ODLUM BROWN REPORT

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ODLUM BROWN
Investing for Generations®

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The Right Blend is All About Balance

Starbucks has been in the news as it announced store closures in Canada and the U.S. Some wonder if there is cause for concern, while others believe the recent weakness in the share price is a good buying opportunity.

Unfortunately, the answer is nuanced and complicated, in part because there is so much uncertainty in the world and the range of economic possibilities is wider than usual.

Before digging into the details, I should declare my biases. I love my morning Pike Place, and I'm even more jazzed now that I'm able to grab a higher-octane cup from my local store, which is open again. It could be psychological, but I think the store-brew tastes better than my homemade Starbucks Keurig pods.

More so than the coffee, I have to admit to loving the company. It's treated me very well as a shareholder. I've owned shares for more than a dozen years, and they have grown to be the second-largest position in my personal portfolio, next to Amazon. Starbucks is also the stock with the greatest gain relative to cost in the Odlum Brown Model Portfolio.* Selling it now would trigger capital gains taxes for many, adding another layer of complexity.

I've also been proud of the leadership that Starbucks has shown around the fight against COVID-19. They were one of the first businesses to react to the dangers of the virus. As they shifted to a drive-thru and delivery-only model at their 9,600 company-owned stores in the U.S. and Canada in late March, they also committed to paying employees for 30 days whether they worked or not. They ultimately closed stores around the world before such precautions were mandated by authorities.

Being responsible comes with a cost; analysts estimate that the company's fiscal 2020 adjusted earnings per share (EPS) will drop by two-thirds to $0.97 from $2.83 last year. That's more than three times the 18% drop in EPS Starbucks experienced in 2008 during the Great Financial Crisis.

What's remarkable is how much better the stock has held up in the face of a much harsher hit to earnings in this current crisis.

At a recent price of around $75, the stock is down about 25% from an all-time high of $100 in July 2019, and up more than 30% from its low of $56 in March of this year when markets were at their worst. Sentiment toward the company and the stock remains generally upbeat, a stark contrast to how investors felt during the last major crisis a dozen years ago.

Indeed, we remember Starbucks being the most hated stock at the firm in 2008/09. Equity Analyst Stephen Boland showcased the nerve-racking experience at our Annual Address event two years ago.

In 2007, we recommended Starbucks after it had fallen to $13 from a peak of $20 in 2006. With the 35% decline in the share price, the price-to-earnings valuation multiple was near its lowest level ever – half of its peak of 45 times EPS in late 2006. We thought we were getting a bargain. But then the banking crisis happened, and the stock dropped to a low of $3.50 in the months following the bankruptcy of Lehman Brothers. At that level, the stock was down more than 80% from its peak and priced at less than 10 times expected 2009 EPS.

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It's potentially going to be a long and bumpy recovery, and therefore we continue to stress the importance of quality and diversification. While the odds remain very good that great businesses like Starbucks will produce satisfying long-term rewards, it's a good idea to balance portfolio holdings of popular growth businesses with less popular yet solid firms, fixed income and even some gold.

Today, Starbucks is priced at close to 30 times expected fiscal 2021 EPS – three times its trough valuation multiple in 2008 – and that's assuming the company's fiscal 2021 EPS recover to more than 90% of their pre-crisis level. Analysts were similarly optimistic about EPS rebounding in the aftermath of the banking crisis.

The positive sentiment toward Starbucks now is not unique; the valuations of other high-quality growth stocks are somewhat elevated relative to history and especially high compared to the depressed levels experienced during the Great Financial Crisis. We can think of four reasons why investor attitudes toward growth stocks like Starbucks are more constructive today than they were then:

1) **Fiscal and monetary policy.** The authorities' response, worldwide, to the COVID-19 crisis has been several fold greater than the support provided in 2008/09. In the United States, in particular, the amount of fiscal and monetary funding is monumental. The U.S. federal deficit will approach $4 trillion this year, which is close to 20% of GDP. On the monetary front, the U.S. Federal Reserve committed to injecting $2.7 trillion of liquidity into markets through its fourth installment of so-called quantitative easing (QE). QE1, following the banking crisis 12 years ago, amounted to just $200 billion. When the Federal Reserve buys fixed income securities, the cash it injects into the financial system has a tremendous influence on all risk assets, including stocks.

2) **Valuation.** Growth stocks were out-of-fashion during the last cycle, as valuation multiples were still contracting from the sky-high levels experienced in the late 1990s. In other words, the valuation pendulum was in the process of swinging from an overvalued extreme to an undervalued extreme. Growth stock valuations bottomed in the aftermath of that crisis and have been rising ever since, contributing to significant outperformance of stocks like Starbucks. With valuations still reasonable relative to fundamentals, it is quite possible they will swing higher. Not only are growth company fundamentals relatively strong compared to value-type businesses, it is also human nature to keep doing what is working.

3) **Adaptability.** We have long believed that the best will get better in a slow-growth world, and that argument seems stronger than ever given the economic hurdles ahead. Starbucks is better equipped than most to leverage technology and evolve its business model. Starbucks' plan to close up to 200 stores in Canada and as many as 400 in the U.S. over the next 18 months merely accelerates the company's pre-COVID strategy of opening locations with better pick-up and drive-thru capability. Before the virus landed in America, 80% of U.S. transactions were considered "on the go." The availability of great locations, at better prices, may also increase as weaker businesses fail.

4) **Learning to hold for the long term.** Perhaps the valuation of Starbucks is higher today because history has taught investors the benefits of holding great companies for the long term. An unlucky investor who bought the stock near its 2006 peak of $20, and held on through the subsequent 80% peak-to-trough plunge, has earned a near-fourfold total return over the last 14 years, or 12% compounded annually! Investors were clearly wrong to be pessimistic back then.

Still, we've highlighted the difference in attitudes toward growth stocks then and now so that investors appreciate the possible downside risks. There is no guarantee that investor sentiment toward Starbucks and other great companies won't sour, even if only temporarily.

We don't know how long COVID-19 will be with us or how changes in consumer habits will affect Starbucks and other companies. Governments and central banks have been extremely successful in keeping the global economy on life support thus far, but the next phase of reopening will be more challenging. Figuring out how to get individuals and companies off government aid and back to business is a complicated yet critical endeavour. In a divided world, governments may struggle to do the job well.

It's potentially going to be a long and bumpy recovery, and therefore we continue to stress the importance of quality and diversification. While the odds remain very good that great businesses like Starbucks will produce satisfying long-term rewards, it's a good idea to balance portfolio holdings of popular growth businesses with less popular yet solid firms, fixed income and even some gold.

MURRAY LEITH, CFA
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* The Odlum Brown Model Portfolio is an all-equity portfolio that was established by the Odlum Brown Equity Research Department on December 15, 1994, with a hypothetical investment of $250,000. It showcases how we believe individual security recommendations may be used within the context of a client portfolio. The Model also provides a basis with which to measure the quality of our advice and the effectiveness of our disciplined investment strategy. Trades are made using the closing price on the day a change is announced. Performance figures do not include any allowance for fees. Past performance is not indicative of future performance.

Odlum Brown in the Community

Usually in the July *Odlum Brown Report*, we showcase some of the exciting summer events that we are proud to sponsor. This year, many of our community partners had to take the difficult step of canceling or postponing their events; we look forward to being by their sides when they come back, bigger and better than ever!

We are staying connected with the community partners we support throughout BC, and many of these organizations are adapting their initiatives to continue to do their important work virtually.

To help recognize the outstanding work that these organizations are doing to help the communities they serve, we have leveraged our social media platforms to highlight partners across our locations that continue to make an impact during this challenging time. Here are just a few examples of our community partners' virtual summer initiatives:

Bard On The Beach Explore at Home – Ongoing

Since Bard on the Beach's Family Days are not possible this year, we are proud to generously support the new Bard Education Explore at Home program. This creative series of resources is designed to help people playfully explore Shakespeare's language, characters and plays at home. The best part? This program is intended to be explored away from screens – a bonus for families who are now spending record amounts of time in front of a screen for work, school or otherwise. **For more information, visit bardonthebeach.org/education/explore-at-home.**

Easter Seals BC/Yukon Camp@Home – July 6 – August 7 Easter Seals Drop Zone – September 10

This year, Easter Seals is bringing 50 years of Easter Seals Summer Camp experience to the online learning world for Camp@Home. Through interactive, fun and social online activities and programs, campers of all ages and diverse abilities can have a unique camp experience that allows them to have personal, genuine camp connections online.

On September 10, we are pleased to sponsor the Vancouver Drop Zone at which fearless Odlum Brown team members will rappel down the Guinness Tower in support of Easter Seals BC/Yukon and the outstanding work they do for families in our communities. **For more information, visit www.eastersealsbcy.ca.**

Fort Langley Jazz & Arts Festival September 4 – 6

This September, Odlum Brown is pleased to present the 2020 Fort Langley Virtual Jazz & Arts Festival. As Title Sponsor, we are looking forward to enjoying the sensational musical performances this event has to offer, in a brand-new virtual format. **For more information, visit www.fortlangleyjazzfest.com.**

To learn more about these and other great initiatives, we invite you to follow us on social media:

@Odlum_Brown Odlum Brown Community OdlumBrown

Planning for a Safe Return to Our Premises

Wow – summer has arrived. When we look back a few months, I'm sure none of us imagined that the measures in place due to COVID-19 would have lasted this long.

At Odlum Brown, this means that the majority of our team members continue to work remotely, and our offices remain closed to the public. Although it is hard not being able to see our clients and each other, we know this is in the best interest of everyone's health and safety.

As a firm, we continue to take guidance from Dr. Bonnie Henry and our provincial government. In late April, we assembled a project team to proactively plan for our next steps, and their hard work means we will be well positioned to move forward when the time comes. That said, health and safety are at the forefront of this planning, and we know that the best path forward is a gradual one.

Fortunately, many of the strategic investments we have made in our business in the last few years have enabled us to continue operating effectively, even remotely. We trust that throughout these past few months you have continued to enjoy the same level of service you have come to expect from Odlum Brown.

We look forward to the day when we can welcome you back to our offices. Until then, be well.

Debra A. Hewson
President and Chief Executive Officer

Pension Considerations Amid Market Uncertainty

If your employment ends in a position that includes membership in a defined-benefit pension plan, you will usually face an important decision: whether to collect a monthly pension or withdraw a lump-sum "commuted value" (CV) payment. While a pension can offer income for life, sometimes taking a CV is preferable. For example, the market risks of investing the CV may seem worth the additional income and estate wealth preservation opportunities you and your family might gain.

A CV is calculated by pension administrators when employment ends or at a later date, by request. Since CV estimates are only valid for a specified time, after which the value is recalculated using new assumptions, future CVs may decrease or increase. Your ability to receive a CV may even be removed; for example, if you reach the pension plan's retirement age or if paying a CV would impair the solvency of the pension plan.

It is important to note that two recent measures could impact present or future CV choices.

Measure #1: CV restrictions announced by some pension regulators

Several regulators have recently announced measures to relieve financial pressure on pension plans in the wake of COVID-19 market turbulence. BC, Alberta, Manitoba, Ontario and Quebec regulators have each reminded pension administrators to restrict transfers when appropriate (e.g., if plan values decline and/or paying the CV would impair a plan's solvency). Federal and Saskatchewan plans have placed certain moratoriums on CV transfers.

Measure #2: Calculation changes effective December 1, 2020

Calculating a pension CV requires a plan to make several assumptions, including one for long-term interest rates. This key assumption has an inverse relationship with the CV. On December 1, 2020, this long-term interest rate assumption will pivot from being based on Government of Canada bond rates to one that blends corporate and provincial bonds. An increase in this rate would result in a lower CV, and vice versa. Plans offering early retirement benefits that are more generous than if actuarially reduced may also change their retirement age assumptions on this date.

Looking ahead

While a well-funded pension plan can be an important source of retirement income security, pension plans are not immune to economic challenges that could constrain your future pension choices. With low interest rates currently boosting CV amounts available, your pension CV may be worth a second look.

There is no one-size-fits-all solution. In conjunction with information and advice from a pension actuary and your income tax professional, a member of Odlum Brown Financial Services Limited may help with making your decision. You will want to consider:

- income tax that may be payable on any CV "excess" portion not transferable to your regular or locked-in RRSP;
- annual restrictions on withdrawals from locked-in funds; and/or
- pension income credit and pension income-splitting restrictions, if the CV option is chosen.

Since pension plans may need weeks or months to prepare your CV options, contacting your pension plan administrator well in advance can grant you sufficient time to weigh your options.

For information about investing a CV and the products and services offered by Odlum Brown Financial Services Limited, please contact us through your Odlum Brown Investment Advisor or Portfolio Manager.

HEATHER RIVERS, BA, CFP®, FMA
Communications and Education Specialist
Odlum Brown Financial Services Limited

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