



Fall 2019

We are experiencing unprecedented financial markets.

For the first time in financial history, we are experiencing negative interest rates. There is fifteen TRILLION dollars' worth of negative fixed income instruments held today; mostly in Europe and Japan. Some speculate that negative interest rates are inevitable in North America and ultimately globally.

Simply put, negative interest rates literally mean that one is paying a bank or borrower to take their money. For example, if you deposit money in a bank or lend out one hundred dollars today you expect to receive 95 dollars when you withdraw it in five years. The objective is to encourage consumers to invest in productive assets for a potentially better return and increase their consumption.

The strategy hasn't worked. In countries where negative interest rates have been implemented growth continues to be anemic if not non-existent. Negative interest rates infer that the purchasing power of money will be greater in the future than it is today. In other words, a severe slowdown is in the offing accompanied by deflation. This implied economic scenario is quite serious. Deflation typically results from a severe recession or worse.

The current situation presents a profound intellectual inconsistency. Deflation results in a loss of value for all asset classes except for the highest quality government bonds and a few very high quality global corporate bond issuers. Corporate debt, real estate, and equities will all fall simultaneously should deflation take root. Recall, deflation means falling prices for goods and services which in turn bring down the value of businesses and assets such as real estate. Yet we have asset bubbles across virtually every asset class!

In the short term, this policy has encouraged a global bubble in fixed income markets, real estate and in many equity markets; particularly in the United States. In the desperate search for income, investors have jumped into any investment

that holds the potential for a return. Rising asset values and speculative capital gains have been confused for sustainable and predictable income streams.

The search for growth and returns has led to two areas of particular excess in the equity markets. The first is the so-called “Unicorns”. These are companies that provide products or services typically using a mobile phone application. Unicorns are considered to have tremendous growth potential because of their perceived first-mover status; brand name and scale provide an insurmountable competitive advantage. Interestingly, they are viewed as high tech companies despite their very common product offerings because consumers interact with these services through a computer or mobile device. Large losses, negative cash flows, and growing debt are ignored in the belief that revenue growth will ultimately result in a profitable and sustainable business model.

The situation is best summarized in *The Atlantic Magazine* (October 18, 2019):

“If you wake up on a Casper mattress, work out with a Peleton before breakfast, Uber to your desk at a WeWork, order DoorDash for lunch, take a Lyft home, and get dinner through Postmates, you’ve interacted with seven companies that will collectively lose nearly (US) 14 billion this year.

... If you use Lime scooters to bop around the city, download Wag to walk your dog, and sign up for Blue Apron to make a meal, that’s three more brands that have never recorded a dime in earnings...”

The total value of the companies mentioned above is well over \$200 billion despite the dramatic losses being reported. The growth in revenues and profitability required to justify the current valuations attributed to these enterprises is a near mathematical impossibility. These investments will eventually result in a large and permanent loss of capital.

The second group of businesses that have experienced a surge in investment demand has been ‘dividend growth companies’. The thesis behind these

investments is straightforward; familiar high-quality companies with a history of growing dividends are a smart alternative to low yielding fixed-income securities. Coca-Cola and Proctor & Gamble are but two examples.

In today's environment this proposal sounds very attractive; especially when packaged in very effective marketing materials and messages. In many cases, this option is being promoted to those who need an income stream. These investments' shares have performed well and the promise of continued capital appreciation of these "capital-light compounders" is an additional selling feature.

The companies being purchased in these portfolio strategies are mature, high-quality businesses with a history of growing dividends. It is a virtual certainty that these investments as a group will continue to pay and grow their dividends over the next several years. It is also a virtual certainty that these investments will provide very low if not negative returns over the next three, five and ten years.

As always our conclusions are drawn from facts and historical evidence. Today high-quality dividend-paying stocks trade at approximately 25x earnings. The results in Table 1 are derived using the following assumptions; initial dividend yield of 3%, a payout ratio of 75% and an expected annual dividend growth of 4%. The table below provides expected **total returns** under various scenarios.

Table 1
Expected Return from Dividend Growers

	Pessimistic P/E 14.0x	Historical P/E 17.0x	Optimistic P/E 20.0x
One Year Return	-38.64%	-26.16%	-13.68%
Three Year Return	-12.77	-7.22	-2.26
Five Year Return	-6.42	-2.89	0.20
Ten Year Return	-1.35	0.50	2.08

The most optimistic scenario assumes a P/E ratio of 20x ten years hence. Even under this outcome, the annualized total return is 2.08%. A more realistic expectation, based on historical trading multiples produces a return of essentially zero. Returns over shorter time frames are even more disappointing.

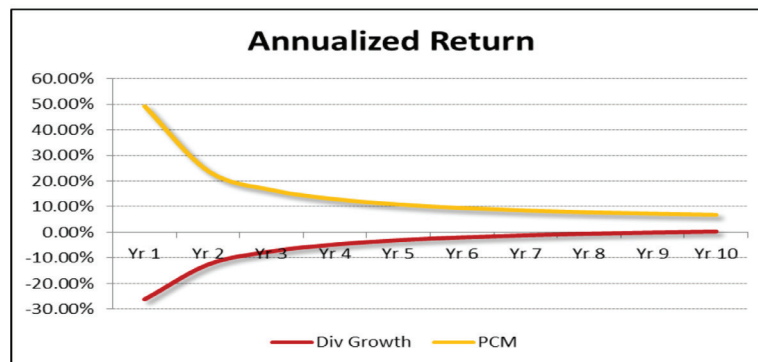
This analysis may surprise many, especially when the starting point is a 3% dividend yield growing at 4% annually. The key driver of all returns is the valuation at the time of purchase. A growing dividend cannot offset a future decline in the P/E ratio to more normalized levels from today's historically high levels. Headwinds are difficult to overcome.

At PCM we have taken a somewhat different approach. We have constructed a portfolio of equities yielding approximately 5%. Unlike, the above analysis, our equity holdings have been purchased at historically low valuations of approximately 10x earnings. We expect that these investments will trade up to their historical valuations, providing substantial capital appreciation in addition to the current dividend yield. Using the same methodology, we conservatively assume the following; initial dividend yield of 5%, a payout ratio of 50% and an expected annual dividend growth of 3%. Table 2 below, provides expected **total returns** under various possibilities. Note that PCM's strategy potentially provides a better return, under every scenario, than the dividend growth approach, despite far more conservative assumptions. Valuations moving up towards normal historical levels provide a very strong tailwind that drives substantially higher potential returns.

Table 2
PCM Potential Equity Only Returns

	Pessimistic P/E 12.0x	Historical P/E 14.0x	Optimistic P/E 16.0x
One Year Return	28.75%	49.35%	69.95%
Three Year Return	10.95	16.58	21.71
Five Year Return	7.70	10.95	13.85
Ten Year Return	5.32	6.90	8.29

The graph below illustrates the returns of PCM's philosophy versus a dividend growth strategy assuming multiples for each respective portfolio return to historical averages. We prefer tailwinds!



PCM's investment philosophy works because we purchase securities that are temporarily out of favour. As the preceding discussion illustrates, our approach provides superior potential returns in the long term, but there is a short term cost. This cost is not financial. It is the uncomfortable feeling that comes with owning businesses that are garnering negative headlines and are not popular. Furthermore, as we consistently experience, the initial share price movement after we purchase our securities is down. This is particularly true in the current era of automated and algorithmic headline based trading.

For the vast majority of investors, our approach is difficult to live with. It requires a very high degree of confidence in both the process and more importantly in the people implementing the strategy. We are truly grateful for your trust in us and your continued patience. You are the envy of the industry!

All of us at PCM wish you and yours all the best for the holiday season and a very happy New Year!

Vito Maida



Patient Capital Management Inc.