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SECOND QUARTER 2022

Index	Q2 2022	YTD
S&P/TSX Composite (C$)	-13.2%	-9.9%
S&P 500 (US$)	-16.1%	-20.0%
S&P 500 (C$)	-13.5%	-18.7%
MSCI EAFE (US$)	-14.5%	-19.6%
MSCI EAFE (C$)	-11.8%	-18.3%
FTSE TMX Universe Bond Index (C$)	-5.7%	-12.2%
C$ / US$	1.2496 to 1.2886 (-3.0%)	1.2678 to 1.2886 (-1.6%)

Index returns are total returns, including dividends.

A RETURN TO EARTH FOR THE HIGHEST FLIERS

During the most recent quarter, the S&P 500 experienced a 20% decline from peak levels and officially entered a bear market. The tech-heavy NASDAQ index fared even worse and has now fallen 30% since the beginning of the year. High inflation, rising interest rates and the possibility of a looming recession: this trifecta of fears drove stock prices lower across all sectors except for energy. With this decline, the S&P 500's forward price-to-earnings ratio has now dipped below its 25-year average, after spending much of the last few years well above it.

As important as it is when investing not to put all one's eggs into one basket, we believe that it is even more important to avoid the wrong baskets in the first place. Many of the unprofitable fast-growing companies that speculators have been clamouring for over the past two years, sending their stock prices to absurd heights, are now seeing a sudden about-face, with their prices falling by 70% or more over a period of mere months. Without the seemingly unending rise in their stock prices for support, cash-burning speculative companies are now discovering what the party is like when the music finally stops. Some may even find it difficult to continue operations.

A huge number of companies, formerly so highly valued, have relied on the feverish market conditions to keep going. One such example is Peloton, which at its height last year was valued at an incredible US$50 billion. Peloton has had an impressive period of growth, more than quadrupling revenues to US$4 billion since 2019, but at the same time ran up cumulative losses of US$1.3 billion and burned through over US$3 billion in cash. The company plugged these holes with large issuances of common stock and convertible debt, which generated US$3.4 billion in cash and expanded their share count by 20% since 2019. However, with its stock price down over 90% from its peak, the company now faces the prospect of self-funding its operations for the first time as investors shun the money-losing business.

Such a dire scenario is a possibility for many such companies, if not already a reality. It is a stark change from the conditions that existed this time last year and shows just how quickly security markets and popular sentiment can turn around. With central banks around the world now keenly focused on tightening monetary conditions to fight the highest inflation seen since the 1970s, companies that relied on an endless flow of new investor money to stanch the bleeding from their operations and maintain their lofty growth rates are now finding out what happens when the cash inflow suddenly slows to a trickle.

BONDS ARE NO HEDGE WHEN INTEREST RATES RISE

The sudden decrease in liquidity, together with central banks increasing their interest rates, has had a dramatic effect on fixed income markets, leading to the worst bond market performance in over 40 years. Rising interest rates have depressed the prices of bonds across the spectrum but have had a particularly pronounced effect on issues with longer duration. Year to date, prices for 30-year U.S. Treasury bonds have fallen by 27% while prices for comparative Government of Canada bonds are down 28%. In contrast, 2-year U.S. Treasuries and Government of Canada bonds are down just 3% and 2% respectively.

It might seem counterintuitive, but yields on the 2-year issues have risen far more than their 30-year counterparts. Since the beginning of the year, U.S. 2-year Treasury yields have nearly quadrupled to 2.9%, while 30-year Treasury yields have moved up just 65% to 3.1%. The far more modest increase at the long end of the rate curve has nevertheless led to a much greater decrease in bond prices, highlighting the very high price sensitivity to rate movements associated with longer-term bonds, a feature known as duration risk that we have discussed in past letters.

Our unwillingness to lock in low returns for long periods of time is the primary reason we deliberately kept duration low across our fixed income and balanced portfolios over the last few years, and were willing to accept even lower returns over shorter periods. These shorter-term issues are now maturing, and we are finding a far more favourable environment to deploy the proceeds into higher yielding bonds.

One example of a bond that we have been buying is the MCAP Commercial 3.384% 2027 issue.[1] MCAP is the second largest monoline mortgage lender in Canada, originating, servicing and selling insured mortgages into government-sponsored securitization pools. As an originator and seller of mortgages, MCAP itself holds very little credit risk on its balance sheet and boasts a solid investment-grade rating from the credit ratings agencies. But despite its strong financial condition, rate increases and general fears about the economy have driven down the price of the bond by over 12% this year: an issue that once traded above par and yielded 3% with seven years left to maturity is now trading substantially below par and yields over 6% with five years left to maturity.

Broadly speaking, investment-grade bond yields have now breached 5%; high yield bonds have surpassed 8%. Such levels have not been seen in more than a decade. With yields now far more favourable, we have become comfortable deploying cash and increasing duration in our fixed income allocations to lock in these higher returns for longer periods.

[1] *Some clients may not hold MCAP due to timing or asset allocation.*

THE BEST RETURNS ARE TO BE HAD FOLLOWING BEAR MARKETS

While prognosticators, both optimists and naysayers alike, routinely spout their views on what inflation, interest rates and the general economy will do in the future, the reality is that no one really knows. At Evans Investment Counsel, we do not believe we even have to know: our focus is always, and has always been, on finding and investing in great companies led by competent and shareholder-oriented management teams, that can withstand whatever the macroeconomic weather throws at them. When market fears result in even lower prices for our companies, the prospective returns become higher, and we like the company even more.

History reveals that the best returns are always earned following steep market declines. Going back to 1950, the median one-year return of the S&P 500 following a bear market decline of 20% or more is 24%, well above its historical annualized level of 9%.

This pattern has also been seen in our own historical performance. Since we first began GIPS reporting in 1993, our equity composite has fallen by at least 20% over three distinct periods. In the one year and two years following each of those periods, our equity composite returned 33% and 20% annualized respectively. Longer term returns were also strong: in the five and 10 years following these periods (excluding the most recent market crash in the first quarter of 2020, for which data is not yet available), our equity composite returned 12% on an annualized basis on average.

That our performance following periods of significant market price declines has been particularly strong should come as no surprise to clients who have been with us for a long time. While a stock's price can change dramatically day to day, batted about by rapidly shifting winds of sentiment, its underlying value changes little over the short run. Furthermore, the more a stock's price trades above or below its intrinsic value, the more rapid the eventual snap back towards that value.

Today, our aggregate equity holdings' forward price-to-earnings ratio stands at just 10x, even lower than where it stood at the end of the first quarter of 2020, following the precipitous market crash at the onset of the COVID-19 pandemic. With many of our holdings trading at substantially lower levels than where they were just months before, and with bond yields substantially higher, we believe that the prospect for strong returns going forward is notably better than it has been in recent memory.

Thank you for your continued confidence and support.

The Evans Team