Gold Investment
Portfolio Manager

Investment Letter

Q2-20 Investment Letter (No. 52)
July 23, 2020

OVERVIEW

Dear Clients and Friends,

We are pleased to provide this quarterly report for the period ended June 30, 2020. The letter will be divided into three sections: (1) Market Recap, (2) What's New and (3) Commentary.

MARKET RECAP

The S&P 500 Index (in USD) soared by 19.95% for the three month period ended June 30, 2020. The net increase over the quarter was 515.70 points; the Index hit a high of 3,232.39 on June 8, 2020 and a low of 2,470.50 on April 1, 2020.

The S&P/TSX Composite Index climbed by 15.97% in the second quarter of 2020, ascending 2,136.47 points. The Index similarly hit a high of 15,974.91 on June 8, 2020 compared to its low of 12,876.37 reached on April 1, 2020.

The Canadian Dollar quoted in USD (CADUSD) increased by 3.62% during the quarter ended June 30, 2020. CADUSD closed at 0.7366 on June 30, 2020 versus a close of 0.0.7109 on March 31, 2020

WHAT'S NEW

COVID-19
Gold Investment Management's top priority remains keeping our employees and clients healthy and safe by implementing appropriate measures as new information emerges. We continue to closely monitor and evaluate the ongoing **COVID-19** situation through various networks and we encourage clients to **contact** us if they have any questions.

KYC Reviews
GIM would like to remind you of its ongoing obligations to conduct annual "Know Your Client" ("KYC") reviews. You likely have already received a call to schedule a review with one of our portfolio managers. If not, you will receive a call from us over the remainder of the year. Investment reviews are a great way to keep us informed of your personal and financial circumstances so we can best serve you. In addition to GIM's obligations, Section 3 of your Investment Management Agreement provides, in part, that you are required to notify us of any change in your personal and financial circumstances that could give rise to a change in your investment objectives or in the way in which we manage your account. You are therefore urged to get in touch with us respecting your marriage or divorce; the birth or adoption of a child; the death of your spouse; the onset of any chronic or terminal illness; any loss or change in your income, savings or employment; or any similar development.

Communication
If you desire more frequent interaction with a Portfolio Manager or your individual circumstances have changed please **contact** our office.

COMMENTARY

The first half of 2020 saw a massive bear market in equities and a huge bull market in bonds, something that hasn't happened since 2008-09 Great Recession. We've picked up a lot of folk wisdom learned from our investment peers over the years and this is a good time to dust them off as they are as relevant today as when they came about.

Current Status
The economic situation is not good right now. The pandemic has caused a drop in our economy, many people have lost their jobs, and there has been a lock down that has kept us isolated and physically distanced. We understand the problems and we have the greatest sympathy for everyone affected. We will come out of this pandemic when vaccines are developed but until then life will not go back to normal. The Government of Canada's "fiscal snapshot" of July 8, 2020 projects a contraction of 6.8% of GDP for the fiscal year. Government finances are also a mess, projecting a deficit of $343 billion for the current fiscal year. Prior to the pandemic the GoC had projected a deficit of $28.1 billion.[1]

The severe slide of the stock markets in March took down high- and low-quality names by equal measure. Chart 1 below shows blue chip companies (S&P500) and smaller companies (S&P600) with equally precipitous falls. This told us it was panic selling, and we used it as a buying opportunity for our clients. Clients that have been monitoring accounts online or

[1] Dow Jones Newsplus, July 8, 2020

reading your statements will have seen us using contributions and investment income to buy our favorite names or sectors as soon as the cash came in.

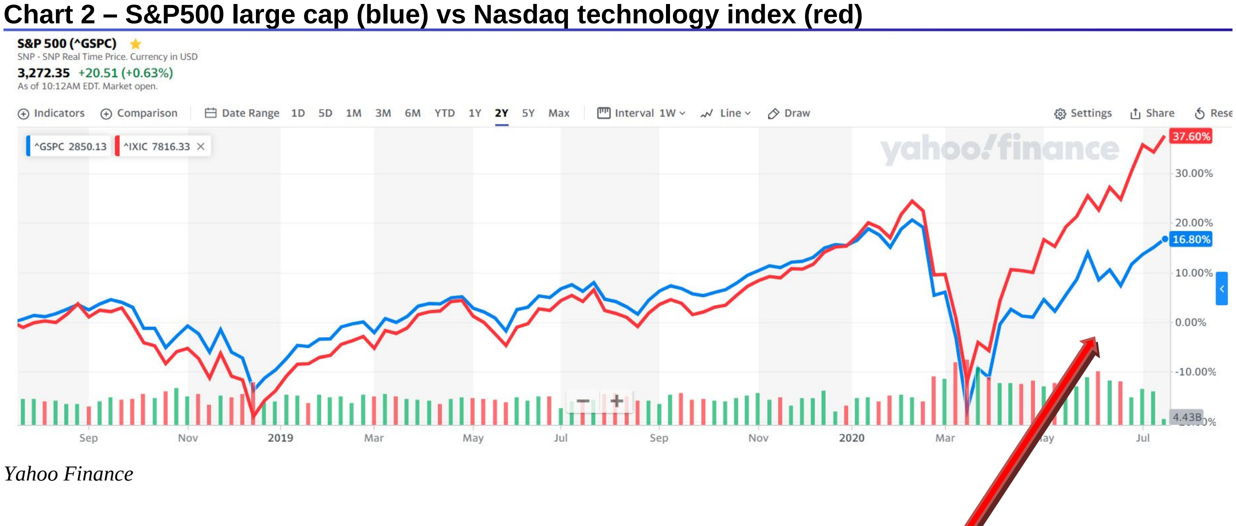
The market's recovery off the lows was initially also broad based, which we regarded as positive (Chart 1). There has recently been a divergence. Leadership in the markets has started to narrow to the FAANG[2] and mega-cap technology stocks. These were the market leaders in the U.S. equity markets before the COVID-19 pandemic. While there has been a rebound off the bottom for the smaller, lower quality companies as compared to the blue-chip S&P500, the smaller names have lagged the blue chips.

Chart 1 – S&P500 large cap (blue, high quality) vs S&P600 small cap (red, low quality)

Yahoo Finance

Investment legend Bob Farrell came up with 10 rules of investing.[3] Rule #7 in particular states *"Markets are strongest when they are broad and weakest when they narrow to a handful of blue-chip names."* As Chart 2 shows in the last 3 months the S&P500 large cap index has gone up by 16% while the technology heavy Nasdaq is up 26%. Interestingly, technology and the broad market moved in lockstep in the prior 2 years before March 2020.

Chart 2 – S&P500 large cap (blue) vs Nasdaq technology index (red)



Yahoo Finance

Last 3 months technology (Nasdaq) ahead of broad market (S&P500)
The 2 sectors moved lockstep in prior 2 years

The year-to-date performance shows that the Nasdaq is actually up 20.0% versus the more diversified S&P500 slightly up 1.1% at July 13, 2020. 20% of the S&P500 consists of FAANG names, so the S&P would be worse if we remove these names. See Chart 3.

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[2] https://www.investopedia.com/terms/f/faang-stocks.asp. FAANG refers to Facebook, Amazon, Apple, Netflix, Alphabet (formerly known as Google).
[3] https://www.cnbc.com/2020/02/11/this-wall-street-legends-10-rules-for-investing-are-very-applicable-to-this-bull-market.html

Chart 3 – S&P500 (blue) +1.1% vs Nasdaq (red) +20.0% YTD July 21, 2020

Yahoo Finance

What to Watch For

In summary, leadership is starting to narrow again, which was the case prior to the pandemic. The same companies that were leading before are leading again. The next question is going to be "Will there be a second down leg of a bear market?" The honest answer is no one knows what the markets will do over the short term. But there are good reasons to be cautiously optimistic over the medium to long term. Here are 5 things we are watching:

1. *Technology leads for fundamental reasons*. There are good reasons for technology names to lead. The pandemic has led to working/staying at home. This means increased demand for technology products while demand for consumer discretionary goods and services has fallen. Anecdotally, we have heard sales by tech companies have not suffered during the pandemic as consumers and businesses have required increased use of mobile phones, laptops/computers, servers and routers, and online/internet sales and shipping services. On the other hand, consumer discretionary items like clothing stores and restaurants have suffered. The share prices of these 2 sectors should reflect this, and we can see it from the charts of the ETFs for the S&P500 consumer discretionary sector (blue) versus the S&P500 technology sector (red) in Chart 4 below.

Chart 4 – Jan 1 to July 13, 2020 YTD Performance:
S&P500 Consumer Discretionary ETF XLY (blue) +10.5% vs S&P500 Technology ETF XLK (red) +23.5%

Yahoo Finance

Panic selling: all down equally

Recovery: technology outperforms discretionary/retail/restaurants during stay-at-home phase

Chart 4 once again shows both technology and discretionary were down with the same intensity in March 2020, reinforcing our belief that it was panic selling of everything, which spells out a great buying opportunity. As we might expect, retailers and restaurants have underperformed technology since April 2020, which we believe is a reflection of lost sales and earnings by retailers and restaurants versus increased demand for technology at the same time.

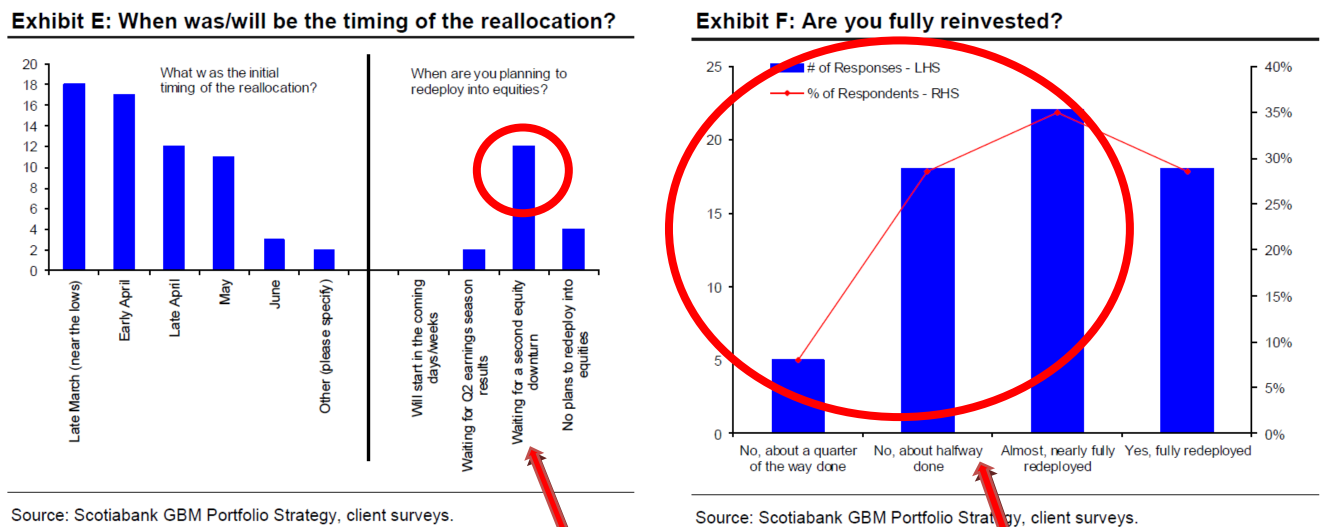
Summary. There is a fundamental reason for technology stocks' leadership over the rest of the market. What actually concerns us now is valuation, as tech shares are expensive; This means the technology sector may be choppy. We plan on using the volatility to our clients' advantage, buying either the sector or individual securities if suitable for a client's account. The important point here is to understand volatility does not necessarily mean a company will go bankrupt. It just means the price of the shares will go up/down – sometimes significantly – which means a possible buying opportunity for you as our client.

2. *Bob Farrell has more rules*. Farrell's rule #9 states *"When all the experts and forecasts agree — something else is going to happen."*[3]

There is no shortage of investors who missed out on the initial V-shaped recovery and are now waiting for a W-shape, that is a second big drop in the stock markets. This may not happen as there is simply too much cash on the sidelines waiting to be deployed. Every time there is a drop in the market it will suck more cash in.

Our peers are the other institutional investors across the country. A recently published survey shows that only 30% are fully invested in the stock markets according to their mandate and most of them expect another deep drop in the market.

Chart 5 – Canadian Institutional Investor Survey



Scotiabank Portfolio Strategy, July 7, 2020

Majority of institutions surveyed want another deep stock market drop…

… because they have to get deployed, as up to 70% of them are below required weighting

To understand the significance of the above charts, institutional investors in Canada manage hundreds of billions of dollars in investments and are deemed to be sophisticated investors. An example is Canada Pension Plan which managed $356 billion at the end of fiscal 2018.[4] However, as sophisticated investors, they must operate under a set of rules called an investment policy, including requirements to have minimum and maximum stock and bond weightings at all times. This requirement is supposed to be absolute, meaning they should never allow themselves to be over/under the required amounts of equities, bonds, etc.

When we worked in an institutional environment, we were trained to never violate our investment policy as it would have likely cost us our jobs. So, we were stunned at how many were not at their required minimum equity weights. Up to 70% of institutions in the survey were below requirement and most of them are waiting for another big drop in the markets as an opportunity to get back in. **The reason for having to be disciplined in the markets is this: A significant number of these institutions missed out on the massive rebound of the stock markets if they violated their required equity weightings**. If this indeed happened, there will be some difficult questions asked by the institutional manager's clients.

Summary. There is another saying, *"It is not market timing, it is time in the markets"*. Going to cash in a bear market is called market timing and we do not believe market timing works consistently. There is a reason why professional money managers are required stay the course in up and down markets. They've learned the hard way timing does not work over

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[4] https://www.canada.ca/en/employment-social-development/programs/pensions/reports/annual-2018.html

the long term and it is a lesson that should be ingrained in institutional memory.

We apply the same discipline with our clients. For example, you have told us that you want a certain level of risk and we do not deviate from those parameters in good times or bad. The market will tend to do the opposite of what the majority of participants want (Farrell's rule #9). Institutions and individuals are nervous about the rebound of the stock markets and want another steep drop so they can get back in, Farrell says that may not happen.

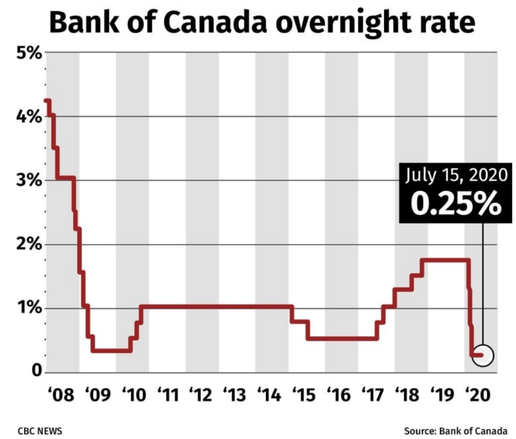
3. *Interest rate policy*. We have written about the high level of debt carried by Canadians in previous newsletters, so we won't revisit the topic here. Frankly we do not think many households will be able to deal with a significant rise in interest rates; even a 1-2% increase in mortgage rates may not be sustainable for some consumers. With the pandemic induced lockdown there have been more job losses, which will make the sensitivity of the consumer to rising interest rates even worse.

Interest rates therefore need to stay low for the foreseeable future, and we believe the Bank of Canada ("BoC") will have no choice but to be accommodative.

On Wednesday July 15, 2020 the new Governor of the BoC, Tiff Macklem, kept the central bank interest rate at 0.25%, which is near zero. For 2020 as a whole, the BoC expects Canada's economy to shrink by 7.8%, rebound by 5.1% in 2021 and 3.7% in 2022. Thus, a recovery to pre-pandemic economic levels is at least 2 years out according to the BoC.[5]

Summary. Interest rates are going to be at or near zero for the foreseeable future. This is to help the economy recover. Rising interest rates will increase expenses for businesses and individuals, something which the BoC regards as unaffordable.

Chart 6 – BoC Overnight Rate Near Zero



Source: CBC.ca

4. *There is No Other Alternative ("TINA").* To complete the discussion of low interest rates we need to discuss fixed income or bonds (both terms are interchangeable). Bonds are *normally* regarded as having less risk than the stock market. Bond prices move inversely with interest rates, so the lower the interest rate the more expensive the bond. However, with such low interest rates bonds look very expensive to us right now.

Here is the income an investor can expect from Government of Canada "T-Bills, the Canadian stock market, short-term corporate bonds, and gold. We've used Exchange-Traded Funds (ETFs) as these are securities that any investor can easily buy, in order to have a real comparison.

Table 1 – Asset classes

Asset	Income %	Comment
3-month T-Bill	0.16% Yield to Maturity	Government of Canada risk, deemed to be risk-free
10yr Gov Canada Bond	0.54% Yield to Maturity	Government of Canada risk, very low risk
XSB – Short corp. bond ETF	2.29% Interest Yield	iShares Core Canadian Short Term Bond ETF, average maturity 2.88yrs
XIC – Cdn equity index ETF	3.35% Dividend Yield	iShare Core S&P/TSX Capped Composite Index ETF
XRE – REIT real estate ETF	5.56%* Dividend Yield	iShares S&P/TSX Capped REIT Index ETF
GLD – Gold ETF	Nil – no income	Long term price appreciation

*Scotia iTrade, July 15-16, 2020 *XRE pays 7 cents/month dividend on $15.09 price*

The table above shows that risk-free Government of Canada 3-month T-Bills are yielding 0.16%, and 10-year Government of Canada bonds have a yield of 0.54%. Investors are loathed to accept such low rates of interest on their savings and investments. Yet, as discussed, the BoC is expected to keep interest rates down for the foreseeable future. A risk-free investment won't even cover the cost of inflation! In bond language we would say these low risk bonds are **expensive**.

If low risk bonds are expensive then we think of *TINA*. This means "*There Is No Alternative*". Instead of 0.16% on a T-

[5] https://www.cbc.ca/news/business/bank-of-canada-rate-decision-1.5650255
https://www.reuters.com/article/us-china-economy-gdp/chinas-economy-rebounds-after-steep-slump-weak-demand-u-s-tensions-raise-risks-idUSKCN24H0AM

Bill we can go up two notches in risk and get 2.29% on short term corporate bonds (XSB). Or go up a further notch in risk and get a decent 3.35% dividend from the broad Canadian stock market (XIC), which is compensation for taking on stock market risk. If we go up further on the risk scale, a specialty asset class such as public real estate or REITS (XRE) gives a healthy 5.56% dividend as compensation for real estate risk.

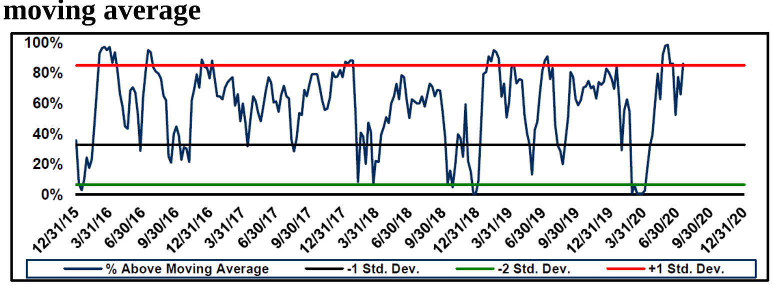
We constantly get questions about gold. Precious metals do not pay dividends and for inflation protection we recommend the stock market or hard assets such as REITs, which pay a regular dividend.

Summary. The stock markets have rebounded quite sharply since March 2020 but there is a fundamental reason for it. If low risk bonds and T-bills are so expensive then TINA says look at corporate bonds and equity markets.

The good news is investors still receive income (return) that is commensurate with the amount of risk taken. If a risk-free T-Bill is 0.16% then corporate bonds and equities offer a reasonable premium for their risk. In other words, our clients are compensated for taking on investment risk. This, in our opinion, is a fundamental reason for the rebounding performance of the equity and corporate bond markets since the March panic selling.

5. *Companies have adapted and are not being given enough credit for it.* The equity market consists of public companies that we, the shareholders, own a part of. Like individuals, companies have adjusted and adapted to the pandemic. Second quarter 2020 earnings began to be reported starting the week of July 13 and the initial results were a pleasant surprise to us. U.S. bank earnings started reporting, and they were down, but better than consensus expectations. Since June 30, 2020, 8 of 11 S&P 500 sectors have had their earnings estimates increased by securities analysts, which indicates there was far too much pessimism in the ability of the companies to weather the pandemic. 88% of the 147 subindustries in the S&P Composite 1500 Index advanced over the past week, indicating a gradual broadening out of the market's participation.[6]

Chart 7 – 80% of S&P1500 sub-industries are above 50 day moving average



CFRA, Sector Watch, July 20, 2020

Summary. There is a reason for the adage *"The 3 most important things to look for in an investment are management, management, management."* Good managers will take action during a crisis to ensure their companies survive. The market was overly pessimistic about the second quarter earnings, and they are currently being adjusted upwards. The share prices, over the short term at least, have followed in lockstep.

Conclusion

There is no shortage of things to worry about. There are over 110,000 cases of COVID-19 and over 8,800 deaths in Canada, concentrated mostly in Ontario and Quebec.[7] The U.S. has seen a resurgence of cases with over 4 million infections and 145,000 deaths.[8]

Despite the dire number of cases, you, our clients are almost all fully invested in the markets according to the level of risk you wish to take, so you have not missed out on the rebound of the stock markets. The fact that there are other investors still on the sidelines is actually a good thing, as this tells us the equity markets will claw their way higher. We leave you with one final relevant saying as to why… *"The market climbs a wall of worry"*.

Thank you for entrusting us with your investments. As always, we welcome your questions and comments. You can contact GIM by telephone: 1.888.436.9955, fax: 1.866.541.7947 or email: invest@gold-im.com.

Yours truly,
GOLD INVESTMENT MANAGEMENT LTD.

[6] CFRA, Sector Watch, July 20, 2020
[7] https://www.canada.ca/en/public-health/services/diseases/2019-novel-coronavirus-infection.html
[8] https://www.cnn.com/interactive/2020/health/coronavirus-us-maps-and-cases/

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