INFORMED INVESTOR NEWSLETTER

September 2021

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INVESTING AND FISHING: BOTH EQUALLY VALUABLE AT TEACHING LIFE LESSONS

Mike Preto, CFP®

When it comes to investing and fishing, there are many similarities between the two. Both have factors we ***can*** control and an equal number of factors we ***cannot*** control. Let's start with fishing; we ***can*** control:

- Where we fish
- How we fish
- What type of gear we fish with
- When we choose to fish

We ***cannot*** control:

- Whether the fish are where we are fishing
- If the fish are hungry
- The weather we are fishing in

The dream scenario is when all the factors align; the fish are biting, the winds are calm, and the sun is shining. This is when life really is good. High fives are flying and with the sun beaming down, it's all 'beer and skittles'.

Investing has similar controllable and uncontrollable components. Here is what we ***can*** control when investing:

- What we choose to invest in
- When we choose to invest in a security (when we buy)
- When we choose to sell a security

We ***cannot*** control a variety of elements, including:

- What the market decides our investment is worth on any given day
- Where interest rates are going
- What kind of monetary policy we have or will have in the future
- Where inflation is going (and so on…)

Hillside has had an ideal situation in both the investing and fishing realms over the last couple months. Our model portfolios have done notably well, and we've all caught some fantastic (and delicious) fish this summer (see photos!).

HILLSIDE WEALTH MANAGEMENT | FREEDOM | FAMILY | PERFORMANCE

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We believe it's important to focus our efforts on the factors we can control. This means not paying too much attention to short term performance and continuing on our path. Hillside has put you in a strong position and we have capitalized on both controllable and uncontrollable factors. Our commitment to you is to work equally as hard whether factors are in our favor or not.

At Hillside, we have a hyper-focused mindset when it comes to having a long, successful investment history. Our strategy is to consistently produce as ideal a situation as possible for you. This means being excellent at controlling the factors we ***can*** control (see above). If the factors we ***cannot*** control go out of our favor, and we have a challenging stretch – we tend not to celebrate. While we don't favor these times, they are essential to capitalize on in the long term.

Introspectively, we'd like to pose the question: why do we celebrate when things are going well and not when we are in the thick of it? Why is it better when the fish are biting, and when our investments are up? We believe it's because you are closer to achieving your goals (i.e. catching 4 fish, buying a cottage, taking that trip – *finally*!) You can feel yourself getting closer to your Big, Meaningful Dreams.

Realizing your Big, Meaningful Dreams is that dream situation. The sun is shining, high fives all around, fish in the bucket. Until we get there, we are keeping our hooks sharp, our gear clean, and working as hard as ever. And don't forget to take a moment every now and again to celebrate life no matter the circumstance, its short and sweet, and high fives are always in order.

PORTFOLIO UPDATE

Jason Del Vicario, CFA

At the risk of repeating ourselves, we, at Hillside Wealth, seek to invest in high-quality and predictable businesses. We define *'high-quality'* as those able to generate above average returns on invested capital using little to no debt, and requiring little capital to grow. For a company to be '*predictable'* it needs to have demonstrated the ability to be high-quality for a reasonable period of time (typically 5+ years) and we need to be convinced it can continue to generate these returns going forward. The rare company that fits this bill inevitably has a cash 'problem' as in it produces excess cash-management must deploy… and ideally deploy skillfully.

Below is a list of capital allocation options available to management for their "cash problem":

- Keep on balance sheet as cash (or pay down debt)
- Re-invest into existing business
- Acquire another company
- Pay a dividend
- Buyback its own shares (a.k.a share buybacks)

In this newsletter we'd like to look at ***share buybacks*** to demonstrate how this can enhance shareholder wealth as well as point out some pitfalls.

What is a share buyback?

A share buyback is the re-acquisition by a company of its own shares. Just as we might buy shares in a company, the same company can elect to use cash (or borrow cash) to buy back its own shares.

How do they do this?

They will typically enlist in an NCIB (Canada) which stands for Normal-Course Issuer Bid. The NCIB must be approved by an exchange and carries a finite timeline (after which the company can re-apply) as well as limits on the number of shares the company can repurchase in a single day.

How do re-purchases affect existing shareholder interests?

Let's imagine collectively all clients invested with Hillside own 5% of a company's outstanding shares. Let's then imagine the company buys back 10% of their shares. This means, without doing anything, our interest in the company jumps to 5.55% from 5%. The company has returned capital to existing shareholders by increasing our ownership in the business.

Why do we like buybacks?

We really like that this mechanism is achieved tax efficiently when compared to a dividend distribution. For example, we could achieve a similar outcome via dividends: after receiving the dividend, we pay our taxes and then could buy more shares in the company. However, the increase in ownership (# of shares one can purchase) is less due to the loss of capital via taxes. There is no 'tax slippage' in a buyback (at least not in the short term).

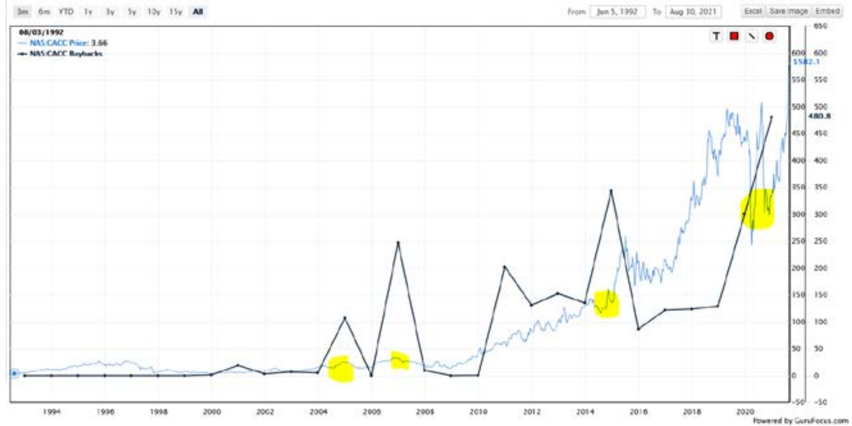
We also like the fact that companies retain flexibility and can be opportunistic with buybacks. A

DON'T MISS JASON ON BNN'S MARKET CALL

Jason will be a guest on BNN Bloomberg's Market Call on September 29th.

The show will be available to view through your local cable provider online or listen live at 9 am PT/noon ET.

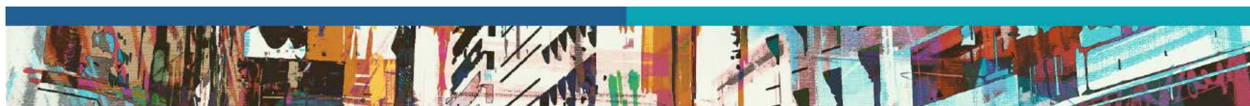
dividend policy is generally set in that a company agrees to pay a fixed (ideally growing) amount every quarter. Buybacks can happen whenever the company feels that its stock is trading below its intrinsic value and/or this is the best use of capital. Put differently, they can choose when and how much to buyback and are not tied to a schedule. The most effective managers will buyback shares when they trade below intrinsic value and can thus create significant shareholder wealth. Let's look at one of our portfolio holdings CACC:



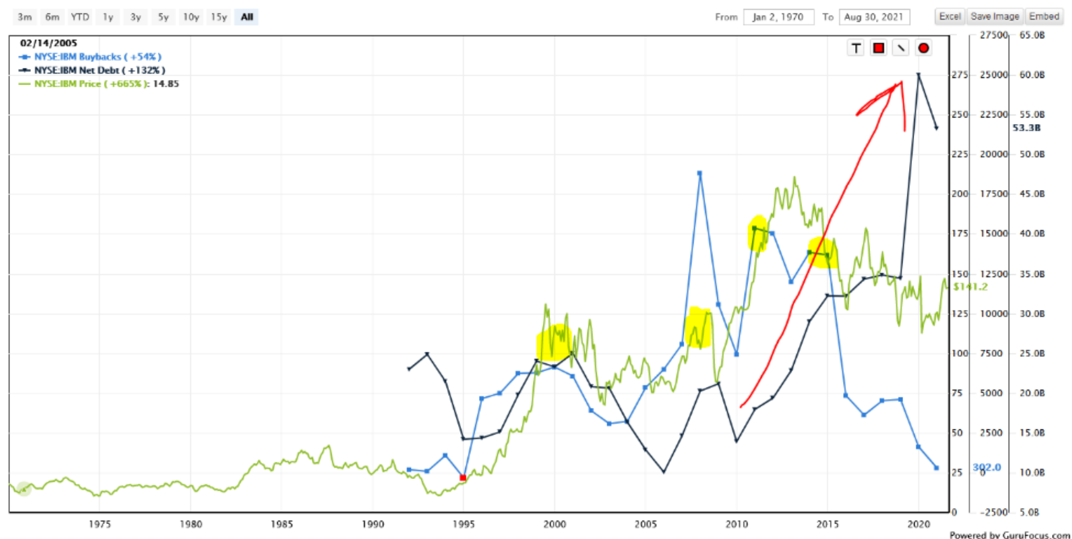
We can see the yellow highlighted areas represented times when buybacks were increased. They generally correspond with lower prices of CACC so we can conclude that management has been opportunistic with their buyback activity.

What are some pitfalls of buybacks?

Buybacks have been getting some attention from the media and well-intentioned public office types. They argue that buybacks are the scourge of the financial world and should be curtailed or banned. As noted above, as investors we'd prefer to 'receive' buybacks than dividends but if buybacks were restricted companies could simply pivot and pay us a dividend so we don't really see the point of this argument. Having said this we see that many companies are engaged in what is commonly referred to as 'financial engineering' and this does concern us. Some companies will borrow money to buy back their shares. The rationale goes something like this: we can borrow at 1-2% and our FCF yield is 2-4% so this is an efficient use of capital. It can be efficient as long as rates stay low, the company has the earning power to pay down/off the debt and the value of the company's shares increases over time. Dollarama, is one company we own engaged in this. We don't love it but they have a very robust business model, continue to invest in their business (so buybacks aren't crowding out these opportunities) and they have self imposed limits on this behaviour.



One example of buybacks done poorly is IBM. Their net debt (black line) has been rising while the have been engaging in share buybacks (blue line and yellow highlights) at arguably inopportune times. They've spent billions adding no value for shareholders. Bad deal!



Ultimately, buybacks can increase shareholder wealth if done well. It increases our ownership in a business without us having to do anything. Given the types of companies we like to source and own generally produce excess cash, this is one way this cash can be returned to us as shareholders. We want to keep an eye on companies that borrow to do this but in general we like it when companies buy back shares assuming they have no better use for the capital.

THE HILLSIDE FACTOR(Y) FOCUS: THE UNIQUE ADVANTAGE OF THE EQUITY PORTFOLIO

In a sense, an equity portfolio (or a collection of businesses) can be seen as a savings account. From a portfolio management standpoint, our job is to build, optimize, and maintain the savings account that maximizes the risk-adjusted return for its owner (in the form of free cash flow).

There are multiple kinds of savings accounts - so which to choose? A high interest rate may come immediately come to mind. But what if the interest payment can be reinvested at a much higher rate? How about an interest rate that itself can rise over time? Does this sound too good to be true? Well, these unique advantages of equities (or equity portfolios), are what we as investors should attempt to capitalize on.

It is important to note, not all businesses heavily rely on capital expenditure to grow. Let's take a look at Mastercard. The global payment network operator would benefit from inflation as it charges fees based on gross dollar volume. Therefore, the company could still grow its free cash flow, even if it did not gain share from the cash segment in the total payment market. Bioventix is another example. The UK-based sheep monoclonal antibody (just skip worrying about the science here) developer earns revenue primarily through royalty fees from blood tests that use its antibody products. The company does not spend a dime on getting those blood-test machines into hospitals. As a matter of fact, it does not even "produce" those antibodies but instead authorizes the production to third parties in most parts of the world. As a result, it should be no surprise to see a staff list of only 12 full-timers for this global business. We like companies like these ones too!

MORE NEWS, VIDEOS & INSIGHTS

Follow Hillside Wealth Management on LinkedIn for our latest updates and news, including a number of videos on a variety of investing topics

So how does the above relate to our model portfolios and their performance? Our recent ***look-through review*** (see below) demonstrates our models (in terms of the equity portion) have delivered a free cash flow yield of around 5% and a five-year CAGR in free cash flow of approximately 25%. When was the last time that you saw any bank offer an interest rate close to this? Our analysis also points to an above 50% cash return on incremental equity, implying attractive reinvestment opportunities internally. These opportunities, however, are limited, given the capex-to-sales ratio of approximately 4% (or a capex-to-FCF ratio of around 15%) - and, our duty to allocate (residual) capital at the portfolio level on an ongoing basis. As indicated above, no savings account possesses such a compounding feature – namely, to earn a much higher interest rate on the interest payment.

The figures above have probably made you thrilled – a high-yield savings account with a rising interest rate (the pace of which far exceeded the inflation rate historically) alongside a super-normal rate of return on reinvestment. So, what is the catch here? Firstly, businesses have risks – i.e., uncertainties relating to sales, profitability, cash flow –meaning the future "interest payment" from the equity portfolio can change considerably over time. In this regard, it is our job to concentrate our portfolios on high-quality companies (e.g., those with a highly-recurring revenue stream, durable competitive edge, conservative balance sheet, and low capital requirement). Then, market risk – the share price (or the market value of the portfolio) can be volatile in the short run as the market plays the role as a voting machine. Since it's impossible to time the market consistently, the solution is simple – commit only long-term capital to the stock market, and "don't just do something, sit there."

Hillside Wealth Look-Through Review

	Gross Margin	Operating Margin	FCF Margin	FCF Return on Invested Capital	5-yr FCF Return on Incremental Capital	Capex to Sales	FCF Return on Tangible Assets	Net Debt to FCF	FCF Yield	5-yr FCF CAGR
Focus	65%	34%	32%	47%	92%	4%	38%	-0.83x	5.3%	32%
Balanced Growth	65%	31%	30%	41%	88%	4%	33%	-0.36x	5.0%	26%
Conservative	65%	30%	29%	40%	90%	5%	33%	-0.57x	4.6%	26%

Source: based on financial data from GuruFocus as of 7/16/2021.

Notes: leveraging the 'savings account' analogy…

FCF Yield = savings account interest rate

5-yr FCF CAGR = compound growth of savings account interest amount last 5 years

AUGUST 2021 PERFORMANCE RESULTS

An overview of our three portfolios to date.

Performance to August 31, 2021	YTD	1 Mo	6 Mo	1 Yr	3 Yr**	5 Yr**	Inception **	Added Value vs. Benchmark**
Hillside Conservative Growth*	**9.93%**	**2.66%**	**10.76%**	**13.3%**	**9.34%**	**8.74%**	**8.88%**	**3.17%**
HCG Benchmark[1]	*5.26%*	*0.83%*	*6.03%*	*9.85%*	*7.43%*	*6.26%*	*5.71%*	
Hillside Balanced Growth*	**15.68%**	**3.5%**	**14.84%**	**20.81%**	**11.05%**	**11.02%**	**11.62%**	**5.15%**
HBG Benchmark[2]	*7.36%*	*1.08%*	*7.36%*	*12.86%*	*8.38%*	*7.41%*	*6.47%*	
Hillside Focused Growth*	**18.53%**	**3.18%**	**16.54%**	**30.18%**	**10.34%**	**11.97%**	**11.57%**	**2.15%**
HFG Benchmark[3]	*16.89%*	*2.4%*	*13.32%*	*27.86%*	*12.02%*	*12.1%*	*9.42%*	

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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Hillside Wealth Management is a personal trade name of Michael Preto and Jason Del Vicario.

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.

HILLSIDE WEALTH MANAGEMENT

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