

Never does nature say one thing and wisdom another

The *Castor canadensis* is the largest rodent in North America. Excellent swimmers and primarily nocturnal, this energetic yet shy mammal can be found living in colonies, near water. Hunted extensively for their fur as far back as the 1500's, and revered among many indigenous groups, this animal has become a recognizable symbol across many cultures. Its likeness is the mascot for the three-time NCAA championship Oregon State baseball team. It is also a national symbol of Canada, the Canadian beaver.

In 1946, the government of Argentina was searching for a new source of revenue for its struggling economy. They decided to implement commercial fur trading as a solution. However, in 1946 there were no furry animals native to southern South America. To address this shortfall, the government imported 20 pairs of Canadian beavers. Their plan was to allow the beavers to mate, multiply, be hunted, and ultimately create a self-sustaining source of local commerce.

It's too bad the Argentinian government didn't know more about animal life cycles. It turns out one of the primary function's beavers play within an ecosystem is being prey for bears and wolves, two other things southern South America lacks. In North America, these carnivores act as natural beaver population control. As well, the comparatively warm Argentinian climate meant beaver's pelts grew poorly making them unsuitable for commercial trade. Lacking both natural and artificial purpose, shortly after arriving, demand for these large rodents fell to zero. The beaver population exploded. At last count, there were more than 100,000 beavers residing in the southern tip of Patagonia.

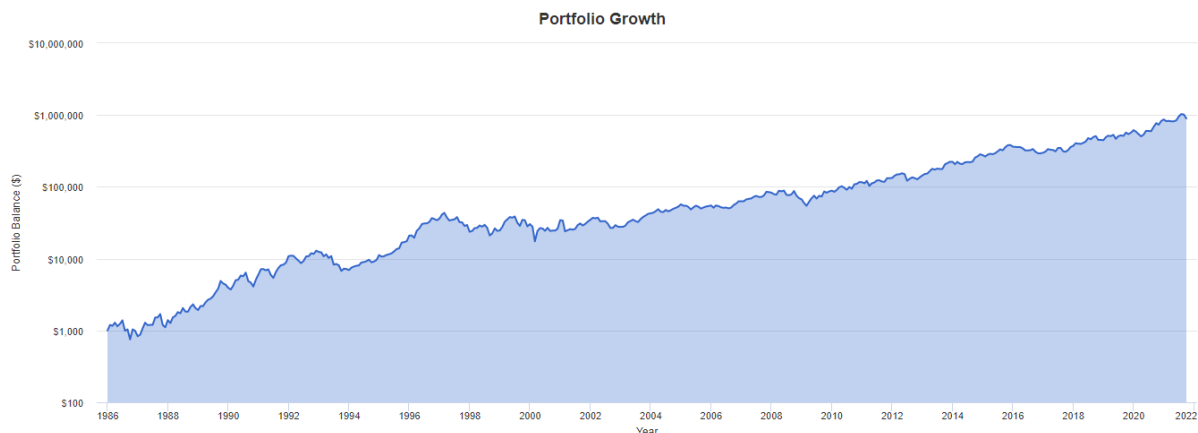
The number of Argentinian beavers continues to grow, much to the chagrin of locals as native vegetation is razed. The original fur trading plan never contemplated a future with 100,000 mammals running around. How could they have known such a situation would exist?

Of course, the growth of beavers wasn't linear; there were many periods where the population declined. Of the original 20 pairs of animals, some perished right away due to the dramatic habitat change. Others couldn't reproduce properly. Several times over the years disease killed swaths of beavers. Controversially, the government has been trying to exterminate them. Yet, even with all these impediments, the beaver population has flourished.

The Patagonian *Castor canadensis* exemplifies the power of compound growth. Over any particular year since 1946 the beaver population may have grown or receded a little, but over the long run, baby beavers grew up, had their own families, multiplied, and furthered the lifecycle.

It took 75 years for just 20 beavers to grow to more than 100,000. A wonderful example in nature showing how uninterrupted growth compounds over longer periods of time. The same principal exists in investing; A healthy business (just like a healthy beaver), with reinvested profits (baby beavers), held for a long time, will grow and multiply.

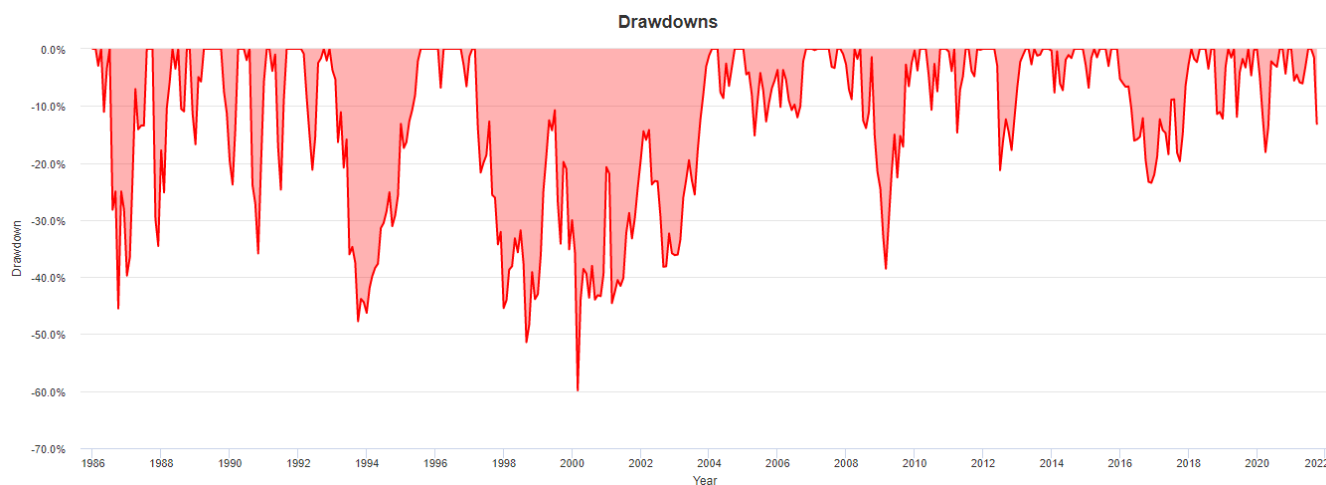
An example of a healthy company is Nike. If you had invested in Nike shortly after the company issued shares for the first time in the 1980's your return would look like the chart below. \$1,000 invested in 1986 grew to almost \$1,000,000 by September 2021, an impressive 20% of compounded growth per year.



At the outset of any venture, the future power of compounding is difficult to appreciate. South American beavers were dropped off in Patagonia 75 years ago and have been largely ignored ever since, yet their numbers exploded. Similarly, \$1,000 invested Nike, and never thought about again, grew to almost \$1,000,000, 35 years later.

The Nike growth chart on the previous page looks like a straight upwards sloping line. There are some small deviations, but the pattern is clear; growth is remarkably consistent. Which begs the question; should investors simply buy a small group of "Nike" type companies and hold them for a long time? Maybe even Nike stock today would be a good thing to buy? Wouldn't this be a simple, but powerful strategy to implement? The answer is undoubtedly yes! But there's a catch. A big catch, which makes this strategy virtually unfollowable.

A 20% annual return sounds terrific, and it is. However, that figure represents the return over a 35-year period. What if we look closer at the individual periods which make up the 35-year stretch? Probing even further, what if we look only at the drawdowns, the *amount* Nike stock declined when its shares fell. Below is a chart of Nike's drawdowns over the last 35 years. This is a far more accurate picture of the path a Nike investor would have experienced.



Even though Nike stock generated on average 20% over the course of an entire year, it temporarily loses value every few quarters. In fact, on average when Nike stock falls in value, it falls by -24%. That is a significant decline. For example, if you had invested \$1,000 in Nike stock at the beginning of 1986, by the start of 1987 your investment had dropped to \$650. How many investors would have been bothered by this? All of them. But only by ignoring this temporary loss can investors let the power of compound growth work. Conceptually this makes sense, but when looking at a statement showing a -24% loss after less than a year, ignoring is not an easy thing to do.

The market drawdown in our most recent memories is the Covid-19 correction of March 2020. While that was a memorable event, note on the drawdown chart above (far right side) Nike stock experienced a loss of -18%, a relatively minor setback compared to the loss in the overall stock market of -40% or even the average Nike drawdown over the last 35 years of -24%. In other words, the price investors paid for realizing 20% annual returns from Nike was experiencing a Covid type market decline almost every year since 1986. A truly brutal experience for even professional investors.

The power of compounding is real, but no one should think it is an easy path to follow. Given the vast majority of investors cannot handle the downside volatility of even the healthiest company's stocks, what is an investor to do? I believe the solution lies in two strategies.

The foundation of investment finance centre around the concept of building a portfolio that will provide the highest return at the lowest possible amount of risk. While I believe this is a noble quest, at least in academic circles, I think investors in the real world need a slight variation. I believe an investor's goal should be to create an appropriate return/risk quotient, but at the same time ensure it is a portfolio that they can actually stick with in times of stress. Outside of research journals, there is little purpose in building a portfolio that will generate a high annual return, only for investors to bail out of after six months.

The second strategy to smoothing out the investment ride is to hold a group of healthy companies that are unrelated to each other (aka low correlation). When some companies zig, others will zag, and the overall volatility should be greatly reduced.

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Also, by adding fixed income (bonds), commodities (energy and metals), hedges (options) and cash we can further dampen drawdowns. Combining these strategies help us generate our target return while allowing us to sleep at night.

Your *hoping to visit Patagonia when travel to South America is finally open again* portfolio manager,

A handwritten signature in black ink, appearing to be the name 'Duncan'.

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