RBC Wealth Management

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"Don't stop thinking about tomorrow,
Don't stop, it'll soon be here,
It'll be better than before,
Yesterday's gone, yesterday's gone."

—Fleetwood Mac, Album *Rumors* 1977

Dear Friends,

The last regular Client Letter we wrote to you the second week in January was, without question, the most bearish we have written in memory. Sadly it was also a very timely call as the S&P 500 fell nearly 35% over the following ten weeks. Worse yet (insofar as our prodigious collective ego goes), the sell-off had very little to do with the basis for our bearishness: wildly over-priced stocks in relation to earnings coupled with little alternative to stocks as interest rates started with the number one. Little did we know that corporate earnings would vanish faster than you could say *pandemic*. Stocks fell faster than a runaway elevator. Next stop? The bargain basement. With a thud. Adding to our frustrations was the fact that we had relatively little time to scoop up deals. We feel good about having been substantial buyers on your behalf but always wish we had done more. As usual, our hindsight is 20/20.

Black Swans

Aka legitimately rare birds. But what about Black Swan events? The term was coined by finance professor and former Wall Street trader, Nassim Taleb, leading into the financial crisis of 2008-09. These supposedly rare events are characterized by a total inability to predict them, both their severity as well as duration. In preparation for this letter, we started debating among ourselves as to what Wall Street events met this criteria over the past fifty years, our tenure in the investing business. (Caveat: by our definition not all Black Swan events have to be directly stock market related.) Here is our list.

- Gasoline rationing in 1972
- Gold mania in 1972-73 (prices ran from $242 an oz. to $1,500 in 18 months)
- The 30-year US Treasury bond trades at *over* a 15% yield to maturity 1981
- Black Monday in October 1987 (stocks fell over 30% in one day and the first hour of the next)
- Dot-com bubble in 2000… aka, the Tech Wreck
- Terrorist attack on the World Trade Center in 2001 closing Wall Street for a week
- Financial crisis of 2008-09
- Fukushima nuclear disaster 2011
- Covid-19 pandemic of 2020 (stocks fell 35% in ten weeks)
- 10-year US Treasury bond trades at **.**64% in return per annum in 2020
- The contract price of a barrel of oil on the futures market falls to a *minus $35*

You would have to agree that these events at the outset were near impossible to predict or, at minimum, the degree of their severity. The financial consequences varied widely. For example, if you had bought the 14% 30-year Treasury bond and held it to maturity, you beat the pants off of Warren Buffet in terms of return *for thirty years running*. If you owned a futures contract for a barrel of oil last month you suffered a substantial loss which far exceeded going to zero, but it was a great week to pull up to the pump. For those investors who were holding what had been far too much cash on February 1 of this year, you got the benefit of at least a 35% markdown in the price of stocks on average. The recovery? A market leader, Apple, fell from a pre-Covid price of 328 to a low of 213 before setting a new all-time high of 375 two weeks ago on a "bounce" of over 75% in just over three months. Your writer had a political science professor in college whose theory was, "Everything makes somebody happy." A corollary to which is, "Opportunity often arrives at your door in strange disguises." And strange this has been. Interestingly, opportune as well.

Seat Belts

What a fine invention this was. The ability to be in a wreck and not be catapulted through the windshield was a bully idea. So, let's assume for the moment that you were able to assemble sufficient cash heading into late March to purchase a few shares of stock amidst the chaos. Are there a few characteristics you might watch for in a company that would have been helpful in addressing risk in buying stocks in the midst of a Black Swan stock market meltdown? If you will, financial seat belts. Our favorites among others include the following. Probably three of the five listed will at least get you directionally correct. Five of five? Even better.

1.) You have at least a basic understanding of the company's business.
2.) The company is not highly leveraged: aka, reasonable debt in relation to total capital employed. Remember: the bank gets paid first.
3.) Day-to-day operations normally generate more cash than the business requires to operate, allowing cash to build up on the balance sheet of the business over time.
4.) Dividends are increased in parallel with earnings growth. Companies that raise the dividend faster may be starving the business of reinvested earnings required to remain competitive and support growth.
5.) The ratio of the stock's price to the earnings per share (aka the P/E ratio) is at the bottom end of historic range despite strong earnings. The technical term for this concept is…a bargain.

These characteristics priced at a discount are not commonly available in routine let alone richly priced markets such as we faced in January. But when the tides go out and prices go down, way down, they tend to be all around us. There for the taking. Certainly that was the case in late March and the first week in April. That's where seat belts 1 through 5 above come into play. Stocks have a funny way of becoming cheap and then cheaper in a market that is capable of falling 1,000 Dow points in a day. Financial strength and taking the longer view help us to become courageous investors in challenging times.

The Taxman Cometh

Taxes matter. We have previously written to you about the recent changes in increased taxation on inherited IRAs. As we write, the heat of the coming election is beginning to grow. At the same time, our government has gone into hock by more than four trillion (with a "t") in debt to help stabilize the economy during the pandemic. With interest rates approaching zero, the cost of borrowing is minimal. And given the degree of deficit spending both parties have pursued in the past fifteen years (the last president to deliver a budget surplus was President Clinton) it would be appropriate to assume that taxes on both higher income earners and corporations will be headed up. Candidate Biden has most recently stated that he believes the top corporate tax bracket should go up by one-third to 28%. Should that become the case, the combination of very richly priced stocks and higher taxes further reducing earnings could become a major headwind for companies and their investors starting next year. For these reasons, we have been relatively heavy sellers of call options of late on stocks owned in portfolios and are fully prepared to see those shares called away (aka…sold) before the end of the year. Stocks are expensive and we love collecting the funds from the sale of the calls. Stay tuned on this one. We will follow up as developments dictate. In the interim, teammate Kathy Crocker recently shared with us a number of observations from that great contemporary philosopher, comedian Bill Murray. Bill advised that the best way to teach your kids about taxes is to eat 30% of their ice cream. Consider the top third of your cone hereby consumed.

A Personal Note…If you will permit us.

This pandemic itself is personal. It has taken lives and altered lives in virtually every way possible. Uncertainty rules the day. Family and friends go unseen. Parents become tutors. Grandchildren lose both front teeth and you cannot be there to see that unique smile. Going to the grocery store entails risk and you can only buy three rolls of TP at a time. Until recently you could not eat out and now do so at your own risk. We are lodged behind our computers more than ever before. The prospect of getting on an airplane is terrorizing. Meanwhile the talking heads keep on talking. Endlessly. Life in a vacuum. It is Groundhog Day over and over again. But here at Spence Partners we have all of you. We get to speak with you, share ideas, pay off mortgages, buy cheap stocks and hopefully hold your plans for retirement and for your grandchildren's college educations intact. What an intimate privilege. It is in this spirit we repeat the gentle prose of Fleetwood Mac with which we opened this letter. We know good counsel when we see it!

"*Don't stop thinking about tomorrow,*
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Your writer suffering the indignity of having his hair cut by his wife while she rattles off her favorite string of bald jokes. Can't stop thinking about tomorrow and my friendly local barber shop.

Stay safe. Be patient. Think about tomorrow. This too shall pass.

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We normally include a personal note with the letter and your review. As a result of our being scattered literally from coast to coast, the logistics were simply a bit overwhelming. Please accept our apologies for the omission.

As you know, we do not manage to a particular benchmark. We provide benchmarks for broad context, and they all have their quirks. Of late, the S&P 500 has traded at higher PE ratios (more expensively) than the kinds of companies we typically invest in. As such, we feel it looks less like us at present than in the past, and we therefore substituted the Dow (DJIA) for the US component of the included benchmarks. Our weighting to international has also fallen for many clients, so we dropped the international weighting to 15% of each benchmark's equity component. Finally, we pushed up equity weightings a bit for most clients, so the primary benchmark is now 70% stocks and the secondary is 60% stocks (a flip), while the tertiary remains 100% stocks.