Investment Letter

Q3-24 Investment Letter (No. 69)

October 28, 2024

OVERVIEW

Dear Clients & Friends,

We are pleased to provide this quarterly report for the period ended September 30, 2024. This report will be divided into three sections: (1) What's New, (2) Market Recap and (3) Commentary.

WHAT'S NEW

FIRST HOME SAVINGS ACCOUNT (FHSA) INFORMATION

The First Home Savings Account (FHSA) provides clients with another method to save for a first home purchase. Savings in the accounts grow on a tax-free basis, up to certain limits. You can contribute up to $8,000 per year, up to a lifetime maximum of $40,000. It is very important to highlight that the $8,000 contribution room only grows ***after*** you have opened a FHSA. A new account opening only generates $8,000 of room in the first year, with no carry forward room from previous years. New room becomes available in each successive year. It would take 5 years to reach $40,000 of available room, matching the lifetime contribution limit.

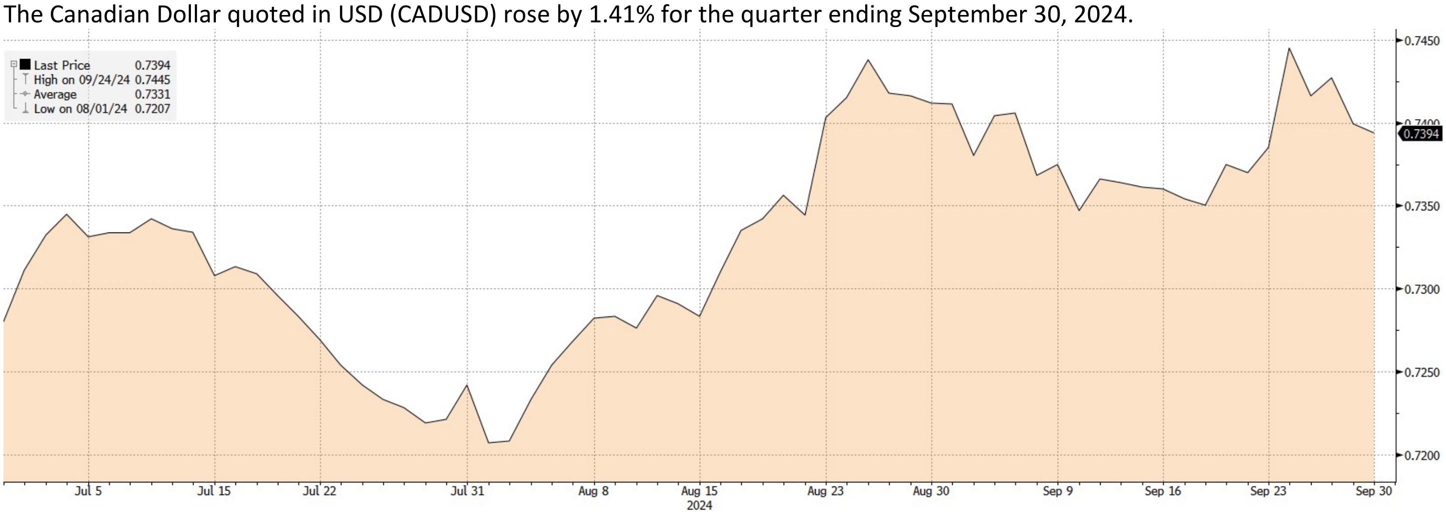
This is a 'registered' account in Canada, and typically you can name a beneficiary for these types of plans. Each province must pass the appropriate legislation in order for beneficiaries other than a client's own estate to be set. An estate designation will typically have assets pass to a next of kin or follow the directions of a will. For any clients who currently hold an FHSA, rest assured we will contact you when beneficiary designations can be updated to named individuals.

MARKET RECAP

The S&P 500 Index (in USD) gained 5.53% in the three-month period ending September 30, 2024.

The S&P/TSX Composite Index grew by 9.71% in the second quarter of 2024.

The Canadian Dollar quoted in USD (CADUSD) rose by 1.41% for the quarter ending September 30, 2024.



COMMENTARY

Part 1. Revisiting our thesis on Canadian Western Bank

Our first topic is a discussion of Canadian Western Bank ("CWB"), which will be taken private some time in 2025.

We wrote about CWB in our Q2 2023 newsletter as we believed it was significantly undervalued and a tempting takeover target. Here is what we said at that time:

> *We have purchased Canadian Western Bank ("CWB") for clients, when it suited their risk tolerance. CWB is also a regional bank like Laurentian [Bank] but is based in Western Canada and headquartered in Edmonton.*
>
> *CWB is solidly profitable and cheap to the point of silliness. The Price/Book value is 0.70x, which means in theory you can buy the entire bank at today's price of 70 cents on the dollar of book value and get at least $1.00 back by selling the pieces of the bank on the open market. Compare this to the Royal Bank which trades at Price/Book premium of 1.7x. CWB pays a solid 5.0% dividend and as a testament to its business it raised its dividend by 3% on May 26, 2023. The best news for us… the market capitalization of CWB is CAD $2.5B even after the Laurentian news, a minnow compared to the other big Canadian banks.*
>
> *CWB has successfully weathered recessions and rising interest rates, the pandemic and the boom/bust of the oil & gas cycles and it has not had the operational problems that plagued Laurentian Bank. With a market capitalization of only CAD $2.5B and trading below book value, CWB is a tasty morsel that instantly gives a strong Western Canadian footprint to any acquiror. This has been one of the reasons we purchased CWB for clients.*

We have been buyers of CWB shares for our clients. Most clients with mandates that include equities will either directly or indirectly own CWB.

It finally happened. On June 11, 2024, there was an offer to acquire all of the shares of CWB by National Bank of Canada ("NA" or "National Bank").[1] National Bank is a Quebec based bank, the smallest of the "big 6" Canadian banks. This is regarded as a strategic acquisition because CWB is Western Canada focused, so buying it will allow National Bank to expand its national footprint. CWB shareholders have voted in favor of the merger and approval from Canada's competition bureau has been received.[2] Approval by the federal regulator, the Office of the Superintendent of Financial Institutions ("OFSFI"), and from the federal government's Minister of Finance are still required, but National Bank believes the transaction will receive final approvals and close some time in 2025.

Chart 1 – CWB price action last 12 months

Source: Bloomberg, 21OCT2024

National Bank offer here…

…but CWB shares keep rising

We continued to hold CWB even after the National Bank offer as we believed there was more upside. Sharp-eyed readers will note that CWB's share price has continued to rise and we will explain why in several steps.

<u>Financing using cash versus shares</u>: We were surprised at how the purchase is being financed. In our opinion, CWB was so cheap that any of the major Canadian banks could have purchased it using petty cash or issuing some debt. This is called a "cash purchase". Cash purchases are usually beneficial to existing shareholders because using debt or cash does not increase the number of shares. The earnings of the target (CWB) will completely accrue to existing shareholders. In other words, National Bank's earnings per share would increase by just adding CWB's earnings to the existing share base. This is called *accretion*.

For example, if a company earns $10.00 per share and trades at 10x Price/Earnings, it's share price will be 10 x $10.00 = $100.00 per share. But if it grows its earnings to $12.00 per share through a cash acquisition, the shares outstanding won't change, and the share price will be 10 x $12.00 = $120.00 per share – a nice healthy $20.00 lift in the share price.

National Bank knows the benefits of a cash deal but chose to finance CWB 100% with a share issue. This increases the number of shares outstanding. So, any gains in earnings or cost reductions will be diluted by the increase in the number of shares. National Bank still expects the purchase to be accretive, but it will be much less so as compared to an all-cash offer, and it runs the risk of being *dilutive* if the assumptions about the quality of assets, revenue or cost reductions are not met.

<u>Exchange ratio</u>: Each CWB shareholder will receive 0.45 shares of National Bank. Now that we know the financing structure we can now understand CWB's price action post-announcement.

National Bank shares have been performing very well in the past 12 months. Bank stocks are called "interest sensitive". This means the share price can do well if interest rates come down, which is what has been happening through 2024 in Canada. National Bank does not have significant international businesses, so its operations are mostly domestic. CWB is focused on Canada as well. So one of the drivers of the share prices of both companies will be falling domestic interest rates.

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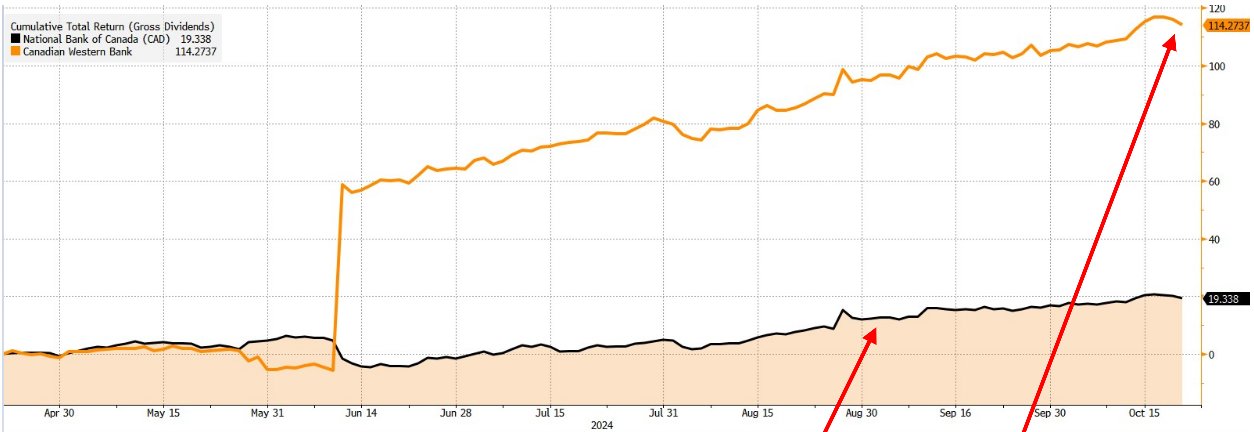
[1] https://www.nbc.ca/about-us/news-media/press-release/2024/20240611-nbc-acquisition-canadian-western-bank.html
[2] https://www.cwb.com/en/news/2024/national-bank-receives-competition-bureau-clearance-for-acquisition-of-canadian-western-bank

Arbitraging the exchange ratio: This is what finance professionals call an *arbitrage*. Because CWB shareholders will ultimately end up with NA shares, as National Bank's share price has continued to rise, so too will CWB. Conversely, if National Bank's share price falls then CWB's share price will also fall – but this only happened for a brief period of time after the takeover announcement. The rise/fall is theoretically at a 0.45:1 ratio, the ratio of the exchange offer.

Chart 2 – National Bank (*black*) vs. CWB (orange) since June 2024



Source: Bloomberg, 21OCT2024

NA stock price continues to rise…

…which drags up CWB at 0.45:1 ratio

Over the past 6 months, National Bank shares are up 19.3%, a very respectable showing. CWB shareholders have done even better – up a whopping 114% in the same period.

Summary: We've kept our CWB positions (both direct & indirect) because, to paraphrase, *it ain't over until it's over*. National Bank shares may continue to rise or there may be a competing bid from another financial institution. Plus, the downside case is actually attractive over the long term.

In a reasonable downside case, if the deal does not go through then we go back to status-quo of CWB being independent, which we were happy with. Prior to the National Bank announcement, CWB had a 5% dividend yield and was profitable, and the shares traded at a cheap 1.0x Price/Book value. If the shares stay at a cheap 1.0x Price/Book, and if book value grows by a modest 5-10% annually plus the dividend stays 5%, over the long term that means 10-15% a year in total return. A 10% compound total return means CWB will double in just over 7 years – as a downside case, that's still very compelling for us, plus this compound growth continues indefinitely. A 15% compounding means a doubling of total return in less than 5 years, also compounding indefinitely after this period.

Part 2. Concluding thoughts on what went wrong with TD Bank

In our Q2 2023 newsletter we also discussed how TD Bank's ("TD") US$13.4 billion acquisition of U.S.A. based First Horizon Bank was abandoned citing regulatory uncertainty[3], which is not really a clear or good explanation. We will continue our discussion of TD from that time and finish with our thoughts.

What was finally disclosed this year is TD Bank's proposed acquisition of First Horizon was not permitted by American regulators due to money laundering by its U.S. operations. TD has now admitted guilt in money laundering and other deficiencies and will be paying over USD $3 billion in fines.[4] Bharat Masrani, TD's CEO, has accepted responsibility as he was involved in the U.S. acquisitions. Mr. Masrani will step down as CEO in April 2025 but will stay on as an advisor until November 2025.[5]

[3] https://www.reuters.com/markets/deals/td-first-horizon-call-off-134-bln-deal-2023-05-04/
[4] https://fortune.com/2024/10/10/feds-slap-td-bank-with-3-1-billion-in-fines-for-money-laundering/
https://www.thebanker.com/Explainer-TD-Bank-s-future-after-unprecedented-money-laundering-charge-1728924748
https://www.cbc.ca/news/business/td-bank-penalties-1.7348819
[5] https://financialpost.com/fp-finance/banking/td-ceo-bharat-masrani-to-retire-bank-names-successor

In Canadian banks, CEO succession is closely watched by the industry, and it is even more closely stick-handled by the bank in question. TD's new CEO is Raymond Chun, a career banker at TD who was head of Canadian consumer banking. This appointment tells us that TD is signaling to investors it is reverting back to its prior successful strategy of focusing on domestic Canadian retail/consumer banking. In our opinion, retail banking can be highly profitable for all banks, but it is certainly less exciting than corporate banking or international acquisitions. *However, at this point being boring and profitable is a good thing for TD's suffering shareholders*.

USD$3 billion is not a big number: TD's fiscal 2023 net income was $10.78 billion ($17.43 billion 2022).[6] In USD this is net income USD$7.81 billion for 2023 (USD$12.63 billion 2022).[7] We are really talking only about the financial penalties equal to 5 months of 2023 net income or only 3 months of 2022 net income. It is not the size of the fines that TD has to pay that will be a problem. It is something called ***consent orders*** that are worrisome.

Consent orders: A *consent order* can be used by U.S. authorities to limit a financial institution's growth. As a part of its plea deal, TD cannot grow its U.S. consumer banking business until regulators allow it. It can only maintain its existing consumer businesses, which officially is a cap on the assets.

Regulatory approval for renewed growth is going to be *solely* at the discretion of the authorities. TD Bank will have to provide clear proof it has cleaned up its operations and this will take time. We believe this will take years.

How long in Purgatory? TD has agreed to 3 years of enhanced monitoring by U.S. authorities and 5 years of probation.[8] However this does not mean the restrictions won't be extended if the regulators are still dissatisfied in any way.

According to the U.S. Federal Reserve, at June 30, 2024 TD is the tenth largest bank in the United States with USD$370.3 billion of assets. A freeze on its ability to grow its U.S. consumer businesses is significant.[9]

Chart 3 – TD Bank 10th Largest in U.S.A.

Source: www.cbc.ca/news/business/td-bank-penalties-1.7348819

How long will TD Bank realistically have a cap on its ability to do business? Let us look to Wells Fargo as a recent case study. Wells Fargo is the third largest bank by assets in the U.S.A., per the above Chart 3. Wells Fargo employees fraudulently signed clients up for credit cards they did not ask for. This was done so employees could superficially meet their quota for selling banking products, and the credit cards were quietly cancelled a short time later by the same employees. Wells Fargo was subject to consent orders in 2019 and in February 2024 the main restriction on growth was lifted. Of Wells Fargo's original 14 consent orders, there are now 8 outstanding.[10]

[6] TD Bank annual report, fiscal 2023
[7] https://www.bankofcanada.ca/rates/exchange/currency-converter/?lookupPage rate is 1.3802 at 18OCT2024
[8] https://www.cbc.ca/news/business/td-bank-penalties-1.7348819
[9] https://www.federalreserve.gov/releases/lbr/current/
[10] https://www.cnbc.com/2024/02/15/wells-fargo-says-consent-order-tied-to-2016-scandal-lifted.html
https://www.forbes.com/sites/tylerroush/2024/02/15/wells-fargo-stock-jumps-as-fake-account-scandal-consent-order-ends/
https://www.cbs8.com/article/news/nation-world/us-eases-restrictions-on-wells-fargo/507-83d673cd-9bcc-4d67-a651-f85d6848f0ca

Wells Fargo was restricted from growing for 5 years and all it did was sign up customers up for credit cards they didn't ask for. We think that money laundering is at least as bad, if not worse. We may be potentially looking at 5 or more years of restrictions on what business TD can do in the U.S., depending on how angry the regulators are.

Why we talk about growth: TD Bank's U.S. operations generate about 25% of its net profit, although this will include businesses that are not restricted, such as wholesale and corporate banking and brokerage operations.[11] But retail/consumer is impactful (per Chart 3 above) and an asset restriction will cause the entire bank to see slower growth. As we discussed in the case of CWB, growing earnings means a higher share price. If TD's earnings can't grow then we will see a stagnant or weaker growing share price relative to the other Canadian banks.

TD's share price perhaps already reflects the risk of lower growth. Since January 1, 2024, TD has materially underperformed the other Canadian banks.

Chart 4 – Year-to-date TD Bank (*black*) versus ZEB (BMO Equal Weight Banks ETF, green)

Source: Bloomberg, 21OCT2024

TD Bank down 3.3% YTD (*black*)…

…while ZEB (all banks ETF, including TD) up over 20.0% (blue)

Summary: In our opinion, National Bank buying CWB is a lower risk proposition than National Bank buying something internationally, including in the U.S. We have long held the view that domestic acquisitions carry lower risk than U.S. or international expansion, regardless of industry.

We are frankly puzzled why another bank has not made a counterbid for CWB. CWB is being acquired at a very cheap multiple of 1.4x Price/Book.[12] Compare this to National Bank's Price/Book at a more expensive 1.91x.[13] Another Canadian bank could simply offer a combination of cash-plus-shares or all-cash (large institutional shareholders typically prefer cash vs. National Bank's all-stock offer) and at a slightly higher premium. A purchase structured this way will be accretive and, for any Canadian bank that is subject to international growth restrictions, the lower risk domestic acquisitions that contribute to growth of the bottom line will *mitigate* such restrictions (**hint**: thinking of you, TD Bank).

Part 3. Inflation and Interest Rates

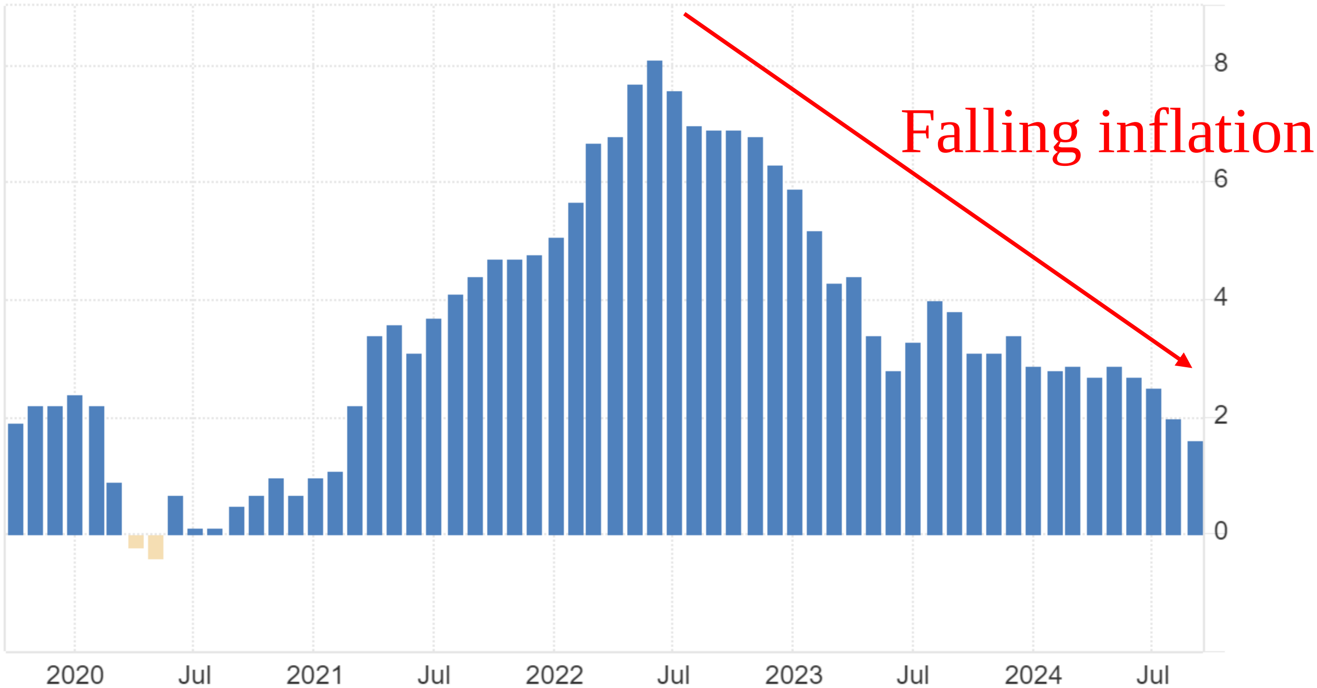
We now switch topics and talk about inflation and the outlook for interest rates. Interest rates went up to fight inflation until early 2024. The Bank of Canada ("BoC") has now been reducing interest rates through 2024 and it looks like the reductions will continue.

The annual inflation rate in Canada fell to 1.6% for September 2024.[14] The Bank of Canada's target rate for general inflation is 2.00%. The low inflation was mainly due to gasoline prices which fell 10.7% in September. Excluding gasoline, inflation was 2.2%. On the good news front, food inflation was less bad at 2.4% for September 2024.

[11] https://www.td.com/ca/en/about-td/for-investors/investor-relations
[12] CIBC Capital Markets – Equity Research. June 17, 2024
[13] https://ca.finance.yahoo.com/quote/NA.TO/key-statistics/
[14] https://www.msn.com/en-ca/news/canada/annual-inflation-falls-to-1-6-in-september-raises-odds-of-50-basis-point-rate-cut/ar-AA1shPXt

Unfortunately, there is still some bad news. High food inflation has been replaced with high shelter costs. Renters saw their rents up 8.2% year-over-year in September 2024, and this is on top of an 8.9% Y/Y increase in August 2024. Homeowners were not left out and mortgage interest costs were up 16.7% in September 2024, up further from a 18.8% increase in August 2024.

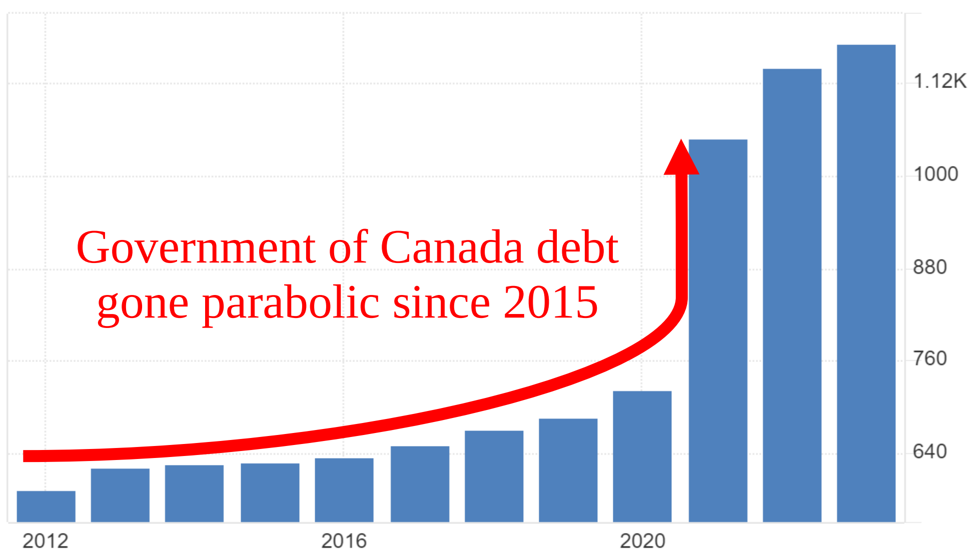
Chart 5 – Near term Canadian inflation falling since 2022



Source: tradingeconomics.com/canada/inflation-cpi#

The declining rate of inflation means the Bank of Canada should continue to reduce interest rates. This is good news for borrowers and homeowners renewing their mortgages. As of this writing, the markets are considering whether the next rate cut will be 0.25% (like the last 3 cuts this year) or if the rate cut will be a larger 0.50%. *After we finished writing our report to you, the Bank of Canada lowered interest rates by 0.50% on October 23, 2024 to 3.75%, with rate cuts to continue as part of their commentary.*[15]

In our opinion, the odds of larger rate cuts would be greater if the Bank of Canada did not have to deal with continued deficits by our governments. As we have discussed in the past, inflation is a monetary phenomenon, meaning it is caused by the federal government printing money out of thin air and running deficits. Deficits are reflected in the level of government debt. Since the current federal government has been in power since 2015, the deficits have caused government debt to go parabolic.



Source: https://tradingeconomics.com/canada/government-debt

[15] https://www.msn.com/en-ca/money/topstories/making-sense-of-the-bank-of-canada-interest-rate-decision-on-october-23-2024/ar-AA1sNNl9?ocid=BingNewsSerp

Summary: We expect continued declines in interest rates by the Bank of Canada but believe the BoC can be even more aggressive in dropping rates if deficit spending by the Government of Canada was curtailed. Unfortunately, this is not happening. On October 17, 2024, the government's own Parliamentary Budget Officer ("PBO") projected a higher deficit for 2024 than previously expected, from $39.8 billion to $46.4 billion.[16] Nevertheless, the good news is that interest rates are coming down, which will be good for the bond market and interest sensitive sectors of the stock market (financials, real estate, telecoms and utilities).

Part 4. Conclusion

Our clients have done very well by their CWB holdings. We continued holding CWB even after the June 2024 takeover announcement by National Bank, as we believed there was more upside to the shares. Canadian acquisitions are less risky than international and U.S. acquisitions, and normally something less risky should be more expensive than buying something with more risk. Yet for CWB, in our opinion, the takeover price of 1.4x Price/Book is inexpensive and we are surprised a competing offer has not been forthcoming (Hello TD? Are you listening?).

We are relieved to see interest rates in Canada and the U.S. coming down and believe this will continue into 2025. This will occur notwithstanding the deficit spending of Canadian and U.S. governments. Our clients with accounts in balanced mandates have had their bond holdings positioned for falling interest rates. Clients in all-equity mandates will have holdings in interest sensitive sectors such as financial, real estate, telecoms and utilities as these will benefit from falling rates.

Thank you for entrusting your investments to Gold Investment Management. If you have any questions, please do not hesitate to contact us.

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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.

[16] https://www.taxpayer.com/newsroom/pbo-projects-higher-deficit-than-budget-2024

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