MAY 2020

Cardinal Update

Value Investing in a Covid-Driven Downturn

The S&P 500 and S&P TSX are now down just -11.6% and -14.5% respectively since the beginning of the year, an amazing recovery from March 23rd lows, down over -30%.

However, a big portion of the market's gains have come from just a few companies, mostly technology. Consider that in the S&P 500, the median performance (meaning the point where half of stocks are below and half above) was -18.4%, almost 7% worse than the index performance. The median stock in Canada was similarly weak.

What does this mean? It means that an ever-smaller group of large companies are driving the majority of index performance. In the U.S., the five FANG stocks plus Microsoft now account for over 20% of the S&P 500. This group accounts for most of the difference between the index and the median. Amazon and Microsoft alone account for almost half of the divergence. In Canada, the concentration of winners is even more stark. Shopify, a business to business ecommerce leader, is up 70.4% in 2020, outperforming the index by 85%. Given that Shopify is now the largest company in Canada, the TSX would have been 3% weaker in 2020 without Shopify!

The continued dominance of technology (the S&P 500 tech index was up a sizzling 54% in 2019 and over 60% in for the tech index on the TSX in Canada) is contrary to what happens in a normal downturn, where the best performers on the way up have the worst performance on the way down. We understand the thematic logic. In the current Covid-driven downturn, society has become more dependent on technology, from using more Zoom and Microsoft Teams at work, to streaming more Netflix and Disney at home.

But the core belief of a value investor is that the success of an investment depends upon the quality of the company *and the price paid for that company.* Thus, even the best companies become poor investments at too high of a price.

Consider Apple, perhaps the most successful and iconic company in history. Over the past fifteen years, shares in Apple have appreciated by over 30% annually including dividends. Revenues grew at a sizzling 40% annually from 2005 to 2015 but slowed to around 11% annually over the past five years. Apple's earnings per share growth followed a similar trajectory, growing 45% annually from 2005 to 2015, and then slowed to 11% annually over the past 5 years.

Of course, like many of the biggest success stories, Apple's growth did not seem as inevitable in the past as it does now in hindsight. The iPhone had yet to be invented in 2005 and most investors viewed Steve Jobs' genius for design as being offset by his fanaticism for control, a factor that allowed Bill Gates' Office software, available to all PC makers, to dominate Apple's proprietary Mac software in the 1990's PC wars.

After Apple did unveil the iPhone in 2007, it had to unseat dominant players such as Blackberry, Motorola and Nokia, and then fend off challenges from Samsung and LG, as well as Google's Android in mobile phone software. Then, in 2011, with Steve Jobs finally proving his business genius beyond a doubt, his untimely death required the company to transition leadership to Tim Cook, who subsequently proved his critics wrong and went on to do an amazing job.

Despite all of this, we regret not purchasing Apple because the price of the company has traded in the range of 14 times earnings and 3 times revenues at different points over the past decade, a reasonable enough level that the risks noted above were arguably priced into the stock. Apple currently trades at closer to 23 times earnings and 5 times revenues, somewhat higher than we would like to pay, but cheaper than the other FANG stocks, in the 27 to 50 times earnings range.

So, what about a company like Shopify in Canada? By all accounts, the company has put Canada's tech industry on the map and has an excellent growth model providing businesses with ecommerce and back office solutions. Shopify's revenue growth rate is close to 40% per year, close to Apple in its heyday. Will Shopify today become the Apple of tomorrow?

Rest assured that Shopify will have to overcome many of the same challenges that Apple did, unseating powerful incumbents, fending off new challengers, and probably even completely reinventing its business model and services as technology and the competitive environment changes.

But let's suspend any of these doubts and assume that the company continues its blistering 40% annual revenue growth over the next decade as Apple did and then further assume that it grows into the same fat profit margins as Apple versus being unprofitable today.

Clearly, these assumptions are akin to arguing that today's leading 15-year old hockey player is set to become the next Sidney Crosby. But the reason we are not buying Shopify, and do not believe we will regret the decision in the future, is not the company's quality or growth prospects. Our concern is price.

In 2005, Apple traded at 2.5 times revenue and was profitable. Shopify today trades at 55 times revenue and is unprofitable. *Based on revenues, Shopify is 22 times more expensive than Apple was in 2005.* **Thus, if shareholders in 2005 bought Apple at the same valuation metrics that shareholders are buying Shopify today at, these same Apple shareholders would have earned a 6% annual return instead of a 30% annual return.**

To return to our hockey analogy, every NHL scout can only dream of locking in the next 15-year-old Sidney Crosby to a multi-year contract, but not if the offer is half of Crosby's current salary! After all, for every Apple, there tends to be a forgotten graveyard of Nokia's, Blackberry's and Motorola's.

At Cardinal, we continue to emphasize value. We like technology companies and some of our current holdings such as Intel, Cisco, and Sony do trade at roughly three times revenues and 12-14 times earnings. In fact, Cardinal's average price to earnings in our Canadian and U.S. holdings is just over 13 versus 16 and 20 for the S&P TSX in Canada and the S&P 500 in the U.S. Our holdings continue to grow dividends, increasing by over 10% annually in both Canada and the U.S. over the past five years.

We have high conviction that this trend will continue, even for some of the companies in the portfolio where share prices have fallen. For instance, Bank of Nova Scotia currently trades for just 8 times last year's earnings, which were over $8 billion dollars. These earnings may fall this year due to the weak economy but will rebound quickly as conditions improve. Given that the bank has often traded in the 12 times earnings range, we can easily envision 50% upside to the shares. Our expectation is that the economy will have largely recovered by early 2021, but if it takes a bit longer than that, the good news is that BNS pays a rock solid 6.5% dividend while we wait.

We continue to believe that only the combination of owning great companies *and paying reasonable prices* will lead to long-term investment success. We are committed to the philosophy of value investing, as we have been since our inception.

COMPANY FOCUS – INTEL

Intel's business is continuing to thrive through Covid-19. In its most recent fiscal quarter ending March 30, 2020, the company generated $19.8B in revenues, up 23.5% year over year, and $1.45/sh in adjusted EPS, up 62% year over year. As the market leader in CPU's with 80+% share in its key markets, Intel is benefiting on two fronts.

The first is in the PC market where sales of notebook computers increased by 19% this quarter. The drastic shift to working from home left companies and employees who traditionally used desktops to scramble to acquire laptops. We would not expect this level of growth to continue long-term as PC's are a mature market, but we would be lying to say it's not nice to have.

The second, and longer-lasting, trend is in datacenters where sales increased by 43% year over year. Datacenters saw across the board strength from Cloud Service Providers like Amazon, Google, and Microsoft, Communications Service Providers like Verizon, and Enterprises/Governments. The key trends here are an acceleration of moving workloads to both public and private clouds and the proliferation, generation, and analysis of more data than ever before. These trends have accelerated with increased video collaboration and e-commerce, but will also be a source of growth for Intel in the foreseeable future.

DIVIDEND INCREASES

Johnson & Johnson	6.3%

(During the period April 1 to April 30, 2020)

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