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2 HILLSIDE PHILOSOPHIES: MEASURED GENEROSITY IS SUSTAINABLE & EARNED SUCCESS IS SATISFYING

Mike Preto, CFP®

Back in April, I took my two boys mountain biking and it didn't go so well: I fell off my bike, badly broke my arm and had multiple fractures in my wrist. The funny thing is that ever since then, both boys have really been enjoying the sport and are now keen to get new bikes to the tune of $3,000 a pop. Well, $6,000 is a big deal in the Preto household, and Mom and Dad aren't going to simply hand that kind of money over. The boys are going to need to work for it; they have an open offer to earn $12/hr working in the garden and then they can use their hard-earned money to go buy a bike. After presenting this offer, the first question one son asked was: "Can you buy the bike and then I'll pay you back by working?". Sounds like a bail out to me - and the answer was no. And good thing it was, as my eldest went hard in the garden for a month and then stopped completely.

There are two philosophies that we have here at Hillside that are worthy of a discussion. The first is that ***measured generosity is sustainable*** and the second is ***earned success is satisfying***; both work together to address many situations in life from parenting to business to corporate governance and beyond.

We live in a world where central bankers are printing money at a pace never seen before in North America, and there's likely a lot more of it coming. If we look across the Pacific to Japan, where they have been printing money for the better part of the last 30 years and are stuck in a low growth, and at times deflationary, environment. There are differences between Japan and North America, but Japan has the 3rd largest economy in the world so they are meaningful and worth paying attention to.

If we look at money printing as an act of generosity (after all, in the short term it works great by providing liquidity to the financial system and allows governments to do things like bail out banks, automobile manufacturers as well as consumers and other businesses) we must ask how sustainable is it? We can look to history for the answer as we've been here several times before. As Jason discusses in his portion of the letter, many of the previous world powers have failed as a result of too much money printing and excess debt. There were no printing presses back in the days of the Roman empire, but there were coins; and those coins contained precious metals and to print money they diluted the newly minted coins with more and more less valuable material. In other words, if the developed world, particularly the US, continues down this path for perpetuity, it won't end well.

The next question is around timing: when will the cheap money party end? Will it be 1 month, 1 year, 1 decade or 1 century or anything in between? No one knows what the future will bring, the crystal ball shattered long ago, but we do know that the range of possibilities is as diverse as it's ever been. We can't count on the same

WATCH JASON ON BNN MARKET CALL

ICYMI: Jason's was a guest on BNN Bloomberg's #Marketcall on July 6th where he discussed North American Growth Stocks

The full episode is now available online.

playbook working over and over again. If lockdowns reappear across the globe because of a second wave of COVID-19 and the market drops as it did in late February through to the end of March, can we count on another market recovery stimulated by more Fed money printing? Maybe, but maybe not. We call this a recency bias: thinking what just happened will continue to happen again and again. Biases can be very costly in portfolio management. To deal with the uncertainty, diversification across asset classes is more important than ever, as Jason will cover in his portion of the letter.

The second point is **earned success is satisfying** - this is a real problem in the world today. Boeing's share price was trading around $350 pre-Covid, it dropped down to $97/share at the March 2020 bottom and has since risen to a recent high of $216/share, why did the share price more than double? They went to Washington to ask for a $60B bail out, which if granted would've been full of restrictions given they had aggressively bought back shares and were in the midst of the 737 Max disaster, but in the end they didn't need to count on the Government. When the Fed committed to money printing which made sure capital markets kept functioning, Boeing was able to raise enough, more than enough in fact, through traditional channels. People were willing to throw money at a company that had planes falling out of the sky and clearly had management issues. Hillside would argue that the reason for their issues is that they didn't have to worry enough about making good decisions because they knew they are the only big commercial airline manufacturer in the country and as a result they knew the system wouldn't let them fail. Aside from the fact that hundreds of innocent people died, why is this a problem?

Capitalism isn't perfect, but it works because (at least historically) businesses that make poor decisions fail and those that make good ones succeed. If poor businesses don't fail, then the system becomes inefficient and eventually fails on its own accord. There's a story of a top Gorbachev aid visiting London during his reign of the USSR. The aid was toured around the city by UK officials showing how their system worked. Half way through the tour, the aid finally said something along the lines of: "This is all great, but there's one thing I don't understand. We have the top minds in our nation trying to figure out how we can eliminate all the queues we have for people wanting bread. Can you please take me to the person in charge of your bread program?". There obviously was no bread program, but there were just enough bakeries selling bread to ensure that supply met demand and so the system worked.

For capitalism to continue providing the free world with goods and services efficiently, there must be consequences for those companies that make poor decisions. The current system doesn't do a good enough job disciplining those that need it, and someone will end up paying for this either through higher taxes, or worse.

So how does Hillside deal with this lack of discipline? The answer is quite simple: we focus on making sure that the Factor(y), that is our Portfolio Management system, continues to operate as it should. Capitalism still

rewards great companies for performing well and so we know which companies are going to make up the stock portion of the portfolio. We know that when the market corrects the babies get thrown out with the bath water, so we will remove them before that happens- yes- we'll reduce exposure again if we see another round of ugliness. In short, Hillside will continue to own high quality companies, regardless of the environment, protect to the downside and get you to where you want to go.

The boys were given a generous opportunity to get what they want, the gardening gig ain't bad for a couple of 10 and 12-year-old kids (albeit slightly measured given that minimum wage in BC is $14.60/hr which my eldest reminded me of). They're also learning valuable life lessons: if you want something, you have to earn it. They'll see that when they do, they'll enjoy their success more and take better care of it than they otherwise would had they not earned it.

I informed them that we're not the only ones who believe in this. On Father's Day, I read the following Tweet aloud at dinner by Ray Dalio (a living legend in the world of finance):

> *"Embrace tough love. What I want to give people I love is the power to deal with reality to get what they want. In pursuit of my goal to give them strength, I will often deny them what they "want" because that will give them the opportunity to struggle so that they can develop the strength to get what they want on their own."*

PORTFOLIO UPDATE: LOOKING FOR ANSWERS IN UNCHARTED WATERS

Jason Del Vicario, CFA

We continue to maintain a diversified approach to the markets as we work through the current recessionary environment.

One of our commitments at Hillside is to honour and recognize responsibilities and given the challenging environment that we find ourselves in, our responsibility to you has never been more important. While I wish we were in a 'normal' economic environment the simple fact is we are not. Coming out of 2008 it was obvious that we needed to think about the macro economic environment and how that would impact our responsibility in growing and protecting our clients' capital. Macro economics speaks to large economic factors such as debt, deflation, inflation, interest rates, GDP growth, etcetera.

I find that I'm spending as much time searching for companies that meet our strict selection criteria as I am wrestling with the following issues/questions:

1. Will we get deflation or inflation?
2. Where are interest rates headed?

COVID-19 OFFICE UPDATE

Our Hillside Wealth team continues to maintain a safe social distance by working from home during the COVID-19 pandemic.

Please know members of our team continue to be available at our usual phone extensions and email addresses (listed on the last page of this newsletter) during regular business hours.

3. What is the end game here? Clearly the current path of piling debt on top of debt and printing fiat currency (paper money) isn't sustainable.
4. How do you value risk assets when interest rates are pinned to the zero bound (0%)?
5. What if market participants start demanding higher interest rates to lend to countries set on monetizing their debts and debasing their currencies (US, Japan, Europe etc.…)?
6. If interest rates stay near 0% and/or rates start to climb how can we generate strong risk adjusted returns for the fixed income portion of our portfolios? Do we need to think about alternatives to fixed income? If so, what does that look like?

I'm sure many of our clients have similar questions and the fact is no one knows the answers with 100% certainty. We are in uncharted waters (to use a Mike-ism!) and I humbly submit I don't know where we're headed. However, let's not confuse 'not knowing' with being ill prepared.

The reality is none of us have ever experienced the financial backdrop we find ourselves in today. The world is awash in debt, we are in the middle of a global pandemic and the worst recession since the 1930s Great Depression and central banks and governments of the world are using increasingly desperate and obscure 'tools' to try and keep it all together.

While we aren't sure where things are headed, we do feel it's important to have a framework from which to compare/contrast actual events. Below is our current framework and represents our best guess as to where things head from here:

1. We feel certain that the economy as we know it would look very different had central banks not kept interest rates near zero for the past 14 years and more recently engaged in quantitative easing (money printing) and outright asset purchases. Risk assets tend to have a fit (drop sharply) even at the suggestion rates will rise. This has led to misallocation of capital and we move from bubble to bubble to bubble.
2. The yield curve inverted summer 2019; signals were already pointing to the economy rolling over… the pandemic flipped it over in a hurry. We are in the middle the worst recession since the Great Depression. Unemployment has skyrocketed and it has disproportionately affected those who can least afford to lose their jobs. Governments have responded by extending interest free loans, outright income supplements and a laundry list of income relief/support.

STAY TUNED FOR OUR NEXT NEWSLETTER IN SEPTEMBER

Our Informed Investor newsletter is published 10 times a year. We will be taking our regular brief hiatus from writing next month, but will be back with more news in September!

3. The world is awash in debt. As we've covered numerous times in this letter debt brings forward consumption that otherwise would happen in the future and beyond a certain point (debt/GDP >90%) begins to hamper future growth. Going into 2008 it was household debt that wound up being too much and toppled the apple cart. American households have deleveraged a bit post 2008; Canadian households have not. This time corporations and governments are up to their eyeballs in debt. Cheap money has been used to fund 'financial engineering' whereby corporations bought back shares. This is fine as long as the company is able to pay the interest on the debt; many can't and we feel that while the central banks have solved the March 2020 liquidity crisis (mass selling due to virus/recession fears) they are going to encounter a solvency problem later this year which will be much more difficult to control/contain. Solvency speaks to the abilities for borrowers to make debt payments. We are in the middle of a simultaneous ending of a short term debt cycle (2009-2020) and long term debt cycle (1940-2020). The last time this happened was in the 1930s. Ray Dalio has written a free e-book about debt crises that is exhaustive and worth a read if you're into this kind of thing! https://www.principles.com/big-debt-crises/
4. So how do these massive debt levels get resolved? One way is through default or debt forgiveness. This is messy. Another is through debt monetization which effectively involves printing fiat currency (paper money) to the point where you get inflation (rising prices). When this happens the value of currency falls thereby make the debt obligations less thereby 'inflating away the debts.' The isn't as messy but has major investment implications. Politicians and central bankers almost always choose the debt monetization route so we'd assign a very high probability that this happens. In fact it's already happening so we really aren't going that far out on a limb with this call. Layered into all of this we have all the makings of a changing world order. The United States post WW2 has been the most powerful country in the world. We have a rising superpower (China) that is threatening this dominance. If we look at the rise/fall of previous empires (Dutch, Spanish, British etc) they typically follow a predictable pattern. Empires usually fall because they abuse their power of having the world's reserve currency and issue too much debt and then print their currency into oblivion as they attempt to fund current and future liabilities (promises). We see this now in the form of trade wars, the situation in Hong Kong and Taiwan. Often these situations are settled/tested with military confrontation which is certainly worrisome.

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5. From where we sit everything boils down to inflation and interest rates. We've shown before in this letter how interest rates are used to value risk assets. All things being equal, the lower the (discount) rate the higher the asset value and vice versa. As we get to very low rates as we are now, small changes in rates (1% to 2% or 2% to 1%) can have dramatic impacts on valuations. We are therefore keeping a close eye on inflation expectations and levels. Our best guess is we are in a low rate and low inflation (if not outright deflation) period for a long time, possibly decades. This is not a consensus view but neither was it post 2008 when everyone said QE would lead to runaway inflation. We accept the points of the consensus view but would first like to see some evidence before making drastic changes to our approach. It also bears noting that we feel the types of companies we look for and own (high margin, low debt, strong competitive advantages/positioning) tend to have great pricing power than weaker companies. This should help them navigate an inflationary environment if and when inflation does show up. This may well be offset by valuation multiple contraction but we're getting way ahead of ourselves here.

Putting all this together we foresee a world loaded with uncertainty. The economic backdrop is unique. The political landscape fragile and social tensions brewing. We believe that a diversified portfolio is warranted at this time. It's also important we understand what I mean by 'diversified' because I often note that we own a concentrated portfolio and diversification for the sake of diversification isn't productive… and this is still accurate. Diversification in the portfolio context means owning non-correlated assets. In plain language, we want to own assets that 'zig' when other assets we own 'zag.' On one hand we own a concentrated pool of ultra-high quality companies (stocks) and on the other we have cash, gold and government bonds which tend to rise when stocks fall and vice versa. We've been moving towards this approach since early 2018. We would need much lower stock valuations or meaningful and sustained economic growth in order to favour stocks.

I hope you find this summary interesting. It can be a bit overwhelming and we do our best to 'keep it simple' the reality is we are dealing with very complex systems and I think it's important our clients understand how the stewards of their capital thinks about all aspects of finance and capital allocation. We have been through a lot so far in 2020 and I suspect we've got a few more surprises on the horizon. I wish you all a wonderful safe summer with family and friends.

JUNE 2020 PERFORMANCE RESULTS

An overview of our three portfolios to date.

Performance to June 30, 2020	YTD	1 Mo	6 Mo	1 Yr	3 Yr**	5 Yr**	Inception **	Added Value vs. Benchmark**
Hillside Conservative Growth*	**1.97%**	**0.51%**	**1.98%**	**4.61%**	**7.55%**	**6.94%**	**7.64%**	**3.08%**
HCG Benchmark[1]	*0.78%*	*1.63%*	*0.78%*	*4.25%*	*4.83%*	*4.59%*	*4.56%*	
Hillside Balanced Growth*	**-0.49%**	**0.44%**	**-0.49%**	**2.34%**	**7.55%**	**7.68%**	**9.32%**	**4.54%**
HBG Benchmark[2]	*-0.56%*	*1.69%*	*-0.56%*	*3.64%*	*5.02%*	*4.92%*	*4.78%*	
Hillside Focused Growth*	**-5.16%**	**0.11%**	**-5.16%**	**-3.56%**	**4.41%**	**4.54%**	**7.17%**	**1.84%**
HFG Benchmark[3]	*-6.52%*	*2.41%*	*-6.52%*	*0.44%*	*4.82%*	*5.54%*	*5.33%*	

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

The performance presented in this portfolio report is hypothetical and does not represent a specific client account. Details regarding actual returns of an investment account are available from the client's advisor.

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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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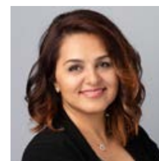

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