BEUTEL GOODMAN FIRESIDE CHAT SERIES

Beyond the Pandemic:
In Conversation with David Gregoris and James Black

As we move further into 2021, we continue to see investors focus on the impact of the pandemic and the current low-rate environment. To get some perspective, we recently sat down for a fireside chat with David Gregoris, Managing Director and Co-Head of Fixed Income, and James Black, Director of Equity Research and Vice President, Canadian Equities to discuss fixed income and equity markets, our portfolios, and where we go from here. Below is an edited transcript of those conversations.

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Linda Watts: Thank you for joining us today. My name is Linda Watts I'm Vice President of Client Service and Business Development at Beutel Goodman and today we will be speaking with two of our portfolio managers David Gregoris and James Black.

As we close the door on 2020 and we move into 2021 we continue to see investors focus on the impact of this low rate environment. We thought it would be interesting to discuss this both from a fixed income and an equity market perspective. So first, joining me to share his macro-economic perspective is David Gregoris, Managing Director and Co-Head of Fixed Income. David we are glad to have you here.

David Gregoris: My pleasure Linda.

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LW : David, as a starting point let's talk about 2020. It was a challenging year, with significant volatility as the crisis unfolded — and your team was very successful in terms of navigating the market, so congratulations on that strong performance. I know there was some dysfunction in the bond market. I'm wondering if you can talk specifically about what we experienced in that market and highlight a few drivers of your team's success.

DG : Our macro process guided us through the turbulence in the markets during 2020. This macro process, developed over decades of market cycles, is based on three fundamental assessments: first, our outlook for general economic growth; second, a valuation of risk assets, and third, the liquidity supplied to the economy and markets.

We analyze these market conditions through many macro-economic and market-based indicators which provides us evidence to determine what is priced into markets. We take this evidence and apply it to the current cycle. Each cycle is different, and it is important to consider that when building our bond portfolios.

Getting back to this year, as the pandemic spread around the world, economic shutdowns and stay-at-home orders were the prescription of choice. In March, markets discounted a dramatic revision in economic growth in world economies. As a result, stock markets corrected over 20%, credit spreads widened precipitously, and market liquidity all but dried up. At this point, monetary authorities sprang into action with zero interest rate policy, bond purchases or Quantitative Easing, extended those bond purchase programs to corporate bond purchases, while the treasury began a major relief program in the form of money direct to consumers.

At this time, our valuation work was generating a "buy" for risk assets. Our growth indicators were a little scary – I'll give you that much. However, our liquidity indicators were suggesting that markets should respond positively. We moved our portfolios to an overweight [position] in credit bonds, both corporate and provincial, and more specifically into those credits that we felt would benefit dramatically from economic recovery.

LW : So in terms of the economy, you note the monetary and significant fiscal response, which has helped the economy bounce back somewhat. We also have vaccinations underway and optimism in the equity markets. What are your expectations for economic growth in 2021, and where do you think we are in the cycle?

DG : We think that we're still in the early expansion of the economic cycle. It's marked with positive growth; it's a bounceback from the negative growth in 2020 and yet we're not back to the level of previous economic output.

As we go forward in 2021 and vaccinations are rolled out, we should see a general reopening of the economy. The vaccinations will lead to "herd immunity", which will allow us to put the pandemic behind us, which means that further lockdowns are in the US before the next winter flu season, which should prevent further lockdowns are probably unlikely. COVID will probably still be with us as a virus, but it won't be in a pandemic form.

As the economy recovers, fiscal policy can be reduced as the unemployment rate continues to fall. This hand-off from fiscal policy to a self-sustaining economic expansion can be a little tricky, and we're keeping a close eye on that. As for Monetary policy, we would expect that the asset purchases can be wound down as early as late 2021 and early 2022, but we don't see short-term rates rising until late 2022 or early 2023. Our growth expectation for 2021 is very strong: 4%-plus real growth rates in the U.S. and in Canada. Some pundits are even looking for 6% real growth rates. However it should take until mid 2022 to have our output gap closed entirely.

LW: So with short rates expected to stay low and central banks pledging to keep rates low for the foreseeable future, one of the things we're seeing is investors re-examining the role of bonds in their portfolios. Can you comment on this and share with us your outlook and how you're positioning fixed income portfolios in this environment?

DG: Our outlook for 2021 is for a continued rise in interest rates, especially in term interest rates; so we're looking for interest rates to top out this cycle around that two to two-and-a-half percent rate of term debt. That would be 10-year or 30-year rates in both Canada and the U.S. That's somewhat lower than the last cycle.

We're assuming that the central bank's inflation target will be met, yet runaway inflation is not probable into our investment horizon of 2023. Our secular and demographic work doesn't suggest any type of problem with inflation going forward. Our position is to be conservative on our duration exposure at this point in time, while positioned for continuation of a steeper yield curve, and while we maintain our exposure to credit for yield.

In a balanced funds, bonds can still provide an offset to volatility of equities. As valuation of risk assets continue to rise, so does potential volatility. Bonds can still have mitigating effect on balanced portfolios' performance even with these low yields, yet they don't provide as much of an offset as they have in previous cycles.

LW: It's good to hear there's still a role for bonds in our portfolios! you have been managing fixed income for many years through decades of falling rates. What is the impact of this ultra-low-rate environment? What [impact] does it have on the levers that you use to add value? And further, does it give active managers a leg up on passive managers?

DG: All very good questions. In this ultra-low-interest rate environment, overall potential returns tend to be lower, but this is true for all asset classes, not only fixed income. The levers haven't changed. Duration, yield curve exposure and credit exposure can all still add the same relative alpha to portfolios. Passive investors in bonds purchase all issued credits throughout the yield curve, regardless of credit quality or valuation. During these times of low rates and tight spreads, quality and relative value do allow active managers to build better-performing portfolios than passive managers.

LW: So switching gears … credit spreads faced a wild ride in 2020 — I think at the height of the pandemic we saw investment-grade spreads reach 150 basis points, high yield spreads toped 870 basis points. Now in many segments of the market we've seen spreads tighten dramatically and they're close to the levels we saw at the start of [last] year. Given this, are there current dislocations in the market that are you targeting and then more generally where are you seeing value within credit?

DG: Our process from the top down — we allocate overweights or underweights to sectors in the bond market. Our work has led to an overweight in credit, which added significant value in 2020. Our credit team spends a lot of time looking at fundamental analysis, and understanding the credit's sensitivity is of paramount importance. Further [we] take a look at the relative value of the underlying securities This too has added value to portfolios. In our current portfolios, we still have a large exposure to credit, both in corporate and in provincial names, and we expect them to outperform the benchmark, albeit at a very slim margin — or less than what happened in 2020, but we still skew it towards the economically sensitive sectors. There are still some pockets of value that we can add value to benchmarks. These sectors include exposure to the Energy and Consumer Discretionary sectors. We have reduced our risk in these sectors, yet we still have an overweight in them. We still see some small opportunities there, but there's no reason – our work doesn't suggest any mass exodus of credit at this point in the cycle.

LW: So keeping that focus on credit selection, we saw a significant number of credit[-rating] downgrades and an increase in the number of fallen angels (so these investment-grade issuers that were downgraded to high yield). Can you talk a little bit about this dislocation in the market and the opportunity it provided?

DG: There [were] two that I can highlight in our Core Plus Bond Fund, where we're able to invest in high yield securities, and we took advantage of this when a couple of issuers were downgraded to BB or "non-investment-grade" during the year by one agency (so they're really split-rated). [They] were Ford Motor in the U.S. and Air Canada. Both were downgraded and they started trading as high yield and we took advantage of them and both benefited from this economic recovery during 2020.

In our core bond portfolios, we were able to find a relatively new type of capital tier bonds issued over the last couple of years. These would be hybrid securities for non-financial issuers. And for the financial issuers, they're referred to as LRCN, or limited recourse capital notes, which is another acronym for bond investors – like we didn't have enough already! These are issued by investment-grade corporations and are debt securities that are at the lowest tier of the capital stack of the corporation. These offer a yield premium to their more highly rated debt, and yet they're still investment grade. During this year they widened a lot more than the underlying, higher-rated [securities] in the capital stack and we were able to take advantage of that in our core funds.

LW: It sounds like relative value played a role in your outperformance, but let me ask you another question, David. What keeps you up at night? There's lots happening in these portfolios; are there any positions you're losing sleep over?

DG: Well, bond managers — it's an over-the-counter market, so it's always open — it never really sleeps!

So when you set a portfolio up and you have exposures like we do (we're conservative on duration, looking for steeper curves and expect an economic recovery to keep credit spreads performing well), our biggest risk on a macro basis is that something disrupts our economic recovery. Could there be a COVID variant? Could there be some economic scarring from this previous recession? Or could it be just the general level of debt in the overall economy? Those are things we're trying to keep a very close eye on.

My worries for 2023 are asset price bubbles. So we've had a lot of monetary and fiscal support and it seems like they want to keep it there for a while longer until the economy can be assuredly self-sustaining. So, I really am worried that […] with this liquidity pushing asset prices higher, when they take back some of that liquidity, I'm quite worried about asset values at that point in time.

Those are the things that we're keeping an eye on; that we're not set up for — we're not expecting — yet we're always trying to be as cautious as we can to make sure that the portfolios continue to perform well.

LW: Well thanks again great David for taking the time.

DG: Thank you, Linda. My pleasure.

LW: So now we are going to shift gears and my colleague Tim Hylton is going to speak with James Black and they're going to provide another perspective.

Tim Hylton: Well thank you everyone for joining us. I'm Tim Hylton, Senior Vice President at Beutel Goodman. Joining me today is James Black. James is the head of Equity Research at Beutel Goodman and is also the co-lead portfolio manager of our flagship Canadian Equity Fund and also the co-lead portfolio manager of our Canadian Dividend Fund. Welcome James

James Black: Thanks Tim.

TH: James, 2020 was certainly an interesting year, impacted by COVID fears and realities. The market sold off hard in the let's call it late winter/early spring, then recovered somewhat steadily, but there was certainly a lot of volatility last year. Can you talk to us about the advantages and disadvantages of the disciplined investment process that is used by the equity teams at Beutel Goodman?

JB: Sure Tim. You are right — 2020 was certainly a very interesting and challenging year. What grounded us and kept us focused through those turbulent days in March and April was indeed our discipline. We have long believed that it provides a framework for repeatable success that is not dependent on any one person – our strength is in our process and our teamwork.

For a new name to be added to the portfolio, the process requires a minimum 50% return, which demands strong conviction that is backed by in-depth research. This high hurdle rate forces us to be very picky about new names and results in a concentrated portfolio, lower turnover and a longer holding period. It really makes us act like owners, not renters.

The process also creates a good risk/reward framework, as both target and downside prices are established before a purchase. These become the goalposts, which require action when they are hit or breached. When a holding hits the target price, we have to sell one-third of the original position, and then justify why we continue to hold the remaining piece. A downside breach requires a second set of eyes to review the investment thesis and valuation to ensure that it remains a good investment. The process demands that active decisions are constantly made.

And you asked me about disadvantages as well as the advantages … of course, no process is perfect. We may sell too early sometimes or start buying too early. Our stocks are usually out of favour when we start to buy them, and as a result, they may go down further. When we're selling, they're typically in favour and may continue rising. Our process is not to pick the bottom or the top. Nobody can do that consistently and the opportunity costs of being wrong can be very large.

TH: Excellent. I guess the proof is in the pudding — the long-term track record. I know some clients ask us, how do you know when you're selling too early or if you're buying too early and the truth is it's very hard to calculate the impact of that because, where are you putting the proceeds, etc., etc., but certainly over multiple decades the performance using this process has been outstanding. Thanks for that James. Another question, to bring it up to date, if you will, or to the current market. The market seems very bifurcated. There's pockets of the market that are out-of-favour and inexpensive, and then there's other sectors are frothy and very expensive. So how do you know when it's time to move from what's hot into what, say, represents great value?

JB: Tim, I'm going to sound like a broken record here, but our process does that for us. When stocks hit their target price, we sell them. Post the process driven sale, we establish a new target price. The lower that new prospective return is, the more likely we are to sell more. As prices go up and prospective returns are squeezed, the greater the potential for froth and the more likely we are to sell and shift the capital to new names or to existing holdings with high prospective returns.

Our buy and sell decisions are based on our process, not on technical trading levels or other momentum-driven strategies.

TH: I guess we saw that last year with the rails, as COVID hit and there was some tariff and trade squabbles at the same time. Movement of goods declined and so the rail stocks reflected that, and they declined significantly. And I know it was around that time — let's call it the Q1 break — Q1 into Q2. We were buying both rails [CP and CN rail] because they were cheap and very soon thereafter they hit our target price and we were selling them. So we're not traders — I know that. We're long-term investors, but by following the discipline, we got ourselves into inexpensive, high-quality names, and then when they got a little frothy, we got out of them. So I think the rails are a good example from 2020 of doing exactly what you say you'll do.

JB: You're right. I would just add, Tim — and you're very right — we aren't traders. We are investors, and when we invest in a new name, we want to look at it as a business we can own forever. However, when valuations become excessive, or when our target prices are hit, our process requires us to take some money off the table.

TH: Exactly. Let's talk about interest rates; I guess as they impact stock markets and company valuations. James, you were an analyst at a major bank, then you worked at Brookfield before joining Beutel in the early days as the Financials and Telecoms analyst. So let's focus on banks. Can you talk about the changes to valuing banks today in an ultra-low interest rate environment compared to, say, a decade ago when we were in more like mid-single digit interest rates?

JB: Tim, the valuation process for banks really hasn't changed. We still look at price-to-book, return on equity, and on earnings multiples. As rates have gone down, net interest margins have absolutely narrowed, but the valuation process has not changed. The interesting thing about lower rates, though, is that is that although they've been declining for 20 years — even longer actually — profitability has not been impacted to a significant degree. And that's because the banks have other levers of profitability growth, such as wealth management and capital markets businesses, which are fee-driven. There are also substantial opportunities for cost reduction as the business shifts away from branches to digital banking.

TH: Interesting. So sticking with the low interest rates, can you talk about their impact – low rates – their impact on valuing other let's say non-financial companies, such as Pipelines or Real Estate? I know you and the team take a very long-term view — I think that's one of your competitive advantages — but do you bake in higher interest rates in the future? Can you tell us a little about the modelling and forecasting metrics used by Beutel analysts?

JB: Sure. We try to be agnostic to rates wherever possible and we certainly never make sector calls. What we try to do is build financial models that are based on reasonable assumptions of sustaining profitability throughout all kinds of macro-economic environments. We have had difficulty finding value in Utilities and Real Estate in the last few years, and that's in part been due to the low interest rate environment that's driven valuation multiples up. What we do is wait for dislocations to buy new names. In terms of the telecom names we own, which are Rogers, Quebecor and Telus, they all have very reasonable leverage levels and if rates do go up a lot in the future that probably means there is going to be inflation. The neat thing about high-quality businesses such as these ones, is that they have pricing power to offset structural cost increases, which absolutely would include higher financing costs.

TH: Enough with the softball questions! Now I'm going to hit you with a brush-back pitch…Rogers is our third-largest holding in the Canadian Equity Fund, but it hasn't performed that well over the last year or two. Can you talk about why it hasn't done well and why you like it so much? What's the outlook for the company and the stock?

JB: Tim, to continue with the baseball analogies, I think that would be a bean ball, and not a brush-back pitch, but you know what, it's a very fair one. Absolutely the stock has underperformed and we're wearing it. But you know what? We think it represents tremendous value.

It's a high quality business that did get hit in the pandemic due to lower roaming revenue. The company has also been moving to what I would call a "quasi unlimited data pricing model" for its higher-end plans, and that has led to some one-time revenue adjustments. However, during the pandemic they have made some significant changes to their cost structure. Coming out of this, we think that revenues should normalize and then on top of that, we expect to see the added benefit of some of the structural cost changes. The company also has a number of non-core assets (stakes in Cogeco Inc., Cogeco Communications as well as sports teams and real estate), and the value of these, we think is not reflected in the current share price.

TH: Funny, I wasn't thinking about the Blue Jays when I used that baseball analogy, but of course, Rogers is the owner of the Jays and they're starting spring training now … I was thinking more about the telecom business but thank you for pointing that out! It does seem like it represents good value.

JB: Yes — Blue Jays and just under 40% of both the Maple Leafs and the Raptors.

TH: All good teams too, right now at least. Okay – thanks for the outlook. Now let's look back over your time at Beutel. Can you think of a stock that you initially missed buying, and then you had to kind of wait patiently for it to come back into your value comfort zone? I imagine that's quite difficult watching the stock take off away from you and then presumably continue on doing well for a little while, and then you've just got to, as they say, sit patiently and wait for it to come back?

JB: You know what Tim? Missing a stock that you thought was a good opportunity but you just didn't quite have the conviction to pull the trigger and you're watching it go up … that is a very painful process. A stock that springs to mind is CAE. This is a very high-quality business; it's a leading global supplier of flight simulators and pilot training, and over the course of the last 20 years, there were three great times to buy CAE. One was post 9/11, one was during the global financial crisis and the third one was in the first half of last year. We missed the first two – but we got it last year.

TH: Thanks again James, and on behalf of Beutel and to all our clients, thank you for joining us for our first mid-quarter [fireside chat]. Please provide feedback to your relationship manager so we can fine tune these events in the future, and have a great day and thanks again.

JB: Thanks.

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