ODLUM BROWN REPORT

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ODLUM BROWN
Investing for Generations®

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The Turning of the Tide

What was the most important financial event of the last 40 years? That was the question Howard Marks posed at John Mauldin's 2023 Strategic Investment Conference in May.

Mr. Marks speculated that most people would say the 2008 Global Financial Crisis or the bankruptcy of Lehman Brothers, maybe the 1987 Black Monday crash, the 1999/2000 technology boom and bust, or perhaps the COVID-19 pandemic. Declaring all of those answers wrong, he proclaimed the most important financial event to be the prolonged decline in interest rates from 1981 to 2022. The fed funds rate, the short-term interest rate set by the U.S. Federal Reserve and the building block for all other interest rates, fell from 20% to zero over that roughly 40-year period. In Canada, the drop to zero started from a slightly higher administered interest rate of 21% in 1981.

This 40-year decline in interest rates had a profound, positive effect on economic growth, asset prices and wealth creation. But, because the positive influence accrued gradually over such a long period of time, Mr. Marks believes most people didn't notice. He likened the situation to walking on a moving sidewalk at the airport. While it's true that you are moving faster, you take the increased speed for granted because you are not gaining ground relative to others on the same conveyor belt.

Mr. Marks is co-founder and co-chairman of Oaktree Capital Management, one of the world's largest distressed debt investors, and he is greatly admired for his thoughtful and insightful investment memos. Late last year, he wrote a memo titled "Sea Change," in which he pointed to the re-emergence of meaningful inflation and one of the quickest rate-hiking cycles as the triggers for a major transformation in investor attitudes.

The first sea change Mr. Marks experienced in his career, which began in 1969, involved the adoption of a new investor mentality toward risk and return in the mid-1970s. He describes how "Michael Milken and a few others had the idea that it should be possible to issue non-investment grade bonds – and to invest in them prudently – if the bonds offered enough interest to compensate for the risk of default." Prior to this, only investment grade bonds were considered prudent. When Mr. Marks started very successfully investing in U.S. high-yield bonds in 1978, the universe amounted to merely $2 billion – today, it's roughly $1.2 trillion. This first major shift in thinking fueled the growth of leveraged buyouts and what's now called the private equity industry.

The second profound change in attitudes followed the inflationary 1970s, which was a tough period for investors. Higher inflation undermined the economy and put significant upward pressure on interest rates. That put downward pressure on the valuations of stocks and bonds and made investors much more risk averse. Commodities and real estate did well for a while, but ultimately their values crashed too. Fortunately, that difficult era came to an end in the early 1980s, after then Fed Chairman Paul Volcker raised the fed funds rate to 20% and broke the upward inflation spiral.

Mr. Volcker's actions ended a brutal inflationary period and set the stage for a declining interest rate environment that prevailed for the better part of four decades. It's helpful to think of interest rates and asset prices on the opposite ends of the valuation teeter-totter. As interest rates decline, valuation multiples increase, and vice versa. The S&P 500 Total Return Index compounded at an impressive 12.34% between 1981 and the end of 2021, helped by the price-earnings multiple increasing from less than 10x to roughly 20x.

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While there are reasons to believe there will be a cyclical drop in inflation and interest rates as economic growth slows, there are also reasons to expect greater structural inflation over the next 10 years than we have experienced over the last decade. If that is the case, the sea change in attitudes and opportunities that Mr. Marks anticipates will likely become a lasting reality.

Investors who used leverage over the 40-year stretch of falling interest rates did even better. Their returns were magnified by the fact that the cost of borrowing was dependably lower than the rate of asset appreciation. Returns were supercharged even more because investors were also able to refinance their leveraged investments at lower and lower interest rates over time. It's the same reason people have accrued significant equity in their homes.

Indeed, it was a virtuous, self-fulfilling cycle for borrowers and investors, with the increase in leverage driving stronger economic growth, fewer defaults and bankruptcies, and greater returns.

Globalization and technology also played a big role in keeping inflation low over the four decades. Cheaper labour and advancements in productivity allowed the U.S. Federal Reserve and other central banks to support the economy with accommodative monetary policies. More importantly, the absence of meaningful inflationary pressures allowed the authorities to aggressively lower interest rates and print money in the face of economic weakness and/or crises without fear of igniting inflation.

This ideal economic and financial backdrop encouraged complacency and a relaxed attitude toward risk. As borrowers got bolder, paying higher prices for assets and using more leverage, lenders demanded lower interest rates and fewer or less strenuous protective covenants.

They say, "nothing lasts forever," and the good times came to a halt in 2022, with the fastest rise in inflation since the early 1980s, precipitating the need for the authorities to aggressively raise interest rates.

Now, for the first time in years, Mr. Marks is excited about investing in distressed debt. His company is making senior loans to quality companies at yields of 11-13%. Compared to the 2009 to 2021 period, the economic backdrop and the "mood" of the market have changed dramatically. Investors are no longer optimistic and are instead guarded. The fear of losses or of a recession has replaced the fear of missing out. Credit has gone from being cheap and abundant to expensive and scarce. In Mr. Marks's opinion, prospective returns (for lenders) have inflected from the lowest ever to more than ample.

The intense tightening in credit conditions and the shift in attitudes about risk have implications for equity investors too. A business's worth is derived from the discounted value of future cash flows. That discount rate has increased alongside interest rates, which has naturally lowered the present value of future cash flows. And we're back to the teeter-totter: valuation multiples contract when inflation and interest rates increase.

The total return investors achieve from owning a stock is the sum of three things: earnings growth, the dividend yield and the change in price-to-earnings (P/E) valuation multiple. For example, consider a business that grows its earnings by 5%, pays a 3% dividend and experiences a 6.7% increase in its P/E multiple from 15x to 16x. In simple terms, the total return is 14.7% (i.e., 5% + 3% + 6.7%). Now imagine the same set of facts, except the valuation multiple falls from 16x to 15x, which is a 6.3% decline. The total return drops to an uninspiring 1.7% (i.e., 5% + 3% - 6.3%).

Earnings growth	Dividend yield	Change in P/E multiple	Total return
5%	+ 3%	+ 6.7%	= 14.7%
5%	+ 3%	- 6.3%	= 1.7%

The struggle experienced by many stocks recently is a direct result of investors using higher discount rates in their valuation models, and in some cases the weakness in share prices has also been influenced by worries about earnings growth.

While there are reasons to believe there will be a cyclical drop in inflation and interest rates as economic growth slows, there are also reasons to expect greater structural inflation over the next 10 years than we have experienced over the last decade. If that is the case, the sea change in attitudes and opportunities that Mr. Marks anticipates will likely become a lasting reality.

In that environment, the price investors pay for owning shares in a business will be as important, if not more so, as the underlying quality of that business. We want to own companies with growth attributes and pricing power, but we have to be careful not to pay too much. Patience and a long-term orientation are characteristics we believe will be considerably more valuable in the era ahead.

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Leaving Assets to Minors

Did you know that leaving money or assets to a minor can lead to complications? To prevent this, take extra steps with a legal professional to ensure that a trustee can administer the funds.

If minors are beneficiaries under your will, insurance or registered plans, or if bequests to other beneficiaries might cascade to a minor if an adult beneficiary predeceases you, appointing a trustee to administer and invest the funds on behalf of a minor may be prudent. Lacking a trustee may result in extra costs, time and administrative hurdles which can complicate and delay the process of distributing the funds intended for the minor and perhaps also delay settling your estate.

Various provincial statutes place restrictions on the distribution of assets directly to minors, instead requiring that they be held in trust on the minor's behalf. Certain jurisdictions may even require a parent or guardian to make an application to the courts to be designated as trustee. In BC and Ontario, the Public Guardian and Trustee (PGT) must be notified of such an application and may challenge it. If the PGT acts as trustee, management and use of the funds while the beneficiary remains a minor may not reflect the deceased's wishes.

Naming minors in a will:
If you wish to leave a specific asset or sum of money, some provinces allow a small amount to be paid directly to a minor. To leave amounts greater than the provincial limit or any amounts paid from the estate's residue (rather than a specific bequest), the will should appoint a trustee and outline trust terms, such as what powers the trustee has to pay income or capital, what powers the trustee has to allocate income to the minor for income tax purposes, and at what age the beneficiary can receive the remaining capital.

Naming beneficiaries on a life insurance policy:
Life insurance companies may offer a variety of payout options, such as payment to a trustee for a minor, an annuity for a beneficiary or an insurance trust. Careful planning is necessary to ensure the various options fit within the larger context of your estate and tax planning. If you would like more information on the products and services, including insurance options, available through Odlum Brown Financial Services Limited, contact us through your Odlum Brown Investment Advisor or Portfolio Manager.

Naming beneficiaries on registered plans:
Registered plans include Registered Retirement Savings Plans (RRSPs), Registered Retirement Income Funds (RRIFs), Tax-Free Savings Accounts (TFSAs), workplace pensions and other group benefit plans such as group RRSPs. Such accounts generally need to be paid to a trustee prior to being accessible by the child at the age of majority. The age of majority is 19 in BC and Ontario, as well as the territories, and 18 in the other provinces. As a result, it is prudent to consider if a beneficiary will be fiscally responsible to administer and manage their bequests at that age.

In most provinces, beneficiary designations for registered accounts can be made using an account form, a will or a stand-alone document and, if correctly worded, should allow the accounts to bypass probate administration and probate fees. Using either a will or stand-alone document to designate minor beneficiaries further allows a trustee and trust terms to be specified.

To ensure that funds are paid out as you intended, the financial institution managing the registered plans would need to be provided with documentation of the designation, and documents would need to be updated whenever accounts are added or altered (e.g., if an RRSP was subsequently converted to a RRIF). Legal advice is highly recommended when creating or altering beneficiary designations.

As a general rule, upon death, the fair market value of your RRSP or RRIF is included as income on your final tax return and taxed at your marginal rate. A notable exception to the rule is the ability to rollover the account to a surviving spouse or common-law partner. If you designate your financially dependent minor child or grandchild as beneficiary of your RRSP or RRIF, it may be possible to defer and reduce the overall taxes payable on the RRSP/RRIF proceeds by using them to purchase a term certain annuity for the minor beneficiary and spreading the payments over a number of years. The annuity payments would need to start no later than one year after the purchase and cease by the end of the year they turn 18. The annuity payments would be taxable as the child's income when received.

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> "Whether you are considering how to include minors as beneficiaries in your will, on life insurance policies or on registered plans, it's important to seek professional planning advice to ensure that the legacy you've worked hard to create is shepherded effectively to the next generation."

If your financially dependent child or grandchild is eligible to open a Registered Disability Savings Plan (RDSP), they can also rollover RRSP/RRIF proceeds to their RDSP to the extent of their available maximum lifetime contribution limit of $200,000.

Whether you are considering how to include minors as beneficiaries in your will, on life insurance policies or on registered plans, it's important to seek professional planning advice to ensure that the legacy you've worked hard to create is shepherded effectively to the next generation.

HEATHER RIVERS, BA, CFP®, FMA
Communications and Education Specialist
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Odlum Brown in the Community

For 100 years, Odlum Brown has been committed to making a difference in our communities. We are proud to showcase two of our exciting community partnerships for the month of June:

CKNW Kids' Fund – Picnic at Playland
Tuesday, June 6
Vancouver, BC

Odlum Brown has proudly supported the CKNW Kids' Fund for many years, through their annual pledge day, Pink Shirt Day and the Picnic at Playland. On June 6, over 3,500 children with various challenges, including learning difficulties, physical and/or mental challenges, will have access to the entire amusement park, just for them. We are proud to sponsor this wonderful event.

For more information, visit cknwkidsfund.com.

Arts Club Theatre Company – Million Dollar Quartet
Thursday, June 22 – Sunday, August 6
Vancouver, BC

Odlum Brown is proud to be the Presenting Sponsor of Million Dollar Quartet at the Arts Club Theatre Company's Granville Island Stage this summer.

Inspired by true events, this rocking jukebox musical takes you to Memphis and into Sun Records Studio on December 4, 1956. Witness the famed jam session that brought together rock and roll legends Presley, Cash, Lewis and Perkins – for the first and only time. Experience all the hits that made these powerhouse stars the icons they are today, including "That's Alright," "Folsom Prison Blues," "Great Balls of Fire," "Blue Suede Shoes" and more!

For more information, visit artsclub.com.

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