the art of boring™

EP50 | Quarterly update 4Q 2019

Speaker	Time	Transcript
David Fraser	**00:40**	Welcome to The Art of Boring podcast, thanks for joining us for yet another quarterly update. This update happens to come at the end of a decade, so it should be a good one. As usual, we've got Greg Peterson joining me today. Greg's the Asset Mix Chair and the Balanced and Global Balance Fund lead manager. Greg, thanks for joining us.
Greg Peterson	**00:58**	Hey, Happy New Year!
David Fraser	**00:59**	Thank you! We have lots to cover today, so let's get right into it. And, as I [said], it's the end of the decade, so I hope listeners will give us a little bit more license to go outside our regular quarterly update and maybe look a bit wider than that. Maybe I'll just start: what was your big takeaway from 2019?
Greg Peterson	**01:14**	Thanks David. Yeah, I think my big takeaway from 2019 is: try not to guess what's going to happen and think that you know, with any certainty, how things are going to unfold. And it's not a learning from 2019, it's something we've been well aware of for a long time. But I think 2019 does help to highlight that.
	01:28	So, if you rewind a year ago from today, back at the beginning of 2019, things were a little more bleak. We had the sharp market sell off at the end of 2018 in the fourth quarter for a host of reasons, and you may have expected something similar to continue through the course of this year and to turn out fairly badly... and you look back at 2019 and actually, the year turned out very well. So, at least from a market performance and return perspective, [its] a pretty good year overall.
David Fraser	**01:54**	Throughout the year, a lot of people were touching on a lot of the common themes we've talked about [on the podcast] as well: disruptive trade wars, Brexit, things like that. Can you give the listeners your thoughts on those?

Greg Peterson	**02:04**	I think the conversation will continue, and a lot of the same themes that we've had for the last couple of years will continue through the course of this year as well. So, I don't think that changes much, in part because some of these themes are very long-term in nature, and resolution doesn't happen very quickly.
	02:18	And just an example: if you go back several years, we had the European credit crisis. And, as much as that's not making headlines any longer, we're still recovering from some of the credit challenges that Europe has faced over the last decade as well. So that's a theme that's still out there, hasn't gone away, but it's gone silent for the time being.
	02:36	I think the ones that you've brought up with respect to global trade, politics and so forth—those themes will be fairly front and centre still as we go through the course of this year. And of course, interest rates and central banks are always a big part of the conversation and are very influential, with respect to market cycles. So that'll be at the forefront as we go through this year as well—although, perhaps a little bit quieter than what it was a year ago.
David Fraser	**02:58**	And I guess we've got new fears even to add to that: in the Middle East there with that uncertainty. But it seems up until now, markets have really been shrugging off that uncertainty. Is it typical of markets? Or is that different today, looking back? It seemed like it was easier to disrupt markets in the past than it is today. Would you agree with that?
Greg Peterson	**03:16**	Yeah, I think markets...I don't know if markets "shrugged off" events of that nature more these days than they have in the past. I think in the last decade they certainly have had a tendency, or at least it's appeared that they've shrugged that off. I do think market participants are optimistic on the outcomes. Part of that may be because information flow[s] much quicker and more freely than it did 10 or 20 years ago, so we get real-time live updates to work with. That may be part of the reason for that.
	03:43	I do think that there's some belief and understanding that both sides have something to benefit or something to lose in any of these events. So, if we take the U.S. and China as a fairly straightforward example, neither one wants to hurt their own economy significantly; they're major trading partners that are fairly reliant on each other, or at least have a good deal of trade between them, so it's in neither [of] their best interest to let this go on forever and not find some resolution.

	04:08	So, I think market participants believe that eventually you get to that point. And you may have some hiccups along the way, which we do experience from time to time—Q4 of 2018 had perhaps been a bit of an example of that. But I think that's what helps to keep markets a bit more positive as we go through some of these major world events.
David Fraser	04:26	Absolutely. And particularly with the U.S.-China trade deal, that's sort of played out where they've gone into a phase one deal—so they're very much dipping their toe in the water and easing into it, and both sides don't want to lose out there. So that's absolutely right.
	04:39	Should investors be expecting the strong performance of 2019 to continue through 2020? Or are you more likely to tell your clients to be a little bit more cautious and avoid becoming too optimistic and too greedy as we go into 2020?
Greg Peterson	04:54	Yeah, it's always difficult to take the most recent returns and extrapolate, expecting the same. Although, that's really human behaviour—to take the most recent experience and expect the same to continue. So, our advice has always [been]: when we have strong performance like that, it's not likely to continue. And not just because we want to try and downplay expectations and keep the expectations lower. Really, if you look at the strength of 2019 but go back on 2018 as well and put the two years together, we had fairly reasonable returns over a two-year period. So, as much as the Balanced Fund was up over 15% in 2019, it was relatively flat in 2018. You put the two years together, and you have a fairly reasonable return of just over 7% annualized over two years.
	05:35	I don't think that 7% is necessarily the number to look at in the next few years as well. I do think that the returns start to slow somewhat from here—although, we're also relatively optimistic I'd say, for 2020. But not the same absolute returns as what we saw in 2019. So what I'm trying to get at is 2019 was a bit of a rebound from 2018 as well, with that sharp sell-off we had at the end of the year creat[ing] some rebound recovery that contributed to market performance in 2019.
	06:02	I think for 2020 though, we do have still fairly reasonable conditions for equities. We still have low interest rates. Low interest rates are likely to be with us for some time. We still have fairly modest inflation, which helps to contribute to expectations that interest rates [will] remain relatively low for a period of time.

		That's very supportive and helpful for equities. We still have companies performing well—earnings growth is still positive although slowing, and (we've been talking about this for a while), but that's still a reasonable environment for equities to be okay. So I think we still have a reasonable year for 2020, but we're certainly talking about lower returns than what we saw in 2019.
David Fraser	**06:39**	That's great—I won't get you to put a number on it so I'll let that one slide.
Greg Peterson	**06:43**	Somewhere between zero and 10. Minus 10, plus 10. How's that?
David Fraser	**06:47**	[Laughs] That sounds good. I really like how you added in the last two years as well, because it is very much important to remember it's an arbitrary date, when we think of January 1st, 2019. It's come at the back end of that 2018 sell-off and then markets have increase from there. So, I just wanted to reiterate that for the listeners as well.
	07:05	Do you think markets are overextended, in terms of valuations now that we've had that run up in returns? Or are we still quite reasonable with valuations there?
Greg Peterson	**07:15**	Yeah, I'm not sure about "overextended" and also I'm not sure about "reasonable" [laughs] valuations. We have had very strong performance—valuations naturally are higher today than they were a year ago, just given that strength in pricing over last year. So, we're starting at a point where valuations are more expensive. So I don't think that we're at the point where things are fair or cheap. And what that means for us is that this contributes towards expectations going forward. We're starting from a higher point; unless we had a really strong resurgence and growth—which seems less likely—then returns are likely to be lower, starting from that higher point going forward.
	07:47	This is part of the reason why we expect lower returns this year: we are starting from higher valuations, and primarily in the United States—the U.S. would be one of the most expensive markets in the world, but I don't think it's overextended. So, what happens in this case, is you're paying for some comfort with the U.S. economy being on quite firm footing for the most part. So you're paying for that comfort, if you will.

	08:08	So, relatively stable, it's an innovative market, it does represent exposure to the global economy as well, so, if we look at our U.S. equity portfolio, roughly 40% of revenues come from outside of the United States, but you are paying up for some of that comfort.
David Fraser	08:22	It's interesting to hear you say that you like the U.S. What is it about the U.S. that sticks out to you?
Greg Peterson	08:28	Yeah, the U.S. has provided leadership in terms of growth, in terms of market performance over the past several years, so we do take some comfort in the innovation and the diversity of companies and businesses that we get in the U.S. They're also technological leaders, and a lot of growth these days is coming on the technology side and ever-changing IT environments and so forth. And so we do have some comfort in the U.S.
	08:50	That's not to say, though, that we think that the U.S. is going to continue as the leader in terms of market performance. I do think that that starts to change as we go through 2020—and not that we're trying to forecast and predict and that sort of thing—but it wouldn't be unreasonable to see that market performance move outside of North America into other parts of the world. And part of the reason for that belief is, we do go through a bit of a manufacturing cycle and we have been on the lower side of that. We've talked in the past about Purchasing Managers Indices slowing over the past six to eight months, or actually, it started in late 2018...so that's typically associated with slowing manufacturing growth. That is cyclical; I think we're getting towards the bottom part of that cycle and it wouldn't be unreasonable to see that start to rebound.
	09:34	In part, China is trying to reflate their economy. They've been at the very slow end of things. Currently, if you look back over the past 30 years, if they are successful in reflating their economy and improving growth, that would contribute to the manufacturing pickup. Also, we've been through a bit of an inventory cycle on manufacturing. Inventories have been drawn down so they don't have as much to sell from, currently. So that inventory cycle could also lead to, or contribute to, a bit of a rebound on the manufacturing side.
	10:02	So, that would contribute to growth outside of North America. I mean, it will help North America as well, but Europe for instance has more exposure on the manufacturing side.

If you look at countries like Germany, they are very much [a] manufacturing-driven and export-driven economy, so we could see them start to pick up as we go through the course of this year. So, I would expect that market leadership is likely to move, perhaps, to Europe as we go through this year. Or perhaps looking on a little bit further.

10:30 So, two things I guess: one is, perhaps, the cyclical uptick that we may have on the economic side, and the other is that valuations in Europe are a bit more reasonable across the board than what they are in the United States. So, we're starting from a lower point there and that may also contribute to some of that pickup.

David Fraser **10:45** So we've talked a lot about the macro environment that's out there today, but remembering we are a bottom-up investor, are there any companies that stick out for you that sort of touch on what you just spoke about?

Greg Peterson **10:54** Yeah, given [that I] mentioned Germany, Fuchs Petrolub is a company we've had in the portfolio for quite some time. Fuchs is a manufacturer of industrial and automotive lubricants. Lubricants are a key input in many industrial and automotive components or products. But Fuchs does have a tendency to be a bit cyclical, so, given that we've been through this manufacturing downturn and the automotive cycle has been relatively soft in the past couple of years, it's also affected Fuchs.

11:20 Now, you may have noticed that we didn't sell out of Fuchs over the past couple of years despite the some cyclical nature to their business, and this is because it's a very well-run company, its balance sheet is very strong, we have a good deal of confidence in their ability to weather through downturns—we do talk about resilience a good deal at Mawer as well—and so Fuchs would be one of those resilient companies. This may be its time to start to shine a little bit more.

We've seen a rebound in Fuchs in the fourth quarter: performance [is] much stronger despite having been a bit weaker, if you look back over the last year or so. So, this was one of those companies that should benefit. And this is one of the reasons too, why we don't try to time things and move in and out of businesses all the time. It's a very solid company. We hold that for the long-term, knowing that we have some ups and downs, and perhaps it's time is starting to come as well.

Speaker	Time	Text
David Fraser	12:05	Yeah, it's a good company that highlights our overall thesis isn't it—where we try and ignore that short-term noise, we like the company, it's a resilient company, and we want to hold it long-term, and that's why we hold it.
Greg Peterson	12:14	Exactly. So, Fuchs is one of those companies that we've continued with and have good confidence in. On the other side of that, again with Germany, is BMW. So, BMW we did exit this year. And you may say, "well, that seems to be contrary to a pickup in the auto cycle." I think BMW also exemplifies some of the other things that we look at, in terms of capital needs; the electrification of cars requires a massive investment, and BMW is in the middle of that as well.
	12:41	And so, with the challenges of that need for capital perhaps being a little bit later in the cycle, this is one that we chose not to stay with (in BMW), whereas Fuchs doesn't have the same headwinds as BMW. Whether you have electric vehicles or not, you still require lubricants to keep things moving. So, Fuchs will benefit, I would say, in either case.
David Fraser	12:59	That's great. Thanks for those thoughts. I also wanted to touch on something that's near and dear to a lot of Canadians' hearts, especially here in Alberta, where we are today. Energy was the worst performing sector in the S&P in 2019, we've talked about the highlighted tensions in the Middle East...what are your thoughts on energy and oil at the moment?
Greg Peterson	13:19	My thoughts on energy is that energy prices have firmed up naturally in the last couple of years—perhaps stabilized a bit more. We've had more recent strength in oil prices with the tensions in Iran, in the Middle East in general. I think, though, you may have short-term flare ups that affect or contribute to stronger energy prices, but if you look at the long-term, there's a good deal of oil and energy available in the world. And so I think that that puts a cap on prices longer term.
	13:48	So, really, the challenges will become either geopolitical that may contribute to spikes in prices from time to time, or it could be technological challenges that may come up from time to time, in accessing things—like the very deep water oil off of Brazil and places like that. But when we look at it, the bottom line is there is a good deal of oil in the world, it's just it's availability, access, and then the ability to transport that as well.

	14:10	It's not that I'm trying to be overly negative on that; I think that good companies will still perform well over the long-term and certainly be profitable, but it does put a cap in terms of the maximum potential that they may have as an investment over time.
David Fraser	14:22	And the U.S. are claiming to be energy independent. Would you agree with that?
Greg Peterson	14:27	Yeah, the U.S. is probably quite close to being energy independent. You can see that actually just in the more recent trade balances as well, so the imports of oil to the U.S. are much lower than they've been, and they've actually become a net exporter of energy as well. So, yeah, the U.S. has much more self-dependent and that may fluctuate a little bit as reserve recovery perhaps goes through some cycles as well—but they do seem to have achieved that energy independence.
David Fraser	14:50	Coming back here to Canada, we normally see a strong correlation between energy prices and the Canadian dollar. The Canadian dollar was really resilient last year. What was your take on that?
Greg Peterson	15:00	Energy prices may have contributed to the stronger Canadian dollar last year. Naturally, we haven't benefited the same way in Canada because we do have the spread between what Canadian companies achieve for oil prices and what we see from WTI and Brent crude prices. However, I do believe that firmer commodity prices did help keep the Canadian dollar somewhat solid. I think it's been more of a monetary policy effect that's helped to keep the Canadian dollar stronger.
	15:23	So, the Bank of Canada has been on hold for some time. They've been fairly clear about not needing to lower interest rates, or at least being fairly stable for some time, whereas we have other central banks around the world such as the Federal Reserve in the U.S. which reduced interest rates last year. So, by us keeping rates higher, the U.S. lower, that does create some strength for the Canadian dollar relative to the U.S. So that's probably a bigger part of the story there too.
	15:47	Other central banks have become more accommodative as well: the European Central Bank became more accommodative last year with fears that growth may be slowing in that region, and so with Canada relatively stable, that's helped to contribute to the dollar strength.

David Fraser	**16:00**	So, Greg—last question and I'll let you go. As the Asset Mix Chair, can you give the listeners an update on what happened throughout 2019 and the adjustments we made?
Greg Peterson	**16:09**	Yes, there're some subtle adjustments to asset mix. Our job is not, as we've talked about, to predict and make placements that way, but to gradually adjust the portfolios based on long-term expectations. So, if we went back a year ago, in early January of last year we actually added a little bit to equity within our balanced portfolios. (This was coming off the sell off at the end of 2018; equity had drifted lower, so it was just a slight rebalance back to equity at that time.)
	16:36	Beyond that, through the course of the year [were] also just some very subtle adjustments. We did add a little bit to fixed income in March towards the end of the first quarter, and then as we got to later in the year, a trim on the U.S. equity side given the strength of the U.S. It wasn't a call that we wanted to reduce U.S. necessarily, but given the strength of that market, it had drifted as a higher weight within our portfolios and we just wanted to keep that in check and keep it from moving too much higher. It is the largest exposure or allocation that we have within Asset Mix (to the U.S.). That continues today; I expect that that's going to continue for a period of time still, but it may be one of those adjustments that we make this year—to continually trim the U.S. back somewhat as we gradually start to reallocate more, perhaps, outside of North America.
	17:18	We already have a fairly strong position outside of North America as well if you look at international equity and global small cap within the portfolio. So, I don't think that we need to make a big change to that. But that may be the natural tendency: just to trim away from areas that had been very successful in the U.S. and start to reallocate to other areas that had been a bit a slower—which is on the international side, predominantly.
	17:39	Canada: we're still watching some of the headwinds in this country. And so, as much as we've had that rebound in 2019 and a bit of a cyclical upturn in Canada, we're still somewhat concerned about household debt levels and debt servicing in this country. It's fine while interest rates are relatively stable, and it may be prolonged if the Bank of Canada does either stay on hold or reduce rates further this year, but longer term that's still a bit of a concern. So we'll wait for those headwinds to abate somewhat before we back much on the Canadian side.

David Fraser	**18:09**	Perfect. And I said last question, but I might just throw one other one out there. With such a strong year (2019)—we've talked about it ad nauseum—does that change anything in your view when you're looking at asset mix? When you see those strong returns worldwide?
Greg Peterson	**18:23**	Yeah, strong returns worldwide, but there is some differentiation, too. Some areas have not been as strong as the U.S. has been, so perhaps affects us somewhat in where we go from here. I think more of what it does, though, is just on the expectation side: it reduces our expectations going forward, given that we've had such a recent strength.
David Fraser	**18:40**	Fair enough. Well, thanks so much for your insights today and thanks to listeners for joining us.
Greg Peterson	**18:44**	Thank you very much and have a great 2020!