DIXON MITCHELL
INVESTMENT COUNSEL

# DM PORTFOLIO COMMENTARY
## 3rd Quarter 2023

*"At all times, in all markets, in all parts of the world, even the tiniest change in interest rates changes the value of every financial asset."*

**- Warren Buffett**

When we write our quarterly commentaries, we're inevitably drawn to what's happening in stock markets and to how the equity side of our mandates is faring. This tendency is natural for a few reasons: first, stocks almost always have a greater impact on balanced portfolio results (for better or worse) than bonds do; second, different companies, in different industries, pursuing different strategies provides a deep pool of potential topics; and, finally, for more than a decade, the bond market operated quietly in the background, with interest rates grounded and rarely necessitating departure from whatever investment approach was working at the time.

All of that changed at the beginning of last year, however, when inflation began to gallop ahead and fixed income yields leapt to levels not seen in a half generation. Now, bond prices and interest rates are not only newsworthy, they're meaningfully influencing virtually every part of the economy, including corporate strategy, household finances, government policy, and the way that stock, real estate, and other equity investments are behaving. And, after experiencing the largest calendar year decline for bond prices in 2022, investors with balanced portfolios have found out that the ballast portion of their nest egg can also cause headaches.

### Higher interest rate fallout

As we've detailed in the past, the risk-free rate of interest (particularly the 10-year government bond yield) sits at the core of the valuation calculation for almost every investment asset. Just as a house is notably less attractive at a 7% vs. 2% mortgage rate, so too are the shares of companies less appealing when their cash flows must be discounted to present value at markedly higher yields. Put in simpler terms, when the riskless rate goes up, the prices of risky assets generally need to fall in order to lift their expected returns enough to encourage investors to stick with them. During covid, rates got so low that money was practically "free" and, when something is free, we tend not to covet it. This meant that for a time, cash was thrown with indiscriminate enthusiasm at everything from electronic currencies named for popular dog breeds, to digital drawings of disinterested simians, to the shares of freshly bankrupted enterprises, and to businesses which offered narrative appeal, but which probably never had much chance of succeeding financially – *at least not to the degree that their soaring prices were implying*.

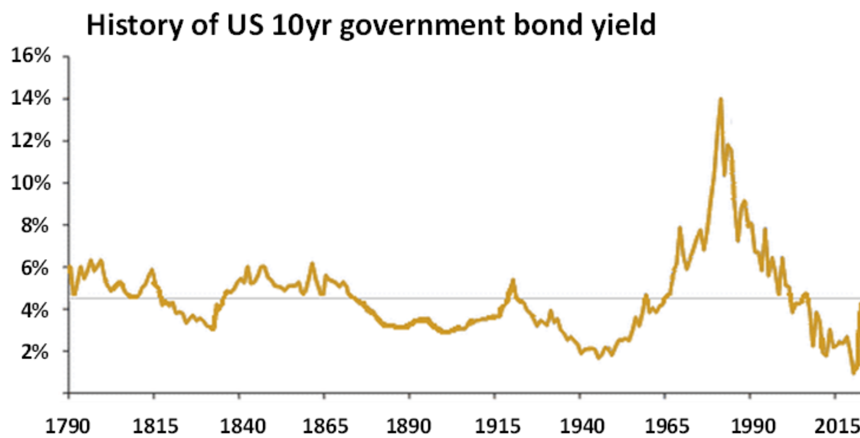
For almost all of these speculative vehicles, the spike in interest rates was as jarring as an ice bucket dumped on a snoozing sunbather, and today most of them either trade at small fractions of their prior levels or no longer exist at all (for example, it was recently estimated that 95% of the briefly white hot NFT market is now worthless). This abrupt return to terra firma has also been felt by the venture capital market. Whereas 50-60 new "unicorns" (private start-up companies with valuations in excess of $1 billion) were being born each month during the speculative heyday of two years ago, they've once again become as rare as

… *unicorns*. Even profitable enterprises like grocery delivery pioneer, Instacart, have been battered by the tight money backdrop: in September, the company went public at a $9 billion valuation, or 77% below the $39 billion mark at which it had raised $265 million just months earlier.

Aside from draining speculative excess from the equity market, rising rates have weighed heavily on bond prices. Incredibly, bonds at the long end of the yield curve have now fallen by more than the stock market did during the Great Financial Crisis of 2008/09, while a 100-year note floated by the Government of Austria in 2020 is down nearly 70% from its issue price – and that's a AA+ credit, not a meme stock! Though central bankers recently paused their hiking programs, mid and long-term bond yields jumped again at the end of Q3, as slight upticks in inflation in both July and August stoked fear that consumer prices could resume their climb.

**What does it all mean?**

While stocks were forced to adjust to a rapid and historic spike in rates last year, today it feels like the challenge might be adapting to a yield curve that stays higher for longer. For equity investment, this probably means that fundamental analysis and prudent selectivity will remain paramount, with the free pass provided by free money unlikely to return anytime soon. This backdrop has favoured our equity approach over the past 18 months and we are confident that our focus on valuation, cash flow generation, and management effectiveness will continue to serve portfolios well in the quarters to come.




After a brutal stretch for bond prices, it may seem difficult to make the case for fixed income investment, but what's happened in the recent past isn't always the best guide to how assets will behave in the future. The accompanying chart shows the 200+ year history of the US 10-year government bond yield and, as you can see, the recent jump in rates has brought yields back to their very, very long-term average, a figure which is skewed higher by the super spike of the 1980s. This isn't to say that rates can't go higher from here, just that their room to rise is probably much smaller than it was two years ago. It is for this reason that we began to boost our bond portfolio duration earlier this year, from a markedly shorter-than-benchmark position to one of market neutrality.

As well, the much more attractive yields now offered by the bond market shouldn't be ignored. Over the decade spanning 2011 to 2021, for example, the DM Balanced Composite returned more than 10% per year before management fees, but through that period the 10-year Government of Canada bond provided an average yield of just 1.7% and generated a total annualized return of 2.8% (the difference owing to a slight capital gain caused by falling rates). The small contribution made by the fixed income component of DM Balanced during that decade meant that our stock selections had to do most of the heavy lifting for the mandate to achieve its realized return. Today, however, the starting yield on the Government of Canada 10-year is around

4.2%, meaning that bonds have the potential to make a meaningful contribution to balanced portfolio returns, making less potentially required of stocks.

Following a very good July and a slightly positive August, September lived up to its bearish reputation and erased much of the third quarter's market gain. Though we'll soon be entering the seasonally favourable part of the calendar for equity investing *(a characteristic which is generally amplified in the fourth year of the presidential cycle)*, good luck to anyone attempting a bold forecast of how things might unfold in the near term. At the close of the quarter, markets themselves seemed unusually puzzled by the economic state of things, as:

- Stocks were sliding like a recession is right around the corner;
- Oil was being bid as though economic growth and energy demand will remain strong;
- The greenback was rallying as if US government finances are in pristine condition;
- Interest rates were streaking well past the heights reached when inflation approached double digits a year ago, even though CPI has fallen by more than half since then;
- Gold was dropping as if inflation worries are behind us;
- House prices were holding up as though mortgage rates aren't a problem;
- And entire subsets of commercial real estate were being pressured like it's 2008.

Our team has done a great job of not letting this dog's breakfast of often contradictory indicators distract from our company-level analysis, discipline which is reflected in the recent performance of DM equity mandates. The current backdrop also means that, in addition to all the variables we ordinarily evaluate in our equity investment process, we're placing greater emphasis on appraising a company's ability to withstand a higher rate environment that sticks around for longer than previously expected. On the flipside, we're also spending time assessing who will benefit if rates begin to retreat and thinking about portfolio changes which might be beneficial if such a scenario unfolds. In the third quarter, we began to trim profits from some of our best performing names and allocate this capital to more reasonably valued parts of our mandates, a tactic which we may utilize to a greater degree in the months ahead.