Leib Zeisler

# Letters from Leib

Summer 2022

## Investing in a Time of Disruption - Risks and Opportunities

Yes, it was more fun when the markets were going up, but falling markets are an important part of keeping markets healthy and dynamic. Much like a forest fire, a falling market can clear away the dead wood, reset valuations, and set up an environment for new growth. Falling markets also motivate investors, encouraging them to reflect and reconsider their circumstances, investment goals, and comfort with risk.

Market falls occur quite regularly. Retreats of more than 10% are referred to as corrections; declines of more than 20% are referred to as bear markets. During this calendar year all the major American indexes (the Dow Jones, S&P 500 and NASDAQ) visited 'bear market territory.' The TSX Index experienced a correction with commodity stocks buoying up the index. The S&P Canadian Aggregate Bond Index also fell into correction territory this year.

*The Bear Facts*

***For the pessimists:*** *13 of 21 bear markets in the S&P 500 dropped more than 30%, eight dropped between 20% and 30%,*

***For the optimists:*** *even the longest bear market ends. The average gain 12 months after the end of the losing streak was 12.4% when taking out disastrous year of 1931 (or a still acceptable 6.8% if we include it). New record highs were not achieved by the S&P 500 climbing out of any bear markets from 1928 to 1946, but every bear market since 1946 did eventually reach a new record high.*

When markets are falling, conversations invariably circle around two questions: how far will they fall and how long will they stay down? The answer, of course, is that we don't know. We can only tell the bottom after it has passed. Market recoveries can happen quickly with little chance to jump in at desired prices.
Could it get worse? Maybe. I do not know if we are out of the woods yet, but I do think we are in a valuation valley. How deep and how long the valley is still to be determined. However, sound companies with productive assets, real earnings, money in the bank, and forward-looking leadership, don't fall forever.

### Actions

Most long-term investors with established portfolios will simply ride through market declines, expecting quality investments to bounce back and income derived from portfolios to continue. Many experienced investors maintain a reserve fund as a strategic part of their holdings. With the market rout underway consider adding:

### 1. Income producing assets

Inflation and recession concerns are sending mixed signals to investors regarding the future direction of interest rates, but rates are finally off the floor and interest bearing investment vehicles are offering reasonable returns. Because movements in rates, both up and down, can happen very quickly, we recommend investors begin locking in fixed income assets with a range of maturities. Consider adding GICs, government bonds, high grade corporate debentures (when available), and income ETFs with different mandates to your portfolios. Shorter term bonds and cashable GICs may be attractive as an alternative to money market where appropriate.

As in the past, we advise staggering purchases and laddering maturities to average out the rate volatility.

## 2. Buy blue chip assets

Few investors will go wrong by adding positions in high quality secular growth companies to portfolios when stock prices appear undervalued. The proviso, of course, is that each investment must still fit the investors' mandate and not result in overconcentration or unbalancing of the portfolio by any asset group.

## 3. Buying magic . . . at least magical companies . . . the future appears to be on sale

The rout in the stock market has particularly affected the value of a number of once highly priced and prized growth stocks. Many were market leaders or regarded as exciting up and comers in their industry groups. Stock prices were pushed up by excess liquidity and fell as liquidity was withdrawn and investors retrenched. A number of these companies are strong businesses with meaningful earnings and leading-edge products or services, with some even paying modest dividends. Buying or adding to positions in well-established growth companies when they are out of favour can provide 'sizzle' to portfolios in the future.

## 4. For those who can afford more risk, commodity stocks, long dormant, have woken up and are gaining investor attention

Commodity companies are considered by many analysts to be in a multiyear sweet spot for growth and are expected to give shareholders capital gains with the potential for increased dividends and share buybacks.

The commodity sector (natural resources including metals, energy, agricultural products, fertilizer) is known to be volatile with cyclical booms and busts related primarily to the strength of the economy and global outlook. There are also company-specific risks to consider, some more predictable than others, including weather, foreign events, new technologies, depletion, and disaster that can have a huge impact on share prices. ESG (short for environment, sustainability, and responsible governance) has traditionally been considered a risk factor in this sector. ESG has become an opportunity for profit for forward looking companies, for example, those working in carbon capture and sequestration and green hydrogen production.

## Some words of caution

In the financial world risk is defined as the effect of uncertainty on objectives. Investors prefer predictable economic environments. This is not the current situation and may not be for the foreseeable future.

## The usual unknowable's

Seesawing interest rates create uncertainty and volatility in fixed income investments and stock portfolios. Most analysts, however, do expect inflation and a potential recession to be handled effectively, but maybe not gently, by central banks manipulating monetary policy. Unfortunately monetary policy is not a finely calibrated tool. Decisions on interest rates often cause the economy to overshoot or undershoot the central bank's objectives creating both risk and opportunity for investors.

Disruptive technologies are creating new realities for investors. In today's fast changing world which industries can be considered safe with dividends and earnings that investors can confidently rely on? Which industries are going to be victims of change, becoming so-called zombie industries that no longer operate productive assets? Have the once dominant American

*Establishing Value*

*Determining a fair, intrinsic, or cheap price for an asset, stock, or index involves a number of factors, but the primary measurement of value for investors since 1906 has been the price to earnings ratio (see the origin of the P/E ratio below). Currently at 11 times earnings Canada's main index the TSX Composite is considered to be undervalued. A number of quality Canadian financial and industry companies are trading at the low end of their valuation ranges and could be timely new additions or top ups for portfolios.*

car companies of the past permanently lost out to bold entrants with new technologies and new ways of doing things?

## The unknowables that keep me up at night wondering

Where have all the workers gone? The demographic surge of the postwar era has ended, not only for the baby boom countries of America and Europe but also China, Japan, and Korea, affecting labour supply and consumer demand. Older people are living longer and risk outliving their savings. There is a shortage of younger workers and immigrants to fill jobs. This dynamic could negatively impact the productivity of world economies. Aging populations are a challenge for government strategists, families, and individuals.

Environmental changes. California's central valley, often referred to as America's Salad Bowl, depends on infrastructure that is running out of water as are many other agricultural regions in the world. Climate and environmental changes are inherently destabilizing, increasing competition for resources, food and water insecurity, and geopolitical risk.

Some analysts believe the impact of these and other structural issues will create long term, sweeping, and overlapping disruptions in the economy which will dampen returns for years to come. They argue that it is extremely optimistic to believe that technological advances alone will save the global economy from widespread shortages and scarcities.

Others believe that it is unwise to bet against economic progress, arguing that need is the mother of invention. Problems stimulate solutions which lead to economic growth and wealth creation. They point to the record time mRNA vaccines were developed and suggest break throughs are imminent in various technologies ranging from energy storage to sustainable agricultural and nanotechnologies.

## In Conclusion: we are in a 'show me' market

Making money in a rising market is the easy part of investing; how an investor responds to a falling market is the real challenge. Primarily a bear market is an opportunity. Inflation and/or recession will become clearer over the next few months. When the economic numbers demonstrate that it is not as bad as feared, I believe markets will rise strongly. Muddling through will be good enough to propel indexes higher.

Investing is not one and done, portfolios must be adjusted to take advantage of opportunities, navigate pitfalls, and respond to personal circumstances. Depending on personal circumstances and financial goals and attitudes, investors have to calibrate their investments to protect capital, grow capital, and secure cash flow. Stashing money in a mattress is not an effective investment strategy: money loses purchasing power over time even in a low-inflationary environment, and much more so in an extended period of higher inflation. Investing in a portfolio of quality equities and fixed income, even with the bumps and bruises along the way, has historically worked out well for investors.

As always, I would very much like to thank Amrita and Rebecca for the wonderful job they do. They always bring their 'A' game with the highest level of responsibility and professionalism to the work. *They* are great credits to the industry.

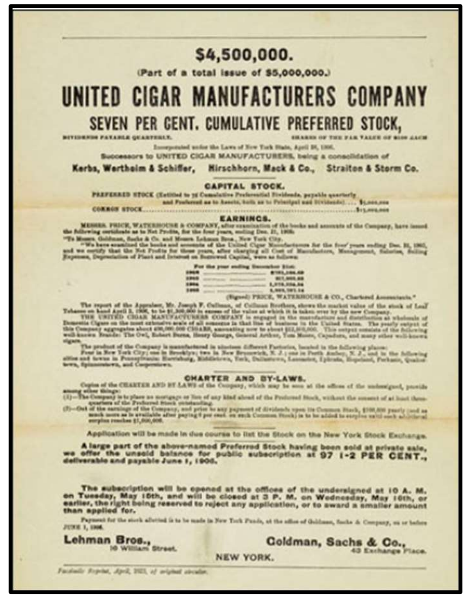
We thank you for your business and for the trust and confidence you place in us.
Yours,

Leib

Leib Zeisler
Wealth Advisor

## The Origin of the P/E Ratio

Retail businesses lacked the hard assets that traditionally secured financing for railroads, steel companies, and other large industrial ventures. Henry Goldman developed the Price to Earnings Ratio to raise financing for the newly formed United Cigar Company in 1906. Goldman believed that the value of capital could be calculated based on expectations of future earnings and goodwill rather than physical assets in the present that depreciated over time. The P/E Ratio remains the preferred tool to evaluate companies based on their future earnings power rather than their physical assets.



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SEVEN PER CENT. CUMULATIVE PREFERRED STOCK,

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Lehman Bros., 16 William Street. Goldman, Sachs & Co., 43 Exchange Place.

NEW YORK.


Leib Zeisler
Wealth Advisor
403.410.3943
Leib Zeisler Wealth Management

Rebecca Gillies
Senior Wealth Associate
403.410.3946

Amrita Basu
Senior Wealth Associate
403.410.3944

Toll-Free 1.877.531.8400
National Bank Financial Wealth Management
Suite 200 - 239 8th Ave S.W., Calgary AB T2P 1B9




NATIONAL BANK FINANCIAL WEALTH MANAGEMENT

Leib Zeisler WEALTH MANAGEMENT