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THIRD QUARTER 2022

Index	Q3 2022	YTD
S&P/TSX Composite (C$)	-1.4%	-11.1%
S&P 500 (US$)	-4.9%	-23.9%
S&P 500 (C$)	1.2%	-17.7%
MSCI EAFE (US$)	-9.4%	-27.1%
MSCI EAFE (C$)	-3.6%	-21.2%
FTSE TMX Universe Bond Index (C$)	0.5%	-11.8%
C$ / US$	1.2886 to 1.3707 (-6.0%)	1.2678 to 1.3707 (-7.5%)

**** Index returns are total returns, including dividends.***

BOTH STOCK AND BOND MARKETS ARE IN A BEAR MARKET

The central banks of much of the developed world continue their most aggressive monetary tightening campaigns since the 1980s, and asset markets everywhere remain profoundly impacted. Bond yields are currently sitting at their highest levels since the 2008-2009 Global Financial Crisis, a sharp reversal from the ultra-low rates of last year when at one point over a fifth of the world's government bonds were trading with negative yields. Stock markets globally are now firmly in bear market territory, having posted a decline of 20% or more from their peak.

The significant and simultaneous drops in both bond and stock markets mark a change from the historical pattern, where bond prices remained relatively stable during periods of substantial stock market declines. Since the late 1990s, the short-term performance of stock and bond markets have often been in opposition – that is, when the performance of one asset class was strong, the other was weak, and vice versa. This led many to think that bonds were always a good hedge for stocks during significant stock market upheaval. So far this year, however, this conventional wisdom has been flipped on its head.

While the period from the late 1990s through last year saw prolonged interest rate declines and a general loosening of monetary conditions supporting bond prices, today's environment is markedly different. Large interest rate increases and monetary tightening have upped investors' demand for returns across all asset classes. Increases in the yields on government bonds, the safest of all investments in terms of credit quality, raise the table stakes for returns across the entire credit spectrum.

Spurred on by the substantial increases in government yields, competition for returns across all asset classes is much more intense now compared to a year ago, when long-term government yields of just 1% pushed investors increasingly further down the credit spectrum in search of higher

yields, not to mention towards stocks of businesses with dubious fundamentals and uncertain long-term prospects. Today, investors are finding yields on bonds and valuation multiples on stocks that they would have had trouble imagining last year. Nonetheless, fears of further market drawdowns and "catching a falling knife" are preventing many investors from stepping up and actually buying.

LOWER PRICES CREATE CONDITIONS FOR POTENTIALLY HIGHER RETURNS IN THE LONG RUN

Somewhat forgotten in the general market malaise is the fact that conditions for higher prospective returns in both stocks and bonds have dramatically improved compared to the frothy environment of last year. The reason for this is simple: when asset prices rise significantly above their fundamental values, long-term returns are likely to be a lot poorer than if prices were more closely at or below those values.

Take bonds, for instance. Telus, an investment-grade issuer, has a bond maturing in 2030 with a coupon of 2.05% that traded at just below par at its peak in late 2020. At that point, the bond yielded a measly 2% to maturity, nearly all of which would be taxed fully as income if the bond matured at par. At the highest marginal tax bracket, that would have equated to a locked in 1% after-tax return over 10 years. No matter how low your expectations, that hardly strikes us as good bang for your buck.

Fast forward to today, however, and that same bond is now trading at 78 cents on the dollar and yields 5.4% to maturity, which includes a cumulative capital gain of 28%. The bond's prospective return is now far higher, and its risk/reward prospects are more attractive, provided that the issuer's credit quality has not changed much (we do not think it has, and in fact we own it for some client accounts[1]). Not only is the investor benefiting from the higher yield at the bond's current price, but also from the tax-advantaged gain when the bond rises closer to par as it nears maturity.

Stocks are facing a similar scenario. At its peak earlier this year, the S&P 500 traded at a forward earnings yield (earnings/price) of 4.5%, near the lowest in the index's history, and investors were making a fairly meager profit on every dollar that they paid. Today, the S&P 500 trades at a notably higher forward earnings yield of 6.7%, which is above its long-term average of 6%, due almost entirely to the index falling by 25%. At its current earnings yield, investors today are now seeing nearly 50% more profit per dollar of investment compared to when the index was at its peak.

ROGERS COMMUNICATIONS: PROFILE OF A LONG-HELD HOLDING

Even more dramatic than the increase in the earnings yield of the S&P 500 are the increases in earnings yields that we have recently seen in individual stocks. The valuation dispersion of the index has widened again during this period of fear, with the difference in the price-to-earnings ratios of the 20th and 80th percentile of stocks rising to 13.6x, well above its long-term average. We have seen quality companies see their stock prices decline to such a level that their earnings yields have jumped more than 50%, despite no significant change to their underlying fundamentals.

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[1] Some clients may not hold Telus bonds due to timing or asset allocation.

Once such example is Rogers Communications, the largest mobile telecommunications and cable broadband company in Canada. Rogers has a virtual monopoly on fixed broadband (cable internet) in the regions in which it operates, and is part of a national oligopoly in the mobile broadband industry alongside Bell and Telus. Its vast network, built over several decades with capital spending in the billions, connects millions of households and mobile phone users, and underpins Rogers' competitive position and the wide economic moat surrounding its business.

We believe that the current period of high inflation enhances Rogers' competitive advantage given the long-lived nature of its primary assets. Rogers' network is likely to be used for decades to come and was built and paid for using yesterday's dollars; therefore, the replacement cost of these assets is far higher than what is recorded on Rogers' books. Higher inflation increases this replacement cost further, making barriers to entry for would-be competitors even higher. In addition, Rogers also has a significant degree of pricing power given the few alternatives available to its essential service. This helps its revenue and earnings better keep pace in an inflationary environment.

Despite Rogers' long-term durability as a business, its stock price has fallen from a high of $80 to $50 currently as part of the market rout. At its peak, Rogers traded at a price-to-earnings ratio of 20x, or a 5% earnings yield. Since then, its earnings have continued to grow while its stock price has fallen by 37%, to the point that it now trades at a price-to-earnings ratio of 13x, or an earnings yield of nearly 8%, the highest in recent memory.

Has the intrinsic value of Rogers fallen by 37%? No. In fact, very little has happened over the course of the year to alter its prospects in any material way. It is only market sentiment and prices that have changed, allowing us to buy Rogers[2] and other strong, durable companies like it much more cheaply than before.

STAYING FOCUSED ON THE LONG TERM

Despite all the history books showing that lower prices lead to better long-term returns over time, broad investor sentiment has gotten steadily worse as prices have fallen. Common sense should dictate that the lower asset prices fall, the more investors should want to buy, as their prospective returns improve. Nonetheless, we have seen time and again that for some inexplicable reason investors routinely act in the exact opposite fashion.

Investors tend to make decisions on the future by fixating on the recent past, or as Warren Buffett likes to say, "driving while watching the rear-view mirror." Just as past coin flips cannot predict what the next coin flip will be, neither does past short-term performance tell us anything about future short-term performance.

Over longer periods, however, the best times historically for investors are typically the periods following substantial market downturns. Since 1950, the S&P 500 has dropped by 25% a total of nine times, including in 2020 and this year. In the 10 years following all of those periods (excluding 2020 and 2022), the S&P rose by an average of 214%, equivalent to a 12% annualized price return, well above its historical average.

[2] *Some clients may not hold Rogers due to timing or asset allocation.*

We cannot predict the future direction of markets and have always believed that any attempt to define market bottoms are a fool's errand. It is possible, perhaps even likely, that the yields on bonds and earnings yields on stocks will continue to increase, further driving down prices for bonds and stocks alike. If they do, however, we will not panic. Instead, we will continue to bargain hunt, and watch as lower prices set the stage for better long-term returns.

Thank you for your continued confidence and support,

The Evans Team