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LIBERTY MARKET UPDATE

Greetings and Happy New Year!

This is the first of four quarterly Liberty market updates. This update will encompass the following discussion points:

1. Last year's market performances for stocks, bonds, preferred shares and currencies.
2. The reason why we hold cash and why buying gradually is a prudent strategy.
3. The importance of having a non-correlated portfolio to reduce investment risk.

1. 2015 Market Returns

Equity Markets

Country	Stock Indexes	Total Return*
Canada	S&P TSX	-8.3%
United States	S&P 500	1.4%
Europe	Stoxx 600	10.3%
Mexico	Mexbol	1.5%
Brazil	Ibovespa	-13.3%
Japan	Nikkei	11.0%
Australia	S&P/ASX 200	4.2%
China	Shanghai Composite	11.2%
India	S&P BSE Sensex 30	-5.6%
*Dividends re-invested in native currency		

Data courtesy of Bloomberg LLP

From this table, note that except for Brazil (down 13% in its own native currency), Canada's S&P/TSX index posted the worst 2015 equity returns.

From a Liberty equity holdings standpoint, the top five winners in 2015 were Novo-Nordisk (up 54%), A.O. Smith (up 36%), Luxottica (up 33%), Lindt & Spruengli (up 27%) and Novozymes (up 25%). Note that 4 of the 5 were European. That's why it's so important that investors have exposure to international investments.

The 5 biggest losers last year were BHP Billiton, Rotork plc, Swatch, W.W. Grainger and Jardine Matheson.

Two companies, BHP Billiton and Rotork, were exposed to the commodity sector. BHP (iron ore) saw its share price plummet 40%, while Rotork (valves) lost 17% as 60% of Rotork's declining revenues came from the oil and gas sector.

Two of the firms faced increased competition from destructive technology. Swatch was down 20% because of competition caused by the introduction of Apple's iWatch and also because of an economic slowdown in China (its biggest market).

W.W. Grainger fell 21% because Amazon may take its logistics capabilities and become more heavily involved in shipping and distribution of more than just books; in Grainger's case, it would be Amazon's potential distribution of small industrial products that could hurt it.

Finally, Jardine Matheson was hurt by an economic slowdown in Asia's emerging markets and a drop in the currencies of those countries, especially Indonesia. Jardine reports in US dollars so the 18% fall in the Indonesian Rupiah in 2015 hurt Jardine's revenues and profits when translated to US dollars.

Overall, Liberty Canadian stocks performed better than the S&P/TSX by about 2%, Liberty U.S. stocks were better than the S&P 500 by about 1% and Liberty European stocks outperformed the Euro Stoxx600 Index by about 9%.

The drop in the Canadian dollar (see below) accounted for the rest of the positive performance, leaving most Liberty investors with high single-digit or low double-digit returns.

Currency Markets

Canadian Dollar vs.	January 1, 2015	December 31, 2015	Gain/Loss %
British Pound	$1.8100	$2.0430	-11.4%
US Dollar	$1.1600	$1.3855	-16.3%
Euro	$1.4100	$1.5041	-6.3%
Australian Dollar	$0.9500	$1.0117	-6.1%
Danish Krone	$0.1888	$0.2016	-6.3%
Japanese Yen	$0.0097	$0.0115	-15.6%
Mexican Peso	$0.0788	$0.0803	-1.9%
New Zealand Dollar	$0.9100	$0.9536	-4.6%
Norwegian Krone	$0.1555	$0.1563	-0.5%
South African Rand	$0.1005	$0.0893	12.5%
Swedish Krona	$0.1490	$0.1638	-9.0%
Swiss Franc	$1.1700	$1.3835	-15.4%
British Pound	$1.8100	$2.0430	-11.4%

Data courtesy of Bloomberg LLP

On January 1, 2015, using the table above, one British pound bought 1.81 Canadian dollars. By year's end, the British pound bought 2.043 Canadian dollars, leaving the Loonie with an 11.4% negative performance (it was worth less by the end of the year). On average, the Canadian dollar fell 7% against the world currencies noted above. Given the drop in the Canadian dollar, it especially hurts folks who spend part of the winter down south.

Dealing with Canadian Dollar volatility when vacationing in the United States

We have heard stories that some people had to reduce their time down South because their spending power had declined dramatically.

The best way to deal with currency volatility is to first make a plan. If a person has $20,000 USD in expenses for the duration of their stay, they should customize their portfolio to create US dollar income to match their US dollar expenses.

Additionally, they should also have a US dollar credit card and a US dollar bank account so they can pay all their bills in US dollars and never have to worry about exchange rate movement again.

Bond Markets

The table below illustrates current 10-year bond yields around the world. A country's credit rating may be investment grade (AAA, AA, A, BBB) or junk (BB, CCC, CC, C, or in default).

Despite its current investment grade rating, Brazil's bonds trade more like Greece's, whose credit rating is 9 notches lower than Brazil's. The implication here is that either Greece's yield needs to rise higher to justify the CCC rating or Brazil may eventually be downgraded to junk status if its economy doesn't recover and its political situation improve.

10-year Bond Yields

Country	Credit Rating	Current Yield
Greece	CCC (High)	7.91%
Brazil	BBB (Low)	7.27%
Mexico	A (Low)	3.90%
New Zealand	AAA	3.56%
Australia	AAA	2.81%
United States	AAA	2.21%
United Kingdom	AA (High)	1.87%
Spain	BBB	1.71%
Canada	AAA	1.36%
Japan	A (High)	0.25%

Data courtesy of Bloomberg LLP

Thanks to two rate cuts by the Bank of Canada in 2015, Canada's 10-year bond yield ranks near the bottom of this list. The difficulty for Canadian investors is that with the drop in the Canadian dollar, their spending power continues to deteriorate.

And with such low yields, when taking tax, inflation and fees into consideration, they aren't earning a positive yield on a real return basis.

For example, take the Canada 1.36% yield above and deduct the 50% interest income tax rate (0.68%), inflation (2%) and advisor fees (say, 1%), and the real return works out to be negative (-2.32%).

In other words, if an investor has a 50% stock and 50% bond portfolio and it's all invested in Canada, there's a negative return on the fixed income portion of the portfolio. So, while the advisor still gets paid, the investor makes nothing.

The reasons we want to have a bond portfolio with international flavour is:

1) Greater diversification to reduce risk.

2) Higher yields so the real return stays positive and investors actually make money after inflation and fees.
3) A natural currency hedge against a declining Canadian dollar.

Preferred Share Markets

There are two types of preferred shares that we own in client accounts:

1) ***Variable rate preferred shares*** – they pay a rate that changes over the life of the security.

   The Algonquin Power 4.5% preferred share pays a coupon of 4.5% until December 31, 2018. At that time, the coupon will be determined as 2.94% plus the 5-year government of Canada rate outstanding. If it occurred today, the rate would be 3.67%, about 18% lower than today's coupon.

   Meantime, the price has dropped 30%, an indication that the market anticipates rates to drop even lower between now and the end of 2018.

   With the price drop, however, the current yield works out to 5.22%. With the dividend tax gross-up (40% in Ontario), the pre-tax yield would be 7.3%, a rate not available in the Canadian bond market today unless investors trade in junk bonds.

   In our opinion, the price has dropped too much, thanks to an illiquid market (owned mostly by retail investors) and because of year-end tax-loss selling. This offers a buying opportunity under the right circumstances (and as part of a fully diversified portfolio).

2) ***Perpetual preferred shares*** – they pay the same rate every quarter in perpetuity.

   For example, Royal Bank has a perpetual preferred share that pays a 4.9% coupon. Its price changed little in the past year (down 8%) because of falling interest rates in Canada and because its call date is not until November 24, 2020. Therefore, investors are guaranteed the coupon for the next 4 years even if rates stay low.

   We also own some US dollar perpetual preferred shares. Their value held steady during 2015 and investors benefitted from the drop in the Canadian dollar. Unfortunately, these securities are being called by the issuer. It gives the company the option to re-issue new securities at a lower rate and save on the interest costs. The Merrill Lynch 7.12% USD preferred share will be called on January 29th at its par value of $25 USD per share.

What one may expect in 2016

Here are some investment adages that usually appear at this time of year:

1) *The "Santa Claus Rally":* This is a surge in the price of stocks that often occurs in the week between Christmas and New Year's Day. The explanations for this rally may include tax considerations, happiness around Wall Street, people investing their Christmas bonuses and the fact that the pessimists are usually on vacation.

2) *The "January Effect":* This rally is generally attributed to an increase in buying, following December tax-loss selling. It also follows that the market movement in the month of January usually indicates the direction of the market for the rest of the year.

For example, if the January return is positive, market sentiment for the remainder of the year should be bullish (higher) and vice versa.

3) *The "Presidential Cycle:* This theory was developed by Yale Hirsch. It implies that U.S. stock markets are weakest in the year following the election of a new U.S. President. According to this theory, after the first year, the market improves until the cycle begins again with the next presidential election.

There was no Santa Claus rally in December as the market fell and stayed down. On the first trading day of 2016, the market dropped anywhere from 1% to 3%, thanks to Middle East unrest between Saudi Arabia and Iran and because of weak factory data in China, indicating that economic growth is decelerating from Asia to North America.

We're also not big fans of the Presidential Cycle. In the 116 years since 1900, there are only 29 data points – not enough to be reliable.

Our advice regarding these adages is to pay no attention to them as there are no guarantees they will always work. In other words, it's important that investors avoid the market "noise" and focus on their own circumstances.

Finally, pundits have made statements that the market is cheap, given ultra-low interest rates worldwide. We disagree, as the table below shows that when extraordinary items are removed from the overall index earnings, the market isn't cheap at all.

P/E Multiples

Index	Country	P/E Ratio After OS Items	P/E Ratio Before OS Items
S&P TSX	Canada	19.91	33.99
S&P 500	United States	17.84	21.62
Euro Stoxx 600	Europe	22.79	22.65
MSCI World Index	Global	18.88	21.62

Data courtesy of Bloomberg LLP

Historically, the market reaches a peak at 23 times earnings and that's where we believe we are now - it's a good time to hold cash.

2. ***FUN WITH MATH***

Using cash to take advantage of stock market corrections

In 2009, we believed the market was fundamentally cheap. That's because Price-Earnings (P/E) ratios for stocks ranged from 6x earnings to 10x earnings. Also, dividend yields were in the 6% to 10% range. To us, that was the investment opportunity of a lifetime.

Today, however, we're concerned. P/E ratios are north of 20x earnings, and, with interest rates so low, you don't make any money on your cash. In this investment climate, we'd prefer you make a positive 0.5% by holding cash than lose 10% in the market.

Using 2015 returns for the S&P 500 Index, below is an illustration how to use cash wisely and earn better, positive returns. We've taken two hypothetical portfolios and made the following assumptions:

1) Portfolio #1: Start with $1 million and buy the S&P 500 Index on January 1st. Hold the position for the year and calculate the value of the portfolio at the end of the year.

2) Portfolio #2: Buy $850,000 worth of the S&P 500 Index on January 1st and hold $150,000 in cash for a total of $1 million. Whenever a month ends with a loss, add $20,000 to the portfolio to buy the index at a lower price. This is known as "dollar-cost-averaging".

The Outcome:

Month	**2015 Returns S&P 500**	**Portfolio #1** $1,000,000 Fully Invested	**Portfolio #2** $850,000 invested $150,000 cash	**Cash Added To Portfolio #2**	**Running Balance**
January	-3.0%	$970,000	$834,500	$20,000	$984,500
February	5.7%	$1,025,290	$903,207		$1,033,207
March	-1.6%	$1,008,885	$888,755	$20,000	$1,018,755
April	1.0%	$1,018,974	$917,843		$1,027,843
May	1.3%	$1,032,221	$929,775		$1,039,775
June	-1.9%	$1,012,609	$912,109	$20,000	$1,022,109
July	2.1%	$1,033,873	$951,683		$1,041,683
August	-6.9%	$962,536	$886,017	$20,000	$976,017
September	-2.4%	$939,435	$884,273	$20,000	$954,273
October	8.4%	$1,018,348	$980,232		$1,030,232
November	0.3%	$1,021,403	$983,172		$1,033,172
December	-1.6%	$1,005,060	$967,442	$50,000	$1,017,442
Return		**0.5%**	**1.7%**		

For Portfolio #1, based on monthly market returns, the $1 million ebbed and flowed during the year. By year-end, the portfolio was worth, $1,005,060, a 0.5% gain.

For Portfolio #2, $20,000 was added after every monthly dip, leaving the portfolio at year-end with $967,442 plus $50,000 in cash for a total of $1,017,442 (the running balance is located on the far right of the table).

By adding cash regularly through the year, Portfolio #2 managed to outperform Portfolio #1 by 1.2% (1.7% versus 0.5%). It doesn't sound like much, but compounded over a 20-year time horizon, the extra 1.2% in performance adds an extra $500,000 to the portfolio value.

This is why buying gradually is a prudent strategy. For retirees, having cash helps preserve capital and saves you from having to go back to work. For people presently working, the regular additions to the portfolio help build a bigger nest-egg for retirement.

3. The Importance of Non-Correlation in Portfolio Management

Finally, we come to the importance of non-correlation in a portfolio. We won't bore you with the math. It can be found at www.prudentnetwork.com under "*Correlation – The Basis of Risk Management*".

The gist of reducing risk in portfolio management is to hold stocks and bonds that aren't similar to each other. At Liberty, we want the portfolio to own businesses that are out there in the world doing their own thing, not competing with one another.

The Risks of Correlation

Say an investor was 65 years old in 2008, had $1 million at retirement and held only Canadian bank stocks. They also needed to withdraw $70,000 a year from the portfolio for living expenses.

During 2008, it wasn't just one Canadian bank that fell 40%; they all did. That would have reduced the value of the portfolio to $600,000. Since they also need $70,000 for living expenses, by the end of 2008, the investor was left with $530,000.

While the Canadian banks did recover, it took about 5 years to do so. During that time, the investor would have needed $350,000 to live on. By age 70, there would be little money left in the portfolio, forcing that investor to either go back to work or move in with the kids – neither one a desirable outcome.

Such concentration risk can be explained another way. In Alberta, the economy is highly dependent on the oil and gas sector. They may not realize it, but people such as dry cleaners or dentists are totally exposed to oil and gas.

That's because if the sector weakens, business at the dry cleaning store or the clinic may slow as people lose their jobs and cut their spending. Since debt doesn't disappear, the unemployed may have to put their houses up for sale because they can no longer afford them. As a result, real estate prices fall.

This affects the dry cleaner and the dentist because they've now seen their businesses slow and the value of their real estate assets decline. And if their stock portfolios are filled with oil and gas shares, they could face a triple-whammy.

Anyone living in Alberta, therefore, should have a portfolio that has little or no oil and gas exposure. They need to diversify away that all-encompassing risk.

How we avoid correlation risk

We diversify among stocks with companies in different sectors, in different countries and of various sizes. For example, we only own one bank stock – TD Bank. We don't need to own a US bank or a broker or a credit card company because TD's operations combine all of them in one firm.

This gives us the flexibility to hold just 30 names in the portfolio, ones domiciled in different countries that carry on their business throughout the world, many that nobody has heard of.

We also diversify among bonds – by type (government, provincial or corporate), by maturity date, by currency and even between regular bonds and inflation-protected bonds. We can diversify further with different types of preferred shares, too.

And, finally, we'll hold cash as a strategic alternative such as when we believe markets are expensive. Having cash with a non-correlated portfolio is the best way to avoid market crashes. It helps reduce your losses and keeps you in the game.