Market Perspectives

PRIVATE CLIENT SOLUTIONS

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February 19, 2021

A Walk Down Memory Lane

Over my 20+ year career in the financial services industry, I've experienced the tech wreck, 9/11, the subprime lending and US housing crisis, the near-collapse of the global financial system, the massive interventions taken by central banks and governments, a trade war between the two largest global economies and most recently, a historic recession brought on by a global pandemic. I've seen the rise and fall of Canadian titans like Nortel, Research in Motion (now BlackBerry) and Valeant Pharmaceutical (now Bausch Health Co.), outright fraud with Bre-x Minerals and Sino-Forest, and of course, the egregious deception by rating agencies, US mortgage lenders and investment banks unloading worthless paper on unsuspecting purchasers. While it is human nature to remember adverse events so that we can avoid repeating past mistakes, there have been many positives. First, from the first day I started in the industry, the S&P/TSX and S&P 500 have gained a cumulative 157% and 182% (not including dividends), respectively. This is impressive wealth creation despite the historical turmoil. We've seen significant technological advances in areas like telecommunications, robotics and artificial intelligence, resulting in shifts in how we work, communicate and live our personal lives. We're on the cusp of commercializing space, which will open up another new wave of innovation. We've landed rovers on Mars (most recently, Perseverance touched down on the red planet) and on asteroids. Where governments have failed, corporations have stepped in to engineer a shift from fossil fuels to renewables and increasingly focus on social issues with the rise of ESG. This marks a remarkable paradigm shift for capitalism where we can simultaneously create economic value as well as improve environmental and social outcomes at the same time. Twenty years is not that long within the context of the markets, but it's been an eventful two decades nonetheless. Before I share some of the insights I've learned over the years, there is a fascinating financial tidbit that I believe historians have missed and I'd like to share; HSBC's role in the financial crisis.

Founded in 1865, HSBC helped finance the burgeoning trade between China and Europe. The institution grew through acquisition, becoming a global finance powerhouse by the late 1990s. It had developed a reputation as a conservative and risk-averse bank, a tradition that extended to its founding in the 19th century. While HSBC's expansion plans primarily focused on Asia, Europe and South America, it had a small presence in the crown jewel of banking, the United States. While that slowly changed in 1987 with the full acquisition of Marine Midland Bank, HSBC still needed a large deal to establish itself in the region. In the early 2000s, HSBC explored expansion plans with then brokerage giant Merrill Lynch. I was an eye witness to the new 50|50 joint venture, working for Merrill Lynch HSBC Canada until the JV dissolved in the spring of 2002. To say the cultures were like night and day would have been an understatement, so it wasn't surprising to see the two parties walk away. However, HSBC still needed the final piece of the puzzle to complete its global expansion plan.

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Household Finance Corp. (HFC) was founded a little over a decade after HSBC in 1878. The lender focused on consumer loans and was one of the first lenders to offer installment loans in the US. By the end of the 1920s, HFC ranked as the largest personal finance company in the country. In contrast to HSBC's conservative lending practices, HFC focused on less creditworthy consumers and had a reputation for predatory lending practices. In late 2002, the company settled with the US attorney general of 46 states related to predatory lending practices for US$486 million, removing an overhang on the company.

In early 2003, shortly after Merrill Lynch and HSBC parted ways, the world's second-biggest bank rolled the dice and acquired HFC for US$16.2 bln, instantly vaulting it the 2nd largest subprime lender in the US. HSBC, one of the most conservative lenders, decided to make a big bet on the least creditworthy segment of the US market. It was an unusual marriage to say the least. The media at the time said, *"when banking historians look back, they may conclude that [it] was the deal of the first decade of the 21st century"*. And what a deal it was.

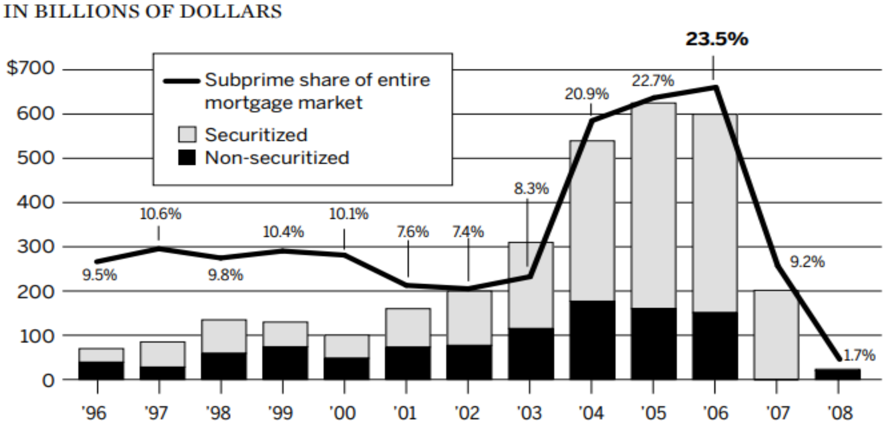
Before HSBC acquired HFC, the subprime market represented ~9% of loan mortgage originations. After the acquisition, subprime lending exploded higher, accounting for nearly 24% of originations before the housing collapse. While many factors contributed to the housing bubble, subsequent crash, and financial crisis, one of the most conservative lender's willingness to bet on HFC surely had many in banking circles wondering what HSBC knew that they did not. If HSBC was betting on subprime, we should be doing the same; plus, it's a profitable business as long as default rates remain steady, which they clearly were.

Financial Crisis Inquiry Commission Report: Mortgage Originations

Subprime Mortgage Originations

In 2006, $600 billion of subprime loans were originated, most of which were securitized. That year, subprime lending accounted for 23.5% of all mortgage originations.

IN BILLIONS OF DOLLARS



NOTE: Percent securitized is defined as subprime securities issued divided by originations in a given year. In 2007, securities issued exceeded originations.

SOURCE: Inside Mortgage Finance

Figure 5.2

Source: https://www.govinfo.gov/content/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf

We all know that this did not end well. In 2007, HSBC wrote down its holdings of subprime-related mortgage securities by US$10.5 bln, becoming the first major bank to report its losses due to the unfolding subprime lending crisis. HSBC would later shut down HSBC Finance in the US. Then Chairman, Stephen Green, stated, *"HSBC has a reputation for telling it as it is. With the benefit of hindsight, this is an acquisition we wish we had not undertaken."*

Many players had a hand in fueling the US subprime lending crisis. Still, HSBC's ill-timed acquisition of HFC potentially gave other institutions the confidence to go all-in on subprime, and the rest, as they say, is history. The lesson here is: if you see a company make an uncharacteristic move or acquisition, question it. This is easier done in hindsight, but always try to understand the motivations of unusual corporate actions.

In no particular order, here are some other insights I've learned so far:

- **Intervention.** Governments and central banks will take whatever measures needed to protect the economy/market (I'm not sure which one) from collapsing. If you think they are out of ammunition, you thought wrong. Our officials have gotten pretty good at bailing out the economy/market; it's almost down to a science. The speed and magnitude of the stimulus delivered to offset the economic lockdown is nothing short of impressive.
- **Changing landscape.** Massive amounts of central bank liquidity has changed the investing landscape for the foreseeable future. Traditional valuation measures are less useful in this world, making it challenging for those primarily focused on them. Flow has become a more critical factor given the amount of passive assets following the market, crowding out active managers.
- **Investing: go with quality.** Regardless of capital flows or valuation, when investing, buy good companies with competent management teams. It's boring, but that's what investing is supposed to be when you're focused on specific end goals. Trading is a different story.
- **Trading today.** When trading, be patient with your winners and use opportunities to average up (yes, average up…I'm not talking about GME or AMC here, but companies that are making legitimate new highs). Be ruthless with your losers and cut them loose. You can always revisit at a later date. The trend is your friend, buy leaders and sell losers.
- **Watchlist.** Build a watch list and look at what stocks are making new 52-week highs. They are generally doing something right.
- **Follow the money.** Earnings are great, but focusing on companies that can generate cash flow growth has served us well.
- **Buyer beware.** Be careful with commodity sectors, particularly companies that are price takers; they are meant to be rented, not owned. Knowing when to be in and out of commodity sectors can make or break your year and if you're not willing to actively manage this exposure, it's general best to steer clear.
- **Open your mind.** Your odds of success significantly improve if you leverage multiple disciplines. The Investment Strategy team leverages fundamental, quantitative, and technical aspects in their methodology.
- **Don't fight the tape. Identify what type of market we're in.** In secular bull markets, be long the market and be careful not to be whipsawed. In oscillating

and bear markets, be neutral to underweight equities and tighten up your stops.

- **Winning.** The goal of managing assets is to be right more often than you're wrong. You will get things wrong; that's life. Deal with it and learn from it.
- **Find your comfort zone.** Always consider the risks when investing. Risks can come in many forms, like company-specific risks or the risk of doing nothing and sitting in cash during a bull market.
- **There is always a bull market somewhere.** Markets will always surprise you, both on the up and downside. It's important to stay invested and leverage the benefits of asset allocation. Trying to sell out at the top of the market requires two extremely difficult decisions. First, you need to exit the market, potentially resulting in FOMO (fear of missing out) if the market continues to advance. Second, you will need to get back into the market either at a higher price or, if you're correct and calling a top, putting cash to work during a period of heightened fear. The second decision is always the hardest.

Finally, I'll end this note with a quote from Chinese teacher and philosopher Confucius, *"By three methods we may learn wisdom: First, by reflection, which is noblest; second, by imitation, which is easiest; and third by experience, which is the bitterest."*

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