DM Monthly Report

MAY 2019

PORTFOLIO ACTIVITY

In April, we opened new positions in MTY Food Group (see below) and Brookfield Infrastructure Partners in DM Canadian Equity.

FEATURE STOCK

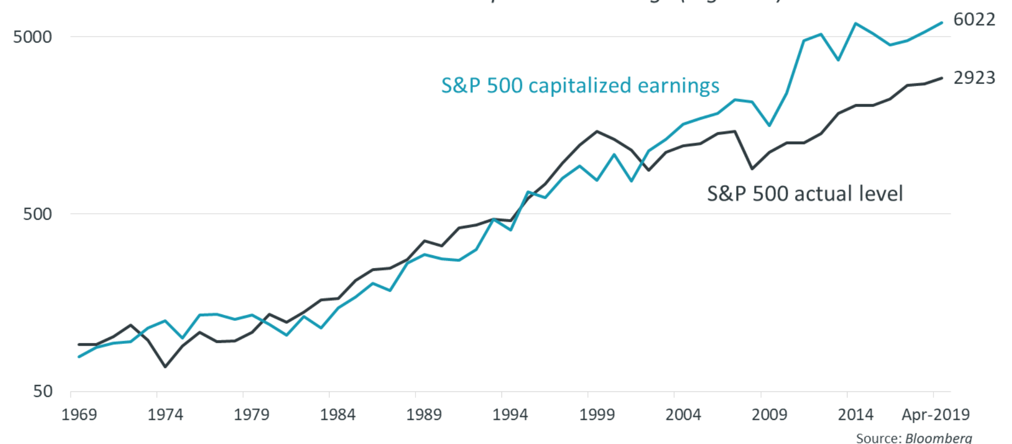
MTY Food Group Inc. (MTY)

MTY operates as a franchisor in the quick service and casual dining industry in Canada and the US, carrying more than 70 familiar brand names (e.g. Vanelli's, Yogen Fruz, Thai Express). The stock had been a long time growth generator in the DM Small Cap Fund, but as the company grew, we looked for an opportunity to add it to our broad Canadian equity portfolio. That chance came in April when the company reported soft first quarter results and announced that it would be acquiring Papa Murphy's pizza, the combination of which caused the stock to drop by just over 20%. We viewed both of these market worries as transitory and felt that MTY's strong operating and acquisition track record would once again dominate in the mid and long-term. Specifically, we like the company's demonstrated ability to integrate acquired companies and its discipline in deploying capital to maximize shareholder value. Over the past decade, for example, MTY has grown its operating cash flow from $11m to more than $100m, with negligible shareholder dilution along the way.

IS THERE A RELATIONSHIP BETWEEN INTEREST RATES & STOCK VALUATIONS?

In last month's missive, we tackled the topic of persistently low interest rates and gave our theories as to why yields have not tracked the significant economic recovery from the depths of 2009. Understandably, this anemic backdrop imparts a direct impact on expected bond performance, but should it also influence how we think about stocks? In a recent interview, Warren Buffet said, "I think stocks are ridiculously cheap, if you think that 3% on 30-year treasury bonds makes sense". In making that statement, Buffet wasn't saying that corporate earnings are about to explode or that companies are going to double their dividend payouts, but was instead suggesting that relative to their primary alternative, the expected return for stocks (and hence their current valuation) looks compelling.

Reading these words led us to update a chart we've produced in the past, which compares the actual level of the S&P 500 with the value that results if the index's earnings are capitalized at the prevailing 10yr US treasury rate. As you can see, the predicted and actual levels of the S&P track each other fairly closely until around the time of the market crash in 08/09. Since then, however, the index has significantly lagged the discounted value of its earnings. As we've said previously, this divergence could be explained by three possibilities: first, it could be that the historic relationship between corporate income and the cost of money no longer holds; second, the market could be unusually doubtful of future earnings; or third, investors don't really believe that rates can stay this low indefinitely. For several reasons, we tend to believe that it's the third condition causing the discrepancy, and even the qualifying words "if you think 3% makes sense" in Mr. Buffet's statement betray a hint of doubt. The longer rates stay low, however, the more likely they are to become accepted as 'normal' by the investing public. If that begins to occur, the appropriate question for investors might be: *Should stocks trade at the same multiple when rates are persistently below 3% as they did when yields sat at 7, 8, or 9%?* We haven't a definitive answer to that query, but won't be surprised if it becomes a hot topic of investor debate in the years ahead.



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