SEPTEMBER 2019

Cardinal Update

Don't Fear a Recession When You Have a Quality Portfolio:

The "R Word" has been cropping up as of late, especially since the U.S. 2 year and 10 year yield curve inverted briefly. When you add this signal to the trade disputes, slowing global growth and various geopolitical events, it certainly raises the risk of a recession in the next year or two.

It's not yet a done deal as employment remains strong, inflation is low and economic growth, while slowing, is still positive. There are also some unusual forces including the search for positive interest rates, central bank quantitative easing, flight to quality and aging demographics that are pushing longer-term interest rates down. But ignoring the warning signs can be perilous. So at times like this it's worthwhile to revisit how portfolios may fare in a downturn.

First, we approach investing as buying stakes in a business and not as trading stocks. Trying to time the market is futile and we'd prefer to own good quality businesses that will continue to pay out dividends while riding out the inevitable recessions that will happen. The Royal Bank of Canada was founded in 1864 and has been through multiple recessions, the Great Depression and oh, also two World Wars. Through these ups and downs, RBC has paid a dividend since 1870. The Walt Disney Company is approaching its 100 year founding and has weathered tough episodes in its early days to become a powerhouse media & entertainment company whose theme parks are a rite of passage for many kids and adults too.

What allows quality companies to manage recessionary times? They are leaders in their industries with competitive advantages. They may operate in a more rational oligopolistic industry like the rails or in regulated industries. They have experienced, strong management teams that are capable of guiding the company through difficult times and also do not make foolish, value destroying decisions during times of market exuberance. One of the most important things is that they do not overextend themselves with excessive debt and live within the means of their cash flows.

Recessions also present opportunities. How? You can think of recessions like a tide that goes out and exposes those companies that have essentially been 'swimming naked' or in other words, they have taken on too much debt or risk. These companies will struggle in a recession and present opportunities for stronger companies to either buy them at a cheap valuation or face less competition if their weaker competitors go out of business. An example is VF Corp acquiring The North Face brand in 2000 for just over US$150 million. The North Face now generates over US$2.5 BILLION per year in sales! Another example was during the 2008 Financial Crisis. While others were retrenching, the Canadian Banks had the balance sheet room for acquisitions. Scotiabank, deployed a whopping $3.5 billion over 2008 and 2009 to acquire businesses in Canada, LatAm, and Asia.

Recessions are only known once they're in the rear view mirror. So given the uncertainly in predicting the exact timing, we've found that if you go into any recession with a battle tested portfolio of quality companies then you'll protect on the downside and outperform the market over the long run. The businesses that you own will continue to reward you with dividends while taking advantage of opportunities that come with tougher times.

Company Focus:

CISCO

The world leader in networking equipment continues to perform.

The recently completed fiscal 2019 exhibited the strongest revenue growth since 2012 (+5.2%) and higher margins leading to a nearly 20% increase in earnings per share, 16% growth in free cash flow, and a 10% dividend increase. In general, Cisco is benefiting from rising usage of cloud application software and growing internet traffic at large enterprises. Specifically, current results are stemming from a new network switching cycle, a shift to subscription-based software, and growth in security products. Cisco is already the global leader in switches and is gaining share with its new products.

Looking ahead, Cisco should remain fairly defensive as it benefits from the aforementioned trends, even in the face of trade-related enterprise spending uncertainty. Cisco has a very sticky customer base, its order book (non-cancellable revenues) continues to grow, it has low exposure to China, and the shift to subscription software increases recurring revenues. Financially, Cisco has more cash than debt and generates substantial free cash flow annually. This ensures dividend sustainability and allows the company to make sensible acquisitions through a volatile market.

DIVIDEND INCREASES

Bank of Nova Scotia	3.4%
Canadian Imperial Bank of Commerce	2.9%
Royal Bank of Canada	2.9%

(During the period August 1 to August 31, 2019)