MacNicol & Associates Asset Management Inc.

April 2022

The Quarterly

With this commentary, we plan to communicate with you every month about our thoughts on the markets, some snapshots of metrics, a section on behavioral investing and finally an update on MacNicol & Associates Asset Management (MAAM). We hope you enjoy this information, and it allows you to better understand what we see going on in the marketplace.

"With so many things coming back in style, I can't wait until morals, respect and intelligence become a trend again"

- Denzel Washington, Hollywood Actor

The Numbers:

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Index:		**2021 YTD:**
S&P/TSX:		3.14%
NASDAQ:		- 9.10%
Dow Jones:		- 4.57%
S&P500:		- 4.95%
Interest Rates:	**Canada**	**USA**
90-Day T-Bill:	0.86%	0.72%
5-Year Bond:	2.64%	2.79%
10-Year Bond:	2.70%	2.77%
30-Year Bond:	2.65%	2.82%

Economic Data:

- US payrolls for March miss
- Crude oil ends Q1'22 at $100 per barrel
- Stocks lower in Q1'22 with markets tied to commodities bucking the trend
- The war in the Ukraine roils oil and gas markets
- Prices of agricultural commodities sharply higher in the quarter
- US consumer prices rose 8.5% in March, highest level since 1981

Valuation Measures: S&P 500 Index

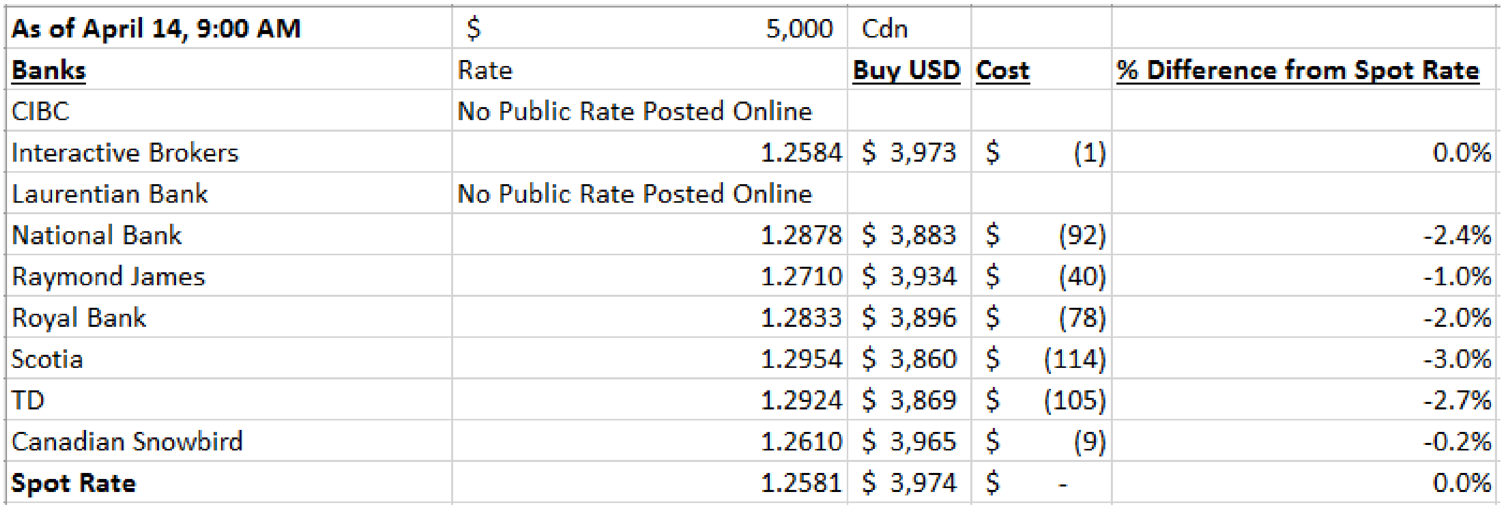
Valuation Measure	**Latest**	**1-year ago**
P/E: Price-to-Earnings	25	30
P/B: Price-to-Book	4.5	4.2
P/S: Price-to-Sales	2.9	2.8
Yield: Dividend Yield	1.4%	1.5%

2022 Calendar Year Performance, by Sector: Mar 31st, 2022

S&P/TSX Composite	3.14%
NASDAQ	-9.10%
Dow Jones Industrials	-4.57%
S&P 500	-4.95%
Russel 2000 (Small Caps)	-12.7%
MSCI ACWI ex. USA	-6.0%
Crude Oil Spot (WTI)	38.6%
Gold Bullion ($US/Troy Ounce)	6.42%
SOX Semi-conductor Index	-13.1%
VIX Volatility Index	-28%

Source: Canaccord Genuity Capital Markets & Thomson Reuters

Foreign Exchange - FX



As of April 14, 9:00 AM	$ 5,000	Cdn		
Banks	Rate	**Buy USD**	**Cost**	**% Difference from Spot Rate**
CIBC	No Public Rate Posted Online			
Interactive Brokers	1.2584	$ 3,973	$ (1)	0.0%
Laurentian Bank	No Public Rate Posted Online			
National Bank	1.2878	$ 3,883	$ (92)	-2.4%
Raymond James	1.2710	$ 3,934	$ (40)	-1.0%
Royal Bank	1.2833	$ 3,896	$ (78)	-2.0%
Scotia	1.2954	$ 3,860	$ (114)	-3.0%
TD	1.2924	$ 3,869	$ (105)	-2.7%
Canadian Snowbird	1.2610	$ 3,965	$ (9)	-0.2%
Spot Rate	1.2581	$ 3,974	$ -	0.0%

They're doing what?

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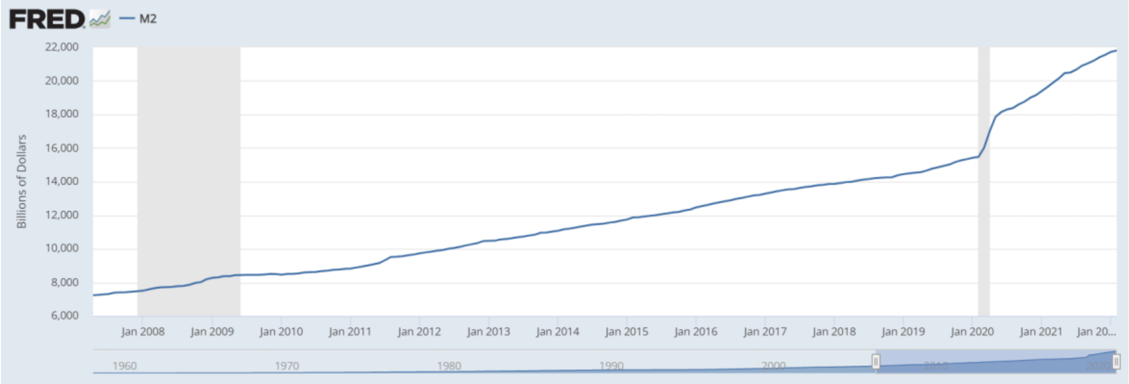
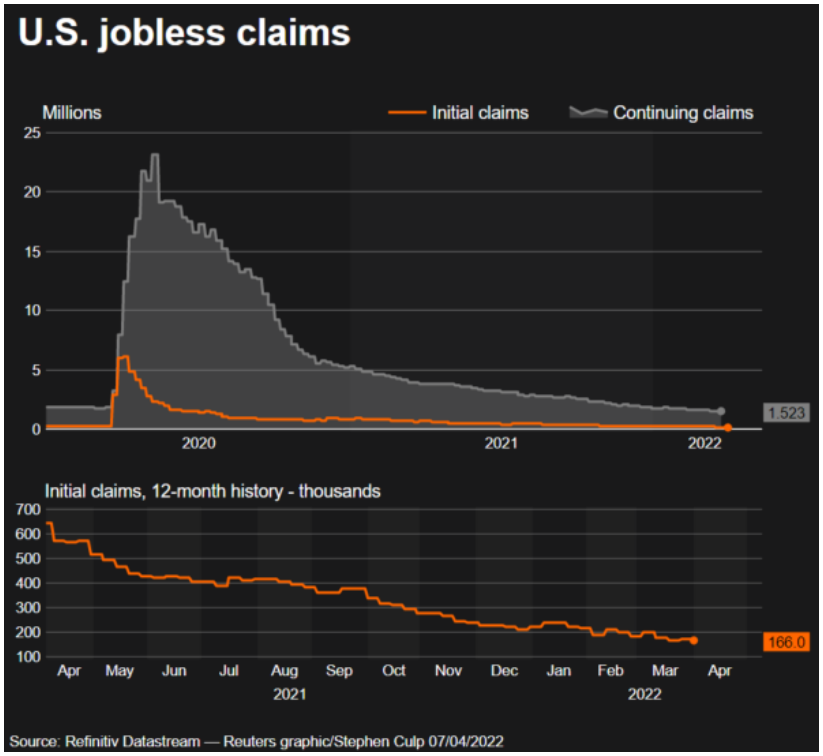
One of the key challenges facing North American financial markets is the risk that monetary policy makers are applying the brakes to an economy that was already beginning to lose momentum. Making matters worse, the US Fed is behind the curve when it comes to inflation. Long gone it seems are the days when inflation was "contained" or simply "transient" and this stark contrast to today's environment puts Jerome Powell and others like him in a tough spot. Problems in the labor market, specifically shortages, and rising prices were happening before the Fed's recent shift to a policy of monetary tightening. Risks of a recession then were present prior to Fed tightening, and some groups, including our own, have suggested that a better time to reign in loose money was a few years ago.

Grumblings of inflation for us began 6-years ago when the US 10-year yields hit 1.48%. Back then, the monetary expansion was part of daily life and we began early-stage work into alternatives because we wanted to be in a position to tell you that we had a solution for what was in store.



[This M2 money supply chart from the St. Louis Federal Reserve Bank illustrates that broad money increased during the recessionary periods of the global financial crisis and the COVID 19 pandemic. Also illustrated is a period of roughly 8-10 years during which M2 grew more or less because someone had wanted it to versus there actually being a dire need.]

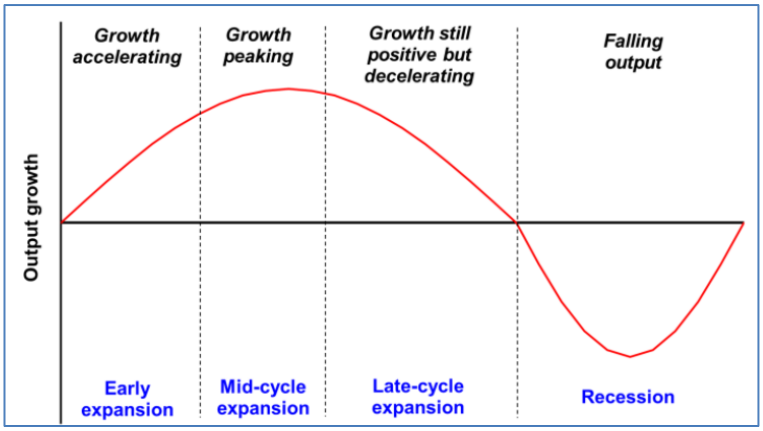
What we cannot tell you is why policy makers waited years to tighten monetary conditions or how they intend to pull this off without guiding the very economy they are mandated to nurture into a recession. A lack of labor supply means the economy is starved of the very workers that produce the goods and services we all use. If central bankers did absolutely nothing at this point, labor shortages would drag growth down on their own.



Source: Refinitiv Datastream — Reuters graphic/Stephen Culp 07/04/2022

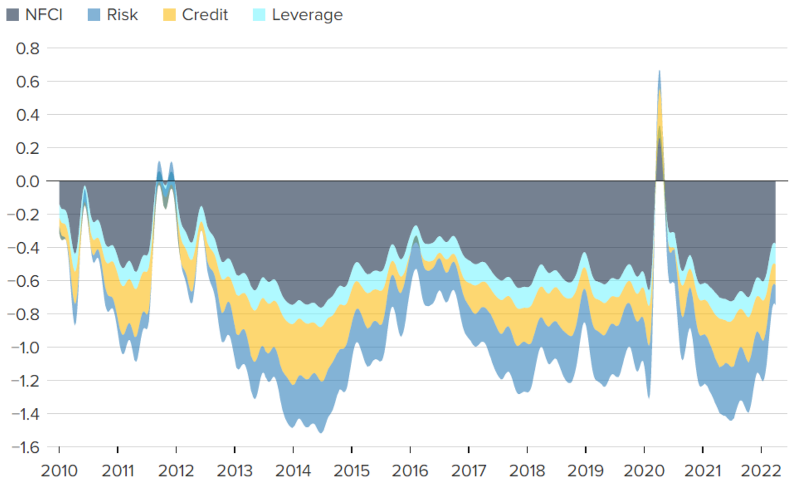
[The number of Americans filing new claims for unemployment benefits fell last week and it has been falling for 2-years. A further tightening of labor market conditions heading into the second quarter could contribute to elevated inflation.]

But with inflation running at decades high levels, central bankers aren’t doing much. Jerome Powell kicked off interest rate increases in March by raising rates to between 0.25 and 0.50%. This was the first increase in 3-years and once markets got over the initial shock of a rate hike actually having happened, they recovered. But the fundamental question remains: is raising rates at this juncture a good idea? Mercifully, this is not a question we need to answer. Yet, when one considers labor market dislocations against the inflationary backdrop in addition to tightening financial conditions one concludes that we are most likely in the late stages of the current economic cycle. In this sort of environment, a shift away from high growth cyclical areas such as technology and towards sectors like energy, utilities, healthcare, and consumer staples is prudent as is a policy of being proactive rather than reactive.



[In a world where investors are overwhelmed with computing power and information overload, a simple chart such as this one of the economic cycle is not only easy on the eyes but helpful in asset mix discussions.]

Whether or not tighter monetary conditions will fix inflation is an academic discussion, particularly given the baby steps taken to date, and one based on the widely held view that demand falls as money becomes costlier to borrow. With bubbles everywhere prices seem potentially immune to the restoration of “conventional” monetary policy. It is this conundrum that has Wall Street confused and markets volatile. In normal times, the Federal Reserve is seen as the antidote to soaring prices. But this time, the Central Bank is going to need some help.



[Financial conditions remain loose. Source: Federal Reserve Bank of St. Louis]

At the end of the day something must be done about inflation, and demand growth has to moderate. Taking some of the wind out of the sales of soaring prices narrow credit spreads and ambitious underwriting standards, will contribute to a reduction in demand growth and hopefully an improved economic outcome. But it won't be easy and policy makers and pure luck, in addition to skill, are needed now. People 10+ years older than myself, my cousin Joe in Mississauga for example, were around during the last serious bout of stagflation, and though they might not all have had economics degrees back then, they remember that impact well.

Faced with runaway prices, Paul Volcker the Fed chair of his day, cranked up the fed funds rate to nearly 20%, essentially killing the economy to fight off inflation. But will that happen in today's environment? Ultimately, no one knows for sure. And that is why our group is taking pre-emptive measures to get our investors ahead of not just inflation but the potential for a policy error. Hopefully this will result in any eye-opening, head grasping moments of incredulity limited to the actions of those managing the economy and not your portfolio.

The MacNicol Investment Team

Are you looking for a different kind of private lending strategy…?
…good…neither are we…

My sister has done well for herself. Elizabeth is a senior executive in the mortgage insurance industry and her firm is one of the main private mortgage insurance providers in Canada. Cumulatively, Elizabeth's firm back stops tens of billions of dollars' worth of residential and commercial mortgages and it is a high stakes game of finance that requires precision and good judgement. In many ways, Elizabeth's firm is the lender of last resort in an area of the market where the line between fortune and foreclosure is a narrow one. When you lend people money you have to see the forest and the trees. I recently caught up with Elizabeth at a Toronto Maple Leafs hockey game and mentioned that some of our clients were beginning to receive calls and advertisements for private lending opportunities. That set of a nearly 30-minute-long discussion about what to do in circumstances such as these.

Now we do hold an equity interest in a private mortgage lender in addition to several US-based financing vehicles in our real estate fund, but these kinds of private lending strategies are quite different from someone calling you up out-of-the-blue with an opportunity “you can’t afford to miss out on”. I write up our approach for you in the appendix at the end of this edition of *The Quarterly*. For now, let’s get into the stuff you need to know. So, first off, interest rates are changing. Everyone knows this, everyone accepts this. Rising rates usually mean that liquidity for mortgages is starting to dry up. All the more reason for you to be suspicious about unsolicited requests for meetings in which you get to hear about a “great” investment opportunity that at the same time carries low risks. Rates in the private lending space in Canada should start at 7.5% for mortgages in the current environment and rise from there. You’ll want to ensure that you are lending your money to segments of the market with ample liquidity. No one would buy a house in the middle of nowhere so why would you lend money to someone who is proposing to do just that?

[Would you buy this house for yourself? No…you wouldn’t. So why would you lend money to someone who would?]

The next thing to keep in mind is that when it comes to private lending is “second place is a risky space”. When you invest in second lien mortgages your capital is in a riskier position because you are always in a subordinated position to more senior lenders. Also, be sure to steer clear of construction loans by asking detailed questions. A big risk in construction loans is generalized approach. Not going to someone who specializes in construction loans can be a terrible mistake because you would be assuming the underwriter knows how to write a construction loan. Construction is about logistics: you are dealing with a gigantic jigsaw puzzle. There many moving parts in a brand-new building, and managing the project requires experience to know how much time is necessary for each stage. As someone who has done a full-blown renovation on his own house, I can tell you, contractors are more likely to get the budget wrong and mainly error on the all-important timelines, and that was just my principal residence in Scarborough. Can you imagine what (could) happen on a 45-story condo development?

Once the loan is already funded, there are no make ups without getting an entirely different loan because the person has already made a credit decision on the existing loan parameters.

[One "solution" that gets bandied about when it comes to construction loans is technology. But will you trust your computer to know the difference between putting up a 45-story office tower in South Bend Indiana versus South Beach, Miami, Florida?]

Now that you have confirmed you aren't lending to a property that won't be ready to accept tenants anywhere close to the forecasted move in date, you need to know to avoid syndicated mortgages, particularly on condo developments. A syndicated mortgage involves numerous investors bolting together funds to create a single registered mortgage and this category of lending has been ripe for fraudulent activity. Another aspect of lending is the simple awareness of what you are lending against. Property values, especially here in the GTA have skyrocketed in recent years, and there's natural temptation to think that will continue. For this reason, you'll want to place a cap on the LTV or loan-to-value ratio of about 60%. Be sure to ask detailed questions if you are being enticed to lend at a higher rate of leverage. Next up is pricing and this is where disclosure really is key. The total fee of a private mortgage is generally comprised of the return you the lender assume in making the loan, and a brokerage fee. Let's suppose that the all-in fee for a privately negotiated mortgage is 12%, and let's further suppose that the brokerage (i.e., not you) gets 6% of that fee? Now in this transaction, which party do you feel has the riskier role to play: the entity sourcing the deal or the entity physically risking their own investment capital? So always remember you should make the overwhelming majority of the mortgage's fee and not the broker. The final thing to apply to private lending is some basic common sense. At the end of the day, someone is approaching you to secure funding for a borrower that ultimately was unable to walk into a bank branch and secure funding there, some automatic skepticism is warranted. Not all deals are underwritten the same and even in our own work in the MacNicol 360 Degree US Reality Fund, we routinely encounter a wide range of financial modeling assumptions that we discount with our own financial models and decades of experience.

To conclude, private lending is not a bad or nefarious part of the lending market, but rather one that requires specialized knowledge, practical tools, and some experience.

The MacNicol Investment Team

Mental Accounting:

Nobel prize winning economist Richard Thaler has spent his career studying the notion that the economy's central agents (humans) are predictable and error prone. Thaler has published well-known books on these topics like *Nudge* and *Misbehaving,* as well as a vault of academic papers. But the concept Thaler is most famous for is that of **mental accounting**, which he introduced in a 1999 paper entitled "*Mental Accounting Matters*".

[The bottom line is Richard Thaler won a Nobel Prize for focusing on the bottom line when it comes to money.]

With mental accounting, people place different values on money due to *subjective* criteria, and this can lead to poor results in one's finances, and this is especially true when it comes to investing. We will look at some examples shortly however according to Thaler's theory one of the reasons people treat money differently usually depends on factors such as the money's origin and intended use, instead of treating money in terms of the "bottom line" as in formal accounting. The example we are most familiar with in our role is that of "play money" versus "safe money". The basic premise of the "play money" versus "safe money" phenomenon is that an investor *can* prevent the negative returns from high-risk investments from upsetting their portfolio as a whole. However, in "play money", "safe money", the difference in **net** wealth is zero regardless of whether the investor holds multiple portfolios or one large portfolio. The only discrepancy in these two situations is the amount of time and effort the investor takes to separate out the portfolios from one another.

Thaler's own example, and it's a classic, is as follows. An investor owns two stocks, stock "A" and stock "B". Stock "A" has an embedded capital gain while stock "B" an unrealized capital loss. For whatever reason the investor needs to raise cash and must sell one of the stocks. **Mental accounting** (and the equally important concept of **loss aversion**) will bias the investor towards selling the winner even though selling the loser is usually the more rational position to exit, due to tax benefits and the fact that the losing stock is a (more than likely) the weaker investment. Realizing a loss, particularly when accentuated by mental accounting is sometimes too "painful" for an investor so the investor relinquishes the winner to avoid that pain. This is the loss aversion effect that can lead investors astray with their decisions. Mental accounting often leads people to make irrational investment decisions, but it can also lead people to behave in financially counterproductive ways.

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A second example, also a “classic” is funding a low-interest savings account while simultaneously carrying large credit card balances. Avoiding mental accounting may not come intuitively to many, so we certainly recommend speaking to us about your investments. But to avoid the broader problem of mental accounting spreading through your finances generally, we feel the best solution is to treat money as perfectly **fungible**, which is to say interchangeable or indistinguishable. In essence, money is money…there really is no such thing as “play money” or “safe money”. To hammer home the point, think of Gold. One ounce of pure gold is exactly the same as another ounce of pure gold no matter where in the world it is held or how you came to obtain it.

To conclude, if you are feeling irrational about your investments or finances generally, just come in a talk to us or book an appointment to speak with us through videoconference. While you’re doing that, if you never lose site of the fact that all money is money, you’ll not likely “go mental” the next time you do some accounting of your own.

The MacNicol Investment Team

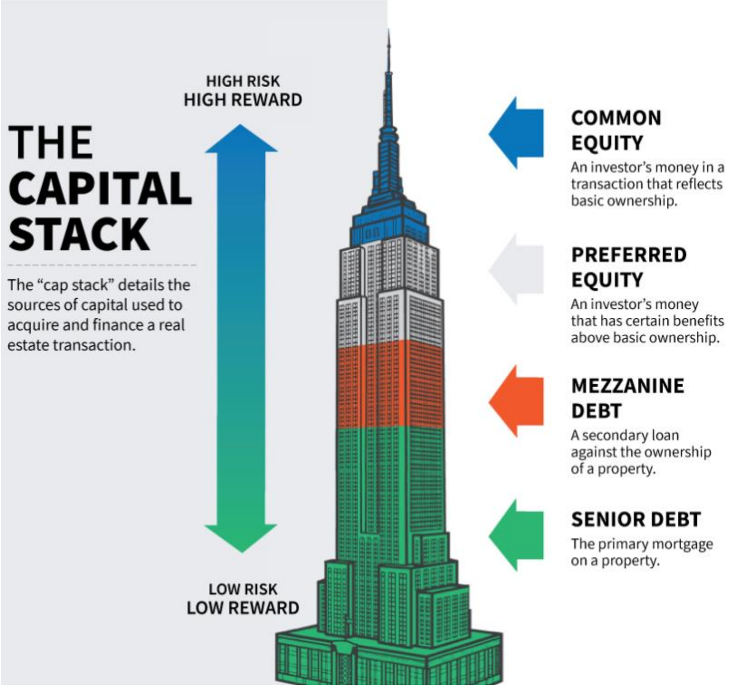
Firm Wide News

After 15-years with the firm we are sad to announce Naima Egal is leaving. Long the pillar of our administrative and trading functions here at MacNicol, Naima's contributions to our business could easily fill a separate commentary just as long as this one. Though we are sad to see her go, we wish her well in the next chapter of her professional life. Naima, on behalf of MacNicol & Associates Asset Management and its numerous investors, thank-you for all that you did and all the very best in your future endeavors.

We are pleased to welcome Angela Knapp to our team as our new Client Services Manager. Angela has over 20 years of experience in the industry having worked for several financial institutions before joining us. Angela has an Honors BSc. from Western University, as well as her CFA Level 1 and is fully licensed with IRROC. She has two children – Scarlett, who is 12 and Harrison, who is 14. We are thrilled to have her join us!

Appendix: A more flexible real estate lending strategy

If you carefully read through the financials statements of the MacNicol 360 Degree US Realty Income Fund, you will notice that the fund participates in real estate lending. Does this mean the fund invests in residential and commercial mortgages? Yes, it does. However, the primary method by which the fund achieves exposure to real estate lending is through direct equity investments and preferred equity investments. The concept of common equity is understood by most. But preferred equity investing is a technique for financing large commercial real estate deals that most retail investors may not be aware of. Preferred equity investments create leverage for both real estate sponsors (the entity of entities that champion all aspects of a real estate deal on behalf of investors – or more commonly the General Partner or Partners) and the underlying investors or limited partners. Units of the limited partnership can in turn be sold to accredited investors looking to earn consistent returns with a reduced level of risk over common equity holders. Preferred equity can represent an advantage for general and limited partners as this category of equity has a high priority in the capital stack. What's more, these deals are not done over the phone or with unrealistic return expectations.



The "cap stack" details the sources of capital used to acquire and finance a real estate transaction.

COMMON EQUITY: An investor's money in a transaction that reflects basic ownership.

PREFERRED EQUITY: An investor's money that has certain benefits above basic ownership.

MEZZANINE DEBT: A secondary loan against the ownership of a property.

SENIOR DEBT: The primary mortgage on a property.

[A typical real estate deal capital "stack", Source: *Arbour Crowd*]

Like all investments the fund makes on behalf of unitholders, each lending strategy the portfolio manager ponders is carefully reviewed and thoroughly researched. Only then are documents signed and wires sent. And our work continues long after a deal is made. Ongoing monitoring is (at least) as important as initial due diligence and it is something we prioritize here at MacNicol & Associates Asset Management.