Cardinal Update

Hindsight is 20/20

A LOOKBACK AT AN UNPRECEDENTED YEAR

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Unprecedented was a term often used in 2020, and it's hard to find a better word to describe the year. 2020 started out ordinary enough with many economies humming along, and the U.S. Presidential election was seen as the mostly likely event that could unsettle markets. Instead, we found ourselves facing down a global pandemic the likes of which the world had not seen since the Spanish Flu in 1918.

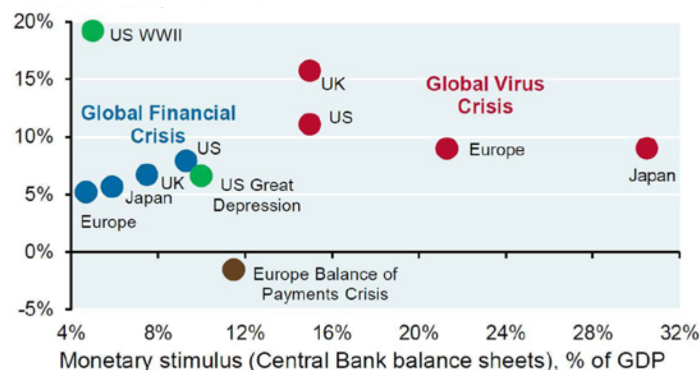
On March 11, the WHO declared a global pandemic just days after Italy went into a nationwide shutdown. Many countries soon followed suit with Canada closing the land border with the U.S. on March 18 and several provinces declaring states of emergencies. Equity markets began to decline from their February 20 peaks and we experienced one of the fastest equity bear markets with the S&P/TSX and S&P 500 touching lows on March 23 that were down 37% and 34%, respectively. On the economic front, we were looking at one of the biggest drops in GDP and unemployment levels rivaling the Great Depression.

What put a floor under equity declines was monetary and fiscal stimulus in the developed markets, far greater in size than we had seen before, and delivered in record time. The chart on the upper right shows the scale of the stimulus in comparison to the Global Financial Crisis and the U.S. Great Depression. Previous stimulus responses look like pocket change in comparison to the Global Virus Crisis! This significant and rapid response arrested the market declines and led to many stocks, especially those in the essential or 'stay at home' category recovering swiftly.

The extraordinary stimulus measures produced previously unseen outcomes. Normally in recessions, average incomes decline, and consumers have to tap their rainy-day funds to get them through tougher times. This time though, average incomes rose because of the stimulus programs as the income assistance was not targeted solely to those who needed it most. The extra income along with not spending on services like travel and eating out, saw savings

STIMULUS RESPONSE TO COVID SETS A NEW BAR

Fiscal stimulus, % of GDP



Source: Central bank sources, OMB, St Louis Fed, JPM Global Economic Research, JPMAM, December 2020
Source: JP Morgan

rates grow substantially as shown in the chart below. Consumers began using these additional funds on things like home offices, home gyms, backyard projects and campers. Ultra-low interest rates helped support the housing market.

At the same time, industries were upended overnight. Theme parks, movie theaters, and class A malls went from full to empty. Conferences, events, and concerts went to zero. Auto sales ground to a halt. Air travel stopped. Oil demand fell an unprecedented 15-20%. Then there were less obvious effects like a steep drop in medical procedures. Revenues declining 25% in a recession is to be expected. Revenues going to $0 is not a scenario that businesses had contemplated. This is particularly true for our investment style of selecting blue-chip, market-leading, large-cap dividend paying companies.

SAVING RATES FOR CANADA AND THE U.S.

Source: Bloomberg

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CARDINAL CAPITAL MANAGEMENT, INC.

In a matter of days, we had to completely reassess many of our businesses. Would they survive? Will there be liquidity available from the banks? Can the balance sheet handle 50, 60, or 70% declines in revenues? Will the industry need to be bailed out? As the days went by, we believed even our most affected companies had extremely strong likelihoods of survival.

The next step was more difficult. Should we make changes to the portfolios? Should we reposition the portfolios towards essential pandemic businesses? Are there any companies at risk of dividend cuts? With the markets falling every single day and individual companies exhibiting even greater volatility, making these decisions was challenging. Share prices for some companies were moving 5+% every day. Companies affected by pandemic shutdowns were trading as if their businesses would be permanently impaired. The work from home (WFH) beneficiaries were trading above their early March levels by April. With the power of hindsight, the WFH winners just kept on winning for the majority of the year. The buys and sells we made through this period were to protect against dividend cuts that had not already occurred, to take advantage of opportunities where companies were overly penalized by the pandemic, and into companies we saw as beneficiaries of the pandemic whose share prices were not behaving as such.

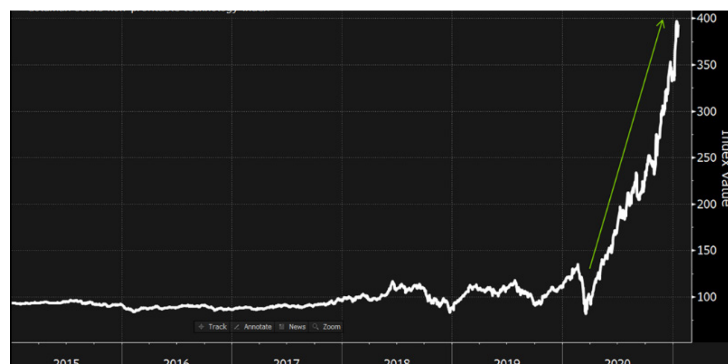
We measure our success on selecting companies that pay and grow their dividends over time. In Cardinal's Canadian Equity portfolio, 70% of our companies increased their dividends by an average of 8.4% for the year. 20% of our companies maintained their dividend. And, unfortunately, 10% of the companies cut their dividend. Overall, the Canadian Equity portfolio saw an average 8% increase in income year over year. The TSX Composite comparatively had 55% of companies increase dividends, 35% maintain, and 15% cut. In Cardinal's Foreign Equity portfolio, 46% of our companies increased their dividends, 46% maintained, and 8% decreased. On average, portfolio income increased 4% year over year. A combination of U.S. and European indices comparatively had 54% of companies increase their dividends, 21% maintained, and 25% decreased. Overall, the execution of our philosophy compared well versus the indices with respect to dividend sustainability and growth.

Along with growing dividend income, share prices kept rising into the autumn although markets had a notable bias towards more growth and momentum oriented stocks. In many cases fundamentals did not matter as the chart on the upper right shows how shares of money-losing U.S. tech companies soared. The value-oriented strategy had its moments of out performance, but it wasn't until the November vaccine announcements that were kicked off by Pfizer on November 9 that we saw a solid rotation into value stocks. The vaccine news was better than hoped and it spurred one of the strongest months for equity market returns with value stocks leading the way. Vaccines were approved soon after and began to be administered.

WHO NEEDS EARNINGS?

Shares of money-losing U.S. tech companies soar almost fivefold in 1

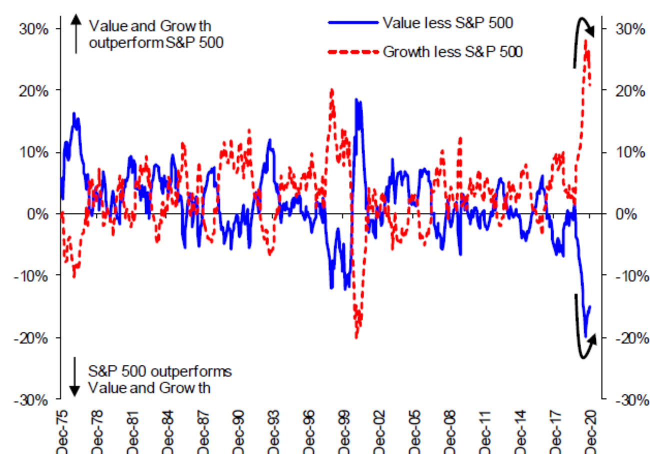
Goldman Sachs non-profitable technology index



Source: Bloomberg

The line of sight to an end to the pandemic gave the markets more confidence that the economic recovery would continue all while most governments continue to provide fiscal support and central banks have committed to keep rates low. As economies reopen, the pent-up savings and demand could set up for some of the fastest growth rates in decades. Valuations for some market segments, particularly for many stocks with outsized gains in 2020, are overly expensive. But there is still plenty of value to be found. Three pillars support our confidence including reasonable valuations relative to the market, a strong economic recovery for 2021 and inflation moving higher even as short-term interest rates stay low. As shown in the chart, the pendulum has only begun to swing back towards Value. We expect the gap to keep closing over the next couple years all while investors continue to earn a growing dividend stream.

MSCI USA VALUE & GROWTH RELATIVE RETURNS (vs. S&P 500, YoY)



Source: Scotiabank GBM Portfolio Strategy, Bloomberg
Source: Scotiabank Research

COMPANY FOCUS – BECTON, DICKINSON & CO.

Becton, Dickinson & Co. (BDX) is a medical device company focused on improving medical discovery, diagnostics and the delivery of care. BDX is the dominant player in its core markets which include syringes, tools, pumps, and blood collection. 85% of revenues are recurring as the majority of its products are single-use. While the COVID-19 pandemic has caused the deferral of many healthcare procedures which in turn has led to headwinds in certain areas of BDX's business, it has also created opportunities in areas such as COVID-19 testing and vaccine administration.

BDX has raised its dividend for 49 consecutive years and the dividend yield is currently 1.3%. The dividend has been increased at a 4.7% compounded annual growth rate over the last 5 years and we expect dividend increases to be even higher going forward. BDX recently finished de-leveraging its balance sheet following the acquisition of C. R. Bard in 2017. With a P/E multiple of 20x, BDX trades at a discounted valuation versus its medical device peers and we see a potential for this gap to narrow with consistent execution.

DIVIDEND INCREASES

Allied Properties REIT	3.1%
Canadian National Railway	7.0%
Comcast	8.7%
Intel	5.3%
Novartis	1.7%

(During the period January 1 – 31, 2021)

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