April 28, 2022

Mark Noble
Hello, I'm Mark Noble, Executive Vice President of ETF Strategy at Horizons ETFs, and welcome to the latest episode of Generation ETFs. What's old is new again, it seems, as the global capital markets embark on what appears to be a seismic shift in sentiment, moving from a growth oriented market of the last decade, much of which was buoyed by low interest rates, to a market that starts to look eerily like the early 1980s. In fact, by most measures, inflation is as high, if not higher than it was in the early 1980s. Some of which is taking into account a lower baseline from the economic struggles of COVID 19, but no longer are the words transitory or temporary being thrown around. Higher inflation and higher interest rates that will follow seem here to stay for the foreseeable future, which is having a dramatic implication for equity investors.

Mark Noble
One area of the equity market that seems to be thriving, however, are dividend stocks. You know, simple, cash flow heavy, dividend growing companies. The ones our grandparents loved back in the previous decades. They aren't all that exciting, but have done an exceptional job at weathering the broader beat down in global growth stocks that we've seen in 2022. If there's one person who can make dividend stock investing exciting, it's our frequent collaborator and Sub-Advisor Srikanth Iyer, Managing Director and Head of I3 Investments at Guardian Capital.

Mark Noble
Sri and his team use cutting edge technology to find the world's best global dividend paying stocks. There's more to dividend investing than cashflow and yields, and when you get under the hood on Sri's process, you find out that dividend investing is very much aligned with the idea of building an equity portfolio that is designed to withstand all market conditions.

Mark Noble
Now, dividend investing is anything but boring when you start to look at the level of analysis needed, to find stocks that will not only continue to grow their dividend, but this is really important - also potentially grow their share price as well. For over a decade, that is exactly what the Horizons Active Global Dividend ETF, which trades under ticker symbol HAZ, and the Horizons Active Canadian Dividend ETF, which trades under ticker symbol HAL, have done. Sri, thanks for being us with us today.

Srikanth Iyer
Thank you very much, Mark. Good to be back.

Mark Noble
Yeah. We love having you on here. It's always a fun discussion. Let's start with the first question that I think comes up in every conversation about at stocks these days, which is inflation. And I'm really curious to know how you think this is going to impact stock returns over the next while.

Srikanth Iyer
So inflation, it's almost like a virus in the sense that people simplify inflation-

Mark Noble
Another virus.

Srikanth Iyer
Yeah. It's a very simple term, but it has implied implications across much of the valuation spectrum of equity markets and fixed income markets. So if you look at the way inflation is measured and analyzed by different sales side pundits, or economists, or even the fed, everybody has a different measure. And in the end, what you're looking at inflation today, is that it has become much more relevant amidst the bond market cycle that we are seeing today. If you remember, me and you talked, Mark, a couple of years ago when we said that the bond booth at church is closed.

Mark Noble
Exactly.

Srikanth Iyer
A lot of financial asset allocators used to make asset allocation mistakes, and the fixed income used to bail them out.

Mark Noble
Always. Every time.

Srikanth Iyer
We talked about this two years ago. It should have happened two years ago what happened this year, but COVID showed up and we saw a recession induced COVID, and then we saw the cash flow glut that came into the market. Almost 35 trillion worth of liquidity that got flooded into the market globally. Saw the market take off again on a very fast V-shape.

Srikanth Iyer
But with the combination of a recovery from COVID, and what you're seeing that's going on in Ukraine, inflation was high even before the war started. And the expectations for inflation, while politically was defined as transitory, we never saw that inflation as transitory, mainly because of one reason and one reason only. Most economists, and most inflation hawks only look at the demand side for projecting inflation. The real

change in this cycle for inflation is not the demand cycle, but is the supply. And when I say the supply cycle is for almost about a decade now with the onset of ESG and environmental, social, and governance responses. There was a mass reallocation of capital from resource intensive industries to service oriented and self-actualization based industries. So a lot of the funding that was going towards either digging on the ground, our crops, or commodities or anything were put into the negative ESG bucket. And there was a very little CapEx and funding going on for that business for eight to nine years. We didn't see it because we were all so happy that FAANG was going up 35% a year.

Srikanth Iyer
And so what happened here, we came to an inflection point where the CapEx cycle for commodity stocks, whether it be oil, copper, iron ore, any of the building block materials that society needs, regardless of our ESG aspirations was so underfunded that we saw a duration gap develop, wherein if today you want something, it takes about five or six years of CapEx to get that for you. You exasperate that, along with the recovery from COVID, as well as the Russian crisis in Ukraine, where Ukraine is not just oil, it's also the bread basket in the EU.

Mark Noble
Yeah, it's 45% of the energy and agricultural commodities of Europe.

Srikanth Iyer
And agriculture, wheat. The bread basket.

Mark Noble
Yeah.

Srikanth Iyer
So people don't see all of that. And so what we are noticing here is that the supply shock and the spread between demand and supply, especially in oil is about a 20% spread right now. That is for 100% demand, there's only 80% oil.

Srikanth Iyer
So when you talk about inflation and the consumption of oil that is used, even for the mills to sift through wheat and separate wheat and make bread, you need oil. And so the supply chain of pricing of oil and supply shortage of commodities and everything else is keeping this inflation ceiling going higher and higher, and the floor is going up and up and up. I think the Fed is significantly behind the curve when it comes to inflation protection at this point. And I don't see any kind of rate hikes in the near feature going to control this inflation -

Mark Noble
They seem way behind. I mean like, the market-

Srikanth Iyer
Significantly behind.

Mark Noble
I saw one chart last week where the market shows, the two year yield, usually works in lockstep with the overnight. The two year yields at like 2.5 probably on its way to 2.75.

Srikanth Iyer
It's like this.

Mark Noble
And that's your baseline, that's your baseline and we're not even there yet in terms of the market. Yeah, it's astounding.

Mark Noble
So in terms of equities though, what does this mean for equities?

Srikanth Iyer
So in terms of equities, high inflation, steeper yield curve, short end rises dramatically. So you're discounting your cash flows in the end at about a 200, 250 bps higher than you did about six months ago. Not only are you discounting cash flow up front, but most of these tech stocks and these heavily funded stocks over the last decade were based on what we call secular growth and growth at any price, you saw a lot of the cash flow in the future coming on future earnings. So not only is the future earnings in suspect, but the discount rate is going up too. So you're getting a double whammy where your uncertainty in earnings and your denominator rate discount rate going up. That creates a dramatic mathematical drop in forward estimates for price targets, and the stock market is realizing it. You're starting to see prices start to catch up on the way down.

Srikanth Iyer
So what's happening now is you're starting to see PE compression after a decade of PE expansion. And so that's a self-fulfilling prophecy in the sense as earnings start to drop amidst a rate hike and a recession, prices will continue to fall to catch up with a certain multiple. And so we're starting to see PE compression amidst very scarce growth, not a good backdrop for just going about rah-rah growth. So all these boom bust products on one end, the ARKs and all that stuff, the boom, the bust, that's a very different approach to investing versus what we call a secular

Warren Buffett 3.0 response, where you try to take an immunization short against recession and try to immunize your portfolio. So, equity valuations are much more sensitive now to discount rates than they have ever been in my recent memory.

Mark Noble
That really dovetails nicely into the next question, because is now I look at flows in the US for example, and investors seem to have... Of course market psychology. The pendulum goes from, as you mentioned, high growth. And now we're just seeing a flood of assets towards mid-vol, low-vol, index strategies. And I think they probably are missing something. Right? Because what I'm thinking what you're trying to say is there's actually a go between, if you're building a diversified portfolio, you can't just move to a defensive sector which might just be utilities, REITs and staples. And so I'm curious to know your thoughts on like, how do I address that dichotomy where people want to sell Microsoft and Apple right now alongside Tesla and Netflix. And they want to buy, basic utilities alongside REITs, and there's a whole bunch of litany risk in doing that.

Srikanth Iyer
Absolutely. You just scratched a 30 year old itch of mine. But it's a very good question you bring up. I'll put answer in two parts. The first part is the philosophical, the second part is practical as data scientists.

Srikanth Iyer
The philosophical part is our industry and investors in general, we have been taught throughout our careers, on the education side or on the practice side to maximize. Maximize returns, maximize profits, maximize sales, maximize relationships, maximize everything in life. The problem with maximization is the path of maximization never leads to the end results in a positive way, there's massive pitfalls in volatility. So what happens is when we are focusing on maximization there is an inert human bias towards the tails. You always are shopping and fishing in the tails, and because you're fishing in the tails the product cycle of our industry is also geared to that in giving products that reside in the tails. Bond proxies, utilities, which are being bid up like crazy right now you look at BCE, you look at some of the stocks, they've been bid up 3X, 4X times already. And on the other side, you add the boom bust type technology companies that are up 400% and that are down now 150, 200%. Both reside on the tails and the liability of this bias industry or any industry has been pretty smart is to pass it on to the end investor. Because somehow everybody knows how to switch from ARK Investments to BCE and from BCE back to ARK, everybody's an expert.

Srikanth Iyer
The problem with that is when you stay in the tails, especially if you're staying in the tails on the bond proxy side you're exposed to interest rate hikes like we are right now. You're exposed to dividend cuts like in 2020. You're exposed to counterparty risk like in subprime. So every time you see a black swan event happen, if you stay in any of the tails you eventually get hurt. The point is not to stay in the tails but go to the middle. Stocks like Johnson & Johnson, McDonald's, Nestle, these are type of companies coupled with Microsofts and Apples which are cash flow positive big giants, but not the boom bust type securities but the good technology companies. You could basically move yourself into the middle and capture 3% coupon growing at about 6% and stay that Warren Buffett route. Warren Buffett's 90 years old, his ideology is not, his ideology could be eternal. So when you try to build wealth in the middle, you get a better glide path versus trying to diversify by tails or switch from one tail to another.

Mark Noble
This exactly highlights your strategy. I mean, we've been doing this for 12 years and I'm definitely a lot more grey. I don't think you age, I don't know what that's about. But we've had a few battle scars along the way with your products. What I love about HAZ and HAL and this goes to your process is you're taking an old school type of investing, as you mentioned, Warren Buffett style dividend investing, but you're applying a new school of very, very significant data mining, machine learning. Can you talk a little briefly about how do you marry the old school with the new school to kind of come up with this kind of philosophical approach where you have a portfolio that basically sails in all kinds of conditions?

Srikanth Iyer
Well, we wanted a Warren Buffett that never ages. How do you do that? Warren Buffett's a human being, so he's going to be 90 like he was 80, 10 years ago. So the question is how do you get an ageless Warren Buffett? The only way you get an ageless Warren Buffett is to teach a machine brain to think like Warren Buffett, or somebody who looks for GPS or growth, payout, sustainability of cash flow. So, our approach was the traditional mathematical sense in the decades of the '90s and the 2000s, much of the data science and mathematical advancements were in the realm of what we call bayesian gaussian linear based normal distribution type solutions. And that's like putting a round peg into a square hole type response.

Srikanth Iyer
But about eight, nine years ago, the application of data science or artificial intelligence machine learning techniques allowed us to move away from linear relationships, which generally generally don't hold in the stock market, to what we call a non-linear response. That is, you never overfit the past to predict the future, you only use what really works in the past, aligned with what's working in the present to predict the future. So in that context, we started to use the core tenants of growth, payout and sustainability, through fundamental balance sheet, profit, loss, cash flow statements, as well as new sentiment analytics, management, transcripts, and anything else that has got alternative data elements to it. We took all those features and then taught a computer brain to look for characteristics that allow us to detect companies like a Nestlé or Johnson & Johnson, that could for decades grow their dividends every quarter.

Srikanth Iyer
So what are the characteristics of these companies that exhibit this kind of behavior? And so if you teach it a Johnson & Johnson, and tell it to search among 90,000 global securities, it will go and tell you, out of 90,000 securities, these are 15 securities that are acting like Johnson &

Johnson. Then we go and do more work on it. So artificial intelligence is nothing but training, either in a supervised or unsupervised way, a computer, to look for characteristics that exhibit certain profiles, but in a concurrent way and in an adaptive way to the market conditions. And that has completely revolutionized investing, in the sense that it allows human beings, like myself, to delegate some of the mundane aspects of searching to the universe, to a computer, and then only jump in when the human intelligence is needed.

Srikanth Iyer
So if I give an analogy, if you're trying to win a football game, would you give the quarterback the chance of winning, who starts on his own 20 yard line to score a touchdown, or quarterback like myself, who's already in the red zone, scoring a touchdown. The bot, the artificial intelligence, takes you to the 20 yard line, but the quarterback still has to score a touchdown, whether he throws it to the tight end, whether he does a quarterback sneak, gives it to the running back, that's a decision I have to make. But if I can start on the 20 yard line of the opponent, the chance that I will succeed for you in picking the right stocks like Johnson & Johnson, or Broadcom, or Microsoft, is significantly higher with artificial intelligence versus starting on our own 20 yard line and doing all of the work.

Mark Noble
And I mean, to use another sports analogy, I think just to even simplify it further, it seems like what you're trying to do is similar to what I'm doing with statistics and sports. I know historically that, in basketball, someone who's 6'7 and can shoot from the three-point line, and does help out defense, is going to be a great addition to my team. Or someone with a 98 mile per hour fastball and has a nice changeup, curveball, also probably great for my team. So in your case, you're looking for dividend sustainability, you're looking for payout, you're looking for cash flow positive. Those are things that you could find that historically are fairly, well understood.

Srikanth Iyer
Good predictors, good predictors.

Mark Noble
That I got someone good to put on the team, right?

Srikanth Iyer
Exactly. Exactly. That's what you should do. It doesn't sound sexy, it doesn't sound very exciting to the tail guys or the product guys who are in the tails. But if you're trying to build wealth, that's exactly what you look for. You're looking for accuracy.

Mark Noble
Right.

Srikanth Iyer
Not precision. So if you look for these type of individuals in a sports game, or these type of stocks for dividend distribution and income generation, then the probability of success increases exponentially. And that's what artificial intelligence does for you.

Mark Noble
So let's move to one of the things that I think is really interesting, what we have seen is that when I start to look beyond three, five years, this is the benefit of having ETFs that have been around for 12 years, through a full market cycle, these have generated real wealth. And I'm curious, in your opinion, what is the key to creating portfolio that generates strong performance? How do you manage both of those tails and have that diversification, so that these products tend to stay in there?

Srikanth Iyer
Well, there are some key features that you need to work into an equity solution. First thing is, you need to have high conviction in your names. So we're not looking to build a hundred stock portfolio, some kind of a proxy beta to the market, because in the end, you're just going to be exposed to the market. What you need is we are looking at anywhere about a 40 stock portfolio, a portfolio of global gorillas. Or in Canada, we're looking at around 30 to 40 stocks, with some of the best leaders in dividend growth and dividend payout. The yield should not be too high because if it gets too high, then you're basically a bond proxy and you are exposed to all the tail risks. So we are giving a yield of around 2.9%.

Srikanth Iyer
We also make sure that 80 to 90% of all stocks in the portfolio are growing the dividends consistently, year after year. In fact, the last 12 months, HAZ, 98% of all stocks in their portfolio grew their dividends. We're also looking for a very strong buyback that is, we want management to signal that if you don't like our stock, we like our stock way more than you. We're going to keep buying back our shares. So when you look at dividend payout plus buybacks, you're looking at an augmented yield, and with high quality debt reduction, you're looking at a very strong shareholder yield. We also look for downside capture because that's why people buy this security, because remember, minimization not maximization. So we getting about a 75% downside capture, that is we participate only 75% on the way down.

Srikanth Iyer
That gives you a lot of ammo and gunpowder to make sure that you're able to keep up with the market cycle on the way up at about 80% to 85% upside. But you give 75% to 65% downside capture. And in the end, you cannot be a passive strategy. No strategy, you cannot buy and hold. You have to adapt to market conditions. So with about a 25% to 30% turnover, as market conditions evolve, we opportunistically go in. For example, for HAZ and HAL, HAL is 36% oil. And I'm not apologizing whatsoever for it because it's trading at ridiculous low cash flow multiples with

maximum dividend growth potential, at decent valuations, with a runway of a supply shock ahead of us. So you can speculate on price, but you can't speculate on fundamentals that will sustain the payout. So when you look at our adaptation to going into oil recently, or if you remember, getting out of banks completely doing subprime a decade ago, these are adaptive conditions that either quantitatively, through AI or through HI, we're able to bring into the strategy.

Srikanth Iyer
So these are some of the main criteria that we would use in HAL, our Canadian dividend strategy, and HAZ, our global dividend strategy, is to be adaptive to conditions, and make sure that the clients are able to participate in harvesting dividends, sustainably across any market cycle, bear cycle, bull cycle, war cycle, peace cycle, high liquidity cycle, or tapering cycle. None of this should have any kind of impact on the strategy. In fact, I would say, if you look at our macro exposure recently, that we have recently been showing to clients, this strategy is basically a put option on recession.

Srikanth Iyer
It's basically underexposed to recession, underexposed to downside risk in a measurable way. But that doesn't mean you buy it only during this regime, and give it up and go back into some crazy boom bust product when things are okay. If you stay vested, not invested in a strategy like this, you start compounding. And when you start compounding, your yield at cost starts to grow. So if you bought McDonald's 10 years ago, paying you $2 a share at $100. Today McDonald's is paying $5.50 a share. So $5.50 a share on $100 investment 10 years ago is giving you a coupon on your cost basis of 5.5%. You show me one corporate bond with a AAA rating today gives you 5.5% yield. Those are the main tenets of investing in dividend paying stocks.

Mark Noble
Well, and it fits, too. I think people don't realize how much dispersion you have in the market when you hit these regime changes.

Mark Noble
I was talking the other day about the S&P 500, where your dispersion amongst the industries is incredible. You're negative 15% on growth, but you're up substantially in healthcare, financials, even real estate, tobacco.

Mark Noble
The problem here is that the dispersion is so big that if you were to ride the one beta wave, you're negative. But if you are able to capture even 5%, 6% above the market during these down periods, the compounding effect when you go up ... Because correlations actually go quite high to one even on the upside, you end up with a wealth generating strategy.

Srikanth Iyer
Because it's mathematics. It takes twice the amount to recover a 1X down. It takes 2X to come back from a 1X down. So when you go into a boom-bust product, when you get that 1X down it takes twice the amount. You cannot assume mean reversion just to say because some boom-bust product has dropped 50%, it'll come back 50%. That's a wrong assumption. That's a linear assumption. You cannot expect that you will see zig and zag happening between two asset classes. You know what's happening in the risk parity space. There's blood on the streets right now in risk parity.

Mark Noble
Bonds and equities are at their worst Q1 ever.

Srikanth Iyer
Bonds will lever up 5X, 6X in a risk parity product when equity's falling right now. So equity falls, bond is 5X. You mix 1X equity with 5X bond, guess what happened this quarter?

Mark Noble
The worst quarter in 40 years.

Srikanth Iyer
The worst quarter in 40 years.

Mark Noble
Final question because we're running out of time and we could keep chatting about this all day, but I want to know what keeps you up at night in the marketplace though? When you look at this market as a money manager, where do you say, "Okay, I have to be really careful here"?

Srikanth Iyer
Where we have to be careful, again, we run growth strategies, dividend strategies, liquid, all type strategies. Where we have to be careful is to make sure that we don't move to the tails without us knowing. The hardest part here is to stay center and stay middle. So for us in our risk management system, our data scientists are constantly worrying about seeing where the flare-out could happen. So you don't want to drink your own Kool-Aid beyond a certain level. In a sense, our overall weight is energy is only 12%, 13% for global. It's 30%, 35% for Canada because Canada is basically banks and oil. But I cannot go 15%, 20%, 30% in oil because that will extend my tail risk for any kind of black swan event either in the commodity space or anything else. So for us, the biggest concern from portfolio engineering and risk management is to make sure

that we stay moderated and normalized in the middle.

Srikanth Iyer
From a macro perspective, I would say what's keeping me up at night right now is I think Europe is in a recession, Asia is untouchable, and US is quite precarious out here for all the reasons that we talked about.

Srikanth Iyer
So overall, we are seeing the market start to not show any kind of tailwind for a mean reversion or any kind of big up cycle here. So there's going to be a generation of human beings that have never witnessed rate hikes and volatility that are starting to see this.

Srikanth Iyer
So this quarter, my biggest sleepless night is the first quarter is just an indication of what might come going forward. If that is the case, I need to stay quite immunized. Some of these hot and cold products that the street has out there is going to start to go back. Some of the more conventional, conservative, minimization-type mindsets, like what I'm talking about, start come more and more in the front because you're going to see continued bond market volatility, equity volatility, geopolitical risks, inflation, all play Russian roulette at different times. So we shall see how it all plays out.

Mark Noble
I guess in the end, what you're trying to do is really, as you highlighted, focus in that middle of quality where you know that you have a ballast for both sets of risks.

Srikanth Iyer
Absolutely. I'm trying to immunize myself. I'm taking the fourth vaccine shot to my portfolio.

Mark Noble
Okay. With that we're going to end things. But I do want to highlight that HAL was amongst the top performing, not just Canadian dividend equity, but Canadian equity ETFs entirely in Q1 of 2022. So that would be from the period ending March 31st, 2022. And HAZ continues to be a higher tier performing strategy. So there's a real proof to these. I urge you as an investor to put these up on whatever your analytics screen are. These ETFs have 12-year track records now. You've seen them through the European crisis in 2011. You've seen them in the growth phase of 2016 to 2018. You've seen them during the pandemic. And now you've seen them in this 40-year regime change. So there's a lot of philosophy and talk about different types of investment approach with Sri, but the proof's also there in what he's done with those ETFs.

Mark Noble
Anyways, thank you for everybody in joining us today. Always love having and talking with Sri, and we'll do it again soon.

Srikanth Iyer
Always a pleasure, Mark.

Mark Noble
All right, take care.