

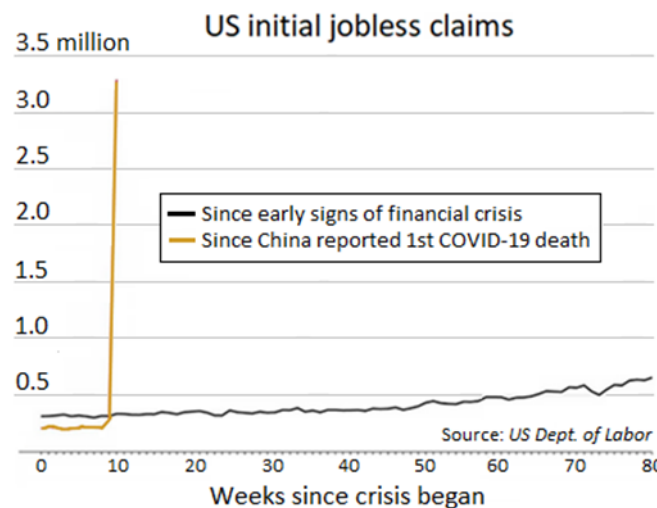
### *It's different this time*

Sir John Templeton once called those the most dangerous words in investing. To be sure, we heard them when tech stocks seemed unstoppable in the late 1990's, when house flipping was free money in the mid-2000s, and alongside virtually every other ill-fated bubble in investing history. They even applied in the opposite sense when fatigued investors convinced themselves that the financial system was irreparably broken in 2009 and fled stocks at the market's nadir that spring.

As things presently stand, however, we're fairly sure that even the late Mr. Templeton would have to admit that the otherwise treacherous phrase is for once wholly applicable. Try as we might, we can find no episode in modern times that compares to the scale and pervasiveness of the COVID-19 crisis has fallen upon all corners of the globe. Some have reached way back to the

Spanish flu outbreak at the end of the Great War as a marker, but that incident didn't include the forced halting of business to the same degree as today nor such a significant monetary and fiscal response. As well, it's difficult to make comparisons between economies so vastly different in terms of composition, development, and interconnectivity.

What we are experiencing at the moment isn't a cyclical contraction, a recession, or even a depression - *it's an induced economic coma*. To visualize what we're all living through, consider the accompanying chart comparing the first wave of US jobless claims at the end of March with the



same metric during the 2008/09 financial crisis (incidentally, the claims figure has since shot significantly higher).

While the economy was undeniably put on the mat 11 years ago, the magnitude of the takedown wasn't even in the same galaxy as what we're experiencing today. The other characteristic reflected in the graphic is the incomparable speed of the retreat, a virtually instant descent which has slammed not only real economic activity, but financial markets as well. You will have undoubtedly

read the word 'unprecedented' countless times over the past few weeks; though we usually find the use of such superlatives to be excessive and needlessly overwrought, this time it is not.

To help cushion the blow, central bankers and governments have launched Everest-scale monetary and fiscal programs, the goals of

which are to both keep markets operating efficiently as the economy-wide demand for liquidity surges and to partially refill the chasm left by diminished corporate revenue and personal income. It is hoped that these temporary measures will see us through to the time when the health battle is won and normal business activity can resume.

### **Will we get to the other side?**

Though it's not yet clear when, and success will likely vary by jurisdiction and crisis management approach, our economy will restart. The shelves and warehouses that we're now emptying will

have to be restocked; plunging interest rates and generationally low oil prices will eventually stimulate spending and investment; and the mountain of capital being let loose by governments will find its way to the real economy (and probably to investment assets as well). Though markets will undoubtedly be reorganized following the crisis and some companies either won't make it or will emerge in very different forms (more on that below), pent up demand for goods and services should ultimately spark a vigorous rebound in consumer and business spending.

The initial roadmap for recovery is being drawn in China, which seems to have mostly tamped down the virus and started the wheels of commerce turning once again. Though headline figures like GDP posted by Beijing are probably suspect (as they've always been), data closer the ground can provide a more credible gauge of economic direction. To that end, we include the adjacent graph which shows subway traffic in China's six largest cities for the first part of the past three years.

As you can see, ridership always falls at Chinese New Year, but with the onset of COVID-19 in early 2020 it declined further than usual and stayed down for an extended period. Now, however, as efforts to stem the disease's spread have gained traction, workers - *and presumably general business activity*- are back on the move.

Of course, North America's ability to join this path is entirely dependent on the virus and, more specifically, our management of it. Though there's presently a raging bull market in armchair epidemiology, we're just wise enough to know

that we have little to offer in this area and so won't guess when our turning point might come. What we do know, however, is that markets tend to be much more forward looking than individuals and will likely begin to sense and respond to any trace of improvement long before conditions on the ground feel anywhere close to normal.

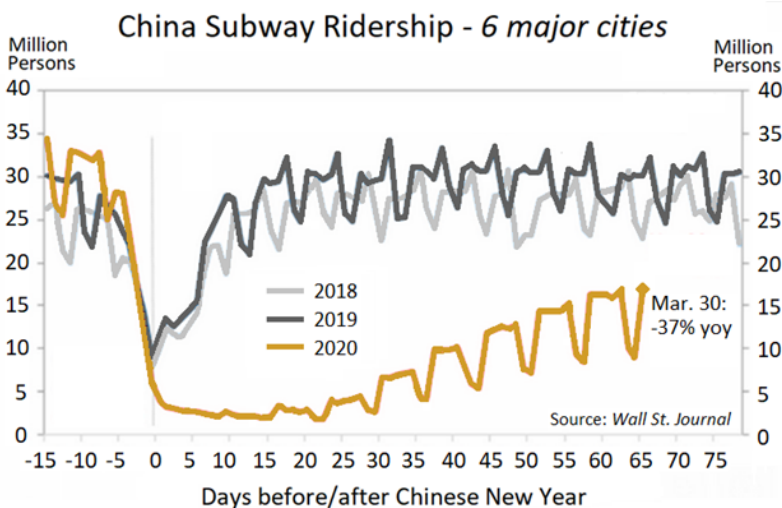
## 20 quarters of earnings

The next two or three sets of earnings reports are going to be horrific, perhaps historically so - *how could they not be, with airplanes sitting idle, factories shuttered, and most of the consuming population holed up re-watching the last Super Bowl or teaching themselves how to bake bread.*

Some or all of this has been accounted for by the stock market's violent fall, however, so the proper investment question from here isn't whether things are going to get bad - *they will* - but rather will they get worse than what stocks are currently discounting. Unfortunately, just as we can't predict when

COVID-19 will be under enough control to restart the economy, neither can we say exactly what level of near-term difficulty is already imbedded in equity prices.

From a true investment perspective, though, whether the market has under or overshot what might transpire in the next three or nine months should start to diminish in importance. Stocks have emphatically taken in everything that is now known and collectively forecast about the crisis, so to focus analysis on near term events is about the same as saying that one knows something that the broad market (and the sum of all opinions, learned or otherwise) doesn't. Being right with such a call at this point would likely be owed



as much to luck as to prescient analysis.

A better way to frame our thinking from here is to return to a proper equity time horizon, such as five years or 20 quarters. Whether the economic deep freeze begins to thaw next month or in three probably won't make a big difference to what strong companies with in-demand products and services are able to do over the medium to long term. Instead of assessing individual stock values based on the sheer drop-off that's already in place, we believe we're better off asking whether current prices look attractive relative to what earnings might look like when the economy is back on its feet again. It's likely that markets will soon start to reflect the same type of 'next phase' thinking as well, if they haven't already.

If asked about stock valuations at the beginning of the year, we would have said that they looked a bit expensive, but not enough to warrant upending an invested portfolio or triggering a pile of taxable gains. The economy was on a modest upswing, strategists who had been sure of a coming recession a year earlier were now silent, and absent inflation had kept interest rates at levels that made the earnings yield on the broad market look very attractive (in fact, the 'equity risk premium' was about as high as it had ever been). Those who had taken bearish bets were deeply underwater and, quite frankly, dead wrong about what was actually transpiring in the economy.

We now face a new economic reality, though, brought about with historic suddenness; at the same time, stock prices are also significantly lower than what they were just six weeks ago. These competing attributes necessitate a fresh look at portfolio holdings, with targeted adjustments made both to shore up portfolio safety against the deluge and to optimize positioning ahead of an eventual recovery.

### DM's portfolio response

In fixed income allocations, our most significant

concerns as the COVID crisis took hold were liquidity and credit worthiness, characteristics which are now closely intertwined. Companies that had assumed high debt loads in recent years on the back of low rates and the assumption that stable earnings could be relied on to meet interest payments are now in much more difficult positions than could have been imagined just weeks ago. At the same time, the anxiety-driven rush for cash exerted unusual pressure on some segments of the bond market, forcing prices markedly lower than fundamentals might suggest and impeding the ability to effectively manage such positions.

Over the past two and half years, we had been actively reducing our lower-rated corporate credit exposure, not because we saw an economic crisis coming, but because we felt that the spreads being offered to hold such securities had become too skinny to merit excess exposure. Though this stance put our bond allocations in a relatively strong position when the downturn hit, we were also quick off the mark to improve this stance further by liquidating select corporate issues and using resulting funds to re-balance accounts.

On the equity side of portfolios, our first point of consideration as the economy screeched to a halt was *survival*. In other words, how long could each company meet its fixed obligations in a scenario of significantly reduced revenue and how much capacity did it have to expand its balance sheet if necessary? These goals have been met through a furious work pace by our investment team which has focused on:

1. Qualitative factors, such as the discretionary nature of product offerings; links to highly impacted industries such as travel; exposure to government shutdowns and social distancing measures;
2. Quantitative factors, including durability of cash flow, net debt load, fixed costs, and liquidity considerations; maximum loss scenarios were also modelled via a full bottom-up

underwriting of all holdings;

3. Management interviews with as many companies as possible and tapping all available resources to gain a stronger sense of conditions on the ground not yet reflected in posted financials.

Because high rates of cash flow generation and balance sheet strength are core inputs to our equity evaluation process, the bulk of our positions came out of this evaluation in good shape. An area to which we did ascribe significant risk, however, was the exploration and production sub-set of the energy sector, in light of both the cascading price of oil and the dramatic shift in credit market conditions. Accordingly, we liquidated virtually all of our exposure to this group in the early days of the market decline. Elsewhere, names which we considered to be structurally challenged under the new paradigm were also eliminated, with resulting capital allocated to holdings which we believe are well positioned for an eventual recovery. This process will continue as business conditions evolve and we uncover additional opportunities to improve and focus mandates against this backdrop.

### Summary

Much as we'd like to, we can't prevent crises or market panics and if we spent our time and energy trying to anticipate them, we'd undoubtedly predict many more than actually took place. As

process-driven investors, however, we *can* control how we respond to such events. In this case, process has meant examining individual holdings carefully and shifting capital away from those which might be significantly or irreparably impaired by recent events and moving it to toward those with the balance sheets and business mix to weather the storm. We believe that many of these survivors will not only emerge from the crisis but will do so in positions of relative strength.

In past commentaries we've discussed the possibility that markets are in the midst of a long-term, secular bull market. Such moves have historically been multi-decade in duration but have often included severe detours along the way (such as the Crash of '87 partway through the prodigious 1982-2000 ascent). Our case for stocks is founded on innovation, historically low interest rates, and a persistent shift from capital heavy (e.g. mining and energy) to capital light business (e.g. services and technology), which tend to leave more cash flow available for the shareholder. These attributes have not only remained intact during the COVID-crisis, they have generally been enhanced and/or accelerated by the episode. When we get to the other side of this difficult time, we're confident that the stocks that meet these criteria, and which are the focus of DM equity mandates, will lead the market once again.