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Editor and Publisher: Gordon Pape
Associate Publisher: Richard N. Croft

THE PANDEMIC—ONE YEAR LATER

By Gordon Pape, Editor and Publisher

It was one year ago last Tuesday that the stock market hit the bottom of the pandemic plunge.

Of course, no one could have predicted that at the time. Before COVID hit we were riding the wave of a bull market that began in late March 2009, after the financial crash sent share prices tumbling around the world.

That 11-year run ended abruptly when investors woke up to the fact the coronavirus was a real and immediate threat to the economy. People rushed to cash in, sending stocks into a spiral. Between Feb. 21 and March 23, 2020, the S&P/TSX Composite fell 7,664 points, losing over 37% of its value. It was thought at the time this was the beginning of a long bear market. The pandemic was just taking hold, businesses were closing down, millions of people lost their jobs, and there was no medical relief on the horizon, either in the form of treatments or vaccines. The vicious death toll was just starting.

One year later, we're looking back on what turned out to be the shortest bear market in history. Major indexes in

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New York and Toronto have set new record highs and continue to do so. The S&P/TSX Composite gained over 66% from its 2020 bottom to the one-year anniversary date. The S&P 500 and the Dow were each up more than 74% over that period, while Nasdaq advanced almost 93% on the strength of technology stocks.

A breakdown of the components driving the TSX shows that the downtrodden energy sector performed a remarkable turnaround, rising 158% over the 12-month period. Financials, which are the largest component of the TSX, were up 73% in that time, despite being hit last spring by a sharp reduction in interest rates as central banks scrambled to boost the economy. Small caps, which had been a drag on Canadian markets for years, did a complete reversal, with the index gaining 125% over the year. It was an amazing recovery in such a short time. But what happens now?

Stocks are expensive, no matter how you measure it. The p/e ratio of the S&P 500 was almost 40 as of the close on March 23. That compares to a mean of 15.91, which covers well over 100 years of the index's history. To drive that figure down to a more reasonable level, corporate profits have to rise and/or market prices must fall. There's a good argument to be made for improving profits as the global economy rebounds from the pandemic, although President Biden's plan to raise the U.S. corporate tax rate to 28% will put a somewhat of a damper on that.

The other factor to consider is rising interest rates and their negative effect on bond prices. The FTSE Canadian Universe Bond Index is down 4.72% to March 25. Investors are pulling their money out of fixed income ETFs at an unprecedented rate; the sector lost 26.1% of its assets under management in February according to data released by Canadian ETF Association. That money was redirected to equity funds, which saw assets increase almost 70% month-over-month. This is the TINA (There Is No Alternative) principal at work. The result is a potentially dangerous tilt to equities that leaves investors vulnerable to a market pullback. What should you do in these circumstances? My suggestions:

Take part profits in inflated stocks. Taking some money off the table when p/e ratios are so high is simply prudent but check the tax consequences before acting. This is not to suggest abandoning the stock market. It could still go on rising for several months. But ease back on your exposure.

Reposition your bonds. The FTSE Short-term Bond Index is down only 0.52% year to date. You should retain some exposure to the bond market to act as a buffer if stocks should tumble but minimise the risk. Look at ETFs like iShares Core Canadian Short Term Corporate Bond Index (TSX: XSH). Also consider hedging your bets with the iShares Convertible Bond Index ETF (TSX: CVD), which is ahead 3% year-to-date and showed a one-year gain of 7.16% to the end of February.

Don't ignore Canada. U.S. indexes outperformed the TSX in 2020, mainly on the strength of the information technology sector. It's a different story this year. As of the time of writing, the Dow was up 5.9% for 2021 and the S&P was ahead 4.1%. Nasdaq was just slightly above break-even. The TSX, by contrast, had gained just over 7%, led by energy and financials.

THINGS THAT MIGHT GO BUMP IN THE NIGHT

Contributing editor Shawn Allen is with us with his thoughts on the possible challenges stocks might face in the coming months. Shawn has been providing stock picks on his website at www.investorsfriend.com since the beginning of the year 2000. He is based in Edmonton.

Stocks markets are near record highs. That certainly does not necessarily mean they are over-valued. But it is reason to be cautious.

The S&P 500, at a level of 3,889, as of Wednesday's close, is trading at 24.8 times its forecast 2021 earnings of $157. That multiple is well above the average, since 1950, of 17.5 times actual trailing year earnings. While low interest rates do justify a higher p/e at this time, it's always worth thinking about some of the things that could spoil the party and cause a material market downdraft.

Higher Interest Rates. Top of mind on such a list is higher interest rates. The U.S. Federal Reserve has kept short term rates extremely low. The yield on one month U.S. Treasury bills is just 0.02% (may as well call it zero!). That compares to 1.5% at the start of 2020 and 2.4% at the beginning of 2019.

But long-term interest rates have recently risen noticeably. The yield on the 10-year U.S. Treasury bond is currently 1.63%. That compares to a low of 0.55% reached at the end of July 2020.

The impact of higher interest rates on longer-term cash flows can be dramatic. For example, if the current 2.21% yield on a 20-year U.S. Treasury bond were to increase one percentage point to 3.21%, the bond's value would decline by 14.6%. A two-point increase would cause a 27% decline.

Higher interest rates act as a gravitational force on the value of all future cash flows. For stocks, higher interest rates could cause a "double whammy" impact as market p/e ratios could decline while higher borrowing costs were leading to lower earnings.

Inflation. Inflation is a worry mostly because it could be a catalyst to push interest rates higher. It also causes an erosion over time in the purchasing power of an investment portfolio even if the market value of the portfolio is stable.

Corporate tax rate increase. The U.S. federal corporate income tax rate was massively reduced from 35% to 21% at the start of 2018. At the time, I thought

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Bump in the night—continued from page 3...

competition would force companies to pass much of the benefit along to customers in the form of lower prices. I was wrong. Average earnings for S&P 500 companies increased by 20% in 2018 and it was attributed largely to the income tax reduction.

Now, President Biden would like to partially reverse the cut and raise the corporate income tax rate to 28%. Logically, this should cause bottom line corporate earnings to fall, which of course would be negative for share prices. So far, the market does not appear to think that such a tax increase is imminent. This could be because, even with the slim Democratic majority in the Senate, passing such legislation is difficult. Apparently, the Republicans can use the filibuster to effectively block most legislation unless the Democrats have 60 votes.

Perpetual pandemic. Virus variants and continued lockdowns are another risk. If vaccines are not as effective and/or vaccination rates are not as high as hoped, then the economy may not open up as much as currently forecast, which would impede corporate earnings growth.

Black Swans. The COVID-19 pandemic was of course the most recent major black swan event to hit the market. The next large and unexpected "meteor" that will inevitably hit the markets at some point is, of course, unknown. The very essence of risk is that it occurs unexpectedly.

Action now: The best defense against market risks is diversification across asset classes and geographies and also holding quality securities within each asset class. That should allow you to sleep better with less worry about things that might go bump in the night!

CORRECTION

In the html version of last weekend's IWB, the updates on Canadian Solar and Horizons US Marijuana Index ETF were incorrectly attributed to Richard Croft. These recommendations were actually updated by Adam Mayers. We apologize for any confusion.

SHAWN ALLEN'S UPDATES

Recommendations are colour-coded:
Green indicates Buy
Yellow indicates Hold
Red indicates Sell

Canadian Western Bank
TSX: CWB, OTC: CBWBF

BUY

Originally recommended on Sept. 15/14 (#21433) at C$40.54, US$36.31. Closed Friday at C$32.57, US$25.69.

Background: This smaller bank, unlike the large Canadian banks, is virtually a pure deposit and lending operation. Fully 88% of its revenues are from the net interest margin on lending and a further 4% is credit-related fees, for a total of 92% from lending. CWB primarily lends to commercial customers as opposed to individuals. The remaining revenue is from wealth management and trust operations.

Alberta and B.C. each account for about 32% of its loans and Ontario 24%. Saskatchewan and Manitoba together account for 8%, and the other provinces account for the remaining 4%.

Performance: The stock was hit hard by the pandemic last spring and ended 2020 down 10% to $28.82. But this year to date it has rallied 13%. Looking at the longer term, the stock remains down 22% from highs of about $42 reached back in 2014. That's despite the fact that earnings per share have grown 12% and book value per share is up 67% since the end of 2014. In 2014, CWB was trading at considerably higher multiples of earnings and book value.

Recent developments: As of its latest quarter, CWB appears to have come through the worst of the pandemic in very good shape and has resumed earnings growth as loan loss provisions have returned to normal levels. In the first quarter of fiscal 2021, total loans grew 6% year-over-year, including 14% growth in Ontario. And its lower-cost, branch-raised deposits were up an impressive 20%.

After three quarters of earnings declines caused mostly by higher pandemic-related loan loss provisions, CWB's earnings per share were up 10% year-over-year in its latest quarter. Revenues per share had continued to grow at an annual rate of 5% for most of 2020 but accelerated to 12% in the latest quarter.

On June 1, 2020, CWB closed the acquisition of iA Investment Counsel Inc., which operates under the brand names T.E. Wealth and Leon Frazer. This substantially increased its assets under wealth management from $2.3 billion to $8 billion, with offices in each of the six largest cities in the country.

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A disappointing development is that its move to a more sophisticated and more advantageous method of calculating its risk-weighted assets and capital has been delayed until 2022.

Dividend: The stock pays a quarterly dividend of $0.29 ($1.16 per year) to yield 3.6%.

Valuation: At my analysis price of $32.67, the price to book value ratio is quite attractive at 1.0. The trailing adjusted p/e is also quite attractive at 11.1. The dividend yield is reasonably attractive at 3.6%. The trailing year adjusted return on equity (ROE) is good although not great at 9.5%.

Outlook: CWB's management notes its recent increased market share and states that the bank is growth-focused and positioned for accelerated growth. CWB's share price could increase materially over the next year or two driven by both expected higher earnings and a potential return to higher trading multiples.

Risks: Bad loans are always a potential risk for CWB, but it has a strong track record in that regard. A weaker economy is also a risk, but its increasing geographic diversifications is lowering that risk.

Action now: Buy. CWB provides the opportunity to purchase a well-managed and growing small bank at book value.

YOUR QUESTIONS

EARK ETF

Q - Why do you recommend the Emerge ETF (EARK) rather than ARKK which has a far lower MER, albeit trading in New York? – John L.

A - The Emerge ARK ETFs are better for Canadian investors because of the tax treatment. When Canadians buy ARKK they are buying U.S. property whereas EARK is a Canadian ETF. Canadian investors can buy a U.S. dollar version (EARK.U), which is still a Canadian-based fund. Emerge says the MER will fall as more money comes into the fund. – Adam Mayers

Q - The Emerge Ark Innovation Fund (EARK) is C$24, but the Ark Innovation Fund (AARK) in New York is US$124. Why is that? – Gord Z.

A - The Emerge Ark fund (EARK) was launched in 2019 and has about C$206 million in assets. AARK was launched in the U.S. in 2014 and now has US$22 billion in assets. The funds have been available for a different amount of time and are different sizes. This means the share prices will be different as each fund has a different number of shares outstanding. The performance though is the same. – Adam Mayers

Berkshire Hathaway Inc.
NYSE: BRK.B

HOLD

Originally recommended on April 4/16 (#21614) at $143.79. Closed Friday at $256.77. (Figures in U.S. dollars.)

Background: Berkshire is a giant conglomerate holding company, with numerous operating subsidiaries and huge (but not so numerous) stock investments. Rather famously, its investments also include a massive cash hoard now amounting to $138 billion or 16% of its assets.

Equity stock investments total $281 billion or 32% of its assets. These equity investments are extremely concentrated. Its shares in Apple Inc. alone were worth $120 billion at year end or an astounding 43% of the entire stock portfolio! This level of concentration is basically unheard of among institutional investors and is probably by far a record in a single stock even for Berkshire.

Only $20 billion or 2% of assets are invested in fixed income. The remaining 50% of assets consist of a vast array of operating subsidiaries. The largest operating segment is insurance, followed by its railroad assets and its energy utilities. The remaining operating businesses consist of a wide variety of manufacturing, consumer service, and retailing businesses.

Berkshire is also an extremely decentralized company. Just 26 of its 360,000 employees are in its head office.

To observe that Buffett has taken an unconventional approach to both corporate management and investing would be a huge under-statement.

Recent Performance: The shares were up 2% in 2020 to $231.87 and are up 10.7% in 2021 to date.

Recent earnings: In 2020, operating earnings at $21.9 billion were down 9% due to the pandemic.

Dividend: Berkshire does not pay a dividend as Buffett has always believed that its share owners would be better served by Berkshire retaining and investing all profits. This could change. In 2020, for the first time, Berkshire repurchased a material amount of its own stock, reducing the share count by over four percent. The main reason for doing that appears to be a lack of attractive investment opportunities combined with the ever-mounting cash hoard. A dividend would be another logical solution to that problem.

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Value ratios: Analyzed at its recent price of $250. The price to book value ratio is reasonable at 1.32 but less attractive at 1.72 after deducting purchased goodwill and other intangible assets.

Berkshire's GAAP earnings are highly volatile because even unrealized gains and losses on investments must now be included in earnings. Operating earnings are more stable and predictable but are subject to volatility, particularly in the insurance segment, and in any case greatly understate long-term results by ignoring all capital gains on investments.

Based solely on operating earnings, the p/e appears unattractive at 27.4 and the ROE is unimpressive at 5.0%.

Outlook: Most of Berkshire's operating businesses should achieve double digit earnings growth in 2021 in comparison to the pandemic-weakened results of 2020. Insurance operating earnings and investment gains or losses are always unpredictable. With its vast array of high-quality subsidiaries and its stock investments, Berkshire should continue to grow in the long term. Probable continued stock buybacks could be beneficial to the share price.

Risks: Berkshire's results are inherently somewhat volatile due to its massive equity investments and the nature of its insurance operations. The share price will also likely dip with the ultimate death or incapacity of Warren Buffett. And it seems unlikely that his successor investment managers could match Buffett's performance or even that the board would continue to allow the kind of incredibly concentrated portfolio that Buffett has favored.

Action now: Continue to hold.

Costco Wholesale NDQ: COST

Originally recommended on July 15/13 (#21326) at $116.46. Closed Friday at $352.02 (All prices in U.S. dollars.)

HOLD

Background: Costco needs little introduction. Some 69% of its 803 stores are located in the U.S., 13% in Canada, and 5% in Mexico. The remaining 13% are mostly in the U.K., Japan, South Korea, Australia, and Taiwan. Its members-only warehouse format and its focus on selling high volumes but a limited selection of products is designed to achieve the lowest costs and lowest prices.

Performance: Costco's shares have rewarded investors handsomely over the years. In 2019 the stock surged 44% to $292.92. In 2020 it added another 28% to end at $376.78. In 2021 to date, the stock is down 6.5% at $352.02. We are ahead 202.3% since the original recommendation.

Recent earnings: Costco benefited substantially from the pandemic as restaurants and some competitors were temporarily shut down and as customers stocked up (#toiletpaper). In the latest four quarters reported, Costco's adjusted earnings per share growth has averaged about 19% year-over-year. Revenues per share increased by an average of 13%. Same-store sales growth adjusted for variations in fuel prices and currency exchange was extremely strong at an average of 12% for the past four quarters. And e-commerce sales, which represent about 6% of revenues, have been surging at a rate of about 80% year-over-year.

Dividend: The stock currently pays a quarterly dividend of $0.70 ($2.80 per year) to yield 0.8%. This excludes occasional large special dividends. The regular quarterly dividend has been increased annually for many years. Special dividends paid were $10 per share in late 2020, $7 in 2017, $5 in 2015 and $7 in 2012.

Valuation: Based on my analysis price of $340, Costco's trailing p/e ratio of 34 is unattractively high, even for such a top-quality company. But this has been the case for several years. Its dividend yield is low, despite recent increases, at 0.9%. The ROE is very strong at 27%. It is clearly a very high-quality company. But the stock remains expensive on a p/e basis.

Outlook: Over the next year, Costco will be "lapping" the very buoyant results of the past year and therefore will likely struggle to maintain or exceed a similar level of earnings per share. But its long-term growth trajectory certainly remains intact.

Risks: The main risk of investing in Costco is its somewhat high valuation in relation to earnings. Operationally it is low risk as it seems unlikely to lose market share or to cease growing.

Action now: Continue to hold. Costco is somewhat expensive in relation to its earnings but is a high-quality company that should be held for the long-term.

RICHARD CROFT'S UPDATES

Recommendations are colour-coded:
Green indicates Buy
Yellow indicates Hold
Red indicates Sell

BMO S&P/TSX Equal Weight Banks Index ETF TSX: ZEB

HOLD

Originally recommended on Sept. 17/18 (21833) at $30.05. Closed Friday at $33.64.

Background: ZEB holds an equal weighted basket of the big six Canadian banks. It does not sell covered calls against the shares.

Performance: Bank stocks have recovered as interest rates have risen and this ETF is now 11.9% higher than when originally recommended.

Key metrics: The fund was launched in 2009 and has almost $1.6 billion in assets under management. It is up about 16% year-to-date, as of the time of writing. The 10-year average annual return to the end of February was 9.4%. The MER is 0.61%. Distributions are paid monthly and are currently running at $0.10 per unit ($1.20 annually), to yield 3.6%.

Comments: Bank stocks are doing well in this rising interest rate environment and that pattern should continue. As well, we can look forward to a round of dividend hikes once the Superintendent of the Office of Financial Institutions lifts the ban on increases that was imposed a year ago.

Action now: Hold.

iShares S&P/TSX Capped Financials Index ETF TSX: XFN

HOLD

Originally recommended Sept. 17, 2018 (#21833) at $38.21. Closed Friday at $43.83.

Background: XFN provides targeted exposure to Canadian financial companies with the objective of capital growth and dividends by holding securities represented within the S&P/TSX Capped Financials Index.

Performance: XFN was originally recommended on Sep. 17, 2018. It slumped when central banks slashed interest rates after the pandemic hit but has come back strongly in recent months.

Portfolio: There are 28 holdings in the portfolio. All of the big six banks are in the top ten as well as large insurance companies like Sun Life, Manulife, and Intact. Brookfield Asset Management rounds out the top ten.

Key metrics: The fund was started in March 2001 and has assets under management of $1.4 billion. Distributions are paid monthly and adjusted quarterly. The current amount is $0.112 per month ($1.344 annually) which, if continued at that rate, would translate into a yield of 3.1%. The MER is 0.61%.

Outlook: XFN has a 65% allocation to the big six Canadian banks as well as minor positions in other interest sensitive securities. The rally we have witnessed in Canadian banks is just beginning. The negative is that interest rates are expected to remain low given recent commentary from the Bank of Canada. Low rates squeeze loan margins, which is a negative for bank stocks. That said, Canadian banks are well diversified and reported record fourth quarter earnings. They are flush with cash, carrying more than twice the Tier I capital they normally hold. I look for the government to ease restrictions on Canadian banks by the third quarter of 2021. That will allow the big six Canadian banks to raise dividends on a semi-annual basis, which will flow into XFN and through to unitholders.

Action now: Hold.

iShares MSCI Emerging Markets ETF NYSE: EEM

HOLD

Originally recommended on Feb. 17/20 (#22007) at $44.19. Closed Friday at $53.27. (All figures in U.S. dollars.)

Background: EEM is a U.S. based ETF that tracks the performance of emerging markets.

Performance: This ETF took a big hit in last year's market sell-off, falling to a low of $30.10. It recovered strongly, reaching a high of $58.29 in February before pulling back.

Portfolio: This fund is heavily weighted to China, which represents 38.7% of its holdings, although that's a reduction from our last review. Taiwan and South Korea are the only other countries with a position of more than 10%. Top holdings are Taiwan Semiconductor Manufacturing, Tencent Holdings, Alibaba Group, and Samsung.

Key metrics: The fund was launched in April 2003 and has just over $29 billion in assets. The MER is 0.68%. Distributions are paid semi-annually, in June and December. The December amount was $0.519 per unit.

Outlook: EEM seeks to track the investment results of an index composed of large and mid-capitalization emerging market equities. Major holdings are domiciled in regions where the pandemic has receded – i.e., China, Korea, Taiwan, and Singapore – and where the economies are generally open for business.

EEM provides excellent geographic diversification within your portfolio and securities in these regions, when measured on a price to earnings ratio, are generally less expensive than comparable U.S. stocks. I believe EEM will continue to outperform, and readers should maintain positions to take advantage of further upside.

Action now: Hold.

GORDON PAPE'S UPDATES

Recommendations are colour-coded:
Green indicates Buy
Yellow indicates Hold
Red indicates Sell

Archer-Daniels-Midland NYSE: ADM

HOLD

Originally recommended on Sept. 10/18 (#21832) at $49.31. Closed Friday at $57.91. (All figures in U.S. dollars.)

Background: Chicago-based Archer-Daniels-Midland is one of the largest food -processing companies in the world. The variety of products ADM produces would take pages to list. They include flours and grains, beans and pulses, nuts, oils, proteins, starches, and sweetening solutions. The company makes products used in medical supplements and health foods, including ingredients used for cognitive, heart, digestive, and immune problems. ADM is also a major player in animal nutrition, chemicals, packaging, personal care, and renewable plastics.

Performance: The stock hit an all-time high of $59.12 in intraday trading earlier this month.

Recent developments: On Jan. 26, ADM reported fourth quarter and 2020 earnings, and they beat expectations.

For the fourth quarter, revenue was just under $18 billion, up 10.1% from $16.4 billion in the same period of 2019. Revenue beat analysts' estimates by $1.5 billion. For the 2020 fiscal year, revenue was down slightly to $64.4 billion compared to $64.7 billion the year before.

Net earnings per share for the quarter were $687 million ($1.22 per share, fully diluted), compared to $504 million ($0.90 per share) in the previous year. For all of 2020, earnings were $1.8 billion ($3.15 a share), up from $1.4 billion ($2.44 per share) in 2019.

"We expect strong growth in segment operating profit and another record year of EPS in 2021," said CEO Juan Luciano.

Dividend: The company raised its quarterly dividend by 2.8% to $0.37 ($1.48 a year) effective with the March 2 payment. The stock yields 2.6% at the new rate. It was the 46th consecutive year of dividend hikes.

Outlook: Senior management is optimistic about 2021, forecasting an increase in earnings per share.

Action now: Hold. The shares have a p/e ratio of 18.38, which is on the high side by historical standards.