

# THE ARTISAN



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## THE MARKETS



## UPDATE AND OUTLOOK



## The Tale of Two Sinks

We wanted to share a story we heard to better explain what is currently going on in the world. It's a entitled 'The Tale of Two Sinks'. It revolved around a well-known bond manager who has a large kitchen in his home, and who is fortunate enough to have two sinks. Although living there

for the past decade, he favoured the sink across from the stove and in fact it was the only sink he used to wash his hands. Last month, a leak began from the tap at his favorite sink. While he was

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**NORTHLAND**  
—WEALTH MANAGEMENT—



## Not all alternative investments are cut from the same cloth

The term alternative investments evolved to become a catch-all phrase for investment products whose returns are unlike those of traditional stocks and bonds. This area of the investment universe has been a focus at Northland Wealth due to the potential for improved consistency of returns, something that is hard to achieve with today's 24-hour news cycle and constantly changing narratives.

The popularity of alternative investments has encouraged many new entrants into the marketplace and the quality has been watered down. Our Research and Portfolio Management team spends a lot of time identifying, performing due diligence and continuously monitoring the solutions from around the world in order to find the best managers in their respective asset classes.

**Each asset class has its unique quirks and unless you have an in-depth understanding of its unique attributes, you as an investor may be misled by the quoted performance of the asset.**



Each asset class has its unique quirks and unless you have an in-depth understanding of its unique attributes, you as an investor may be misled by the quoted performance of the asset. The following will highlight some of the risks that Northland identifies in our industry leading due diligence process. (Northland was shortlisted at the 2020 Private Asset Manager Awards held in NYC for the category of Best Due Diligence, where we were recognized as one of the best firms in North America).

One of the key topics in the wealth management industry revolves around the discussion of liquidity. Liquidity is the ease with which an asset can be converted to cash at very close to its fair market value. Like high tides, many investors seem to take liquidity for granted, but when it's needed the most, it seems to vanish.



Since the Great Financial Crisis ('GFC') the world's central banks have been injecting liquidity into the world's largest economies: the United States, Europe, Japan and China. They have done this through "quantitative easing" or QE by buying approximately \$15 trillion of assets in the markets. This artificial demand from the central banks created rising prices of government bonds which in turn caused yields to decline. Investors who need yield began to look for that yield elsewhere in places such as investment grade corporate bonds, non-investment grade "junk bonds", equities and real estate.

As bond yields declined, corporations have issued more and more bonds as the current interest rate was less expensive than what they were paying on previous issues. The proceeds from these bonds may be used to buy back higher costing debt, or for various corporate transactions. Since opportunities for the productive use of capital are limited in a world that has slower economic growth, much of the monies raised from the bond issuances were returned to shareholders through dividends and stock buybacks. Shareholders then typically have used this

additional cash to buy more risk assets – more bonds, more stocks, more real estate.

It's this excessive corporate leverage which was encouraged by the central banks with their zero interest rate policy and QE which has created risks to the system. In addition, private equity and hedge funds have been utilizing these lower borrowing costs to increase leverage of their funds to finance leveraged buyouts ('LBOs') of increasing size.

This extended period of artificially low interest rates and easy money has created very large amounts of debt which would be difficult or impossible to service under the normalized conditions of the past 50 years.

Corporate debt in the United States is now at \$9.4 trillion which is 46% of economic output - the same level it was at during the past financial crisis. Just as concerning is that 80% of this corporate debt is considered to be "covenant light". Half of investment grade bonds are now rated BBB, which is the lowest quality rating.

**Even Janet Yellen, the former Chairperson of the Federal Reserve in the United States has shared her concerns about corporate debt. She sees a "huge deterioration" of lending standards and foresees a wave of bankruptcies during the next economic downturn.**

With interest rates now beginning to rise in North America due to a combination of central bank tightening (interest rate increases and the unwinding of QE) and market expectations since their secular low in July 2016, what could this portend for investors?

For investors, this means declining valuations of bonds, and potentially stocks and real estate investment trusts ('REITs'), unless earning increases can offset the higher costs of borrowing. In many cases,

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Not all alternative investments are cut from the same cloth  
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During Northland's due diligence process, we examine over 50 areas to better understand potential risks. Below are some insights:

**1. In private debt, not marking loans to market keeps price volatility muted and artificially inflates risk-adjusted returns.**

Private debt assets have grown significantly because investors are not satisfied by low interest rates in government and corporate bonds. Private debt managers took the place of traditional banks after the 2008 recession to lend monies and provide lines of credit to private companies.

Like any other portfolio, these assets must be valued periodically. Unlike listed instruments where values change daily, these assets are not actively traded, and they are usually held to maturity. These managers follow the IFRS or ACS1200 valuation principles, which dictate that if a loan is going to be held to maturity and is relatively short in duration, then there is no need to constantly reprice the loans. The lack of price fluctuations understates the true risk of the loan portfolio.

**2. The rising trend of using lines of credit (LOC) against limited partners' (LP) undrawn commitments inflates the internal rate of return (IRR) performance.**

A major feature of a certain subset of alternative investments is that investors first make a commitment to invest in a fund, then the fund searches for appropriate investments, and as allocations are made the fund makes 'capital calls' on commitments made by investors. This is different than traditional investments, whereby the entire intended amount can be invested right away. Commitments complicate the process, because it often takes 2-3 years before funds are fully called and the intended exposure is gained. Rather than calling capital, asset managers often make investments using a LOC provided by the banks and backed by the legally binding commitments of the investors.

The managers utilizing LOCs will argue that this is to the benefit of the investors because it saves administrative costs and allows them to act quickly. The reality is that the use of a LOC boosts IRR, which is a common performance measure by which those same managers are compensated and it is used for comparative purposes.

**3. The rising trend of using general partner (GP) led secondary trades for orphan/single positions artificially shortens the life of funds.**

This follows the trend of private equity managers trying to manipulate the IRR measure, as it enables them to have the ability to fundraise for

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## UPDATE AND OUTLOOK (CONTINUED FROM PAGE 1)

fortunate enough to get it to a slow drip, he had to wait a week for the plumbers to arrive. In the meantime, he began using his other sink to wash his hands. What he noticed was that this sink, which he never used before, had better views of the garden and a better sightline to his TV. The plumbers arrived the next week and fixed his sink. However, the realization came to him that he liked his newfound sink and has kept using it, not going back to his 'old sink'.

**However, what we need to realize and accept is that we are not going back.**

With the lockdowns, quarantines and social distancing much of the world is following to combat the COVID-19 Pandemic, the world that we knew at the beginning of this year has now changed. In some cases, for the worse, and in many cases for the better. However, what we need to realize and accept is that we are not going back. Many companies are going to find that while office space is still needed, it may be less so. Working remotely can allow many to reduce or eliminate commuting times by a multitude of hours over a month. This increases the amount of time that can be dedicated to work if one wishes or to other personal pursuits such as family or fitness. Many meetings that always were done face-to-face may now take place through video conferencing. While there have been hiccups with internet bandwidth due to high demands, many who have never experienced this technology are enjoying its benefits.



From an investment viewpoint, the uncertainty faced by individuals and financial markets in these times are uncharted and unprecedented. While we can debate over the best way to have handled the virus, (border lockdowns sooner, more testing, public mask wearing, protection of high risk individuals such as the elderly vs. lockdowns) we need to deal with the current economic and market conditions. What we have seen is that this

crisis is being met with equally unprecedented monetary and fiscal stimulus around the world. Central banks have lowered interest rates to close to zero, while fiscal stimulus by governments in the trillions of dollars is being pumped into economies. Thus far, this combination appears to have stabilized equity and credit markets.

**Valuations, while maybe not in 'bubble' territory, were excessive in many cases as they left no margin for error.**

Over the past decade, we have experienced a bull market in risk assets such as US stocks, fixed income and Canadian residential real estate. Valuations, while maybe not in 'bubble' territory, were excessive in many cases as they left no margin for error. These valuations were due to a combination of factors which include the secular decline in interest rates, stock buybacks which were financed by debt, and easy borrowing conditions. In general, many asset classes needed a correction. It was the pandemic combined with the lockdowns that was the pin that popped the balloon. The result was unprecedented daily declines in both credit and equities which was brought on by massive margin selling and panic which exceeded levels seen in 1929.

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## Not all alternative investments are cut from the same cloth (CONTINUED FROM PAGE 3)

future funds and is the main measuring stick used to compare funds.

A fund would usually invest across 10-20 separate positions to diversify its risk. Often a small number of holdings under-perform and what often happens is that after all the investments are liquidated and returned to investors, there are 2-4 laggards that remain. The GP wants to provide liquidity to encourage investors to commit to their next fund and investors want to eliminate small holdings and simplify portfolios. There has been a trend towards selling those orphan holdings or spinning them off to another investment vehicle. This shortens the life of the fund and improves IRR.



As most alternative investments are not regulated entities, it's imperative to understand the nuances of reporting by asset managers; doing so allows Northland to properly understand the risks we are taking for our families. To conclude, our team devotes many resources to stay on top of trends in the growing alternative investment industry. We are dedicated to our mandate to identify, access and invest in the best institutional quality solutions on behalf of our families.

**Victor Kuntzevitsky, CFA, CAIA**  
VP, Investment & Portfolio Strategy



## UPDATE AND OUTLOOK

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What is becoming clear is that although markets have declined and rebounded to some degree, the broader economic impact is only beginning to be realized and felt. Mainstreet - small family owned businesses and those employed by them, especially those which focus on service industries, will be hardest hit. Depending on which numbers one looks at, up to 80% of the North American economy is service based. In many cases, these workers live pay-check to pay-check, spending what they earn each month, with typically less than a month's savings for emergencies such as we are experiencing now.

**We are hopeful that this stimulus will offset the huge jump in unemployment numbers and the economic contraction in North America and Europe.**

With the curve flattening and countries and/or states beginning to re-open on a case-by-case basis, we are carefully examining how various regions react. Globally, massive stimulation programs have been enacted rapidly and the proceeds are beginning to be distributed through economies. We are hopeful that this stimulus will offset the huge jump in unemployment numbers and the economic contraction in North America and Europe. In North America, the decline in the first quarter will be matched by an even greater decline in the second quarter of as much as 14%.

In Canada, things have been made worse by the oil price war between Saudi Arabia and the Soviets. With the virus slowing economies and the need for oil, the oil supply surplus will explode. This played out recently with oil prices for delivery trading for a short time at MINUS \$38 USD/barrel as volumes surpassed storage! Unfortunately, this will put additional pressures on Alberta and Saskatchewan, already reeling from misguided federal government policies, will suffer additional economic decline.

With the distressed selling behind us due to exhaustion selling and government intervention, credit and equity markets are seeing good quality companies recover from their recent lows. In the U.S. and Canada, the passing of measures that provide significant fiscal stimulus are a major positive to the economies in the short to medium term. The risks will then shift to when and how to remove this additional stimulus. Who and how



will we (re)pay these massive increases to our debt? It is likely that governments try to monetize these away as they did in the 1970s.

**In this type of environment, the modest addition of a store of value such as gold and digital gold (bitcoin) may provide some hedge against the debasement of fiat money by governments.**

For those who were around in the 1970s, although it appeared the nominal return on stocks was positive, the real (after inflation) returns were negative for more than a decade. In this type of environment, the modest addition of a store of value such as gold and digital gold (bitcoin) may provide some hedge against the debasement of fiat money by governments.

In regards to current investments that are held in our families' portfolios, Northland has been in contact with all of the underlying alternative investment managers, and participated in numerous conference calls with banks, economic strategists and some of the world's leading investors, to better understand how they view the current situation as well as the future risks and opportunities.



While we expect economies and markets to recover over the medium to longer-term, we do believe that equity investors who were used to good returns with low volatility may have begun to understand the risks involved in

not having a well-diversified portfolio which utilizes both traditional as well as alternative asset classes. While alternative investments such as private debt, private equity, and real estate do not have the same liquidity as public markets, given the multi-generational investment horizons for many families, these longer time horizon investments provide better alignment and the potential for improved return with less volatility.

Looking further into the future one must conclude that this pandemic is a world-altering event. The march to globalization may well end – fragile supply chains that depend solely on external sources will need to become more robust or, to quote Nassim Taleb, anti-fragile. There are costs associated with this, which will reduce economic efficiencies but also reduce the chances of a mission critical failure. Like the 'Tale of Two Sinks' we will adapt to the new normal.

**David Cockfield**, MBA, CFA  
Managing Director & Portfolio Manager

**Arthur C. Salzer**, CIM, CFA  
CEO & Chief Investment Officer





## A DOSE OF MEDICINE

After 22 years as a Personal Financial Planner (PFP®) and having completed hundreds of comprehensive financial plans, I recently took the time to reflect on the number of successes and challenges I have encountered over the last 2 decades.

**Having helped people from all walks of life, with varying degrees of complexity, it has never been the level of analysis that determined success, but rather the willingness of the individual/couple/family to engage in the process and be open to what would be discovered.**



Everyone has a plan to some degree. Those who have worked with a trusted and knowledgeable planner have an in-depth account of their overall financial situation with a multitude of scenarios mapped out and addressed. Others have opted for the do-it-yourself approach, which ranges from a good foundation of financial analysis, to a free for all and just going with the flow, the latter being very troublesome and often leading to situations which are very difficult, if not impossible, to rectify.

It is curious how often we run into people who do not want to share details of their financial status. At Northland, the financial planning process, which we refer to as a Life Plan, is completely unbiased and only driven by a desire to improve each family's financial position for multiple generations. Furthermore, for our client families the process is included in our management fee. So why not take advantage of the opportunity? **It is not the cost of the plan, but the cost of not having a plan. That cost could be the lost opportunity for unsurpassed savings and wealth creation.**

If we draw a parallel to visiting your family doctor, or better yet a doctor in the ER, the doctor will ask you how you feel, where does it hurt, have you had the following symptoms? From there the doctor embarks on a process to figure out why you are sick and prescribe the appropriate treatment to ideally heal you and provide you with longevity. Now if you opt to withhold information from the doctor or you don't visit the hospital in the first place, chances are you are

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## THE REVOLUTION WILL NOT BE TELEvised

Machiavelli wrote in his Second Treatise that you make your own fortune in this world by putting yourself in a position to take advantage of the opportunities that come your way. By fortune Machiavelli meant luck, but it works both ways.

Drivers of opportunity now are changes created by global economies undergoing the fourth industrial revolution, as capital and labour reallocates ahead of future technological advancements in artificial intelligence, quantum computing and distributed production technologies like 3-D printing. But individual's fortunes are changing now as we progress deeper into the Fourth Industrial Revolution, as not everyone is, or can be, prepared for the changes to come, let alone recognize and seize the opportunities created by advancing technologies.

**The nature of industrial revolutions is to increase both productivity and wages, while increasing employment in the long run.** In effect the 'economic pie' gets larger. However, in the near term, there may be periods of technological unemployment, dislocation and rising inequality. Over the past forty years, we have moved out of the second Industrial Revolution, through the third and into the fourth. The Third Industrial Revolution (1970–2000) was defined by the move from mechanical/analogue to digital, with widespread adoption of electronics from both the home and work environment. The Fourth Industrial Revolution (2000 onwards) in which we find ourselves today anticipates the dawn of true Artificial Intelligence with advances in robotics, nanotechnology and quantum computing.



With the benefits of technological revolutions 'old' jobs tend to be lost before 'new' jobs are created. We witnessed this disruption as the United States and Canada moved through

the Third and into the Fourth Industrial Revolutions from 1970 until the present. The decline of the US Rust Belt and the rise of Silicon Valley is an old story now, but the magnitude of social and economic disruption during this shift towards the new service-based economy can be seen in US non-farm payroll report.

From 1970 to 2000, the US service sector increased its percentage of non-farm payrolls from 50% to 65%, whereas producing sectors fell from 32% to 19%. As of February 2020 the US producing sector was 14% of non-farm payrolls and the service sector was 71%. In contrast, from 1970 to now, government sector payrolls in the US was flat, changing from 18% to 15%.

**What has occurred is that the manufacturing economy is declining while the service-based economy is growing.** One driver is the increasing economic importance of intangible capital. Intangible assets include intellectual property, such as patents and trademarks, but also product quality and intellectual capital. Investing in intangible capital is impactful and is estimated to be responsible for 1/3rd of the labor productivity growth in the European Union and the United States between 2000-2013.



## A DOSE OF MEDICINE

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While delivering future economic benefits to business, deploying intangible capital also contributes to technological and thus societal growth. Owning an abundance of intangible assets could enable some economies, companies and individuals to propel themselves through periods of disruptive technological change, while a paucity may leave some others behind.



Although societies, economies, business and individuals have relatively equal access to the opportunity to develop intangible assets, they do not have an equal ability to do so.

There will be winners and losers

as we move further through the Fourth Industrial Revolution. This is not dissimilar to the distribution of intelligence and physical ability among humans – these characteristics may have a normal distribution, but they are not equally distributed. (For instance, this writer has lived with symptoms similar to Multiple Sclerosis for much of my adult life).

**That may not be fair, but fairness does not exist at nature, it may exist in human nature.** Fairness is just an artificial human construct, less tangible than the intangible assets underpinning the physical technological components within your mobile phone, which have themselves a planned obsolescence lifecycle. Similarly, fairness may or may not continue as a dominant evolutionary trait – that is for game theorists and geneticists to argue. What is more certain is the uncertain future availability of existing social safety nets as the pace of change quickens.

Knowing that the pace of change is getting faster each year encourages Northland to dedicate significant time and capital to understanding the past, being up to date on the present, and to think about the future. By doing so, we have a better chance to avoid large potential risks and to take advantage of opportunities that present themselves. The ultimate objective is to help protect and grow your family's wealth over generations.

**Richard Scarisbrick**, J.D. Law

Managing Director & Chief Compliance Officer



### Northern Lights (photo on page 6)

Tom Thomson Of The Group of Seven

Thomson painted not merely to paint, but because his nature compelled him to paint - because he had a message. The north country gradually enthralled him, body and soul. He began to paint that he might express the emotions the country inspired

in him; all the moods and passions, all the somberness and all the glory of colour, were so felt that they demanded from him pictorial expression." In the brief span of his mature career Thomson created an unforgettable body of work, and was viewed as embodying the spirit of the northland.



not going to address the issue(s) and potentially pay the ultimate price. Let's take it a step further, if we look at it from a preventative perspective, i.e., an

annual physical where the typical issues are checked and are compared to previous results to see if there is a trend developing. At a higher level, there are private medical clinics for corporate executives and professional athletes that do a full day complete head to toe physical assessment. This would be comparable to a Northland Life Plan. The common theme is the disclosure of information and symptoms.

The results of the process might suggest a slight change in diet, or a worse diagnosis that we would not wish on anyone and would require a drastic change in lifestyle.

**What is worse, going through the planning process to be enlightened, or dealing with the financial repercussions of not having a proper plan?** The true challenge is



overcoming one's fear of what may be discovered, the impact it may have on our ego and a feeling of loss of control. Participants must be willing to fully participate in the process, as well as be willing to implement the suggestions and strategies offered as a result of this process.

Those who embark on the financial planning journey will reap the rewards. Those who choose not to, write their own future.

We look forward to continuing to assist our client families with the development of their customized Life Plan and encourage everyone in the Northland family to embark on your own financial planning journey with us.

**Jeff Sproul**, Hon BBA, PFP, CIM

Senior Vice-President, Wealth Management  
and Associate Portfolio Manager





## A WAVE OF UNCERTAINTY (CONTINUED FROM PAGE 3)

weaker or overleveraged companies will have difficulties rolling over maturing debt. The consequences of these debt challenges have the ability to spill over to main street with the potential to cause a slowdown in economic growth or even next recession.

Given these potential risks, where should an accredited investor (an investor who has sufficient net worth, asset size and/or income to be able to invest in securities not registered with financial authorities) look to obtain a satisfactory return vs. the risks taken?

**In Canada we are fortunate to have some sophisticated private debt managers who have created funds which hold a diversified portfolio of loans which are secured by underlying collateral that typically consists of mortgages of a real asset (land, buildings, high quality receivables or even something exotic such as a boat or aircraft).** The loan to value will typically not exceed 70% and will be combined with additional personal guarantees by the borrower. Terms of these loans generally run from 90 days up to a couple of years. While private debt is not risk free, a good private debt fund will charge a sufficient interest rate to the borrowers, and will have the experience and legal resources to successfully foreclose on the collateral should the borrower default.

On the downside, these private debt funds offer moderate liquidity restrictions of 45-90 days notice of investor redemption after a 1 year initial commitment. More specialized funds which typically have higher return expectations exhibit lock-ups of 3 to 5 years. While this may sound reasonable when times are good, be forewarned that private debt funds have the ability to gate their investors during times of financial crisis. This means no redemptions are allowed until there is sufficient cash available in the fund. During the GFC, many private debt funds stopped redemptions for more than a year.

**As Warren Buffett has said, "Only when the tide is going out, do you discover who has been swimming naked".**

Arthur C. Salzer, CIM, CFA  
CEO & Chief Investment Officer



## A Gentleman In Moscow

by Amor Towles

The mega-bestseller with more than 1.5 million readers that is so to be a major television series. He can't leave his hotel. You won't want to. From the New York Times best selling author of Rules of Civility – a transporting novel about a man who is ordered to spend the rest of his life inside a luxury hotel.



GREGORY LAWRENCE

I'm now fluent in another language.  
It's called,  
**Family Enterprise.**

**fea** FAMILY  
ENTERPRISE  
ADVISOR

DESIGNATED 2020



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