Quarterly Commentary

July | 2018

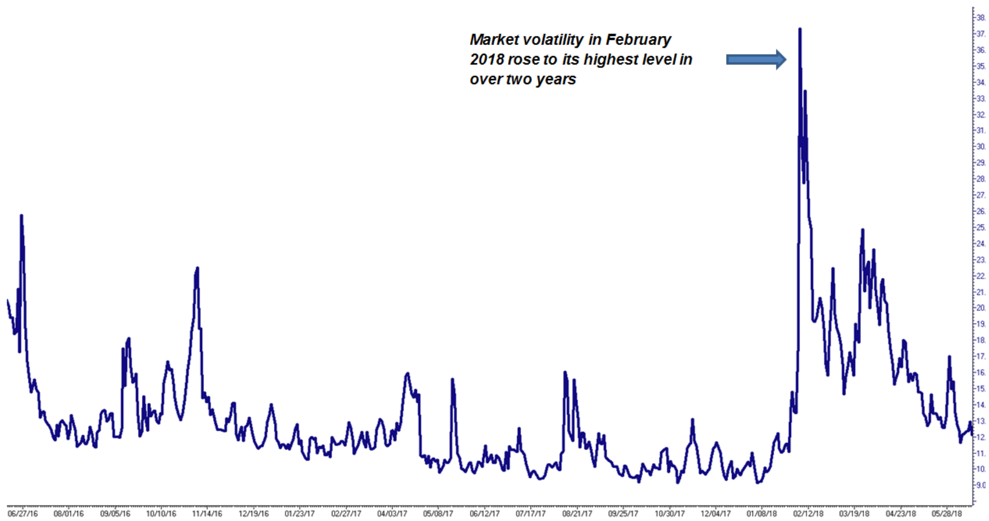
Higher Portfolio Turnover in 2018

We are in the midst of one of the longest economic expansion cycles ever. The length of this current expansion has been extended as global central banks have kept interest rates lower for a much longer period. Inflationary pressure, which typically arises from low borrowing rates and cheap money, has remained lower than for earlier expansions. Barring an unexpected shock to the economy, this expansionary cycle still has legs, but we are indeed in its latter stages. Late stage market environments usually include good earnings growth, higher volatility, and out performance by smaller businesses. In this market environment we find it both prudent and rewarding to be more active (tactical) in asset allocation changes, and taking advantage of short term exaggerated price swings in stocks, both from a buying and a selling perspective. All of our investment mandates have become more active and this has added value to our portfolios in what has been a time of greater uncertainty.

There has been a lot of headline noise leading to market swings, but the underlying conditions for the stock market, in particular strong corporate profits, continue to improve. In mid-to-late January we reduced stock exposure, believing that the stock market had gotten ahead of itself in anticipation of the benefits of corporate tax cuts in the U.S. As good as things seemed, the surge in the U.S. stock market at that time looked to have been overdone. Many future positives were already reflected in stock prices. Canadian stocks did not see the same appreciation given continuing concerns over our land locked oil, and our less favourable tax regime.

During the first part of the year, depending on the portfolio, we sold positions in Alphabet, KB Financial, Aegon, Citigroup, Western Digital, and Thomson Reuters. We also sold some laggards such as Loblaw and Whitecap Resources. Many of the positions sold in hindsight were timely, just prior to the February market swoon. In the following months, as market volatility (chart 1) picked up, we redeployed some of this cash back into stocks which we believed had fallen to levels that were good price entry points. Simply put, the "babies had been thrown out with the bath water." Depending on the mandate (balanced, growth etc.), we

Chart 1: Market volatility has led to more opportunities for active management



Source: Thomson

CBOE Volatility Index – a measure of implied volatility of S&P 500 index options proceeded to add, on price weakness, shares in high quality names such as Visa, Microsoft, Bank of Nova Scotia, United Healthcare Group, Alibaba, the Home Depot, SVB Financial, Teck Resources, and re-added Alphabet and KB Financial at price points 14% and 13% lower than our initial sells, respectively. Most of these stocks are now well above our buy points. Some have also since been sold due to outsized gains in a relatively short period of time (SVB Financial was sold after a 21% gain within two months, Teck Resources sold after an 18% gain in a month).

In earlier quarterly commentaries, we have indicated that portfolio returns will be more modest over the next decade, given the low starting point in bond yields and high stock index levels. Being more opportunistic on a shorter term basis will help to keep returns competitive going forward.

Style bias

In recent years, growth stocks (of higher growth business) have outperformed value stocks (cheaper stocks, typically dividend yielding, more mature businesses) by a large margin. With the current strong economy, investors have been willing to pay more for the stocks of companies that are positioned to benefit. In fact, the appetite for investment in large growth companies has led to a significant valuation premium of 17% compared to the 15 year average of this segment of the stock market (table 1). Growth companies have tended to be more in technology, consumer discretionary and industrial sectors, while financials, healthcare, and energy are seen as more value style. We believe portfolios should have components of both styles at all times but we do change the bias as market and economic conditions change. The portfolios, through 2017 and in the first half of 2018, have been tilted more towards growth stocks, primarily due to our positive viewpoint on the technology sector, but recent portfolio additions have been more tilted towards value given our additions within the financial and energy sector. We view the reward to risk in these segments of this market as even more attractive given recent price declines.

Table 1: Current P/E ratio as percentage of the 15 year average

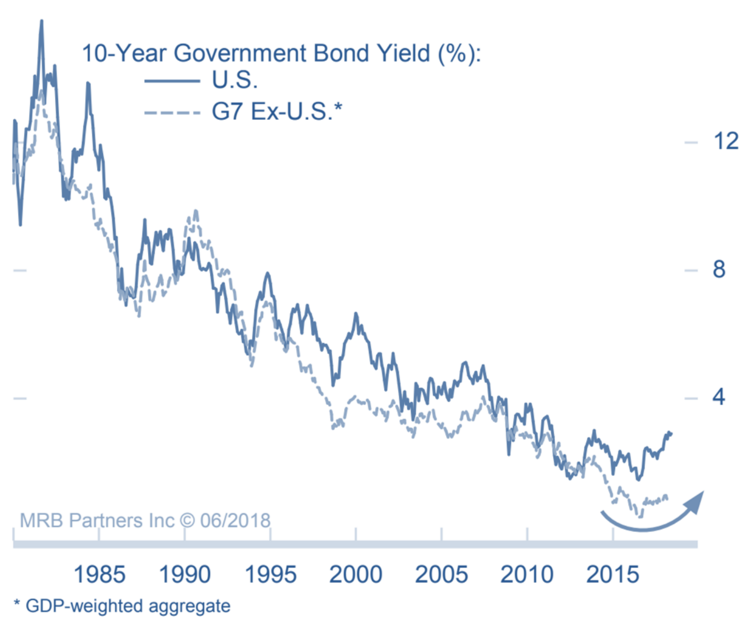
	Value	Growth
Large	104%	117%
Mid	102%	109%
Small	105%	121%

Source: J.P. Morgan Asset Management Guide to the Markets May 2018

Low, but rising bond yields

From an investment perspective, the depressed interest rate environment has marginalized returns from lower risk fixed income investments such as GICs and bonds. Fixed Income yields fell to such low levels that returns were negative on a real (after inflation) and on a post-tax basis, for the entire term of the investment. Investors have been forced to seek returns in risk assets, such as stocks. In the middle of 2016, the U.S. Government 10-year bond established an all-time low yield of 1.37%. At around the same time, the Canada 10-year bond yield touched a low of 0.98%. In other words, an investment in that bond at that time would have provided a rate of return of less than 1% per year, for 10 years, even before factoring in taxes and inflation. This was a losing proposition, yet given the uncertainties of the pending U.S. presidential election, investors were willing to settle for little or no return for the perceived safety of a government guaranteed investment. This has been the greatest challenge for

Chart 2: Global bonds yields are rising



Source: MRB Partners

retirees and investors with less appetite for investment risk, and the biggest drag on portfolio returns.

With the new U.S. government in place, the lower personal and corporate income tax rates are widely viewed as positive for economic growth and corporate profits. We have seen a major inflection point in bond yields. The three decades long decline in bond yields has finally come to an end (chart 2). It is worth noting that at the time of this writing, the U.S. and Canadian 10-year government bond yields are at 2.9% and 2.3% respectively. Expectations are for rates to continue to rise. This change has significant implications for both savers and borrowers alike. We believe there will come a time, over the next few years, when medium and longer term bonds will become attractive investments once again, and become positive contributors to the portfolios.

Outlook

Even as the U.S. raises rates, borrowing costs remain low. The U.S. economy is exceptionally strong and global GDP growth continues to rise. This bodes well for markets even in this late stage of the cycle. Likewise, the Bank of Canada (BoC) has been also been raising the prime rate, but has done so at a slower pace. The BoC has the added challenge of setting the appropriate policy rate while needing to be aware of what these increasing rates will mean for our debt-heavy households. Couple that with new provincial and municipal government policies that have hurt housing market demand, we believe the pace of rate hikes in Canada will continue to be slow.

Protectionist rhetoric is worrisome, but the markets have continued to take this in stride. There is a realization, and perhaps a certain level of acceptance, that Trump's mannerism and approach towards negotiations may be largely noise. This was evident following the Trump government's scathing words directed at Trudeau post the G-7 summit. The ensuing market response was quite muted. Equity and currency markets barely budged in the days shortly after the latest war of words.

Further shocks from Brexit and the ongoing internal issues of the eurozone give us some caution, but absent a major shock or a dramatic escalation of trade skirmishes into an all-out trade war, stock markets are poised to repeat what is typical of late cycle expansions, a period of good returns. Rising bond yields should eventually make fixed income investments more competitive with stocks, leading us to move towards more defensive assets, but it is still too early to make a significant move into bonds and bond proxies (telecoms, utilities). We still see stocks as more attractive than bonds through this year, but this bull market in stocks is maturing.

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