the art of boring™

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David Fraser: 00:41 Welcome to the Art of Boring podcast, thanks for joining us for the third quarter update for 2020. Greg Peterson's here with me. Greg's the asset mix chair and global balanced fund lead manager. Greg, thanks for being here today.

Greg Peterson: 00:54 Hi David, happy to be here.

David Fraser: 00:55 Well, like much of 2020, Q3 wasn't exactly overly quiet. What are some of the big storylines that you saw over the last three months or so?

Greg Peterson: 01:04 So, normally summer is relatively quiet. And naturally, with all the things taking place this year, it wasn't terribly quiet. One thing I would note that the old "sell in May and go away" didn't work very well for anybody this year, given the markets were relatively strong and performance was actually pretty good over the course of the summer.
As far as storylines, I think it's still dominated by much of the same: it's still the progression of the coronavirus pandemic, government stimulus programs around the world, and central banks. So, I didn't see storylines that were significantly different in terms of sort of…"big" headlines. And then the news is always dominated by political headlines, which is just a bit noisy.

David Fraser: 01:41 You touched on the "sell in May and go away"—that's a strategy that some people tend to use. I assume it's not something you're recommending with your clients all too often?

Greg Peterson: 01:52 No, we never recommend that to our clients, so perhaps I shouldn't even bring that up. But it comes up in conversation from time to time, and I think it's really just because summer is generally quite quiet and volumes are relatively low.

However, in the third quarter of this year, the Balanced Fund Series A was up 4.5% in the third quarter of this year led by strong equity markets globally, so that strategy would not have been paying off this year.

David Fraser: 02:18 So it was better to stay in the market there. But looking ahead, what are some of the major risks out there? What keeps you up at night, and pessimistic about future performance over the medium-term? Perhaps the next two or three years?

Greg Peterson: 02:30 I would say I'm generally optimistic, otherwise it'd be very difficult to invest in equities over the long-term [laughs]. So, I mean, there's many things that keep us up, but I think the main concerns for us right now are just the general ebb and flow to economic activity. The coronavirus pandemic naturally caused an abrupt halt to economic activity early this year; we've seen a fairly strong bounce in activity and recovery since. And I think the sort of…"quick" part of the rebound is now behind us.

I think, going forward, it's a bit more difficult to see much pickup in economic activity—even as businesses and that start to reopen and resume sort of something closer to normal again.

03:11 So, major concerns would be a resurgence and inability to stop the virus; no vaccine in the next couple of years would be a major concern, unless something happens to change with the virus where it's not as dangerous as it has been. And I think one of the other things that, if you're talking about big picture concerns over the next two years, would be inflation or resurgence in inflation. That's something that's likely a few years out, if we do see it at all.

There's always been lots of talk of inflation over the last decade, and really there's been inability in the developed world to create much inflation. And really, we've been more in a deflationary environment for some time and are likely to stay in that again for a bit of time here.

David Fraser: 03:52 On the topic of inflation and internal meetings, I think you've pointed out that you're a little bit more concerned with inflation with this crisis and this go around than you were perhaps in the past. Is that true? And why is that?

Greg Peterson: 04:05 We're a bit more concerned about inflation for a few reasons—one is the volume of stimulus this time around is much larger. So, there's a significant amount of money that's being printed by central banks, interest rates are back to zero, but this time we also have massive fiscal stimulus programs from governments around the world, as well. So there's been a huge injection of liquidity into the system. And this time—what's different than the financial crisis of 10 years ago—much of that stimulus was absorbed by the financial system. This time, you have money going direct to consumers and businesses, so that's more likely to at least stimulate inflation to some extent.

04:42 The other additions this time around is the de-globalization that's been taking place for several years. In our view, that's likely to make goods more expensive as manufacturing comes back home in many cases. So, you don't have the efficiencies and economies that you would have with the globalization trend. And so that's also likely to add to the inflation story somewhat.

David Fraser: 05:04 So, a few things there to be concerned about. In terms of—you mentioned you're "optimistic"—what are you seeing out there that might be green shoots that will help with the recovery going forward?

Greg Peterson: 05:15 There [are] a few things. One, I think because so many of us have been at home for so long, there's a pent-up demand from consumers. Consumers haven't had the same ability to go out and buy things, quite frankly, as they've had in the past, so there would be some pent-up demand there. If anybody's like me and you've had lots of time to spend around your house, you notice all the things that you'd love to improve or fix or replace. So, there's likely some pent-up demand with respect to furnishings and appliances and electronics and that type of thing. You have seen some pickup in home improvement spending in the last few months; things of that nature that have been pent up.

05:49 The other is that as manufacturing and production was halted or declined significantly early this year, the last few months have seen a fairly large drawdown on global inventories, so there'll be a natural inventory restocking process that'll take place as well. That'll increase production, that puts people back to work, and so that creates a bit of a cycle there to improve incomes and improve consumption because of higher disposable income.

David Fraser: 06:14

So, you pointed out as well that policy makers and central banks have had a lot to do with the recovery since the March 23rd lows. What is the latest from those most significant players there? (That being the Federal Reserve in the U.S. and the ECB over in Europe?)

Greg Peterson: 06:31

From the central banks, it's been more of the same. So, continuing with their stimulus programs; interest rates at zero, essentially; bond buying programs that are injecting liquidity into the system; and basically printing money for the most part through quantitative easing. The other change that's taken place too, is just the Federal Reserve has gone to an average inflation target rather than a fixed target for inflation. So what they're trying to say is that they're willing to accept higher inflation for a period of time before they react to that and raise interest rates.

It's really just a way of saying that they're willing to tolerate lower interest rates for longer by doing that. And then the European Central Bank is toying with the same average inflation approach that the Fed has implemented this year.

07:16

The other thing with the Fed too, is that the U.S. Federal Reserve has always had a dual mandate. Inflation is one of their mandates and managing employment in the U.S. is the other part of their mandate. And it's always been treated somewhat equal. I would say that the emphasis has now shifted somewhat to more emphasis on employment and improving employment in the United States. And so that's a bit of a change in the central bank side, too.

David Fraser: 07:38

Absolutely. And there seems to be a consensus that the U.S. Federal Reserve is reluctant to implement negative interest rates like we've seen in some parts of Europe. Do you agree that that's the case, and where's the reluctancy coming from?

Greg Peterson: 07:53

There's a reluctance in Canada and the United States to implement negative interest rates. Part of it's because I don't think that they have to. I mean, low interest rates or zero interest rates are one thing. Real interest rates are already negative. So if you adjust interest rates for inflation, we already have real rates that are negative and they're very stimulative on their own. So I don't really think they need to take interest rates lower. I think they'd also prefer to keep that in their back pocket if the crisis got much more severe. They don't want to use all of the tools right now, and that would be one of the tools to hold on to for later on. But like I said, negative real interest rates [are] already quite powerful and so I don't think they need to go any lower with that.

David Fraser: 08:32 Beyond the pandemic, the U.S. election seems to be at the forefront of investors' minds. It seems to be a pretty tight contest and things seem to change by the day. What are your biggest concerns heading into the election?

Greg Peterson: 08:46 Our biggest concern with the U.S. election is that it's a contested election, or that there's no clear result and that that takes some time to work out. I think that would be biggest risk around the U.S. election—is just that delayed outcome. I think if you had a clear winner, whether it's Biden or Trump, I think the markets are willing to accept that in either direction. So, despite the fact that policies are somewhat different between the two, I think overall, the fact that you would have less uncertainty with a clear victory would help stock markets.

David Fraser: 09:16 And I assume you're potentially cautioning your clients to brace for a little bit more volatility as we head towards November 3rd?

Greg Peterson: 09:25 Yeah, I think always caution on that. If anybody listens to me, I'm like a broken record: always expect more volatility, but certainly around events like the U.S. election. It creates a great deal of noise.

I mean, if you pay attention to the media now, there's always a lot of noise that's out there and an ebb and flow to that media. Then the news around the election, also. So it's likely to create some volatility for markets. We've seen volatility creep back in. Well, not that it really ever went away, but September was certainly more volatile than we've seen for a few months, so it was a bit of a correction that took place (in September) and then relatively quick recovery after that as well.

So yeah, more volatility is certainly on the landscape.

David Fraser: 10:05 But as always, we want to remind clients to not focus too much on that short term. This is an event that's going to come and go and markets will revert to their mean, I guess, so we always try and focus on the long-term, don't we?

Greg Peterson: 10:18 Yeah, that's a very important point. Even if we had a market correction take place because of the U.S. election, that's something that will work through over a relatively short period of time, so it is important to stay focused on long-term investment objectives and investment strategy and really not to overreact to anything short-term, particularly politics.

David Fraser: 10:38 Are there any examples of companies that we hold that are effectively agnostic to the outcome of the election or even the major impacts of COVID?

Greg Peterson: 10:46 There are certainly companies in the portfolios that focus on products that aren't as economically sensitive. So, Bunzl is one company from the UK that's a distributor of recurring consumables. So a lot of this is supplied to large organizations and because their products are consumable, they get used up and there's a pretty steady revenue stream for that type of business.

David Fraser: 11:09 Their business is going to continue on regardless of the outcome of the election—and even [with the] major impacts of COVID, they've shown quite a resiliency to pivot and adapt with a good management team at the helm, haven't they?

Greg Peterson: 11:22 Yes, absolutely.

David Fraser: 11:23 On the asset mix side of things, did we make any significant asset mix changes during Q3?

Greg Peterson: 11:28 We made some small changes during the quarter: in August we did trim U.S. equity weights slightly and just redistribute that to Canada and international. The rationale behind that was that the U.S. market had performed very well and was starting to creep higher as a weight within the portfolios. And so we just wanted to keep a lid on that, if you will; trim that back somewhat and then redistribute without actually reducing the equity weights.

Also, if we looked at valuations, U.S. valuations are probably a bit more expensive than other areas so it's just a slight improvement to the portfolio to reinvest those proceeds in other markets.

David Fraser: 12:03 With everything that's happened in 2020, have your return expectations for any asset classes changed significantly since the beginning of the year?

Greg Peterson: **12:12** I wouldn't say that they've changed significantly because we're always looking out over the long term, so those long-term expectations may have crept down just slightly. If we think of the bond market, bond yields are exceptionally low. Bond returns come from two areas: one is from the interest earned on the bonds, so then the other is from capital appreciation if the bond yields continue to move lower. Because there's not much room for them to move lower, we wouldn't expect too much from the capital appreciation side on bond prices.

So, our return expectations for bonds have come down slightly. Our equity expectations are always pretty modest anyway, given that we don't predict or try to forecast "what next?", but really, in this environment, with low interest rates and very low discount rates, it is still fairly supportive of equity returns over the long term.

David Fraser: **12:59** There's no doubt that the pandemic has hit some companies quite hard. Are there any names that we hold that are finding it tough sledding right now? And what are we doing about their weights in the portfolio?

Greg Peterson: **13:11** Yeah, there [are] definitely a few examples in the portfolio of companies that have struggled due to the pandemic. One that comes to mind is On the Beach. On the Beach is a UK-based travel agency, and you can imagine with travel cut the way it has been that they've definitely suffered through this. So it's been a difficult time for On the Beach.

As far as weights in the portfolio, companies like this have a relatively low weight and so not much influence over the overall return for the [Mawer] Balanced Fund. And we've maintained that lower weight as well. If we were truly concerned with this company and the way it was managed, naturally it would exit the portfolio, but long-term prospects are still relatively good. So we'd expect them to recover and improve down the road, also.

13:51 Another company, just as an example, is Glanbia. One of their divisions is sports nutrition, and so with the closure of gyms and specialty nutrition stores, it's been more difficult for them to distribute their products. One of their products that may do well coming out of this is their Slim Fast line. Many of us have been at home, maybe put on a few pounds [laughter] so perhaps that'll help with their recovery.

David Fraser: 14:12 Absolutely. And no doubt there's some pressure on some of those names, but as we all know, the benefit of diversification is that we have different business models that benefit from different market conditions. Do we hold any names that are directly benefiting from the pandemic?

Greg Peterson: 14:26 There's many names actually that are benefiting, especially on the technology side. So, companies like Microsoft have done very well through this; the direct-to-home consumer companies like the Amazons of the world have done well, and Alibaba in China, who's very similar to Amazon in the United States. So those are companies that are quite well-known that have done well. Just the move to online shopping and commerce has also helped companies like Shopify in Canada. Shopify provides the online platform for businesses to take their goods and services to market online. So there are many companies like that that have done well through the pandemic.

David Fraser: 15:03 It's certainly been a pretty unsettled year, to date. We've got one quarter left in a pretty eventful 2020. What are you looking to see play out for the rest of the year?

Greg Peterson: 15:14 I'd like to see a fairly quiet quarter for the rest of the year, but I'm sure that that's not likely to happen.

15:20 As I was saying earlier, we've seen the quick bounce in economic activity. I would expect that for the fourth quarter this year, we'll probably see things slow down significantly. We have already had that pickup in activity. Just as an example, Canadian GDP activity, or economic activity, is about 5% below where we were in January. So we've made that quick recovery for the lion's share of the slowdown.

To recover activity levels back to where we were at the beginning of January is likely to take some time now. So, we've had the easy part of that, if you will. Not that it's been easy, but sort of like the quick bounce. So I think things definitely slow down.

15:54 And as we go forward, there'll be more of an ebb and flow to both economic activity as well as progression with the coronavirus. That may mean partial shutdowns here and there; I think we've already seen some examples where, regionally, either countries or provinces and states, have had to implement more controls and shutdowns to try and stem the tide of the virus. And so that's likely to continue now for several months—at least for the foreseeable future. So I think things generally slow down for the last part of this year.

David Fraser: 16:23 I assume you're probably, like most people, expecting accommodative fiscal and monetary policy to continue for the foreseeable future as well?

Greg Peterson: 16:33 Yeah, I don't think there's any change to policies. In fact, central banks have been pretty clear that interest rates are staying low for a very long time. And that also provides the environment for stock markets to do as well as they have. So I think that that part of things, we'll see some consistency on the policy front.

David Fraser: 16:49 Well, thanks Greg. That's very insightful and it's always great to get your thoughts and a better understanding of what's on your radar and what's happening in our balanced portfolios. I guess the next time we speak on the podcast will be 2021. In any case, thanks for joining me today and I look forward to speaking with you again.

Greg Peterson: 17:06 Yeah, thanks very much.