October 2020

IN THIS ISSUE

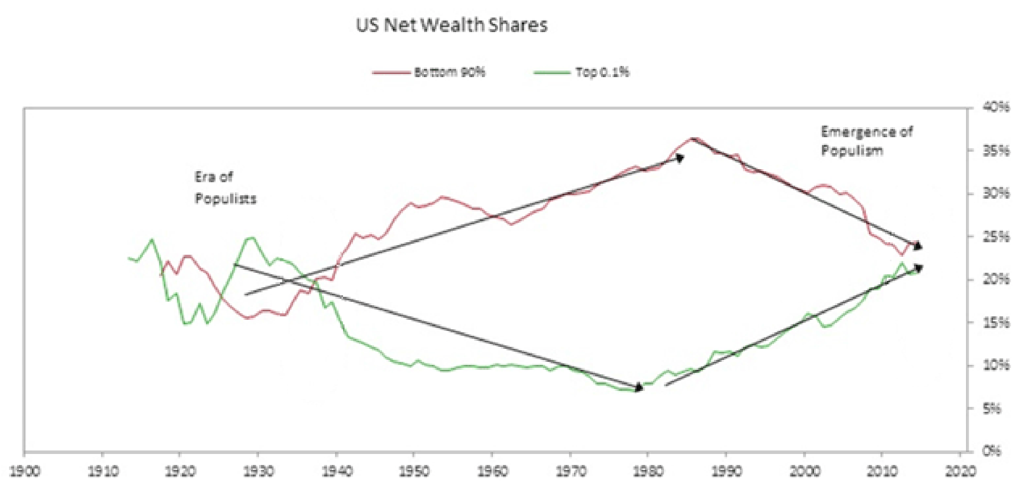
LOOKING AT WHAT HAPPENS WHEN YOU PULL THE SWING BACK

Mike Preto, CFP®

The other day, I was at the park with my daughter and she asked to go on the swings. She hopped on and I pulled the swing back slowly until she was as high as possible - then let go. We repeated this process (with her giggling nervously pretty much the entire time) and I couldn't help but think how this play in the park session relates to life in general: the more the swing is pulled back, the farther forward it would go. This analogy provides many answers in the world of finance as we look at it more closely.

Currently in the US, the wealthiest 0.1% are almost as wealthy as those that represent the bottom 90% of the population; that's a large cohort. Looking back in time, we see that compared to everyone else, the rich have been getting richer for ~40 years. Prior to 1980, you can see the opposite trend: there was a healthy middle class that held a significant and growing share of US wealth. From 1940 to 1980, the average nominal economic growth in the US averaged at 4.7%; and from 1980 to 2019, it grew at an average rate of 2.7% (*source: Bureau of Economic Analysis*).

Far more analysis would have to be done for us to say that the economy grew at a healthy rate because there was a healthy middle class, but it certainly didn't hurt and there's a very simple reason why. When someone who has average or below average wealth gets an extra dollar, they typically spend a good portion of that dollar on things or experiences that they don't have or have not had the opportunity to enjoy. When a wealthy person gets an extra dollar, they tend to save it. Although savings is important, it doesn't do much to stimulate the economy. It certainly isn't a stretch to suggest that a healthy middle class is much better for the economy than a wealth gap of epic proportions is.



Source: Bridgewater Associates

WATCH JASON ON BNN MARKET CALL

Jason's was a guest on BNN Bloomberg's #Marketcall on October 6th where he discussed North American Growth Stocks and answered viewer calls.

In case you missed the live show, the full episode is available online to view at any time.

When the rest of population is grinding it out decade after decade and they see the wealthy get wealthier, at some point they start to get agitated and demand change. It's happened throughout history and unless human nature suddenly changes, it will keep happening into the future. It's no coincidence that a populist movement is currently emerging across the globe, just as it did the last time the economy was suffering from a similar sized wealth gap (1930s).

It's interesting to note that interest rates were at or close to 0% throughout the 1930s, then rates rose for the next 40 years and peaked in the early 1980s, when the bottom 90% were the wealthiest, relatively speaking. We are talking about the last hundred years or so, but it goes back even farther as we've discussed in previous letters.

It's very easy to look backwards and see how things changed, it's another to look forward and see how things will look before the change happens. In other words, it's obvious that interest rates will be higher at some point in the future than they are now and I would argue that it's obvious that the wealth gap will narrow and we'll again live one day with a larger middle class. What's not obvious is when these changes start to take place; next week, next month, next year or next decade? If we know the change is coming, then it would be prudent for us, as portfolio managers/investors/citizens/governments and so on, to prepare for that change. As Portfolio Managers and Financial advisors, we are doing the following:

1. Owning only the very highest quality companies that don't need to constantly rely on borrowing money to thrive operationally (Jason will elaborate more on this).
2. Owning a meaningful position in gold, which you can't print more of, unlike fiat currencies.
3. Owning companies all over the globe. Exposure to different currencies and countries can reduce political risk.
4. Developing a solid plan to achieve your target retirement lifestyle going forward, even if we experience challenging conditions, even though we have a history of delivering superior returns than we're planning for.
5. Checking to make sure that your debt levels are manageable and dealing with them if they're not.
6. Putting you in a position to enjoy life today, that is doing whatever we can to help you realize your Big, Meaningful Dreams, without compromising your future.

Talking about what Governments of the world should do is a polarizing topic, especially now, but it seems pretty obvious from a 35,000 foot level. It would seem to reason that they need to start taking care of and growing the middle class so that our society and economy can operate more harmoniously.

How they do that is a totally different conversation that is much too dangerous a territory to wade into, even for me. But whatever they do, they better do it carefully because they've pulled the swing back farther than the eye can see.

Photo Credit: talkingplant

PORTFOLIO UPDATE: DEBT IS A 4-LETTER WORD

Jason Del Vicario, CFA

One of the pleasures I receive in my role is the constant learning I experience as I analyze business models and businesses from across the planet. I'd like to share some of the insights particularly as it pertains to how businesses behave during periods of economic distress and the extent that having little to no debt plays a role.

At Hillside we believe that data drives decisions. We screen developed countries every quarter for companies that meet our strict selection criteria. Without boring you with the gory details we are looking for companies that boast above average returns on invested capital (and more importantly have done this CONSISTENTLY), have strong margins, **use little debt** and are run by capable managers.

When we say 'developed' countries we are talking about: US, Canada, Europe, Israel, Australia/NZ & Japan. Up until 3 years ago our 'universe' was US & Canada… so it's not that we aren't able to screen developing areas of the planet such as SE Asia, Africa, India & South America but our sphere of comfort is being expanded in a measured way.

There are 271 companies in the countries listed above that meet our strict selection criteria. From those 271 companies we have identified 107 that we deem 'Ultra High Quality' and the distinguishing feature between the 271 and 107 is how their business operations fared in 2008. It'll be interesting to re-examine this relationship once the current downturn is behind us but we are paying attention to less than 0.1% of potential investment options.

COVID-19 OFFICE UPDATE

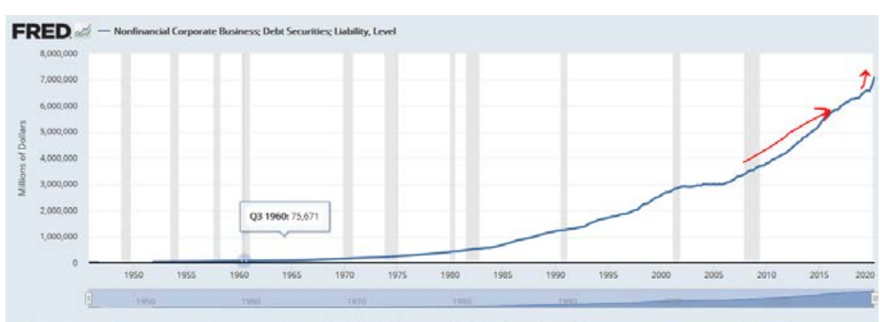
Our Hillside Wealth team continues to maintain a safe social distance by working from home during the COVID-19 pandemic.

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.

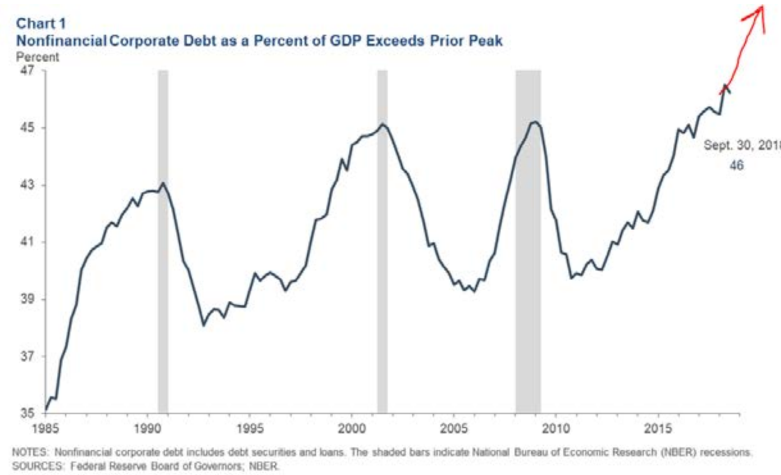
The point of this newsletter isn't to discuss our screening process but I think it's important that readers understand that we are not just looking at 'local' businesses anymore. What's striking is that world class companies have a lot of similarities and that in itself is an important lesson. High quality products/services and management teams are borderless.

During a typical economic downturn most companies look to cut costs, pay down debt and try to stay in business. Staff are let go, suppliers are squeezed, payables are delayed and debt covenants are renegotiated. A drop in economic activity is by definition deflationary meaning we generally see downward pressure on pricing. If the price for one's product/service drops then it seems to reason that valuations drop and this is exactly what we see in the form of falling (insert risk asset class) prices. To the rare forward-looking manager, this is precisely the time to put the offence on the field! To quote Warren Buffet: "To refer to a personal taste of mine, I'm going to buy hamburgers the rest of my life. When hamburgers go down in price, we sing the 'Hallelujah Chorus' in the Buffett household. When hamburgers go up in price, we weep."

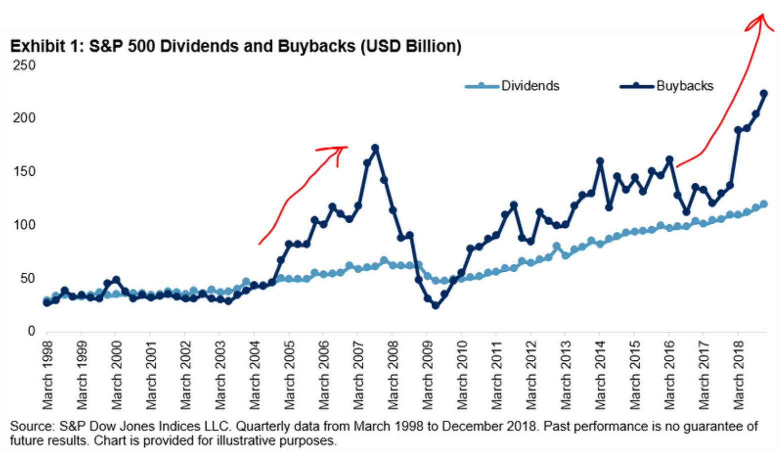
This is a lot easier said than done. How can you structure your business to not only weather a downturn but also take advantage of it? The commonality I'm finding generally lies in the capital structure and capital allocation decisions/history of management of a given company. We focus on companies that have little to no debt. This was a parameter we inserted into our screening process because it seemed like the right thing to do; I wish I had a brilliant reason why but we certainly do now as you'll see below. One of the pleasant unintended consequences of focusing on companies with little to no debt is learning from management of these companies why they avoid debt. To be clear, this is a contrarian strategy. Corporate debt has exploded recently and much of this debt has been issued to keep zombie companies (can't survive without constant injections of capital) alive or buy back shares. Below is a chart showing total corporate debt in the US since 1950. The main reason for this is that CEO's are often incented to increase earnings per share (EPS). An 'easy' way to do this is to buy back shares which all things being equal increases a company's EPS which is expressed in mathematical terms: earnings /shares outstanding. There is a great quote by Charlie Munger "*Show me the incentives and I will show you the outcome*."



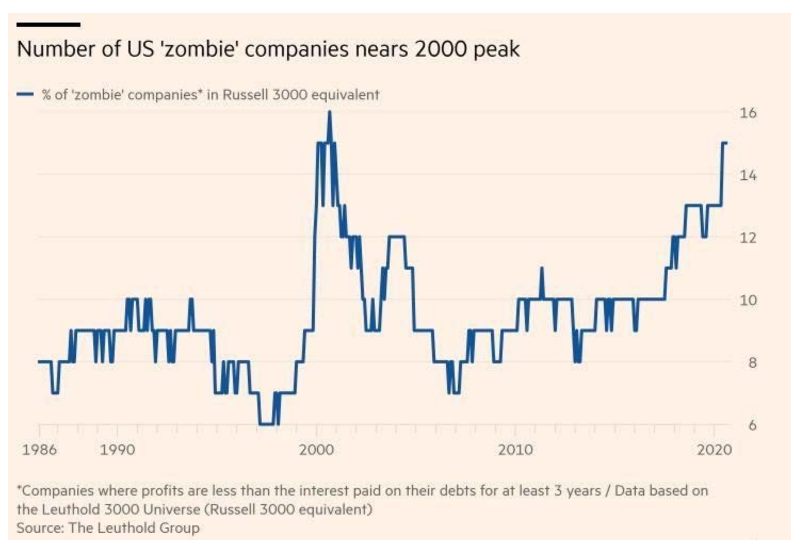
Followed by this signal expressed in relation to GDP. While this graph ends in 2018 we can imagine it's continued to rise at a rapid rate.



We see the explosion in share buybacks:



… and the number of zombie companies approaches the 2000 tech bubble peak:



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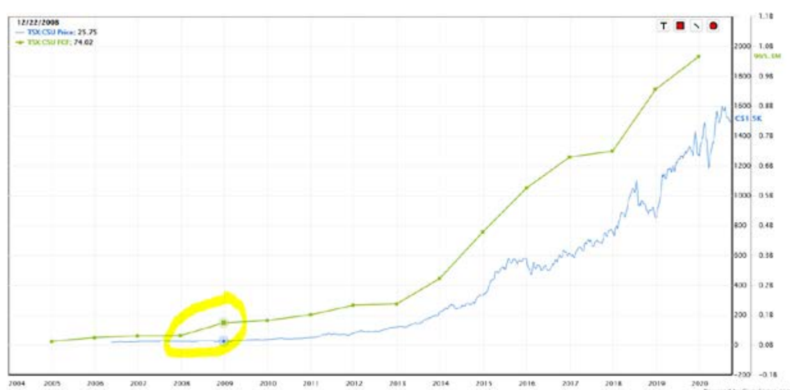
This is all the more astounding given record low interest rates. We can imagine the percentage of zombie companies rockets higher if/when rates rise!

Interestingly we see that debt/gdp drops during and after recessions which dove tails nicely into what we're discussing above… most companies batten down the hatches and concentrate on paying down debt (or defaulting in the case of bankruptcy!) during recessions.

However, if a given firm already has very low debt or no debt (heck many we know and love have net cash on their balance sheets!) then you can be aggressive while your competitors are trying to keep their heads above water.

This is all rather abstract so let's examine some examples. [Constellation Software (CSU)] has almost no debt on their balance sheet. They do have some and we know it very well as we own the CSU debentures but they have more than enough cash and cash flow to pay that off in a New York minute. We could write an entire letter on why they have these debentures outstanding, but you'll immediately fall asleep! CSU acquires software companies and much like Buffet with his burgers CSU would rather pay less than more. As we know lower valuations exist during periods of economic distress and uncertainty so those firms with financial flexibility can be aggressive when others are fearful. I can't for the life of me find the quote but CEO Mark Leonard said his only regret through 2008 was not being more aggressive. This tells us he 'gets it' and is a disciplined acquirer. As way of comparison CSU competes against private equity groups who copycat CSU but they notoriously use a lot of debt. CSU has in fact bought assets from private equity firms who have gotten themselves into trouble! The fact that they don't see part of CSU's secret sauce is their conservative allocation of capital tells us this is massively underappreciated competitive advantage.

As we can see below CSU navigated 2008 impeccably as their Free Cash Flow grew through the Great Recession.



Heico is an aftermarket aircraft parts manufacturer. We covered them recently in a previous newsletter (April 2020) and they also rely on an active acquisition model. On the recent Q3 earnings call, board member Laurans Mendelson explained:

> *"Our time-tested strategy of maintaining low debt and acquiring an operating high cash generating businesses across a diverse base of industries beyond commercial aviation such as defense, space and other high-end markets, including electronic and medicals puts us in a good financial position to weather this uncertain economic period."*

There's no sugar coating that we are in a VERY difficult environment for air travel. However, Board member Eric Mendelson (yes, this is family/founder run) noted:

> *"But I think this points to the importance of the HEICO products out there. We offer great cost savings. We're very aggressive on developing new products. We've got a lot of stuff in the pipeline. And I think that we're going to be a very key part of our customers' recovery plans."*

In a roundabout way the fact that airlines are struggling can work in Heico's favour because instead of buying the part from Boeing or Airbus they will opt for the less expensive aftermarket part from Heico thereby increasing Heico's market share. I expect Heico to increase their pace of acquisitions and to set the company up for continued success and a rapid recovery once the pandemic subsides. This is not by fluke but rather by design.

I could go on and on but I'm always on the look out for competitive advantages and moats. How can the companies we own continue to generate above average returns on invested capital? If you were to google 'source of competitive advantages' you'll find brand, network effect, and high switching costs amongst a few others, but nowhere have I ever seen 'little to no debt.' This has been a most pleasant surprise. While it intuitively makes sense, it would appear that portfolio managers and corporate managers don't necessarily appreciate this advantage, or their compensation incentives are guiding them in the opposite direction.

Naturally this speaks to the companies we own but if you'll permit me, I would suggest this can also be applied to our own financial houses. Interest rates are low and while I suspect they will be low for a long time there are no guarantees in life, and I would encourage everyone to focus on debt repayment and to increase the financial flexibility of their own financial houses. Financial flexibility provides us with peace of mind, the ability to be aggressive when others are fearful and of course to pursue our big meaningful dreams!

SEPTEMBER 2020 PERFORMANCE RESULTS

An overview of our three portfolios to date.

Performance to September 30, 2020	YTD	1 Mo	6 Mo	1 Yr	3 Yr**	5 Yr**	Inception **	Added Value vs. Benchmark**
Hillside Conservative Growth*	**6.09%**	**-0.11%**	**10.04%**	**6.61%**	**8.57%**	**7.34%**	**8.01%**	**3.15%**
HCG Benchmark[1]	*3.71%*	*-0.61%*	*12.91%*	*5.89%*	*5.57%*	*5.75%*	*4.86%*	
Hillside Balanced Growth*	**5.16%**	**-0.09%**	**12.81%**	**6.08%**	**9.11%**	**8.54%**	**9.91%**	**4.7%**
HBG Benchmark[2]	*3.14%*	*-0.92%*	*14.99%*	*6.07%*	*5.82%*	*6.44%*	*5.21%*	
Hillside Focused Growth*	**4.45%**	**0.01%**	**25.78%**	**4.91%**	**6.95%**	**7%**	**8.57%**	**2.4%**
HFG Benchmark[3]	*-0.61%*	*-1.99%*	*24.89%*	*5.88%*	*5.78%*	*8.52%*	*6.17%*	

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.

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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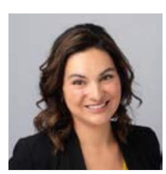

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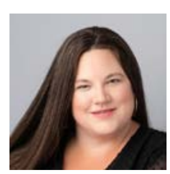

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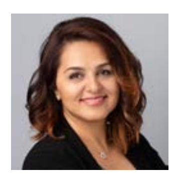

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