April 2020

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FROM THE EYE OF THE COVID-19 STORM: WHERE WE ARE, HOW WE GOT HERE AND WHERE WE'RE GOING

Mike Preto, CFP®

This issue of our **Informed Investor** newsletter is a little different than usual. Jason gets technical in this month's **Performance Update**, which is great as it allows him to walk you through the depth of analysis that we undertake when looking at potential investments. To honour one of our core commitments of "keeping it simple", I'm going to provide a high level summary of Jason's message in basic terms.

Here's a quick recap of how the financial world got to where it is now: In 2008/09 the world's banking system was at risk of failing. The Federal Reserve (also known as the "Fed"), which is the US Central bank, came in and lowered interest rates; which is a pretty standard move when it comes to stimulating the economy during recessionary times. The Fed also started Quantitative Easing (QE): printing money which they injected back into the financial system by purchasing bonds, mortgage-backed securities and debt held by banks. These moves were not standard and considered necessary to deal with unprecedented times.

As the various rounds of QE took place from 2008 all the way through to 2014, the world's debt levels increased, as did the price of stocks, bonds and real estate; creating a financial environment that we weren't entirely comfortable with. Having experienced two 50(ish)% drops in the markets before, **Hillside Wealth** was ready to respond with the implementation of our **downside protection plan** which has been much discussed in previous newsletters and put into action through this current correction.

Fast forward to 2020 and we had record levels of debt across the planet, a stock market that was very expensive (historically speaking) and a business cycle that was well into the late stages. However, all things considered, things were moving along relatively nicely. Then COVID-19 arrived and turned everything upside down.

To right the ship, the Fed, along with other central banks of the world including (for the first time ever) our very own Canadian Central Bank, are firing up the printing presses to buy more assets to ensure the system keeps functioning the way it's supposed to. One of the potential problems with QE is unhealthy levels of inflation: when prices and services increase in value too quickly and the economy overheats to which the solution is to raise interest rates and decrease the supply of money. The obvious question is what lies ahead and what's the best way forward. Jason mentions a couple of different scenarios:

1. **Stagflation of the 1970s**
   Stagflation occurs when there's slow economic growth and high inflation; not a good recipe for stock markets to say the least. In the 1970s, the post World War II economic expansion came to a halt and stagflation set in. As a result, the stock markets of the world barely grew throughout the decade.
2. **Japan-type deflation**
   The Japanese stock and real estate markets peaked in 1990 and have yet to recover. The primary cause of the problems in Japan is deflation - the opposite of inflation. Healthy inflation, which is considered under 3%, encourages consumption and investment. Deflation occurs when goods/services get cheaper over time; this is bad news for economies because consumers don't go out to buy or invest in something when they are expecting the price to keep dropping.

COVID-19 OFFICE UPDATE

As you know, our Hillside Wealth team is currently social distancing and working from home until applicable health agencies advise that it is safe to return to our usual activities.

We want to reassure you that we were very prepared for this, and have the technology and security measures in place to continue operating as "business as usual".

All members of our team are available at our usual phone extensions and email addresses (listed on the last page of this newsletter) during regular business hours.

The flipside of the coin is that with all the stimulus measures taken on by Central Banks and Governments of the world, we may go through another prosperous period, like 2009 -2019, where the stock markets of the world re-accelerate even though we have somewhat underwhelming economic growth. We are extremely confident that our process of owning concentrated positions of high-quality companies will continue to produce solid results, regardless of what the future holds.

When we say "concentrated", we will own 15-25 stocks in our models at any given point. This allows us to keep a very close eye on all the positions that we own for you and the rest of our clients. When we say "high quality", we like companies that consistently earn above average profits while carrying little or no debt. No matter what is coming down the road, we know that there will always be a group of thriving companies and we have spent the last 5.5 years developing a system to find them.

For you, this means that regardless of what lies ahead, we're still going to deliver successful retirement plans where target lifestyles are attained and where dreams continue to be realized. Our doors, while virtual for now, are open and we're happy to chat further with you about what's happening here at **Hillside Wealth** - don't hesitate to reach out and book some time to chat.

PORTFOLIO UPDATE: A DEEP DIVE INTO SECURITY ANALYSIS

Jason Del Vicario, CFA

Throughout my career I've witnessed three market crashes: the tech bubble burst of 2000, Global Financial Crisis of 2008 and now the COVID-19 crash of 2020. The financial media will tell you crashes like these happen every ~50 years or so; however, we've had three 'black swan' events in the last 20 years alone. The following quote may actually not have been uttered by the brilliant Albert Einstein (according to Google) but the source of the words is not important in this context:

> ***"Insanity Is Doing the Same Thing Over and Over Again and Expecting Different Results"***

It is my firm belief that once we reach zero bound in interest rates the game changes. I've said it before and I'll say it again: the world's financial system is addicted to cheap money and low interest rates. Much of what we experience as workers and consumers is predicated on the unfettered access to cheap money. This is a dangerous state because there will inevitably be times when money is scarce. We are in the middle of such a time.

I've written extensively about our views of the macro environment and why we employ a downside protection plan in our work. We've been sending frequent notes and updates to our clients updating them on the administration of this plan. There will be a time look back on the details and effectiveness of this plan but now isn't the time. Now is the time for us to communicate where we go from here.

How do we steward investor capital in a world when interest rates are likely going to be pinned close to 0% for a long time? How do we steward investor capital in a world where central banks and governments are hell bent on monetizing the debts of yesteryear which could in fact lead to a stagflationary environment? In either of the above scenarios traditional fixed income investments will be very challenged to deliver us anywhere near the return they've delivered in the past. Are we staring into decades of Japan-style deflation or are we looking forward to a period that most resembles the 1970s? We don't know… we do know that any of this is possible and

DON'T MISS THE LATEST NEWS WITH OUR VIDEO UPDATES

In addition to direct communication with clients, we've been keeping our Hillside Wealth family updated with current news with a number of video blogs available online!

March 19, 2020: COVID-19 Market Update

March 23, 2020: COVID-19 Market Update

March 31, 2020: COVID-19 Market Update

we feel it's important to stay nimble and have as few biases as possible.

In an uncertain world, it is vital to take a step back and pay attention to facts and factors we can predict. One of our core commitments at Hillside is to keep it simple. We firmly believe that no matter the economic backdrop there exists exceptional companies, brands and services run by dedicated and honest managers that can increase returns to shareholders. As noted in previous e-mails, we applied our screen across the entire planet in January and February. This left us with a list of 269 securities. We have spent the last two weeks whittling this list down to 100 companies. I want to spent time helping our clients understand the characteristics of these very special companies because many of them are not household names.

The very best companies possess:

1. **Consistently high margins**: every time they sell their product or service, the company is profitable. We prefer companies with net margins over 15%.
2. **Consistently high returns on capital/assets**: the profits of a company in a given period when compared to their asset base is elevated. We prefer companies that can consistently return greater than 20% on capital employed.
3. **Consistent and growing free cash flow**: Is the company converting their earnings into cash that can be used to pay dividends, buy back shares or invest in new revenue streams?
4. **Little to no debt**: the very best companies do not rely on debt to lever their returns. We prefer companies with debt/EBITDA under 3. Many of the companies we follow have net cash positions (their cash is larger than their debts).
5. **Asset light:** it's one thing to be wildly profitable but does this profitability require constant injections of capital or does the business require very little 'maintenance' capital? The very best business models are scalable without requiring gobs of capital.
6. **Management has skin in the game:** we prefer companies where management has a vested personal interest in increasing the share price and shareholder value. We favour founder run companies.
7. **Managers are efficient allocators of capital:** Management has demonstrated a solid track record of deploying excess cash either through dividends, buybacks or value enhancing acquisitions.
8. **Robust business line(s):** How has the company done in previous recessions? Did demand and profitability fall off a cliff or was the business model resilient?
9. **A strong and durable competitive position/advantage:** There is a moat around the business that allows it to consistently provide above average returns to its shareholders.

There are 130,000 publicly traded companies in the world. We have identified 100 companies that meet the criteria noted above. To say we are hunting with a sniper rifle is an understatement; we are interested in fewer than 0.07% of available investment options the world over.

Of the 100 companies we own some are household names, many aren't. Below is a description of one lesser known gem: Heico Corporation.

Heico is an aircraft parts manufacturer run by the Mendelsons. They have acquired 78 companies since taking over the company in 1990, price their

HILLSIDE WEALTH IN THE FINANCIAL POST

Find out what companies Jason is keeping his 👀 on in this March 26, 2020 Financial Post article: [Here's what the investing pros are buying amid the coronavirus volatility]() (read to the end for Jason's pick!).

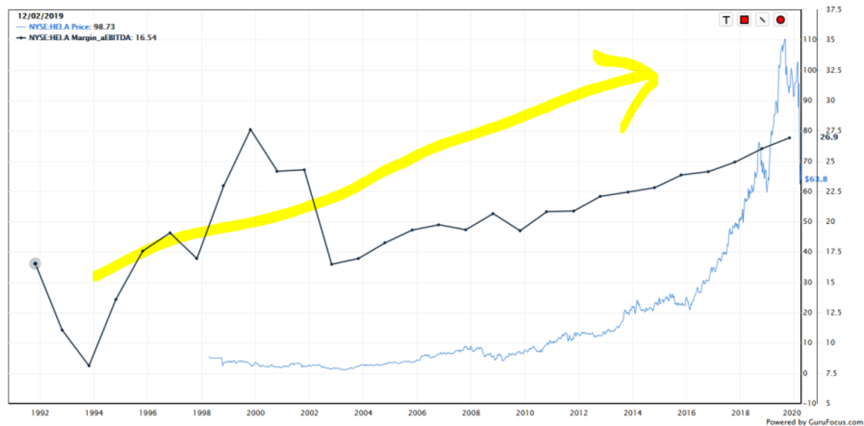
products sharply and count most of the world's airlines as customers. This [Forbes article]() explains their value proposition and competitive positioning well:

> *"The Mendelsons have been able to earn a foothold in an industry dominated by the so-called original equipment manufacturers, the GEs and Boeings of the world, who are the first to develop the parts and keep prices high on any replacements to help recoup the original R&D costs."*

Many of us will be familiar with this business model vis-à-vis car ownership. I'm sure we've all been presented with the "The <insert car manufacturer> oil filter is $150 or the after-market filter is $75."

Let's go through each of the 9 attributes above as they pertain to Heico:

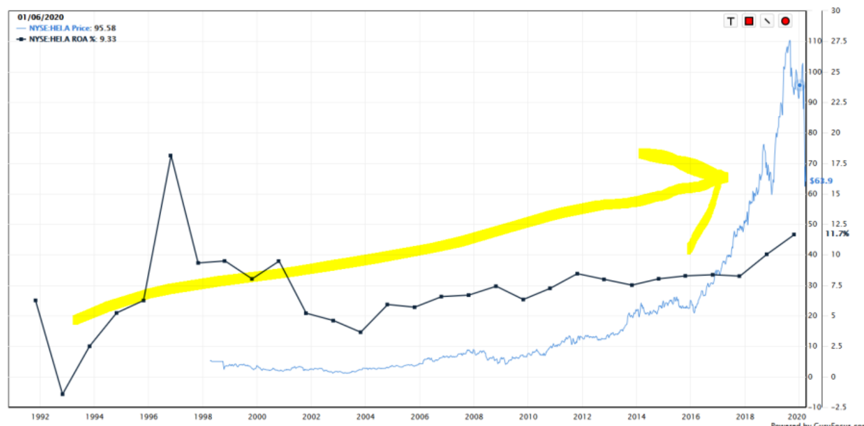
1. Consistently high margins:



Worth noting:

a. Margins have been above 0% for the entire 28-year period.
b. Margins dipped in the 2000 recession and to a lesser extent in the 2008 recession but generally held up well.
c. Margins have been expanding over time.
d. Margins have been over 20% for most of the period in question.

2. Consistently high returns on capital/assets:

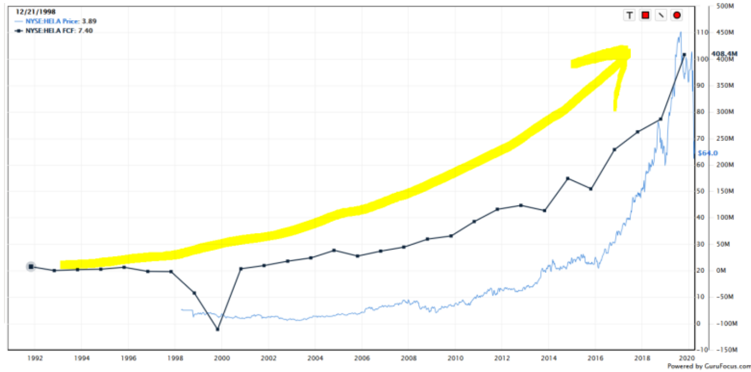


Again, we see that Heico has experienced consistently positive and growing return on its asset base.

DID YOU KNOW?

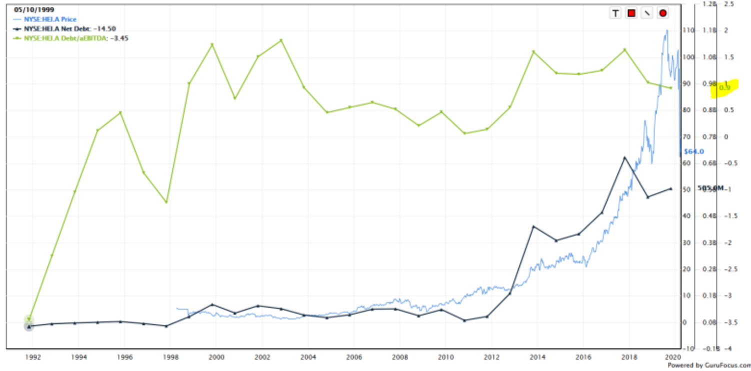
Did you know one easy way to move cash directly from your bank account into your Hillside account is to give Heidi a call and let her do it for you? If you have banking information attached to your account with us, it is as simple as a quick call to Heidi with your request and there is nothing else to worry about. She can be reached directly at 1-800-665-6424.

3. Consistent and growing free cash flow



Heico have been very disciplined. We see that Free Cash Flow has been positive every year but for 1999 and 2000 and has been growing nicely.

4. Little to no debt



Net debt (debt minus cash) has been very low until 2012 after which point we see net debt rising to $500m. Is this a concern? Debt must always be looked at in the context of profit/earnings and ability to service said debt. The net debt to adjusted EBITDA ratio is 0.9 which is comfortably less than 3 so we conclude this isn't a problem but something worth keeping an eye on.

5. Asset light

HEI.A Historical Data

F/aEBITDA	FCF Yield	Purchase Of Business	Capex	Growth Capex	Maintenance Capex	Capex/aEBITDA	Date
77%	5.14%	-185.145	$30	$3	$27	-5%	Mar 23, 2020
74%	3.19%	-240.841	$29	$23	$6	-1%	Jan 01, 2019
62%	3.23%	-59.775	$42	$22	$20	-4%	Jan 01, 2018
69%	4.08%	-418.265	$26	$13	$13	-3%	Jan 01, 2017
69%	5.67%	-263.811	$31	$17	$14	-4%	Jan 01, 2016
54%	5.29%	-166.784	$18	$5	$13	-5%	Jan 01, 2015
68%	5.73%	-8.737	$16	$10	$6	-2%	Jan 01, 2014
50%	4.39%	-222.638	$18	$11	$7	-3%	Jan 01, 2013
62%	7.66%	-197.285	$15	$12	$3	-2%	Jan 01, 2012
73%	7.02%	-94.655	$9	$13	-$4	2%	Jan 01, 2011
72%	7.57%	-39.061	$9	$8	$1	-1%	Jan 01, 2010
63%	8.14%	-59.798	$10	-$5	$15	-15%	Jan 01, 2009
50%	8.05%	-29.038	$13	$8	$5	-5%	Jan 01, 2008
45%	3.93%	0	$13	$13	$0	0%	Jan 01, 2007
48%	4.85%	0	$10	$15	-$5	7%	Jan 01, 2006
53%	6.62%	0	$8	$9	-$1	1%	Jan 01, 2005

HILLSIDE WEALTH IN THE GLOBE AND MAIL

Read what Jason had to say in this March 12, 2020 Globe and Mail article: [TSX suffers biggest one-day plunge in eight decades]

Ignore the fact that I can't highlight well (!) and rather focus on Heico's [CAPEX] (Capital Expenditures) profile. These are costs required to maintain and grow the business. We see CAPEX rising from $8m in 2005 to $30m recently however we noted that as a percentage of adjusted [EBITDA] (Earnings Before Interest, Taxes, Depreciation and Amortization) CAPEX has generally been in the 5% range which is very low. Heico is asset light.

6. Management has skin in the game

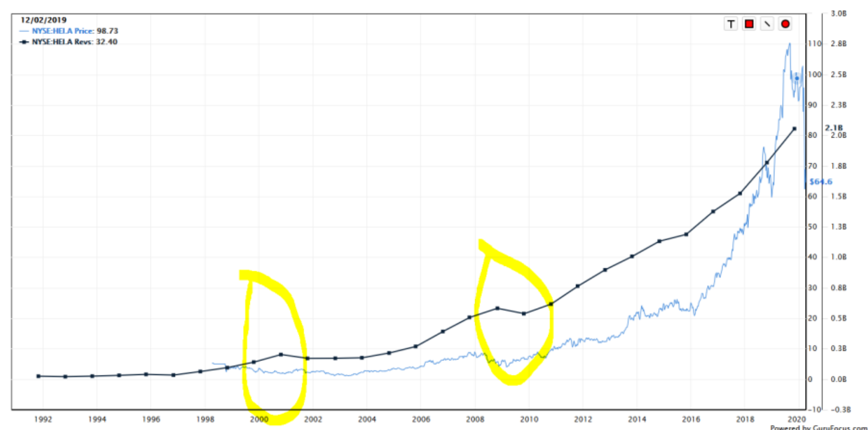
The Mendlesons control 17% of the company. This is significant; the majority of their net worth is tied to the success of HEICO. Management's interests are aligned with shareholder interests.

7. Managers are efficient allocators of capital

Normally when I come across a company that is very profitable and asset light, we see their share count dropping because management uses this money to buy back shares. This isn't the case for Heico… so what are they doing with the cash? The answer lies in the column in the table above 'purchase of business'… they have used their free cash flow to make 78 acquisitions over the past 30 years. Given adjusted EBITDA has risen 10-fold since 2005 we conclude this has been an efficient use of capital. The corporate world is littered with managements that have 'lit money on fire' by making poor acquisitions. The Forbes article quote below highlights the Mendelsons' discipline:

> *"The Mendelsons are shrewd buyers themselves, having in 2019 completed seven more acquisitions. They shop for owners or top executives who resemble them. "The companies we buy are very entrepreneurial—entrepreneurs that started years ago, started businesses in their garages," says Larry. "They started with nothing," which, he says, means "they watch every nickel." Generally, the acquired businesses have around $10 million in earnings and margins north of 20%. The Mendelsons don't usually buy an entire firm. More often than not, they leave a fifth of it in the hands of the owners or the chief executives running the place to keep them incentivized."*

8. Robust business line(s)



Highlighted above are Heico's revenues during the last two recessions. While revenues did dip, they certainly didn't collapse. We noted above that the company still managed to generate positive free cash flow in 2008 but negative in 2000. Not perfect; but pretty close.

LET'S STAY CONNECTED

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9. A strong and durable competitive position/advantage

Warren Buffet always says the true test of a business is its ability to raise prices aka pricing power. A strong business can raise the price of its product/service without its customers running away or to a competitor. Larry Mendelson notes: "We don't try and screw the customer." Heico prices its products cheaper than the OEMs but customers have come to expect sharp pricing from Heico. This accomplishes two important feats: 1) it keeps competitors at bay and 2) it builds a loyal customer base. Perhaps more importantly, there are significant barriers to entry to designing and manufacturing airline parts. Before a part can be brought to market it goes through rigorous testing and needs FAA approval. Again, the Forbes article sums this up nicely:

> *"Everything needed Federal Aviation Administration approval, which ensured that not every Tom, Dick and Larry could easily enter the industry. Plus, replacement parts weren't generally patent-protected, so all the Mendelsons had to do was reverse engineer them, then prove to the FAA that they were up to snuff."*

Questions:

Question: Will Heico's earnings be down this year given the virus and its disruption?
Answer: Likely.

Question: Are airlines facing the biggest crisis perhaps ever?
Answer: Most likely.

Question: Are some airlines likely to go under?
Answer: Yes; this is likely.

Question: Will all airlines go out of business?
Answer: No; not likely.

Question: Is travel being curtailed and dramatically impacted by the virus?
Answer: Absolutely.

Question: Is air travel dead?... are we ever going to get on an airplane again?
Answer: Not likely and very likely.

Re-visiting our commitment to 'keep it simple' we don't want to overthink this. One could argue that cash strapped airlines will have an even greater need for Heico's parts coming through this downturn. Furthermore, one could also argue that the acquisition landscape will become more favourable for Heico; namely multiples have dropped (cheaper to buy) and surely some smaller players won't be able to weather the storm as well as the larger and better capitalized Heico. This environment should yield greater acquisition opportunities for them.

We haven't spent a lot of time in our newsletter highlighting the companies we own or are looking to own. We must not forget that at the end of the day we are looking to own and acquire pieces of businesses that are producing products and services for real people such as ourselves. Not all companies are created equally and we continue to hunt for the very best. I hope this analysis helps our clients gain a window into our selection and thought processes.

MARCH 2020 PERFORMANCE RESULTS

An overview of our three portfolios to date.

Performance to March 31, 2020	YTD	1 Mo	6 Mo	1 Yr	3 Yr**	5 Yr**	Inception **	Added Value vs. Benchmark**
Hillside Conservative Growth*	**-3.6%**	**-4.22%**	**-3.13%**	**4.25%**	**5.78%**	**5.41%**	**6.86%**	**+3.82%**
HCG Benchmark[1]	*-8.15%*	*-7.44%*	*-6.21%*	*-2.63%*	*2.05%*	*2.36%*	*3.04%*	
Hillside Balanced Growth*	**-6.8%**	**-5.98%**	**-5.98%**	**0.84%**	**5.57%**	**5.96%**	**8.43%**	**+5.35%**
HBG Benchmark[2]	*-10.31%*	*-8.67%*	*-7.76%*	*-4.13%*	*1.87%*	*2.5%*	*3.08%*	
Hillside Focused Growth*	**-16.69%**	**-9.92%**	**-16.59%**	**-9.7%**	**-0.87%**	**2.14%**	**4.97%**	**+2.39%**
HFG Benchmark[3]	*-20.41%*	*-14.66%*	*-15.22%*	*-12.54%*	*-0.25%*	*2.04%*	*2.58%*	

Past performance is not an indication of future returns.

* Performance is presented gross of fees. **Inception: Sept 2, 2014. Results beyond 1 year are annualized.
[1] Hillside Conservative Growth Benchmark: 100% Vanguard Conservative ETF
[2] Hillside Balanced Growth Benchmark: 100% Vanguard Balanced ETF
[3] Hillside Focused Growth Benchmark: 100% Vanguard All-Equity ETF

Source: SIACharts.com

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Insurance products provided through Hollis Insurance Agency.
Performance is calculated using month-end market values of the model portfolio. Since we use a model portfolio to calculate performance there are no client-initiated cash flows (deposits/withdrawals) to account for. Performance is calculated by dividing the change in the model portfolio's market value by the model portfolio's market value at the beginning of the performance period. Also, all income generated by the portfolio's holdings are held within the model portfolio in cash and is accounted for in the portfolio's month-end market value - this results in a total return measure of the model's performance.
Returns for periods less than 1 year are shown as periodic returns while returns for periods greater than 1 year are annualized. Returns do not include fees and actual returns experienced by an investor may differ from those shown. Past performance is not a guarantee of future results.

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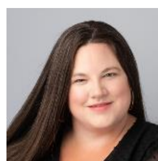
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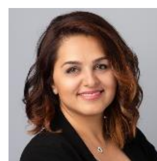
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