include: 1. Low interest rates and a low-growth environment have led to higher valuations on a firm's future growth and future cash flows; 2. The value premium has eroded as more investors (and quantitative methodologies) flocked to the style thereby minimizing the potential to earn the factor premium; 3. Growth stocks are not as expensive as they appear given the potential shift in how companies are now valued (today's companies are less capital intensive and have more intangible assets). This has made it difficult to compare today's multiples to historical multiples; and 4. The sectors synonymous with value investing such as financials and energy will continue to face secular and structural headwinds (low interest rates, environmental challenges, respectively). They are therefore priced to reflect these risks.
- The growth style, through the technology sector, has benefitted from the significant disruption that technology has had on our lives. While it has been a long time coming, the disruption has been accelerated and magnified by the global pandemic. Sectors that were already on the margin before the global economic shutdown now need more than a lifeline to survive, while sectors that thrived prior to the pandemic are now soaring to new heights each day. All this to say, what discount is sufficient to accept the risk to buy a "value" stock today, and conversely, how much more of a premium are we willing to pay for a "growth" stock? **Chart 12** shows the valuation spread between the Russell 1000 Growth and the Russell 1000 value indices (growth – value). The chart shows that the market has paid progressively more for growth relative to value, especially over the last three years. The valuation spread between value and growth is now at its widest level since the tech bubble. We are not calling this a bubble. However, we recognize the valuation spread between growth and value are at multi-decade highs. As the saying goes, history doesn't repeat itself, but it often rhymes.
- At these levels, we thought it would be prudent to trim the portfolio's growth exposure on strength. **Chart 13** shows the decrease in the portfolio's aggregate exposure to the growth style that was made earlier this year. While the growth style may continue to outperform value, a well-diversified portfolio should have exposures to multiple styles to prepare for multiple outcomes.

Disclaimer

Source: All charts are sourced to Bloomberg L.P. and Richardson Wealth unless otherwise stated.

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