RBC Global Asset Management

Our approach to fund management

Portfolio manager perspectives

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A successful investment advisor told each of us early in our career to "never take a shot on the beak, so you can come out for the next round." It was great advice then and still is today.

We appreciate this opportunity to share the fund management approach that we've developed over the past 19 years at RBC Global Asset Management, drawing on lessons learned in previous years at RBC Capital Markets and through many hours studying the habits of successful money managers. Ours is an iterative process that begins with unbiased screening, follows with our own research and analysis, and culminates in ongoing active management of the funds under our care. The touchstone of our process is a commitment to understanding a wide variety of outcomes for the stocks we follow and avoiding attachment to any single forecast. We believe this approach helps in handicapping the odds available in each investment and in building a collection of favourable risk/reward trade-offs that will deliver good results over time. And we invest our money along with our unitholders; the lion's share of our personal equity holdings is invested in the funds under our care.

Stu and Doug

Process highlights

Checklist

Use an initial checklist that rewards characteristics that many good stocks have in common while penalizing those that many likely poor performers share.

Fundamental analysis

Use fundamental analysis to focus on good quality companies with attractive returns on capital and appropriate financial and operating leverage.

Scenarios

Understand a range of fundamental scenarios for each position and avoid anchoring positions around a single forecast.

Technical analysis

A strong appreciation for technical analysis, utilizing both absolute and relative strength as a foreshadowing of potential shifts within the stock market.

Portfolio construction

Construct the portfolio to reward good stock selection and avoid heavily relying on the correctness of a strong point of view.

Decision-making process

The decision-making process is workmanlike and ongoing, constantly circling through the process.

The Checklist

"The secret to survivin' is knowin' what to throw away and knowin' what to keep."

Kenny Rogers, *The Gambler*

Every stock market investor needs a checklist as a way of narrowing down a list of stocks to the ones best suited for a portfolio. The best kind of checklist is one that automates the kind of work you would perform on your own. Over the past 25 plus years we've done a lot of thinking about (and practical experimenting with) scoring and ranking systems. While we use a number of screens to try and identify stocks with the investment characteristics we're looking for, a three discipline system remains at the centre of the process.

A robust checklist is a great starting point when building a portfolio; however, our thinking has evolved on *why* it's so helpful. When observing the good results achieved by well-ranked stocks against the broad market, it's natural to assume that the process is working because it selects the stocks with the most appealing characteristics. If this is correct, then there should be equally compelling differences between top-ranked stocks and middling ones; but, this isn't consistently true, suggesting that the real value in the ranking system comes from eliminating the lowest scoring stocks. For us, this means the bottom 20% of stocks.

It's important to remember that performance (both absolute and relative to a benchmark) is just as easily defined by what you *don't* own as what you *do,* and maintaining an "avoid pile" has a lot of advantages. The ranking systems that we use will typically drop stocks that are very expensive, have lousy business momentum or a poor technical profile, or are disliked by a respected analyst with a strong track record. Nobody would set out to own a collection of stocks with these characteristics, so having a checklist helps a lot in avoiding the temptation to buy them and enforces some discipline in selling them, even after they've deteriorated.

The three disciplines in our checklist are as follows:

1 The **quantitative assessment** is a compilation of statistics that most fund managers would find useful in making decisions. In general, the statistics measure the quality and underlying momentum of the operating performance of a business and combine these with a number of stock market-specific measures, like valuation and price momentum. The measures of business performance evaluate if the business is stable, improving or deteriorating relative to its own history, comparable companies and current expectations. Similarly, a number of valuation measures are used to assist in determining if the business is expensive, reasonable or attractive relative to its historical valuation and that of comparable companies.

2 The **technical assessment** is driven by the rate of price changes for the specific stock on its own and relative to the market. Identifying absolute and relative price acceleration or deceleration over the intermediate and long-term often signals a shift in perception of a company's prospects. A system that can signal these turning points has been a helpful tool in our assessment process over time.

3 For the purpose of the initial screening process, the last piece of the checklist is the **expert opinion** of a respected observer of the company – an analyst who has had success covering the company from both a financial modelling and recommendation standpoint. This person should know the business, the management and the sector well.

The three ranking systems are combined into an overall quantitative assessment. Together, they represent the first stage in improving the odds of a favourable outcome.

While we like the results of this approach, we would also point out that a checklist doesn't have to be complex in order to be useful, and we use a number of other "quick" screens in our search for ideas; for example, something as simple as screening for high return on equity (ROE) companies with low financial leverage and high free cash flow yields is a decent first cut at winnowing down the investable universe. The important thing is to pick a checklist that fits with our investment philosophy and suits the character of funds we manage – and stick with it.

Fundamental analysis

“Behind every stock is a company. Find out what it’s doing.”

Peter Lynch

The checklist gives us a large pool of companies with above average odds of being good stocks – and, just as importantly, removes a number of stocks with poor odds. However, a list of stocks that represent roughly 80% of the stock market has a couple of practical drawbacks; first, it’s a list not a portfolio and, second, there are far more stocks than we require. The process of paring down a list of stocks and assembling them into a portfolio begins with an assessment of each company. After developing a solid understanding, we then move on to construct a range of fundamental scenarios.

The stock market discounts, or anticipates, future financial results, so we necessarily spend a lot of time focusing on what these results could look like. Company financials, however, are best seen as “counting up” the results of business activity, so in order to understand and forecast financial results, we need to understand the business that produces them.

Time spent in learning and thinking about the business usually pays off when it comes time to think about the stock.

In our funds, we try and have a focus on good quality companies – they tend to grow in value over time and roll with the punches better, surprises are more often positive and the cost of being wrong in the stock market is usually more manageable.

Factors to consider:

Return on capital employed
A consistent track record of competitive returns.

Management
Capable and honest.

Financial leverage
Debt levels that are appropriate for the business.

Operating leverage
Assessing fixed costs in the context of cyclicality.

Free cash flow
To fund growth or return to shareholders.

Ten questions that we would like to be able to answer about the companies we follow:

1. How does the company make money?
2. What is the outlook for sales, profit margins and capital spending?
3. Who are the company's customers and why do they deal with the company?
4. What kind of shape are its customers in?
5. How's the company doing relative to its competitors?
6. How is the company going to grow?
7. How will growth be financed?
8. What could really hurt the company in the next few years?
9. How does management get paid and are rewards aligned with shareholders?
10. Who could replace the current CEO?

We use a number of resources to help answer these questions:

- Reading company materials and research reports;
- Talking with analysts;
- Meeting directly with management;
- Reading conference call transcripts; and
- Listening to company webcasts.

> *"Over the long term, it's hard for a stock to earn a much better return than the business which underlies it earns. If the business earns 6% on capital over 40 years and you hold it for that 40 years, you're not going to make much different than a 6% return – even if you originally buy it at a huge discount. Conversely, if a business earns 18% on capital over 20 or 30 years, even if you pay an expensive looking price, you'll end up with one hell of a result."*
>
> Charlie Munger

Return on capital employed (ROCE) is important, as it drives value creation over time and is a good metric by which to assess the inherent attractiveness of a business. In addition, ROCE is a good scorecard to use in judging management, as capital allocation is one of the most important jobs of senior management.

The best kind of company to invest in is one that earns consistently competitive returns, has ample opportunities to invest capital at attractive returns and has the free cash flow to fund those opportunities without diluting shareholders or leveraging the company with excessive debt. We're very aware that the stock market has an amazing ability to sniff out changing returns at the margin and to reward or punish companies accordingly.

We assess **management** by reviewing their track record, often through individual meetings. Reading several years' worth of CEO letters (available on most company websites) is a great way to get a feel for management if we can't meet with them directly. We're looking for good operational execution of the business and clear thinking on corporate strategy. We often look at business strategy through the lens of ROCE, trying to understand how returns could evolve going forward.

Operating leverage primarily refers to the percentage of a company's cost structure that is fixed – it doesn't vary with revenues. When companies have high fixed costs, small changes in revenue will have an outsized impact on financial results, leading to a high degree of cyclicality in earnings and cash flows, which means that even leading companies in industries with high operating leverage can sometimes be very disappointing stocks. These types of businesses can be good investments, but timing plays an especially important role in investment success from our perspective.

Financial leverage refers to the amount of debt on the balance sheet. Debt represents a claim on a company's assets and profitability that stands ahead of shareholders and can often severely limit a company's ability to manage through difficult times. In addition, because debt is a fixed number, changes in the valuation of the enterprise need to be reflected through the equity value, raising the potential for highly indebted companies to be much more volatile in the stock market.

We'll cover our scenario analysis approach next; however, it's worth remembering that companies with above average operating and financial leverage often have a wider range of outcomes than those without.

The ability of a business to generate **free cash flow** – cash that is left over after all expenditures associated with the maintenance of current earnings power – is an important factor in judging the quality of a business. Having cash left over after maintenance expenditures are taken care of is a real asset. This surplus cash can be used to grow the business, pay down debt or be returned to shareholders in the form of share buybacks or dividends.

Some of the ways we assess management:

- A good handle on business drivers and how they're used in managing the business.
- A close understanding of customers and their evolving needs.
- The ability to discuss growth opportunities, including new markets and a focus on new products, or projects (in the case of resource companies).
- People are an important resource and we like to see evidence that senior management thinks about people development.
- A long-term orientation that focuses on permanently improving the business over short-term financial results.
- A shareholder-friendly compensation system.

Scenario analysis

> *"The financial markets generally are unpredictable. So one has to have different scenarios ... The idea that you can actually predict what's going to happen contradicts my way of looking at the market."*
>
> George Soros

We use **scenario analysis** to establish a range of fundamental outcomes likely to be realized by a company and then work to understand the degree to which these outcomes may or may not be factored into the current stock price.

If the market is always anticipating future events, then spotting opportunity in the stock market requires thinking about how the future might unfold. While most investors understand that there are more things that *can* happen than *will* happen, most of us still insist on believing that we have the ability to forecast what *will* happen. While dampening this instinct is hard, we think that focusing on what *can* happen pays large dividends when thinking about stock prices.

We work with our internal analysts, company management and analysts at various brokerage firms to model and understand what a company's earnings, cash flow or net asset value would look like when a company is firing on all cylinders, operating in a normal manner or struggling. We also test these scenarios against past performance metrics to understand if we're implying that a company will perform in a way that it historically has not.

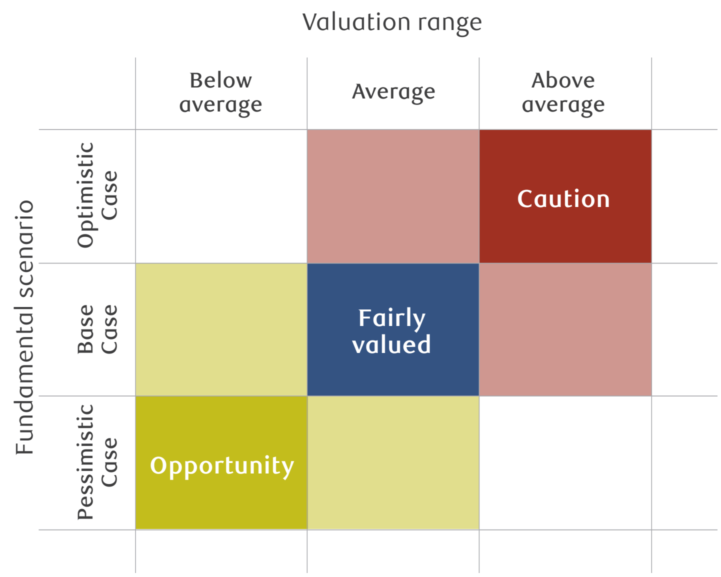
Some of the beliefs that underpin our approach to scenario analysis are:

- Stock prices are the product of investor assessments about the future.
- Markets are relentlessly forward-looking, continuously handicapping the likelihood of a variety of scenarios unfolding, which can lead to volatility in times of great uncertainty.
- A company's past history matters only to the extent that it helps investors understand what the future might look like.
- There are times when the view of the future embedded in a stock is so skewed to one of the many possible outcomes that the other outcomes become "free" in the current share price.
- Shifts in the perception of future events drive stock price changes ahead of the events themselves taking place – if indeed they take place at all.

Once the scenarios have been developed, we determine possible share price outcomes by applying a range of historical multiples to our scenarios. The valuation range is determined using historical data along with other current factors, like interest rates and a dose of judgment. Applying a range of valuation multiples to a range of financial forecasts fills in the grid (pictured on the right) and provides a range of stock price outcomes as well as some clues about which scenario the current share price is most heavily anticipating.

A "quick and dirty" way to check if a stock might be interesting from a scenario analysis perspective is to look at its valuation based on consensus forecasts. If a stock is trading at a historically low multiple of consensus, it's likely pricing in something measurably worse and may be an interesting opportunity if the upside scenarios are being ignored. If it's trading at a high multiple of consensus, then investors are likely anticipating something better, potentially making the stock risky if the market is practically ignoring negative outcomes.

Scenario analysis



Fair value generally grows with the passage of time, unless the business is facing structural or competitive decline.

> *"The model I like – to sort of simplify the notion of what goes on in a market for common stocks – is the pari-mutuel system at the racetrack. If you stop to think about it, a pari-mutuel system is a market. Everybody goes there and bets and the odds change based on what's bet. That's what happens in the stock market."*
>
> Charlie Munger

The idea of the stock market as a handicapping machine is a powerful one and scenario analysis is the most important tool we have to assist in successfully calibrating the odds in our funds. It helps us to understand when good companies have the potential to be great stocks.

We have a saying that people would rather be right than rich. In practice, it means that investors will often accept the psychological satisfaction of being with the consensus, even if there is a low payoff, and ignore the lower odds of a high payoff (or a large loss) that requires an out-of-consensus view. Many successful investors have learned to exploit this tendency in the stock market. We think that scenario analysis raises the odds that we'll benefit from this bias as well.

Making a single forecast creates the potential for bias – focusing only on the information that supports the decision that has already been made. Envisioning a variety of outcomes is liberating for us, particularly in today's environment, as it provides a road map to deal with a volatile pricing environment.

Technical analysis

"I tried to figure out how to become a better stock picker, so I started to attend a weekly meeting of a group of market technicians. That helped me quite a lot. To this day I use technical analysis. The way I refer to it is: When I go hunting I take along my dog, but I don't give him the gun."

Byron Wien

As the quote implies, we've found **technical analysis** to be a very useful tool.

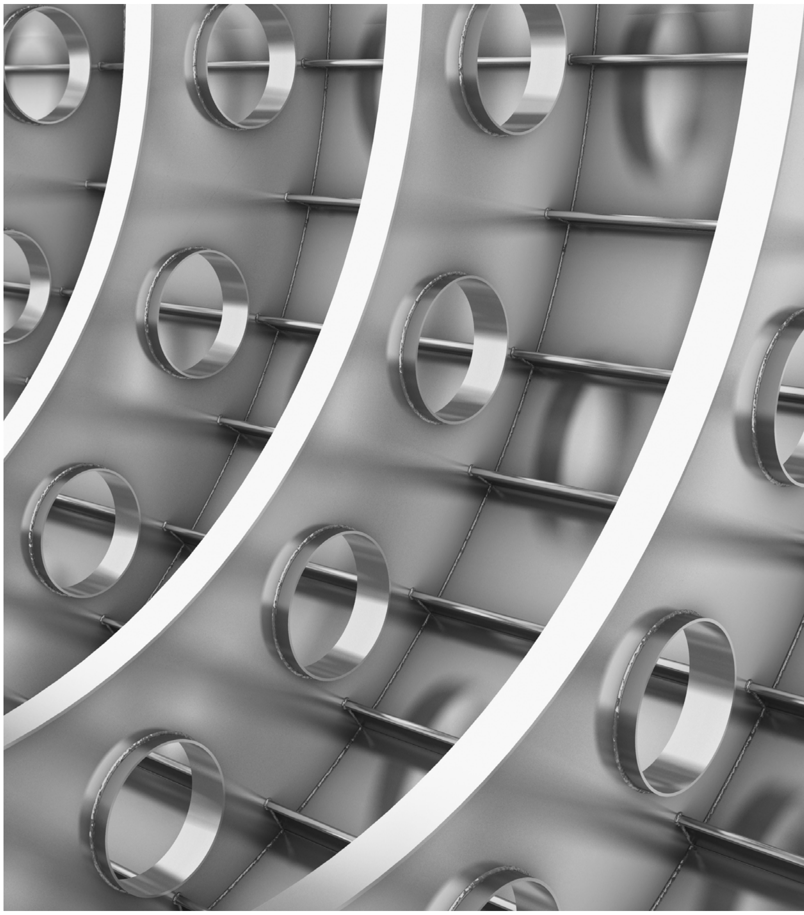
Alongside our scenario-based approach, we employ it in two ways:

1. To tactically trade positions, where there are no extreme views embedded in prices.
2. As a signalling mechanism for stocks that are pricing in more extreme scenarios. We look for signs that perceptions may be about to shift.

Our technical toolbox is always evolving; however, we've come to rely most heavily on intermediate term plots of absolute and relative strength. Augmenting the charts with short and longer term moving averages, as well as some momentum indicators, has also proven useful.

Technical analysis taps into our ability to recognize patterns after repeated exposure to a set of conditions. To employ it effectively, it's important to personally review the chart patterns of stocks on a regular basis.

Also, technical analysis is a tool that complements the other elements of our approach. Not every decision we make will have optimal technical characteristics; however, we believe that filling our funds with stocks that have lousy charts would be asking for trouble.



Fund construction

"What if I am wrong? Any rational investment plan has to start with that question."

Peter Bernstein

Portfolio weights are heavily influenced by risk/reward analysis. In constructing the portfolio, we try and focus on where our scenario analysis indicates that poor fundamental outcomes are anticipated. Conversely, we try and avoid stocks where pessimistic outcomes are practically being ignored.

Stocks discounting pessimistic scenarios can improve in price through a shift in perception, leading to a better valuation, improving fundamentals or, in some cases, both. Stocks that ignore pessimistic outcomes can experience the opposite – shrinking valuations as perception turns more negative or the nasty combination of deteriorating fundamentals along with a shrinking valuation.

It should be noted that most of the time the majority of stocks available for consideration are usually trading within a stone's throw of fair value. These stocks may still have significant roles in the funds if they've filtered well through the checklist and we believe they're good, well-managed businesses with attractive returns on capital. These stocks perform a workmanlike function in our funds, as they have reasonable odds of compounding their fair value and share prices – hopefully at a higher rate than that of the stock market.

In terms of sector weightings, most of our funds are broadly sector neutral. We think the strengths of our approach are reflected through stock selection. If stock selection argues for a reduced commitment to a sector, we may tilt a fund in that direction, but we try and avoid a top-down approach to sector allocation.

"Everybody has a plan until they get punched in the face."

Mike Tyson

There is a general belief in the investment management business that good stock funds have concentrated positions – built to look very different from a benchmark, with large positive and negative differences in individual stock weightings. A fund that looks otherwise is often said to be lacking conviction, a quality that is presumed to be worth a lot in the stock market.

However, concentration is also the curse of the worst performers. In our view, a well-constructed portfolio has enough concentration to produce good results, but not so much as to become a one-way bet that we'll be right.

There's an appropriate level of concentration that ensures enough risk is being taken to accomplish our clients' goals – any risk beyond that level may add to potential returns, but at the cost of adding risk that needn't be there.

If we do a decent job of assessing the odds in individual situations within our funds over time, the results should be acceptable and the funds are likely to outperform in down markets and keep pace in rising ones. At all times, we try and keep the conversations we have about the positions in the funds anchored around process, with an open mind to negative outcomes for stocks we own and positive outcomes for stocks we don't. We find this is better than falling in and out of love with stocks, which can hamper good decision making.

Concentration without process can be particularly damaging. A concentrated portfolio anchored around a set of high-conviction beliefs often makes removal of a position in response to signs of trouble extremely difficult. It's impossible to be right all the time, so we don't manage our funds in a way that requires us to be right all the time.

> *"In this business, if you're good, you're right 6 times out of 10. You're never going to be right 9 times out of 10."*
>
> **Peter Lynch**

The rationale for building a portfolio in the first place is the acknowledgement that we can't always be right. Overconfidence in one's abilities to forecast the future, when mixed with large portfolio bets, can be a toxic recipe.

While some great long-term investment track records have been assembled from periods of performance that differ widely from benchmarks in both directions, we believe that an approach that minimizes performance volatility has its own benefits. Periods of significant underperformance necessarily require a period of significant outperformance later on in order to produce good long-term results. In our experience, performance that comes together in this manner raises the risk that a lack of patience or other timing issues will interfere with long-term results.

Decision making

"Cross the river while feeling the stones."

Chinese Proverb

Decision making in our funds is an ongoing effort to consistently improve the odds of a favourable outcome. The biggest aid to successful buying and selling in the funds is scenario analysis.

Having identified the handful of stocks that are heavily anticipating extremes of pessimism and optimism allows us to react well to modest changes at the margin in fundamentals and sentiment. This goes for fine-tuning positions that are closer to fair value as well. The quantitative and technical inputs are often useful in spotting these sometimes subtle changes at the margin.

If we've thought carefully about the positive and negative developments that can affect a stock in advance, we think it raises the odds that we'll react well to evolving information at the margin. We believe this is true for two reasons:

1. We should've already thought about the implications of the scenario and can react quickly while others are adjusting to new developments. Some of the hardest decisions involve stocks that open dramatically higher or lower on news. While anchoring the move in the stock against yesterday's price usually makes the reaction seem "crazy," these types of events are often pivotal moments. If the scenario analysis is done well, the size of the prize in both directions is understood and we can better deal with market volatility.
2. We believe that having thought about a variety of outcomes (as opposed to anchoring around just one) will help us be more open-minded to receiving new information. Investors who are betting on a scenario that they have personal conviction in may be more likely to dig in their heels and reject information that contradicts their thesis.

The process that we use is workmanlike and ongoing. Does the stock pass the checklist? Does the company have attractive fundamental qualities? What scenario is priced into the stock? What do other scenarios look like for the stock? Does the stock have attractive technical characteristics? The stock market is a relentless competitor; if portfolio positions are regularly re-evaluated in light of these questions, then the odds of success are higher.

We feel the scenario approach we use helps us to achieve the right temperament by approaching situations in a manner that's open to a number of different outcomes and by focusing on observing rather than forecasting. There are no style points awarded in investing – results are all that counts.

A note on temperament

"The most important quality for an investor is temperament, not intellect ..."

Warren Buffett

Temperament and self-awareness are important ingredients in a successful investment process. The lessons we've taken away from our experience to date would include the following observations:

- **Try for a pragmatic temperament** that prioritizes earning returns ahead of the personal gratification of being seen as correct.
- **Don't anchor yourself in recent events**: More things can happen than have happened recently; be open to a wide range of outcomes.
- **Watch out for overconfidence**: Stay humble and open to ideas and input from good quality sources.
- **Be open-minded:** Accept the world as it comes, rather than looking for confirmation of your positions.
- **Be a worrier**: Look for mistakes and signs that you're wrong; the good stuff takes care of itself.
- **Be resigned to making mistakes**: It makes it easier to recognize and deal with them quickly.
- **Be a lifelong learner**: Study mistakes, learn new things and never rest on your laurels.

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Stu Kedwell and Doug Raymond lead the North American Equity Team at RBC Global Asset Management. In this capacity, they oversee approximately $70 billion on behalf of Canadian investors and have direct portfolio management responsibility for a number of funds, including RBC Canadian Dividend Fund, RBC North American Value Fund and PH&N Canadian Equity Value Fund.

Stu joined RBC in 1996 and, in addition to his fund management responsibilities, is a member of the RBC Investment Strategy Committee, the group responsible for formulating asset allocation recommendations for institutional and private clients across RBC Wealth Management. Stu is also a member of the RBC GAM Executive Committee.

Doug has more than 35 years of investment industry experience. Prior to assuming portfolio management responsibilities at RBC Global Asset Management, Doug provided investment management advice to both individuals and institutions as a Director of RBC Dominion Securities and as a Managing Director with RBC Capital Markets.

Disclosure

101848 (08/2021)

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RBC Global Asset Management

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