Stewart Financial

Thoughts that count

July 2022

A Spanish lesson

Being unable to speak Spanish was a serious problem when I was trying to navigate the Barcelona bus system in 1997. Google translate didn't exist yet, so I used a borrowed English-Spanish dictionary to navigate the multiple transfer expedition through Spain's second largest city. I was at the end of a post-university medieval church tour/European pub crawl and sadly had run out of money and needed to change my airline ticket home. At the time, airline tickets were physical, and the only way to get my updated voucher was to pick it up at the airline office in the outskirts of town. After a confused and tiresome journey, I finally arrived at the correct address and obtained my new ticket. Then I had to do it all again in reverse. It took me all day.

I find it fascinating that 25 years later; finding, booking, paying for, and receiving an airline ticket takes less time than it does to read that last paragraph. No phone calls to travel agents, no buses, no translation issues, just type, click and go. Awesome!

Recently, I decided to take my family on a summer trip and needed to book a flight. Because the world has been locked down on-and-off for the past 24 months, I was excited to start planning our getaway. As I logged on to the airline's website (thankfully no Spanish translation necessary) I felt three different emotions; I was excited (yeah, I finally get to travel!), I was cautious (everyone else wants to travel too and I don't want to overpay), and I wanted to be rational (this is a vacation after all, I want to ensure our trip is fun). Each of these emotions leads to a different booking strategy, outlined below.

Emotion	Reasoning	Representative thought	Booking strategy
Excitement	Because of Covid, I haven't travelled which causes me to be even more enthusiastic about a vacation.	"I want the experience; I don't care what it costs"	Buy best flight available regardless of price.
Cautious	Too many people are travelling, and airports are too busy. Look for flights with multiple layovers to save on ticket cost or delay purchasing right now.	"I want to travel, but don't want a negative outcome"	Wait until prices fall or delay trip.
Rationality	My vacation should be relaxing. I recognize there is a cost to flying and within reason, want to maximize family time while minimizing cost.	"Time is as important as cost"	Book a direct flight, at a reasonable time, which gets my family to its destination at a convenient time.

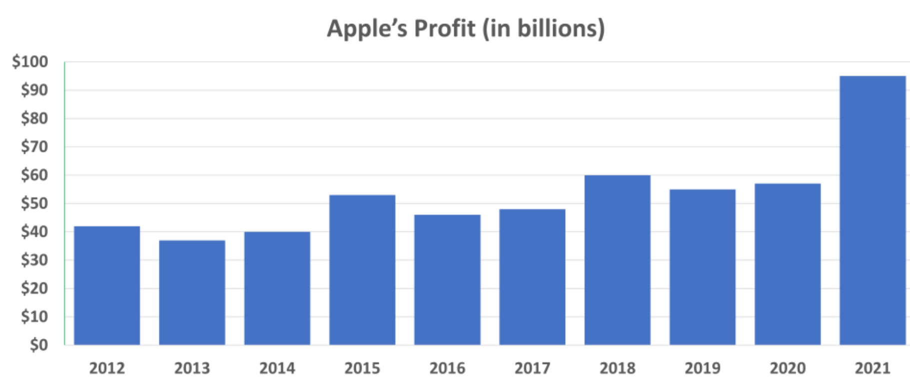
If I book a flight in a heightened emotional state, I am more likely to make a poor decision. Getting overly excited will cause me to overpay, while being too cautious may mean I miss out on a family trip altogether. The best decision is to be rational, to accept that travelling in a busy time will not be perfect, but the goal is to realize a family experience. As time passes, the only thing I am going to remember is the family getaway, not the cost or experience of the flight.

When investors make decisions, they face the same emotional challenges I did when making a flight choice. However, instead of vacations, emotional reactions are induced by the pursuit of investment returns and the compulsion to avoid loss. The type of reactions investors experience from pursing profitable opportunities is highly influenced by the state of the prevailing business cycle. When times are good, and the market has been advancing for some time, investors react with excitement, seeing only return potential without regard to risk. This is exactly the market we have experienced the last few years. When markets are highly uncertain, like today, investors take a far more cautious approach. This emotional pivot from enthusiasm to fear usually occurs abruptly, which exasperates investors. The ensuing emotions and investing strategies are outlined below.

Emotion	Reasoning	Representative thought	Investment Strategy
Excitement	The market has been advancing for some time, embrace risk.	"I don't want to miss an opportunity"	Buy maximum growth investments.
Cautious	The market is uncertain, and the headlines I am reading are scary.	"I want my money to grow, but I do not want to lose money"	Wait until trends are all positive again before investing.
Rationality	Investing is a process, over an entire business cycle. I recognize there is uncertainty in all investing, and within reason, want to maximize my return while minimizing risk.	"There cannot be return without some risk"	Make reasonable investments, which over time have the highest chance of helping me achieve my goals.

Flipping between excitement and caution is the trap many investors fall into, never letting the business cycle run its full course. Long-term investments need the benefit of a full cycle because the future is permanently uncertain; patience is always required. There is simply no way out of this truth. Investment decisions made in an excited state may result in overpaying for investment growth that will not continue through the trough of the business cycle. Being too cautious may mean missing the rebound segment of the cycle, resulting in insufficient returns to meet an investors' ultimate goals.

As an example of how this works in practice, consider the company Apple. Apple sells many things people want and it makes a lot of money doing so; last year Apple made $94 billion profit (income minus expenses). That means during 2021 they made $257 million every single day. Below is Apple's impressive annual profit over the past 10 years:

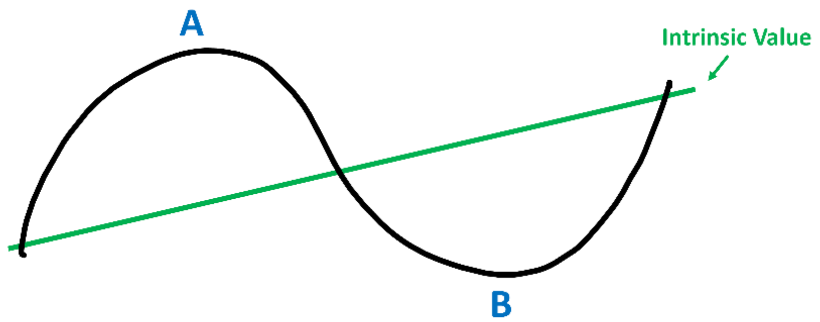


Investment markets have performed well over the last few years and so has Apple's stock. Much of this increase can be attributed to Apple's continued profit growth. In the first quarter of 2022 this uptrend continued; Apple's profit increased 6%; what was the stock's reaction to this news? A rational investor would expect the stock to increase when profits rise. That is not what has happened. Apple's stock has fallen 25% this year, despite its profit growth. The primary reason it has fallen so dramatically is because investors have moved from 'excitement' to 'caution' for reasons which have little to do with Apple itself. This relationship is modeled in the figure below.

Stewart Financial

Thoughts that count

July 2022



The green line represents the "intrinsic value" of Apple stock over time; the price an investor is comfortable paying based on the profitability of the company. An intrinsic value is neither high nor low, it is an investor's estimation of what the company is truly "worth". Intrinsic values do not fluctuate easily, while market prices change (because of human emotions) all the time. Every asset you own has an intrinsic value; it is the price at which you are indifferent buying or selling should someone make you an offer. If the intrinsic value of your watch is $500, you would be happy to sell it if someone offered you more than $500 and unwilling to sell it for an offer below that amount.

If the market price of Apple stock exceeds the intrinsic value, an investor would be comfortable selling the stock and locking in a gain. If the market price is trading below intrinsic value, investors should be interested in buying the stock as over time it will trend back toward its true long-term value.

The black line represents the business cycle over time. When investors are excited, they are in position A; willing to overpay for Apple stock. When sentiment turns (fear of recession, high inflation, war in Europe, etc) the business cycle slows, and investors move to position B; significantly cutting what they are willing to pay for Apple stock. The antidote to this situation is to use Apple's 'intrinsic value' as the litmus test for whether the current market price represents a reasonable investment, rather than focusing on extraneous information. With this view, investors will not get over excited nor unnecessarily pessimistic, irrespective of where we are in the business cycle. This is the correct way to view investments, but it's a concept often forgotten or disregarded, especially in times of stress.

After several good years of returns, 2022 is off to a rocky start. Investors have become fixated on higher inflation and interest rates, which have caused markets to falter. In the first half of the year, US stock markets have decreased 20%, and bonds have fallen 15%. Our defensive positioning has helped protect our portfolios this year as we increased our positions in cash and hedging strategies. As well, overweight positions in the energy sector, and limited exposure to long-dated bonds or overvalued technology stocks have helped protect capital.

While the business cycle is slowing, after years of above average growth, this is rational. Even though the market has been difficult, there are some positive developments; because of increasing rates, we can once again invest in conservative bonds which pay a reasonable rate of interest, a strategy that has been out of reach for many years. As well, there are segments of the market, such as dividend growers, which have performed extremely well even as the overall market has struggled. We will continue to hold a defensive bias for the foreseeable future.

Just as no one knows exactly when markets will turn from peak to trough, no one knows exactly when they will reverse course again. It is during difficult periods where the greatest gains are generated, as temporarily depressed quality investments return to their intrinsic values. There are many investments which traded well above their intrinsic values last year, which are off those levels by 20% or more. The market is having a *seat sale*, and over the medium and long term that will be a good thing for patient investors.

Your *looking forward to getting out and exploring the world* portfolio manager,

Duncan Stewart, MBA, CIMA, FCSI, CFP, CPWA
duncan@stewartfinancial.ca / duncan.stewart@manulifesecurities.ca