PENDER

Forward thinking. Finding value.

Assessing the Trinity of Risk during Uncertain Times

Assessing the trinity of risk is a key pillar of Pender's investment strategy at all times, but during a financial crisis, when the risks increase, it becomes more crucial than ever to double and triple check the level of catastrophic risk associated with every investment.

Valuation Risk

This is always important. Today, most stocks are well off their highs, so all things being equal, there is less "valuation risk" than just a few short months ago. But all things are not equal. Most companies will feel the negative impact from COVID-19, but a few will see benefits. How the market *perceives* the potential risk, relative to the long-term fundamental reality, is a very important consideration when investing. Stock prices can sway wildly from their fundamental values, particularly when extreme greed helps to create "bubbles" and extreme fear fosters panic during bear markets as we are seeing today.

Hypothetical Example of Valuation Risk

A hypothetical business was worth $100 before the COVID-19 outbreak.

After dealing with the real business impact associated with the fall out, but also accounting for the benefit from an eventual recovery, the business might be fundamentally worth $85.

- If investors **overestimated** the true impact of COVID-19 in a time of extreme fear, and the stock falls 50% to $50 in panic selling, then there is **low valuation risk** because the stock fell more than the business value. Getting more value than you are paying for by purchasing a stock for $50 for a business that is fundamentally worth $85 is what sound investing is all about.
- However, if investors **underestimated** the impact of COVID-19 and the stock price only drops 5% to $95, then there is **high valuation risk**. The business value fell more than the stock price. Buying or holding a stock at $95 for a business fundamentally worth $85 is likely to lead to disappointing results.

Balance Sheet Risk

This is at the forefront of our analysis and we are reducing or eliminating weightings in companies that are over-levered relative to our assessment of their businesses risk. Surviving a market downturn is key. Debt reduces flexibility and can be potentially fatal for businesses with high business risk. A reasonable level of debt in normal times can become catastrophic when business activity comes to a halt.

Business Risk

The facts have changed for almost every business due to COVID-19. Some industries have been hit very hard over the short term like airlines, offline retailers, restaurants and the travel sector, but some businesses have seen a massive demand boost, such as online grocery delivery and work-from-home related firms like video conferencing solution providers. Some businesses are facing headwinds today but could experience booming demand in a post COVID-19 world – infrastructure firms and legal services are potential industries that come to mind. Remember that although most businesses have been hit hard right now, many will recovery eventually. For example, China was the first to experience fallout from COVID-19, but many businesses including restaurants have now reopened as the first steps are taken towards normalization. Of note, there is pent up demand as Chinese consumers start to emerge from months of being trapped at home in some cases, many excited to get out, get back to work, and ramp their consumption of goods and services back up. Some Chinese stocks are now trading near 52-week highs (for instance, we own shares in JD.com, "the Amazon of China", in a few of our mandates). Still, it's important to acknowledge some businesses will not survive the downturn or will be severely hit. It is important to assess business risk because it impacts the fundamental value of a business. If business risk is so high that the fundamental value is likely to be zero, no price is too low to sell.

The situation remains fluid, but we are focussed on updating our thinking about potential risks and opportunities of existing holdings. Now is not the time to sell a sustainable business with a robust balance sheet that is very undervalued due to broad-based market fear that we believe will eventually pass. In addition, there is an entirely new opportunity set of ideas that did not exist a few months ago, many of which could see sharp rebounds in the recovery scenario in the future.

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