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RECESSION READY

After months of economists sounding the alarms for a recession, many investors are seeking advice on how to prepare for the uncertain economic future. In this piece, Investment Counsellor Rachel Davies highlights three important things for clients to consider during times of uncertainty.

KEY POINTS:

- Predicting macroeconomic outcomes over the short term is next to impossible.
- Focusing on downside protection is at the core of our investment approach.
- Having cash reserves and fixed income in your overall portfolio can offer stability and help manage the emotional toll of market uncertainty. These options provide much higher yields today than we've seen in the past 15 years.

Amid leading indicators like slumping housing markets, lower consumer confidence, and an inverted yield curve, recession predictions hit the headlines in the middle of last year. While the timing (and severity) of a recession is speculative, we acknowledge that the chances appear higher now than they were a few quarters ago.

In response to the signals and endless chatter, many investors are increasingly seeking advice on how to prepare for the uncertain economic future. Recently, I received a question on the topic from someone considering Burgundy as an investment manager. The response I gave inspired this piece.

While many of our long-term clients are already familiar with the following principles, these reminders can be valuable during times of heightened emotions and uncertainties.

> “While a recession may be on the horizon, in 2022, economists were predicting that one would have started by now. Investors who sold equities based on those forecasts would have missed out on significant returns.”

THREE IMPORTANT THINGS

Negative economic headlines can make it difficult to stay the course, but I want to remind our clients of three important things. (1) An upcoming recession lacks a key aspect of volatility: the element of surprise, (2) Burgundy bakes recessionary risk into our investment approach and portfolio positioning, and (3) Careful planning may help to assuage some of the fears raised by market instability. Let’s explore each concept further.

1. The Element of Surprise

As an investor, it’s crucial to expect the unexpected. Despite comprehensive research, unforeseen circumstances still take place from time to time. (COVID-19 comes to mind.)

Markets tend to be most volatile when something surprises us and since an upcoming recession has been widely discussed in the media, it’s unlikely to come as a complete shock to anyone. The severity of an economic slowdown is the greater potential unknown, and factors like job market strength and consumer sentiment will determine whether a potential downturn is mild or severe. Predicting macroeconomic outcomes over the short term is next to impossible, and while the risk of a recession has increased compared to a year ago, we still cannot pinpoint its exact timing.

2. A Steadfast Approach

As our clients know, Burgundy follows a quality/value investment approach. We own well-managed businesses that are profitable under various market conditions, and we aim to acquire them at reasonable prices. Instead of relying on uncertain macroeconomic forecasts, we base our decisions on valuations. While a recession may be on the horizon, in 2022, economists were predicting that one would have started by now. Investors who sold equities based on those forecasts would have missed out on significant returns. For example, the Burgundy Partners’ Global Fund, a core holding in many private clients’ portfolios, is up over 20% over the past year (to June 30th; 19% on a net basis; in Canadian dollars). At Burgundy, we believe timing the market consistently is impossible.

Portfolio Positioning

Given the challenge of accurately timing the markets, our focus lies in owning quality businesses that can navigate difficult economic conditions effectively. Economically sensitive sectors, such as energy and commodities, housing/construction, and certain consumer discretionary sectors, are not heavily featured in Burgundy’s portfolios. (One exception here is Canada, where the stock market is more economically sensitive than other regions due to its concentration in energy, mining, and banking). So, one could say that we are always positioned for a recession. The companies we invest in are well-managed, consistently profitable, and have low levels of debt. Over our history, this approach has helped us safeguard our clients’ capital during downturns.

Since Burgundy prioritizes capital preservation in our investment approach, we have not made significant changes to our portfolios in recent months, unless supported by valuations. When a company in our portfolio reaches our estimate of full value, we may choose to sell it. While this occasionally results in a build-up of cash in our strategies as we seek to deploy it into new investments, we are typically fully invested in our strategies.

Despite minimal adjustments, there are a few activities in Canada and the U.S. worth highlighting. These regions comprise a significant portion of our clients' exposure in the Burgundy Partners' Global Fund:

In Canada: When the price of oil rose and energy companies performed well last year, Portfolio Manager David Vanderwood reduced exposure to the energy sector. This decision allowed us to take advantage of market volatility and invest in higher-quality businesses trading at attractive discounts. Recent additions include **Boyd Group**, the operator of a network of over 850 automotive collision repair centres, and **Element Fleet Management**, the largest automotive fleet manager in the world.

In the United States: When worries about a potential recession emerged in May 2022, Portfolio Manager Doug Winslow initiated a position in **Ross Stores**. We purchased shares when the stock was down more than 20% in a single day after Target reported a weaker-than-expected quarter, turning investors negative on consumer businesses. Similar to Winners in Canada, **Ross Stores** is the type of store that consumers turn to for cost-effective options during tougher economic times. Burgundy also holds shares of the discount store **Dollar Tree**. We expect Dollar Tree to benefit from its recent change in management and from consumers trading down to lower-priced items.

3. Our Advice to Clients

For clients relying on their portfolios for living expenses, Burgundy recommends holding two to three years' worth of known expenses in cash and equivalents. This helps ensure clients do not have to sell equities during periods of market volatility, allowing them to manage through tougher market conditions without being forced to make untimely investment decisions. This advice is more appealing today, given a healthy 4.9% yield on Burgundy's Money Market Fund compared to a low of 0.3% experienced in 2021.

In addition to cash equivalents, Burgundy recommends allocating a portion of the portfolio to fixed income. Doing so provides further stability to the portfolio by ensuring a few more years of spending needs are invested outside of equities. The Partners' Bond Fund, Burgundy's model fixed income strategy, is currently yielding 6.1%.

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SOME FINAL THOUGHTS

While market downturns can be unsettling, Burgundy's guidance to clients is to stay the course. Having cash reserves in place is one way to manage the emotional toll of market uncertainty, offering financial peace of mind through these tougher periods. Additionally, we hope you find confidence in the businesses you own through Burgundy's investment strategies. Selected based on our quality/value approach, we are confident these companies are better able to weather challenging economic conditions.

During these slower summer days, Burgundy recommends examining how your spending habits have changed over the past 12-18 months. Expenses have risen for all of us, and it is important to consider how this affects the withdrawal requirements of your portfolio. Perhaps they are higher now and, if they are, we want to ensure that your two to three-year cash allocation aligns with this new reality.

If you have any questions or concerns about your portfolio, please do not hesitate to reach out to your Investment Counsellor or contact us to learn more.

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