LIBERTY
International Investment Management

MARKET UPDATE

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YEAR-TO-DATE PERFORMANCE

The Markets – January 1st to December 31st, 2016

Equity Markets

The high returns of the Brazilian and Canadian indexes are indicative of their resource-heavy concentration, whereby they make a lot of money during the good times but lose it all during the bad ones.

2016 Returns

COUNTRY	STOCK INDEXES	TOTAL RETURN (with dividends re-invested in native currency)	TOTAL RETURN (with dividends re-invested in Canadian Dollars)
Brazil	Ibovespa	+ 38.93%	+ 64.49%
Canada	S&P/TSX	+ 21.08%	+ 21.08%
United States	S&P 500	+ 11.95%	+ 8.89%
Australia	S&P / ASX 200	+ 11.79%	+ 7.64%
Mexico	Mexican Bolsa	+ 8.15%	- 12.21%
Japan	Nikkei	+ 2.34%	+ 2.48%
Europe	Stoxx 600	+ 2.24%	- 3.47%
India	S&P BSE Sensex 30	+ 1.95%	- 3.38%
China	Shanghai Composite	- 10.49%	- 18.62%

Data Courtesy of Bloomberg LLP

For example, the TSX return in 2015 was -11%. If you take $1 and drop 11% in 2015 and gain 21% in 2016, you net a total return of $1.08, a 2-year average return of 4%, barely keeping up with inflation.

It's important, therefore, that investors focus more on long-term return potential. Resource stocks are highly volatile and, therefore, are shares to be traded. We do not consider them to be long-term investments, especially for retirees who need rising dividends at rates that will offset inflation.

Other issues specifically about owning oil and gas stocks are two-fold:

1. The share prices have doubled from their lows and are almost back to where they were two years ago when oil was at $100 a barrel. I would suggest that prices have risen too fast, too soon.

2. Oil is a commodity that is open to competition. In the past, if oil rose too high, companies would switch to cheaper alternatives such as natural gas. Today, there are new sources of competition, notably from renewable energy resources – solar, wind, hydrogen and biofuels.

As a result, some of the major oil companies have begun the conversation of peak demand instead of peak supply. From Royal Dutch Shell's transcript of their latest quarterly earnings, Simon Henry, Chief Financial Officer (CFO), noted the following:

"We've long been of the opinion that demand will peak before supply. And that peak may be somewhere between 5 and 15 years hence, and it will be driven by efficiency and substitution, more than offsetting the new demand for transport."

"We still have a view that there will be a substantive business for us for many decades to come as a result….. new forms of energy used for transport such as gas or electricity, or biofuels, or hydrogen will actually form part of the future energy system after the transition."

"And, therefore, even if oil demand declines, its replacements will be in products that we are very well placed to supply one way or the other, so we need to be the energy major of the 2050s. And that underpins our strategic thinking. It is part of the switch to gas, it is part of what we do in biofuels, both now and in the future, second generation and third generation. And hopefully it will be part of how we develop the new energies business overall in the electric or electricity value chain."

As a result, Shell has decided to stop investing in the oil sands and will devote their capital expenditures on natural gas, liquefied natural gas (LNG) and biofuels.

Instead of investing in oil and gas or other resources or mining stocks, our focus is on water—water purification (A.O Smith), water treatment (Danaher Corp.) or water irrigation (Lindsay Corp.) These are companies that generate consistent and growing free cash flow and are a better long-term investment than short-term trading in resource stocks.

The high volatility in resource stocks shows in the table below as the TSX is trading at 41.98 times earnings when all extraordinary items are removed.

While we thought the P/E multiples in June were high, they're even higher now at the end of December, thanks to the results from the U.S. election.

Price/Earnings Multiples

INDEX	COUNTRY	P/E RATIO Estimated	P/E RATIO Before Outstanding Items
S&P TSX	Canada	23.04	41.98
S&P 500	United States	20.97	24.92
Euro Stoxx 600	Europe	27.44	27.79
MSCI World Index	Global	22.03	24.56

Data Courtesy of Bloomberg LLP

The Price-Earnings Ratio (share price divided by the earnings per share) for the markets is at a cyclical high that usually indicates peak valuations.

Since soon-to-be-US-president Donald Trump was elected in November, the market has rallied. Depending on the stock market, gains were between 3% (Canada) and 6% (Europe).

Expectations are for corporate tax cuts, corporate repatriation of capital from overseas holdings, a $1 trillion infrastructure bill and higher military spending. If these things happen, corporate profits should rise and that could help reduce the P/E ratios.

However, even though Republicans hold both houses (Congress and the Senate), there will probably be limits on how much spending will be allowed.

In a Bloomberg article by Erik Wasson, he notes that, "House conservatives such as Iowa's Steve King are already demanding that the next round of spending bills immediately cut $30 billion in domestic spending. Republican centrists consider the overall levels for social spending largely settled while wanting military spending increased."

Republican Charlie Dent of Pennsylvania said the spending bill vote will be a precursor to a debt-ceiling vote where the new administration will find out they need Democrats to get bills passed, because some Republicans refuse to vote for most debt or spending bills.

"The very non-ideological Donald Trump will bump up against some very ideological members of our conference (the Appropriations Committee), said Dent." April 28th is the deadline for a spending bill.

Meantime, U.S. corporate CEOs have all said that lower taxes would markedly increase their profits. This would have the biggest influence over the future direction of the stock market. That's because company spending exceeds cash flow by a near-record amount.

According to SocGen's Andrew Lapthorne, global head of quantitative strategy, "Companies have used debt to repurchase their own stock, flattering their bottom-line financial performance." While not all buybacks are financed by debt, Lapthorne did note a correlation between net repurchases and the change in corporate indebtedness.

For the Liberty stock portfolio, the 5 best/worst performers for 2016 were:

Year-to-date Price Performance
(dividends not included)

TOP 5	% GAIN	BOTTOM 5	% LOSS
Cognex Corp.	+89%	Novo-Nordisk A/S	-34%
Littelfuse Inc.	+43%	Novozymes A/S	-25%
TransCanada Corp	+40%	Amerisource Bergen	-23%
Balchem Corp.	+38%	Femsa	-16%
Intertek Group plc	+27%	Lindt & Spruengli	-13%

Data Courtesy of Bloomberg LLP

The way to think about the chart is to take a dollar and calculate the net performance result of all 10 stocks. In this case, the $1.00 at the beginning of the year is today worth $1.84. Note this is just price movement. It doesn't include dividends re-invested, currency movements, trading commissions or fees.

To create portfolio alpha (a return greater than the underlying benchmark), all it takes is a few big winners to carry the load. Think of them as the lead sled dogs. In the long-run, however, it won't always be the same names.

That's why it's important to remember this phrase, "The wider the base, the greater the space." This means that the longer a stock moves sideways with rising earnings, the more room the share price may increase.

This should provide confidence for investors, if they wish, to dollar-cost average and buy more of the losing names. That's what we did recently for clients (see below).

Some notes to the above:

1. Cognex has secured new contracts from manufacturers for their robotics systems (machine-to-machine cameras) and also introduced new products that offer vendors 2D or 3D machine vision.

2. Littelfuse makes fuses for multiple applications including smartphones and all types of computer hardware, notably in automobiles. They also own subsidiaries that make sensors and LED lights.

3. TransCanada Corp. moved higher thanks to a Republican victory which re-opens talks to complete the Keystone XL pipeline.

4. Intertek Group plc is a company that provides measurement and quality-control services to a number of different industries, such as clothing, toys, food and oil and gas equipment. Also, the drop in the British Pound has helped increase foreign revenues while it gets paid in higher-valued currencies.

How dollar-cost averaging can work

As noted above, there are a number of stocks that hit new 52-week lows in 2016. If the issue is macro-economic in nature and not directly related to the company or its revenues or profits, investors can take advantage of sell-offs. That's why it's so important to keep cash available in the portfolio.

The table below shows when the stock fell to a new 52-week low and what happened to the stock price thereafter.

The cause of the price weakness could have been year-end tax-loss selling or a re-valuation after a poor earnings announcement.

For example, Luxottica Group, the maker of designer eyeglass frames (RayBan and Oakley) and retail outlets such as LensCrafters and Sunglass Hut, hit a 52-week low of 39.92 euros on October 7th around the time of its earnings announcement.

For clients who were underweight the stock, we were able to buy more shares at a cheaper price and enjoy a short-term recovery in value and a higher dividend yield.

Finally, quality also counts, whether it be quality of earnings, cash flows and/or balance sheet items. If you're tired of me repeating myself, I'll hand it over to Laurans (Larry) Mendelson, Chairman and CEO of Heico

Stock Performance Off the Bottom Lows in 2016

COMPANY	SYMBOL	52-WEEK LOW	DEC. 31 PRICE	% CHANGE	DATE OF 52-WEEK LOW
Luxottica Group	LUX IM	$39.92	$51.10	+28%	Oct. 7
Gemalto NV	GTO NA	$46.53	$54.92	+18%	Dec. 2
Novo-Nordisk	NOVOB DC	$218.20	$254.70	+17%	Nov. 23
Essilor International	EI FP	$93.41	$107.35	+15%	Nov. 22
AmerisourceBergen	ABC	$68.38	$78.19	+14%	Oct. 28
Coloplast A/S	COLOB DC	$428.00	$476.30	+11%	Nov. 14
Fairfax Financial	FFH CN	$586.00	$648.50	+11%	Dec. 19
Novozymes A/S	NZYMB DC	$220.70	$243.50	+10%	Dec. 8
Unilever NV	UNA NA	$36.22	$39.12	+8%	Nov. 11
Lindt & Spruengli	LISP SW	$4,877.00	$5,275.00	+8%	Dec. 8

Data Courtesy of Bloomberg LLP

Corp., an aerospace firm and a stock we hold in our Legacy and US portfolios. During Heico's latest quarterly teleconference, Mr. Mendelson said the following:

"The strong cash flow generated by Heico during fiscal 2016 allowed us to internally fund the growth of our existing businesses while reducing borrowings under our line of credit by $170 million. And I continue to be very pleased with Heico's laser focus on strong cash flow generation which is a core strategy for Heico and in my opinion the most important aspect of building a successful business."

"I have said many times at conferences that Heico is focused on cash flow and earnings per share will then take care of themselves. We could focus on earnings per share and as many companies do would have no cash flow or very low cash flow and to us at Heico that is not the formula for a successful business."

"In addition, given the strength in Heico's share price and the company's history of stock splits and dividends, the Board of Directors intends to consider a stock split at its next regular meeting which will be held on March 17, 2017. I remind you historically that we have declared 14 stock splits or stock dividends since 1995."

In fact, the three most important metrics that we use when evaluating a company is: Free Cash Flow (FCF), Return on Invested Capital (ROIC) and Operating Margins (OM).

Free cash flow is simply what's left over after all the bills are paid. For an individual, they can save it, invest it or spend it. For corporations, they can raise the dividend annually, pay down debt, make acquisitions, buy back shares, invest in research and development and continuously hire new and skilled employees.

Return on Invested Capital is the return a company makes on every dollar of capital invested in the business (both equity and debt). Good companies will have ROICs in the mid-teens. If it can make 15 cents on every dollar of capital invested compared to a competitor that's making only 8 cents, the former company has a huge leg up financially on its rival. This has always been an important metric for Benjamin Graham and Warren Buffett.

Operating Margins reflect how well a company can control its costs. The higher the margins, the better the cost containment and the higher the profits will be.

Taken together, we are able to reduce the number of investable companies in our universe by over 90% and stay focused on those that operate efficiently and to the benefit of its shareholders.

With this kind of financial flexibility, the Chief Financial Officer (CFO) of the firm can build the company by allocating capital three ways:

1. Rising Dividends – it gives shareholders a piece of the profits each year.
2. Research & Development – constant innovation helps keep the firm relevant.
3. Mergers & Acquisitions – helps the company grow its market share and pricing power.

Currency Markets

Canadian Dollar vs.			
CURRENCY	**DEC. 31, 2015**	**DEC. 31, 2016**	**GAIN/LOSS %**
Mexican Peso	$0.0803	$0.0648	+ 23.9%
British Pound	$2.0430	$1.6594	+ 23.1%
Swedish Krona	$0.1638	$0.1479	+ 10.8%
Euro	$1.5041	$1.4153	+ 6.3%
Danish Krone	$0.2016	$0.1904	+ 5.8%
Swiss Franc	$1.3835	$1.3215	+ 4.7%
Australian Dollar	$1.0117	$0.9677	+ 4.6%
US Dollar	$1.3855	$1.3435	+ 3.1%
New Zealand Dollar	$0.9536	$0.9305	+ 2.5%
Norwegian Krone	$0.1563	$0.1555	+ 0.5%
Japanese Yen	$0.0115	$0.0115	- 0.2%
South African Rand	$0.0891	$0.0978	- 8.9%
Average Gain			6.3%

Data Courtesy of Bloomberg LLP

The chart above is determined as follows: On December 31st, 2015, one British Pound bought $2.043 Canadian Dollars. By December 31st, 2016, it bought only $1.6594, meaning the Canadian Dollar strengthened by almost 24% against the Pound.

On average, the Loonie rose 6.3% against this basket of currencies, trading like a petro-currency, moving in the same direction as the oil price.

For clients, the 6% gain by the Canadian dollar caused a headwind against foreign holdings. So, if foreign holdings were 80% of the equities, it hurt performance by 5%.

I'm not concerned about this as currency risk becomes benign over a 10-20 year time horizon. And since 2000, the Canadian dollar has only hurt performance significantly during 3 of those 16 years:

→ 2003 when it rose 18%,

→ 2007 when it rose 14% and

→ 2009 when it rose 14%.

In fact, the stronger Canadian dollar during this time (about 7% higher since 2000) has provided investors with opportunities to buy other currencies that have weakened. That's another way to invoke the dollar-cost averaging strategy.

For 2017, the Canadian dollar should move depending on four factors:

1. The movement of interest rates – if US rates rise at a faster rate than in Canada, there should be downward pressure on the dollar.
2. If oil prices rise significantly from their current USD $55 a barrel price, the Canadian dollar could rise.
3. If the Canadian economy struggles with lower real estate prices and oil prices don't rise, that should also cause downward pressure on the Loonie.
4. If the Trump administration re-opens the North American Free Trade Agreement (NAFTA) or erects trade barriers (beef, softwood lumber and drywall are current sticking points) or implement trade tariffs, the Canadian dollar will be pressured to drop.

From all that I've read, forecasts are for the Canadian dollar versus the US Dollar to trade in a range of 60 to 80 cents.

Bond Markets

Just three months ago, interest rates reached record lows around the world. Some European countries actually faced negative interest rates, whereby investors paid the banks to hold their money.

That's why, eight years after Lehman Brothers' collapse sparked the financial crisis, Europe's banks still have 1.2 trillion euros of non-performing loans and why they may be stuck with them for decades to come.

Richard Partington wrote in Bloomberg that, according to a KPMG report in October, "European lenders are battling to cut soured loans as they face evaporating income from lending amid negative interest rates from the European Central Bank (ECB)."

"Net interest margins, the difference between income from lending versus cost of funding, average about 1.2% in the region compared with about 3% in the United States."

After the US election, meantime, the bond market turned upside down on the expectation that an increase in spending would cause huge fiscal deficits. Coupled with tax cuts, this was seen as inflationary and the bond market responded with higher yields.

As a result, fixed income mutual funds saw an outflow of $41 billion USD in 2016 compared to an inflow of $24 billion USD in 2015. With the sale of these mutual funds and ETFs, bonds held within the pools were sold to raise cash, thereby putting downward pressure on bond prices, causing higher yields.

This is shown in the table below as 10-year bond yields rose in the last quarter of 2016, even more for bonds with longer maturities. You can also note the gap in 10-year yields between Canada and the United States.

If the U.S. Federal Reserve raises rates another two or three times in 2017, the 10-year yield should approach 3% and perhaps move toward 4% in 2018, the Fed's ultimate goal. If rates reached 4%, that would give them flexibility to cut rates if we entered an economic recession.

10-Year Bond Yields

COUNTRY	MOODY'S SOVEREIGN CREDIT RATING	CURRENT YIELD
Greece	CCC-Low	+ 6.93%
Brazil	BB-Mid	+ 5.43%
Mexico	A-Low	+4.17%
New Zealand	AAA-Mid	+ 3.31%
Australia	AAA-Mid	+2.76%
United States	AAA-Mid	+2.44%
Canada	AAA-Mid	+ 1.71%
United Kingdom	AA-High	+ 1.23%
Japan	A-High	+ 0.04%
Germany	AAA-Mid	+ 0.20%

Data Courtesy of Bloomberg LLP

So, in just three short months, investors seeking income first had to deal with re-investment risk, whereby their 6% bonds that matured could only be re-invested at rates below 2%.

Now, they have to think about inflation where there's no protection outside of inflation-protected bonds.

For our fixed income portfolios, we're not trying to be heroes with attempts to outsmart the Fed.

Instead, we own a laddered bond portfolio with short, medium and long-term bonds with about 5% invested in inflation-protected bonds. That way, we can cover all the bases, and keep the turnover and the costs low.

If rates continue to rise, we can use the cash flows from the bond payments to buy more at lower prices, yet another reason to keep cash on the sidelines.

Preferred Shares

TYPE OF PREFERRED SHARE	YEAR-TO-DATE PRICE CHANGE
Canadian Perpetual Preferred Shares	+ 6.87%
Canadian Variable Rate Reset Preferred Shares	+ 6.83%
BofA Merrill Lynch US Perpetual Preferred Index	+ 2.07%

Data Courtesy of Bloomberg LLP

During the first part of the year as interest rates fell, the perpetual preferred shares outperformed the rate reset preferred shares. Since the fall, however, the rate reset preferred shares rallied back to show a positive return for the year.

Perpetual preferred shares pay a quarterly dividend at a stated rate in perpetuity. For example, if you own the Brookfield Asset Management 4.75% coupon perpetual preferred share, you would be paid 4.75% on your money each year.

As interest rates fell in the early part of 2016, the value of the Brookfield preferred shares rose as it was better to own it and its 4.75% coupon than a bond or rate reset preferred share that yielded only 2% or 3%.

As rates rose in the fall, the Brookfield share price fell as the rate reset preferred shares offered a higher yield. Rate reset preferred shares are instruments that pay a fixed coupon for 5 years and then reset at a rate set by the issuer plus the 5-year Government of Canada rate.

For example, Northland Power has issued a rate reset preferred share with a 5% coupon that resets on December 31, 2017 at a new reset rate of 3.46% plus the 5-year Government of Canada (GOC) rate. That instrument (GOC) now yields 1.11%, up from 0.50% in the summer.

With the five-year GOC rate expected to keep rising, the value of the Northland Power preferred share jumped 16% in 2016 on the expectation that it may pay 5% or better in 2017.

Again, we are not trying to call a market direction and own both perpetual and rate reset preferred shares.

FUN WITH MATH

Understanding Performance Numbers

I believe the biggest problem in the investment industry is the ability of the average investor to calculate and understand their performance numbers. During my 37-year career, it's certainly the biggest challenge I have faced.

Naturally, investors always want to earn the best returns that are out there. However, I doubt many would have wanted all their hard-earned money invested in the Brazilian stock market in 2016, despite the fact it rose 65% in Canadian dollars (see table on Page 1).

Instead, it's more important to understand that risk and reward walk hand-in-hand. If you want the risk of an all-equity portfolio, you have to deal with the reality that by doing so, you may see a range of returns in any one year between plus or minus 40%. If you can stomach that, then invest away. However, most people aren't made of such brazen stock, especially when their retirement nest egg is involved.

There are a slew of numbers thrown around at investors depending on how they're invested. If it's invested all in equities, the results compared to underlying benchmarks should be straightforward. However, when investors decide to have a more balanced and diversified approach, returns are not the same for every asset class.

I've decided to walk you through two types of calculations, one easy (all equities) and one difficult (a mix of cash, stocks, bonds, preferred shares and inflation-protected bonds.

That way, you can understand how important it is to have an apples-to-apples comparison.

First, we'll start with the fairly easy one. We'll use the simple price returns of an international portfolio and compare them against their respective benchmarks. Remember, however, that:

1. These numbers do not include fees.
2. The numbers are not converted into Canadian dollars – more on that below.
3. The numbers only assume a static portfolio (owned the entire year and no transaction costs involved).
4. There were no contributions or withdrawals.
5. The portfolio consists of 30 different stocks, of which 4 are Canadian, 12 are U.S. and 16 are international.
6. This is not representative of any client or overall Liberty performance. It's just an example.

100% Equities – The Easy Calculation

2016 Global Portfolio Total Returns (with dividends re-invested for both individual stocks and indexes).

The four Canadian stocks below matched the performance of the TSX in 2016 which is pretty good, given that 35% of the TSX is resource-based and that was what moved the Composite needle last year.

CANADA	SYMBOL	2016 RETURN	5-YEAR CAGR	10-YEAR CAGR
TransCanada Corp.	TRP	+40%	+10%	+8%
TD Bank	TD	+26%	+15%	+10%
CN Rail	CNR	+18%	+19%	+15%
Alimentation Couche-Tard	ADT.B	+0%	+42%	+22%
Average Return		+21%	+22%	+14%
S&P/TSX Index		+21%	+8%	+5%

Data Courtesy of Bloomberg LLP

I've also shown the 5-and-10-year compounded annual growth rate (CAGR) to illustrate the quality of the companies and their ability to generate consistent and growing free cash flows. It also suggests that you don't have to deal with the volatility of resource stocks if you don't want to – you can invest in ancillary businesses like CN Rail or TransCanada Corp. who do business with the oil and gas producers but with less risk.

The next set of returns are the 12 US holdings versus the S&P 500 Index. Again, 2016 was a good year for this group, as has been the last 5 and 10 years.

UNITED STATES	SYMBOL	2016 RETURN	5-YEAR CAGR	10-YEAR CAGR
Cognex Corp.	CGNX	+89%	+30%	+19%
Littelfuse Inc.	LFUS	+43%	+30%	+17%
Balchem Corp.	BCPC	+38%	+16%	+22%
A.O. Smith	AOS	+25%	+38%	+24%
C.H. Robinson	CHRW	+20%	+3%	+8%
Paychex Inc.	PAYX	+19%	+19%	+8%
Chubb Ltd.	CB	+15%	+16%	+10%
Danaher Corp.	DHR	+11%	+17%	+11%
Becton Dickinson	BDX	+9%	+19%	+10%
J.M. Smucker	SJM	+6%	+12%	+13%
Thermo Fisher Scientific	TMO	-0%	+26%	+12%
Roper Technologies	ROP	-2%	+16%	+14%
Average Return		+22%	+20%	+14%
S&P 500 Index Return		+12%	+15%	+7%

Data Courtesy of Bloomberg LLP

Since nothing's ever perfect, here's how the remaining 14 stocks (all international) fared in 2016. Or, as the singer Meatloaf once crooned, "Two out of three ain't bad."

Not a great year for the European names but that's after a 19% positive return in 2015 – more a reversion to the mean coupled with geopolitical concerns on the Continent.

What can we learn from this underperformance? The first lesson is that one year doesn't make them bad investments. In fact, the five and 10-year numbers are good and just as profitable as the US and Canadian names.

And while some investors may think that by owning these European names in 2016, the diversification backfired. On the contrary, the opposite should be considered.

The diversification has helped in the long-run as the 30 names in this portfolio example are out there in the world doing their own thing, helping to reduce correlation risk, concentration risk, country risk and industry risk.

And, finally, the dividend growth has been above-average, providing rising incomes for investors to help ward off inflation risks.

Here are the price returns of the non-North American portion of the portfolio:

INTERNATIONAL	SYMBOL	2016 RETURN	5-YEAR CAGR	10-YEAR CAGR
Intertek plc	INTRK LN	+27%	+13%	+17%
Jardine Matheson	JM SP	+16%	+6%	+13%
Halma plc	HLMA LN	+5%	+25%	+17%
Inditex SA	ITX SQ	+4%	+23%	+17%
Unilever NV	UNA NA	+1%	+12%	+10%
Gemalto NV	GTO NA	0%	+9%	+12%
Dassault Systemes	DSY FP	-1%	+19%	+15%
Essilor International	EI FP	-6%	+16%	+12%
Luxottica Group	LUX IM	-11%	+14%	+10%
Coloplast A/S	COLOB DC	-12%	+27%	+19%
Lindt & Spruengli	LISP SW	-14%	+15%	+7%
Femsa	FMX US	-16%	+3%	+9%
Novozymes A/S	NZYMB DC	-25%	+8%	+11%
Novo-Nordisk NV	NOVOB DC	-35%	+16%	+20%
Average Return		-5%	+15%	+14%
EuroStoxx 600 Index		+2%	+12%	+3%

Data Courtesy of Bloomberg LLP

Now that we have the returns, we can then calculate for each group (the portfolio and the benchmarks) and compare them:

For the Portfolio:

→ 13% Canadian stocks x 21% = +2.7%

→ 40% US stocks x 22% = +8.8%

- 47% International stocks x -5% = -2.4%

Add it up and this gives us a portfolio return (unconverted) of 9.1%.

For the Benchmark (Unconverted)

- 13% Canadian x TSX Return = +2.7%
- 40% US x S&P 500 Return = +4.8%
- 47% Europe x EuroStoxx 600 = +0.9%

The sum total gives you the Benchmark return (Unconverted) of 8.4%

In the table below, I've shown returns in both Canadian dollars and on an unconverted basis. I prefer the unconverted performance because there are more risks to consider than just the currency when looking at returns. To me, the unconverted numbers are the true apples-to-apples numbers and a better barometer of how the portfolio is actually performing.

COMPARING GROSS RETURNS	RETURN
Global Portfolio (Unconverted)	+ 9.1%
Benchmark (Unconverted)	+ 8.4%
Global Portfolio (In CAD)	+ 3.6%
Benchmark (in CAD)	+ 2.9%

Data Courtesy of Bloomberg LLP

Overall, the portfolio performed slightly better than the benchmark. Note that these calculations are before fees so the manager has to continually beat the market to justify the fees.

Next is the more difficult calculation.

60% Stocks / 40% Fixed Income with an Annual 5% Drawdown – The Difficult Calculation

By adding more asset classes to the mix and an annual drawdown, the calculation gets trickier. However, it's important to show the individual asset returns because it clears out the projection of comparing a return to just one stock market like the TSX or just one asset class such as equities.

Because there is fixed income in the portfolio, we now have to consider the following benchmarks. We'll use 5 in this calculation (their percent weightings in the portfolio are listed beside them):

1. The FTSE TMX Canada Mid-Term Corporate Bond Index (ZCM): 35% weight
2. The BMO Mid-Term US IG Corporate Bond Index (ZIC): 10% weight
3. The S&P/TSX Laddered Preferred Share Index (ZPR) for rate reset preferred shares: 40% weight
4. The Merrill Lynch Preferred Securities Index (POP1): 10% weight
5. The FTSE TMX Canada Real Return Bond Index (ZRR): 5% weight

Next, we can compare the portfolio returns for each class against its benchmark:

BONDS	RETURN
Canadian Bonds	
Portfolio Return	+ 5.10%
FTSE TMX Canada Mid-Term Corporate Bond (ZCM)	+ 3.83%
Canadian Inflation Protected Bonds	
Portfolio Return	+ 0.10%
FTSE TMX Canada Real Return Index (ZRR)	+ 2.51%
United States Bonds	
Portfolio Return	+ 4.81%
BMO Mid-Term US IG Corporate Bond Index (ZIC)	+1.65%

Data Courtesy of Bloomberg LLP

PREFERRED SHARES	RETURN
Canadian Preferred Shares	
Portfolio Return	+ 5.59%
S&P/TSX Laddered Preferred Shares Index (ZPR)	+ 6.82%
United States Preferred Shares	
Portfolio Return	- 2.31%
Merrill Lynch Preferred Securities Index (POP1)	+ 2.07%

Data Courtesy of Bloomberg LLP

The performance for the fixed income portion of the portfolio would be as follows:

- Canadian Corporate Bonds: 35% x 5.10% = 1.79%
- Canadian Inflation Protected Bonds: 5% x 0.10% = 0.00%
- US Corporate Bonds: 10% x 4.81% = 0.48%
- Canadian Preferred Shares: 40% x 5.59% = 2.24%
- US Preferred Shares: 10% x -2.31% = -0.23%

Add it all up and the fixed income performance was 4.28%. Using the same calculations, the fixed income benchmark was 4.58%.

To calculate the overall performance, you take 60% of the equity performance (60% x 9.1%) plus 40% of the fixed income performance (40% x 4.28%). For the benchmark, it would be (60% x 8.4%) plus (40% x 4.58%).

PERFORMANCE FOR A SAMPLE 60/40 PORTFOLIO	RETURN
Overall Portfolio Performance	+ 7.17%
Benchmark Performance	+ 6.87%

Data Courtesy of Bloomberg LLP

Finally, if the client draws down 4% of the assets each year to live on (whether or not from a RRIF, an RRSP or their cash account), the performance would show as 3.17%.

Summary

While some investors may be unhappy with a 3.17% return (they may say the TSX was up 21% and use that as their comparison), the reality is that the capital *after* the drawdown still grew 3%. And on an apples-to-apples basis, the portfolio did marginally better than the benchmark which ETFs cannot do (see below).

Therefore, the portfolio has accomplished what it set out to do: Provide growth to offset inflation with average risk and create an income stream to live on.

Whenever you have a meeting with your advisor, they should be able to show and prove what the actual portfolio returns are.

What are your thoughts on Exchange-Traded Funds (ETFs) and Robo-advisors?

A website called *Tradeciety* combed the academic research and among other findings, uncovered that "the average individual investor underperforms a market index by 1.5% per year. Active traders underperform by 6.5% annually."

Exchange-Traded Funds (ETFs) are an instrument that can reduce those errors by indexing – owning units that own the underlying stocks on an index.

Investors unhappy with the cost and performance of active funds are increasingly shifting to index and exchange-traded funds. They pulled USD $67 billion from active mutual funds while adding USD $70.6 billion to passive funds in November, the most in both cases this year, data compiled by *Morningstar Inc.* show.

That makes sense, too, because the old style mutual funds and hedge funds have large Management Expense Ratios (MERs) that at 2% or 3% compounded over 20 years wipes out half the investor's growth during that time.

Robo-Advisors have taken the ETF concept a step further by telling investors that they can do a better job than just owning ETFs. If you own the *right* ETFs and rotate when necessary, you can improve your performance returns. All you have to do is answer 10-20 questions and their computer algorithms will take care of the rest.

Of course, nothing is ever a slam dunk. Here are some of the drawbacks of both:

1. ETFs have now grown to a size that they are now "the market". In a *Globe & Mail* article by Ian McGugan, a Sanford C. Bernstein & Co. report suggested that, "Index funds mindlessly funnel money into the same handful of market benchmarks. According to Bernstein, indexing encourages stocks to move in lockstep and disrupts the thoughtful, discerning allocation of capital to the most deserving firms."

   In other words, there's no differentiation in company quality. In an ETF, you own the winners, the losers and the mediocre firms. Two of the three groups might not be appropriate or may hold back on potential long-term returns.

2. When you look at the largest ownership of each stock in an index, it will be the ETFs that dominate ownership. Voting proxies, therefore, may become irrelevant, allowing companies to get away with violations, especially with Republican control of both Houses and the Presidency (less regulation and removal of the Ethics Committee are two of their mandates). Remember, the shareholders are the owners, not the management teams.

3. ETFs move the market daily as they have to keep the proper proportion of shares relative to the underlying index. This adds to transaction costs and must be added to the published MERs.

4. Here's the big one. When the market falls or goes through any type of downward correction, the investor goes down with the ship because ETFs are always fully invested. In 2008, having 20% in cash preserved capital as the market fell 35% to 40%; investors with a 100% equity portfolio correctly diversified should have only fallen around 25%.

   That's because the cash portion is considered a "synthetic short", meaning if the money's not in the market, it is short the market. Instead of being 100% exposed, the portfolio is only exposed 60% to the market (80% long stocks minus 20% cash). Forty percent times sixty percent leaves a 24% loss, not 40%.

As active managers, is Liberty concerned about competition from ETFs and Robo-Advisors? Not at all, because our business model is set up to compete directly with those investing types while providing more services to the clients. As the firm grows, we'll eventually have a fee model similar to ETFs and Robo-Advisors.

Here's a checklist of what all three parties offer:

QUESTION	ETFs	ROBO-ADVISORS	LIBERTY
Are portfolios customized?	No	Yes	Yes
Do you have access to the portfolio manager?	No	No	Yes
Do you get other advice outside of portfolio management?	No	No	Yes
Can you outperform the market?	No	No	Yes
Can you take advantage of tax-loss selling?	No	Yes	Yes
Are there fees on top of other fees?	No	Yes	No
Are the management fees tax deductible?	No	Yes	Yes
Can you add more risk using leverage?	Yes	No	No

Aren't bonds risky to own now that interest rates are rising?

As long as you have a plan and structure in place, that portfolio immunization will help with both inflation and rising interest rates.

If you hold bonds to maturity, prices will move during the duration of the bond but they ultimately should mature at par. Here are some things to consider to help immunize your bond portfolio from rising rates and still earn a real return that's positive after tax, inflation and fees:

→ Have a 10-year bond ladder – this means owning bonds that mature in subsequent years, say from 2019 to 2029. That way, there'll always be cash available each year to roll over into a higher coupon bond if rates have risen.

- → Own some inflation-protected bonds as insurance against a bump higher in inflation rates – interest rates rise in reaction to a rise in inflation.
- → Rate-reset preferred shares will raise their payment stream if rates rise higher than the original coupon.
- → Some high yield bonds can help. We like the BB rating category but only for those bonds that have solid balance sheets. Many are new companies that aren't mature enough to have gone through business cycles or are too small to be rated investment grade. That's where opportunities lie. When they do rise to BBB or investment grade status, the price of the bond should rise to reflect this.
- → Focus on buying bonds at par or a discount. This prevents capital losses from occurring so you enjoy the full yield that the bond offers. In this environment, bonds purchased at a premium are most exposed to interest rate increases.

Why not just own Apple?

I was asked this question both while as a guest on BNN Market Call and by an acquaintance of mine. Of all the stocks listed globally, Apple has one of the highest proportional ownerships (it's in most mutual fund portfolios). That's why my comment was, "If you wish to own it, what do you need me for?"

The problem with owning the big market cap stocks is that there's no margin for gains or errors, and therefore, no advantage to owning it.

Instead, I prefer to own companies that 100,000 pairs of eyes aren't looking at every day. For example, Atrion Corp. is a small-cap company that is in the Legacy and US portfolios that has grown under the radar for a number of years; it isn't even covered by any brokerage analysts.

The company has grown on its own merits. If it ever has a market-capitalization that would move it from small-cap to mid-cap status, all the mid-cap ETFs and mutual funds would have to own it. This would also cause the price to rise.

One of our other stocks, Littelfuse Inc., was added to the S&P Mid-Cap 400 Index in November and the buying by mid-cap mutual funds pushed the stock price up to $150 a share.

How much money will I need to live comfortably in retirement?

This is a common question asked by investors just starting out and those preparing for retirement.

If you have $1 million of investable assets at retirement (this doesn't include your home) and you draw down 5% a year, you'll have $50,000 of gross income (before taxes and fees) to live on and you shouldn't run out of money in your lifetime. If you need more income, then you'll need more investable assets.

If you believe you'll need $125,000 a year to live on then multiply that amount by 20 (the reciprocal of 5%) and that will give you the amount of investable assets you'll need in retirement ($2.5 million).

Of course, the phrase "that depends" must come into the conversation because it depends on each individual's circumstances (single, divorced, children, grandchildren, pensions or other sources of income, inheritances, etc.)

The best thing any investor can do now is to calculate their annual living expenses now or an average for the past 5 years to get an idea of how much you may need to live on.

If you consider that the stock market is expensive, how do I go about taking a position in equities? I don't want to invest today and then watch the market drop 20%.

There are 3 ways that you can enter today's stock market:

1. If you have a long-term time horizon, you can just go ahead and buy what you want and create your portfolio. You'll garner the dividend income immediately and valuations in 10-20 years should be in your favour.

2. You can buy ½ positions of each stock. For example, if you wish to buy $10,000 of an individual stock, you can buy $5,000 worth and keep the rest in cash. If the company does well and doubles on its own, you can allocate the other $5,000 elsewhere.

   If it falls in price, you can allocate the other $5,000 when you feel there's a better opportunity. Buying gradually has never wiped out an investor. It actually helps keep you in the game when the market is in a correction phase.

3. Sell put options, the best way to enter a position.

By selling puts, you can earn a premium for selling the option, thus reducing your eventual cost and increasing the dividend yield at purchase.

For example, say you sell puts on TD Bank shares at a $60 strike price (the shares traded recently at $66.85). You'd pick up a small premium for the sale of the put (60 cents per 100 share contract) and if the stock fell to $60, you would own the stock. Your cost would drop from $60 to $59.40 as that's the difference between $60 and the premium received.

Instead of buying the stock at $66.85 where the dividend yield was 3.30%, you'd own the stock at $59.40 and your yield would be 3.70%.

We don't trade options at Liberty because our clients are already high-net worth investors and don't need to take on the risk of trading options.

Finally, as we move into 2017, here's a list of dos and don'ts to ensure a prosperous year:

DO	DON'T
Save 10% to 20% of your take-home pay.	Spend beyond your means.
Make a list of your living expenses.	Buy too much house.
Pay off your mortgage as quickly as possible.	Have debt in retirement.
Make your TFSA contribution.	Trade actively.
Make a plan and stick to it.	Let others sway your thinking. Avoid the noise.
Diversify stocks by country, industry and size of company.	Fall victim to concentration or correlation risk.
Diversify fixed income with a laddered approach.	Let your emotions control your investment decisions.
Keep some cash handy to take advantage of market corrections.	Follow the herd. You'll eventually wind up in the slaughterhouse.

If you have any further questions, let me know.

David Driscoll

President & CEO
Liberty International Investment Management Inc.

