Huggan White Wealth Management

Protect Capital. Manage |Risk. Provide Income.

Portfolio Management Report

Third Quarter 2020

"Sourcing the Best Produce"

The media is ripe with opinions, polls, forecasters, economists, politicians and more recently medical experts as DJT announced his contraction of COVID-19. From the outside looking in, the environment appears to be riddled with insurmountable headwinds that should only serve as a detriment to portfolio performance. At least that's the common response amongst investors as the disconnect between the stock market and the economy seems unfathomable. At times, it can be difficult for some investors to control their emotions. It's fair to say that emotions can't be avoided, but they can be controlled. But for those who have the dexterity to look under the surface, understand the actual message of the market and the catalysts that drive it, the picture is not as dire as general consensus. In the end this assists in controlling one's emotions and contributes greatly to investment success.

At HugganWhite Wealth Management, we work hard to remove emotions from our investment process. That doesn't mean we remove emotions from everything, as we have a tremendous bond with our fellow portfolio managers and most importantly with our valued clients. At the core of our practice is that relationship which every client has bestowed upon us. We take that handshake and that trust seriously. But it's at that point, however, that the emotions stop as every other facet of our wealth management offering is based on a rigorous process. That process incorporates financial, retirement, tax and estate planning and as noted above investment management. Decisions involving the latter are driven by diligence, rationality, prudence and an understanding of every client's situation. Emotional decision making is always absent when it comes to allocating your capital.

In a recent conversation with a new client, I was asked, *"What are your thoughts these days?"* to which I responded, *"My thoughts on which, could you please be more specific?"* That was followed up by, *"What are your thoughts on our portfolio and the overall markets*?" Now without recalling the conversation word for word, my formal response resembled something along the following:

That's a great question and something that needs a few minutes to elaborate on so you can perhaps better understand our approach to portfolio management. First off, portfolio management and "the market" are not one in the same. In fact they are quite different which is why we consider ourselves portfolio managers <u>not market managers</u>. Do we monitor markets and expropriate information that we deem relevant? Of course we do, as portfolios and markets do exhibit some degree of correlation (more on this later). Now let's take a few widely followed market indices such as the Toronto Stock Exchange (TSX), Dow Jones Industrial Average (DJIA), S&P 500 or the New York Stock Exchange (NYSE) to emphasize my point. Currently there are 1,560 companies listed on the TSX itself, 30 stocks for the DJIA, 505 on the S&P 500 and 2,400 on the NYSE. These are all broad indices with a number of different companies from various sectors of the economy. Each listed company represents a "seat" on their respective index, displaying diverse characteristics such as market cap, ownership structure, volume, volatility, debt, valuation, revenue and earnings to name a few. But here's the rub! The market itself doesn't provide guidance as to what you should be buying and selling. It doesn't differentiate between the good or the bad just because a company is listed on an exchange (although over a time a bad company eventually gets voted off). Furthermore, the performance of each constituent is based on supply and demand; more supply results in lower prices where as stronger demand equates to higher prices. It's basic economics.

Metaphorically speaking, the stock market is much like produce at a grocery store - the grocery store is the platform to which products are offered to customers (investors) with each shelf carrying various fruits and vegetables (stocks). A shopper surveys the offering looking for the finest produce with the intention of only selecting what appears to be the best "bag of apples" per se. If the demand for this product increases over time while supply diminishes, the result is higher prices. Conversely, if the same bag of apples are in low demand, yet supply is high, prices then fall. Once the bag is purchased though, the risk of owning the product now lies with the consumer (investor). If at any point in time, the consumer discovers a "bad apple" within their crop (portfolio), they simply discard that product resulting in an overall higher quality of fruit. Does the consumer dispose of all apples? Likely not as the remaining product is still of high quality.

Our portfolio management team adopts similar principals. Every day we are sourcing the line up of investable opportunities looking for best in class solutions to meet our clients demands. The process which we have developed over the years (and continue to build out) looks at a number of different fundamental and technical indicators that assists us in constructing what we believe are leading portfolios. We seek out companies that are currently in high demand or are at the beginning of a demand cycle. Management, valuation, cash flow, earnings strength, liquidity, economic moat and profit drivers are some of the inputs that help us determine the investment viability of the business in consideration. If the investment fits our parameters, it finds its way into client's portfolios. Once the position is initiated, we continue to monitor the position looking for a change of trend. If supply is increasing due to a number of variables then we <u>potentially</u> look to harvest gains by reducing the position size or even consider an outright sell. Periodically, we do uncover a "bad apple" which forces us to re-evaluate the company. If removal of the position is warranted, then we once again follow our process which should only result in a stronger portfolio. We refer to the latter as risk management; an integral component to investment success. As I've often stated, if you manage the downside, the upside will take care of itself.

During the third quarter, our process led us to trim our position size in Apple, Microchip and UPS in July and August. We firmly believe these companies continue to be leaders amongst their respective peers but we concluded that a number of key fundamental and technical indicators had become stretched/overbought. In hindsight, these were timely strategic decisions as September's volatility impacted sectors associated with these names. We also eliminated our longer standing position in Chevron as our outlook for this company remains challenged. On the buy side, we added to our core position in Premium Brands, McDonald's, Google and Microsoft in a few select accounts.

And finally, as for our thoughts on general markets and their influence on portfolios, we continue to believe the longer term bull market remains in tact. The impact of COVID-19 certainly caused a sharp recession which was reflected in stock market performance in the first and second quarter. Since then, markets have recovered substantially and the outlook appears to be improving. Some of the main catalysts include:

- Monetary Policy will remain accommodative for years to come and will likely remain supportive for a lot longer than many assume today. The Federal Reserve's gas pedal is fully engaged and there is plenty of fuel in the tank. The latter will run hotter than previous cycles and this has been confirmed by Central Banks.

- Although Fiscal support may feel absent at this time, there will likely be a non-partisan response in the near term. This will only serve as an octane booster for the above noted.

- Sector performance is widening. Financials, Industrials, Consumer Discretionary, Utilities and Real Estate are now participating and are showing leadership on a one month relative basis.

- The S&P 500's dividend yield at 1.83% is more than 100 basis points higher than the 10 Year Treasury at 0.69%. Additionally, while the S&P's price to earnings ratio is elevated relative to history, when compared to the yield that risk-free bonds offer, stocks don't look all that overvalued in our opinion.

- Sentiment has improved as the excessive bullishness witnessed throughout the second quarter has now been alleviated. Clearly the bullish camp remains a narrow crowd.

- Equity fund flows remain widely absent with cash on the sidelines near historic highs. According to FINRA, cash in customers' cash and margin accounts surged to the highest level since July 2008 in March of this year, reaching $417 billion, before dropping to $387 billion this May. After putting in a lower high in June at $415 billion, free credit had again ticked lower in July and August but still remains near the 2020 peak. Bottom line - this contrarian signal bodes well for equities (source – BOA).

- Consumer confidence is showing significant improvement after plummeting during the first quarter of 2020. As Investech Research noted recently, *"with the largest monthly increase since 2003, consumer confidence is in fact emerging sooner and stronger compared to past recessions. It should be noted that the majority of the gain came from the Future Expectations component, while the assessment of the Present Situation remains far below levels of the past several years. The improved outlook of consumers should help support consumer spending, the largest part of the U.S. economy, in the months ahead."*

- The U.S. manufacturing sector remains soundly in expansion territory. Strong demand for durable goods as well as supply disruptions have dropped inventories to the lowest level in a decade, suggesting that readings from the Purchasing Managers Index will remain favorable for the months immediately ahead.

- With earnings season in full swing in the coming weeks, we expect analyst consensus to once again come in below actual reported numbers. As already seen for third quarter data, the percentage of companies topping analyst expectations has been noticeably robust. This is also true for sales beat rates as well as top line revenue. Recall, there is a 94% correlation between earnings and the direction of equity markets.

Although this list is not exhaustive, it should be evident that our base case is for a continued grind higher as we believe the fundamental backdrop is supportive. Certainly volatility will remain elevated with COVID-19 and the U.S. election at the forefront at this juncture. In the end though, our work has allowed us to maintain our near full equity weighting across various mandates and we continue to believe our portfolios are invested in the best “bag of apples” we can find.

We continue to invest accordingly.

With regards,

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