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Waypoint Public Equity

Waypoint All-Weather Strategy
2018 Annual Letter

January 1, 2019

The Waypoint All-Weather investment strategy produced positive investment results in 2018. The drawdown in equity holdings at the end of the year was largely offset by option returns. Several of these equity positions now provide yields in excess of 6%, which we view to be favorable when contrasted with Government bond yields below 2% in Canada. This yield provides ample room to fund options purchases to protect against further market declines. Our team believes 2019 is likely to be another year of elevated volatility for equity markets in North America but remains confident that Waypoint's All-Weather investment strategy will position clients to capitalize on opportunities that emerge this year.

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We are starting to see more red flags now than we did at the beginning of 2018

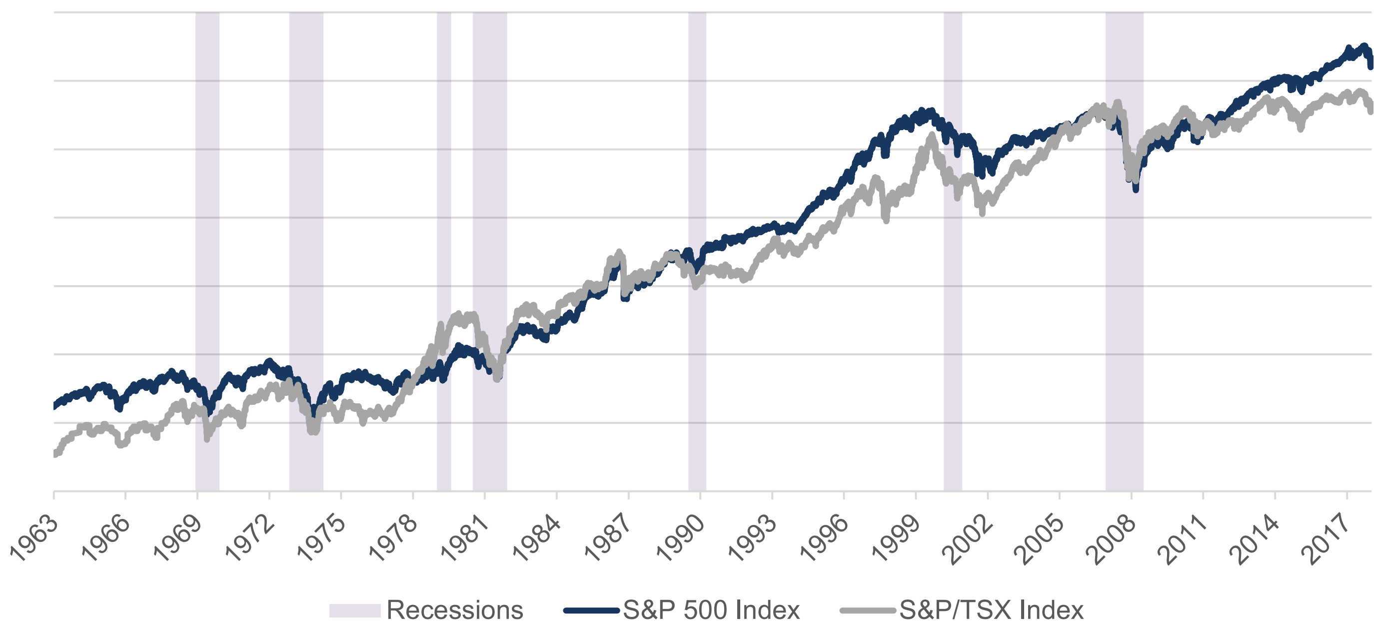
2018 proved to be a difficult year for markets all around the world. In North America, the S&P 500 Total Return (USD$) ended the year down 4.4% and the S&P/TSX Composite Total Return (CAD$) down 8.9%. The table below shows annualized returns for common investment time horizons relative to long run market returns.

Table 1: North American Index Returns

North American Market Returns	1 Year	3 Year	5 Year	10 Year	Annualized since 1950
S&P 500 Total Return (USD$)	-4.4%	9.2%	8.5%	13.1%	10.8%
S&P 500 Total Return (CAD$)	4.0%	8.7%	14.0%	14.4%	Not Available
S&P/TSX Composite Total Return (CAD$)	-8.9%	6.4%	4.0%	7.9%	6.7%

Source: Bloomberg

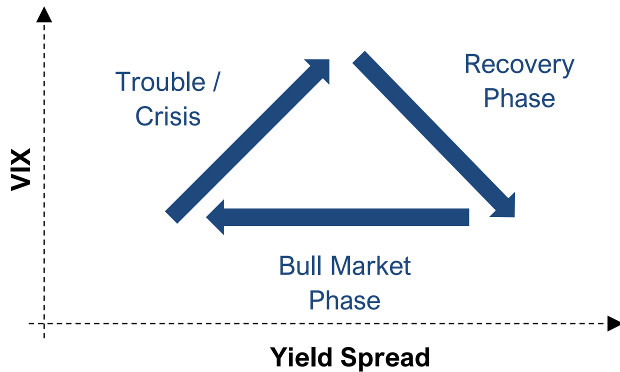
Figure 1: North America Market History of Recessions



Source: Bloomberg

The somewhat regular cadence of economic downturns is evident in Figure 1. On the surface, the likelihood of another recession is high given the time that has elapsed since the 2008 financial crisis. History suggests that equity markets begin to decline ahead of official recession declarations and therefore we look for other indicators of market stress to evaluate investment risk. Figure 2 is one such framework used at Waypoint to evaluate market cycles.

Figure 2: Framework for Market Cycles



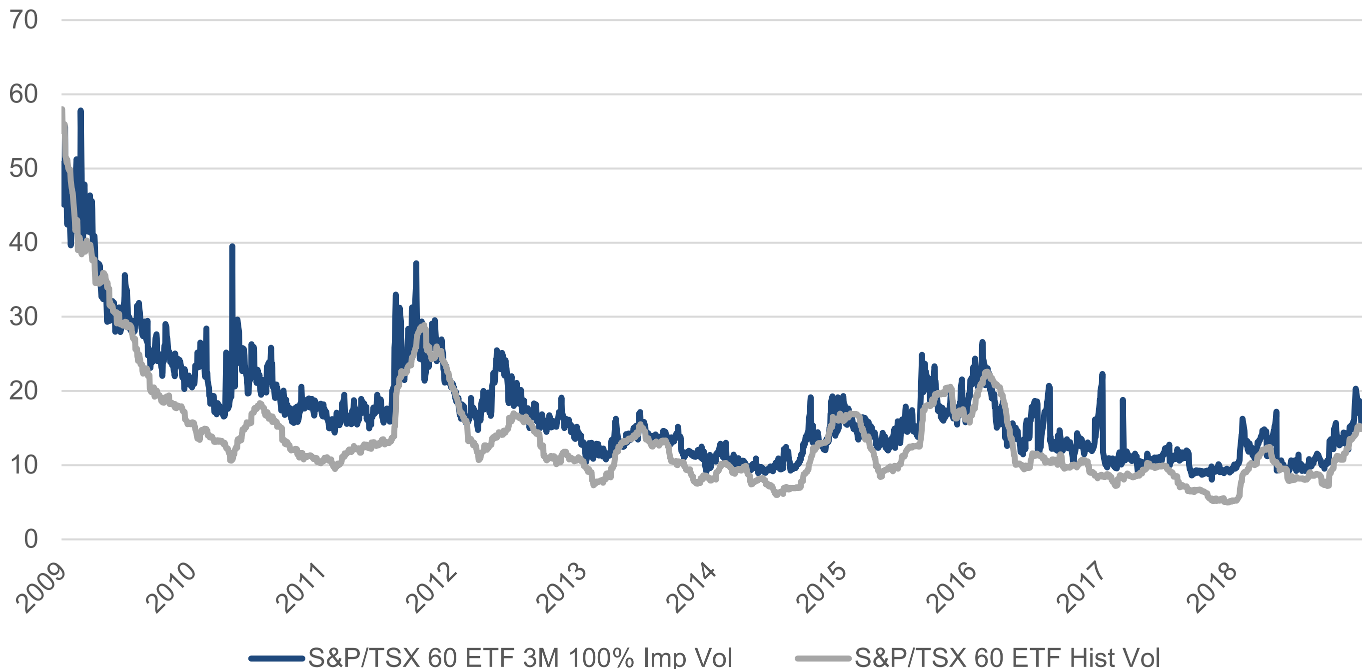
Since 2008, the combination of extremely low interest rates and funds flowing out of actively managed strategies and into passive index funds and ETFs has exacerbated declines in volatility. Passive investors are misinterpreting the low cost of ownership for "value" while corporations are taking on additional debt to conduct share buybacks.

Historically, market stress builds up during periods of low volatility and declining interest rate term and credit spreads. One explanation for this phenomenon is that the decline in volatility is misinterpreted for economic stability. As a result, investors misallocate capital into risky investments that they perceive to be safe. This misallocation of capital ceases as performance fails to meet expectations and investors are forced to re-price risk. This process of re-pricing investments increases volatility and creates a more normal risk vs. return structure across asset classes and investment duration.

You are here

Since the financial crisis in 2008, volatility has declined to an all-time low in the Canadian equity market (Figure 3). This decline ended at the beginning of 2018 after reaching a 25-year low. In addition, term spreads for Canadian Government bonds are at a 10-year low (close to 0bps). The current level of these market indicators suggest stress is building in the financial system and that the probability for equity market declines is high. This, coupled with the fact that a larger number of market participants lack a firm view of intrinsic value, may result in even higher levels of volatility moving forward.

Figure 3: S&P/TSX 60 Implied and Realized Volatility

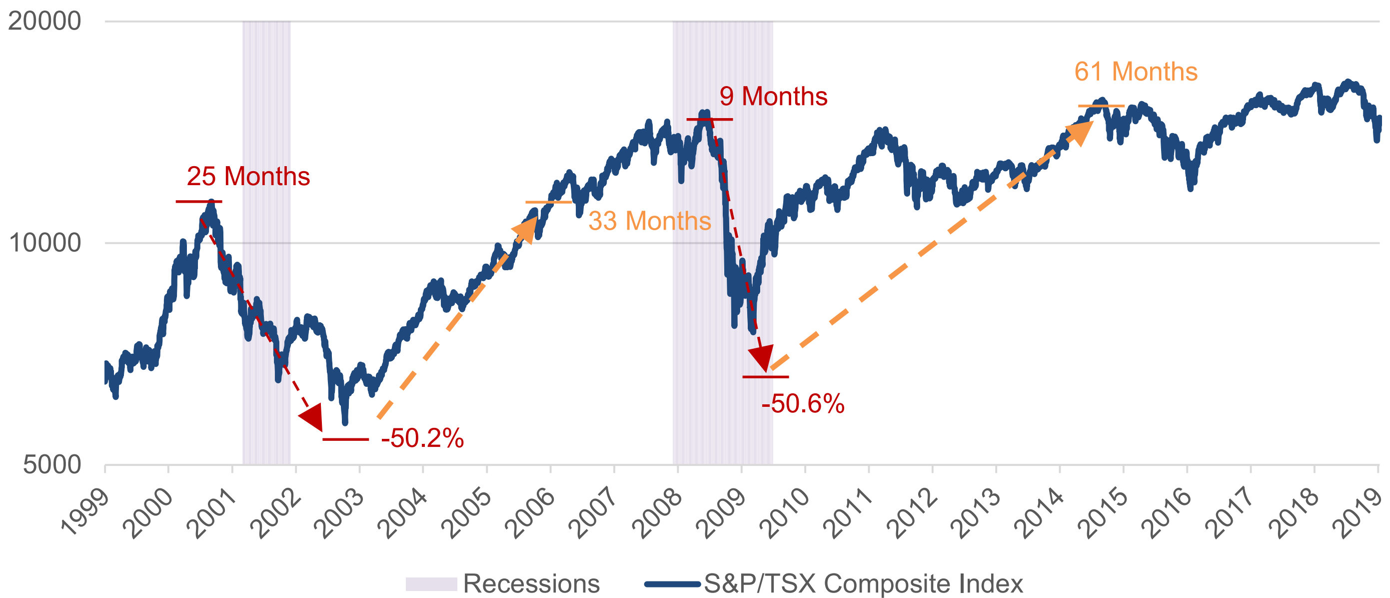


Source: Bloomberg

Market declines coincident with economic downturns are much greater than the tremors experienced in 2018. For example, during the past two economic recessions, the Canadian market fell in excess of 50% from peak to trough and required multiple years to recover (Figure 4). These are the events that investors should be most concerned about as they can impair capital permanently (whether through required withdrawals to maintain one's lifestyle or investments that never recover). Periods where these risks are elevated require investment tools that are less commonly deployed across the asset management industry.

Large Index declines occur while asset correlations are rising. As a result, investors struggle to find diversification in alternative assets that can offset losses. Long volatility instruments provide investors certainty that their portfolio will have at least one negatively correlated asset class during periods of material draw downs.

Figure 4: Historical S&P/TSX Drawdowns and Recoveries

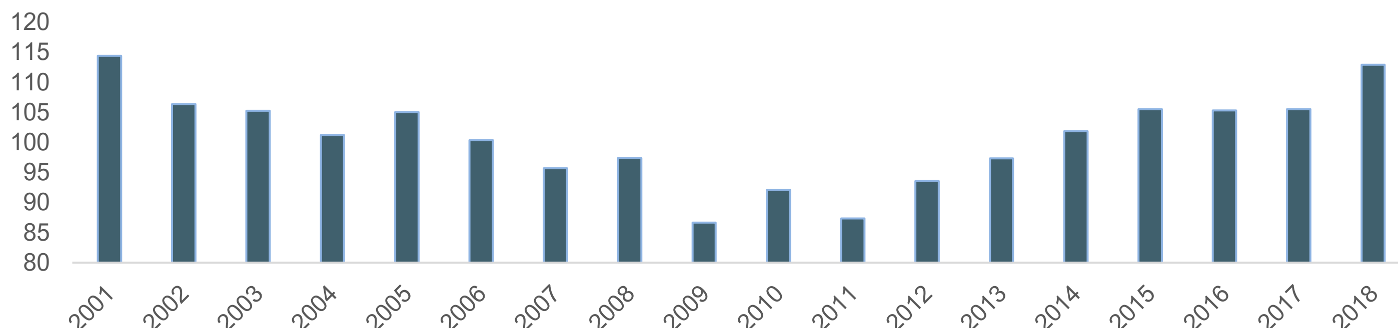


Source: Bloomberg

The financial position of Canadians is weak today. Elevated levels of debt brought upon by low interest rates creates the conditions for declines in spending as rates rise. The persistence of easy money creates inflation pressures and the resulting path to rate hikes. Similarly, corporations have been utilizing low interest debt to repurchase stock (Figure 5). The impact of these activities has smoothed out earnings (reduced volatility) and left corporations more sensitive to economic shocks or changes in macro policies. The impact to corporate profits during a recession will be larger than markets anticipate today.

Commonly quoted valuation metrics focus almost entirely on the pricing side of the equation and ignore the operating side of businesses (the component impacted when the economy turns). In the 2008 recession, corporate earnings for S&P/TSX listed companies fell 30%. Opinions expressed on valuation prior to the downturn in markets neglected this risk due to overconfidence and limited volatility.

Figure 5: S&P/TSX Debt to Equity Ratios



Source: Bloomberg

This is the time to focus on cash flows

Going into 2019, we maintain a portfolio of 20-25 North American securities with an emphasis on dividend yield and sustainability. These companies have meaningful founder/insider ownership, well-managed balance sheets and a focus on cash flow generation.

At Waypoint, we invest in businesses and management teams capable of generating value for investors over an investment cycle. Price volatility in public markets is inevitable despite opportunities to invest in secular trends, strategic growth opportunities or fundamentally mispriced assets. We therefore prefer compensation in the form of cash dividends for investing our clients' capital. This approach provides us with a margin of safety when underwriting investments with 3 to 5-year time horizons; knowing much of our initial investment will be returned to us over this period.

We believe this investment strategy is particularly well suited for this stage of the economic cycle. Investors can remain exposed to equity markets, collect dividends and not fear the specific timing of an economic recession by utilizing portfolio protection. The cost of protection is low due to record low levels of volatility and high-quality dividend securities provide reasonable yields over government bonds. We like this combination of variables in the face of the rising, end of cycle, risks.

Table 2: Portfolio Profile

Portfolio Profile	P/E	P/CF	Dividend Yld	Debt to Equity
Portfolio	13.3x	6.7x	6.0%	115%
S&P/TSX Composite	15.6x	7.8x	3.4%	138%

In the short term we can be wrong

A simple illustration of this is Chorus Aviation. The company operates approximately 70% of Air Canada's regional seat capacity under the Jazz brand. Once a part of Air Canada's parent company, ACE Aviation Holdings, Chorus was spun-out in 2006 when Air Canada was under financial distress and now remains independent in order to provide a point of leverage when negotiating with pilot unions (one of Air Canada's largest expenses). At the 2018 lows, Chorus paid a 10% dividend yield that was fully supported by contractual cash flows from the Air Canada contract through 2025.

What further excites us as shareholders of Chorus is the company's continued growth in its regional aircraft leasing business. Currently the third largest globally, Chorus is benefiting from both favourable lease factors in the regional aircraft niche and a weakening number two competitor in GECAS as General Electric looks to shrink the subsidiaries assets as it restructures.

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Furthermore, we believe Chorus is positioned to be a best in class regional aircraft lessor due to its superior ability to underwrite regional aircraft leases. This comes from experience as one of North America's largest regional airlines, full life-cycle asset value expertise through the company's maintenance and repair facilities and parting out business, and finally best in class lease transition services as witnessed by the fact that some of Chorus' largest leasing competitors use the company to do just this.

Over the next seven years, the contract flying business though Air Canada's 3rd party charter will generate $1 billion in cash flow. Over $460m will be paid out to investors in dividends over that time. At today's share price, this equates to receiving over 50% of your capital back over the next 7 years while management continues to execute on growing the company's regional leasing business and works towards extending and amending the current Capacity Purchase Agreement with Air Canada. Although like everything in life, this proposition involves inherent risks; risks that we believe are worth taking.

The opportunity

Given the rise of volatility in 2018 we see growing dislocations across our universe of publicly listed businesses in Canada. This is evidenced by high dividend yields and low valuations both historically and relative to peers. There are over 600 exchange-listed companies in Canada with market capitalizations above $250m – the most popular ETF only provides investors exposure to 60 of them. We believe there exists plenty of opportunity for those capable of investing beyond the common index constituents to find mispriced assets.

Many well managed, high quality businesses are paying dividend yields in excess of 6%. For investors looking for alternative sources of income relative to low returning fixed income strategies – now is a compelling time to invest capital into these businesses. Common 60/40 equity bond strategies (balanced) are struggling to provide competing returns relative to this baseline. Furthermore, they are unable to benefit from volatility strategies that protect investors from rising correlations and severe market drawdowns.

We at Waypoint have designed the All-Weather Strategy based on the needs of ourselves and our families. As late cycle risks increase, we encourage investors to consider this approach for their own families.

Wishing you a healthy and happy 2019,

The Waypoint Team