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Market Update for Q3 2016

This Market Update will discuss the following:

1) Year-to-date performances for stocks, bonds, preferred shares and currencies.
2) Dealing with the British referendum.
3) Fun with Math: Why investors shouldn't chase returns.
4) Answers to client questions.

1. Year-to-date Market Performance – January 1st to June 30th, 2016

Equity Markets

2016 YTD Returns (at June 30, 2016)			
Country	**Stock Indexes**	**Total Return (with dividends re-invested in native currency)**	**Total Return (with dividends re-invested in Canadian Dollars)**
Canada	S&P TSX	+9.83%	+9.83%
United States	S&P 500	+3.83%	-2.53%
Europe	Stoxx 600	-7.38%	-11.41%
Mexico	Mexican Bolsa	+7.83%	-5.59%
Brazil	Ibovespa	+18.86%	37.93%
Japan	Nikkei	-17.37%	-9.75%
Australia	S&P/ASX 200	+4.30%	-3.08%
China	Shanghai Composite	-16.50%	-24.60%
India	S&P BSE Sensex 30	+4.54%	-3.91%

Data Courtesy of Bloomberg LLP

Market returns in some countries have shown good year-to-date numbers (Column 3) but many of those indexes were down last year so it's just a re-tracing exercise, or reversion to the mean. For example, the TSX was down 11% in 2015 and is up 9.8% in 2016. As a result, the TSX appeared cheaper on a relative basis entering 2016 and attracted foreign investors.

If you convert the returns to Canadian dollars, however, almost everything in the above chart turns red (Column 4). That's because the Canadian dollar has risen against almost every currency in the world in 2016.

Despite negative outlooks for earnings, money managers who have sat on the sidelines with cash and watched the post-Brexit stock rally are now in the market because they ***have to be in the market*** not ***because they want to be***. Their overlying fear is to fall too far behind the benchmarks and suffer fund redemptions.

This is a huge concern for us because investment decisions are being made for the wrong reasons. We continue to hold roughly 15% to 20% in cash because we have been able to stay ahead of the benchmarks. If the stock markets continue to rise, the clients will still make money. But if it falls, we have cash available to take advantage of opportunities. To us, this is the best of both worlds and the prudent place to be.

Price/Earnings Multiples			
Index	**Country**	**P/E Ratio After Outstanding Items**	**P/E Ratio Before Outstanding Items**
S&P TSX	Canada	21.61	51.96
S&P 500	United States	17.86	24.17
Euro Stoxx 600	Europe	15.63	27.30
MSCI World Index	Global	16.81	24.21

Data Courtesy of Bloomberg LLP

Compared to the first quarter of 2016, price-earnings multiples have moved higher still, numbers we haven't seen since the sell-off in 2001. Back then, the market fell after September 11th and continued down for another two years.

Expanding P/E ratios have been caused by:

- Stock prices rising faster than earnings.
- Lower bond yields – some sovereign rates are actually negative (see below).
- Eight years of ultra-low interest rates that has attracted speculation and margin borrowing.

According to a *Bloomberg LLP* article, "The S&P 500 is poised to match its longest earnings recession since 1936. At 25 times reported profit, the S&P 500 is trading at a higher multiple than it has for 90 percent of the time in the past eight decades. The one saving factor for the index is the shallowness of the decline in earnings, which is nothing close to the previous three drops."

For the Liberty global stock portfolio, the 5 best/worst year-to-date were:

Year-to-date Price Performance				
(Dividends not included)				
Top 5	**%Gain**		**Bottom 5**	**%Loss**
FEI Company	+33.9%		Luxottica Group	-27.7%
TransCanada Corp.	+29.4%		AmerisourceBergen	-23.5%
Cognex Corp.	+27.6%		Coloplast A/S	-10.6%
Intertek Group plc	+25.3%		Novo-Nordisk A/S	-10.5%
JM Smucker Company	+23.6%		Roper Technologies	-10.1%

A few comments here to explain the performance numbers:

- FEI Company was bought out by Thermo Fisher Scientific at a 30% premium.

- TransCanada and Intertek were price reversals from 2015.
- Cognex, a technology stock, was part of the Nasdaq Index rebound from 2015.
- J.M. Smucker's acquisition of pet food brands caused its earnings and share price to rise.

To deal with the bottom five, we first have to ask ourselves, "Was the drop in share price because of the business, P/E multiple contraction or due to macro-economic conditions? Since it's been the second or third reason, we remain comfortable owning these shares and are buying more.

Currency Markets

Canadian Dollar vs.			
	December 31, 2015	**June 30, 2016**	**Gain/Loss%**
British Pound	$2.0430	$1.7220	18.6%
US Dollar	$1.3855	$1.2931	7.1%
Euro	$1.5041	$1.4370	4.7%
Australian Dollar	$1.0117	$0.9626	5.1%
Danish Krone	$0.2016	$0.1932	4.3%
Japanese Yen	$0.0115	$0.0125	-8.3%
Mexican Peso	$0.0803	$0.0708	13.4%
New Zealand Dollar	$0.9536	$0.9215	3.5%
Norwegian Krone	$0.1563	$0.1547	1.0%
South African Rand	$0.0891	$0.0878	1.5%
Swedish Krona	$0.1638	$0.1532	6.9%
Swiss Franc	$1.3835	$1.3279	4.2%
Average Gain			5.2%

Data Courtesy of Bloomberg LLP

The chart above is determined as follows: On December 31, 2015, one British Pound bought $2.043 Canadian dollars. By June 30, 2016, it bought only $1.722, meaning the Canadian dollar strengthened by 18.6% against the Pound.

The Canadian dollar has rebounded as commodity prices have risen from their 2016 lows. The Mexican peso has fallen 13.4% because of the fear that if Donald Trump wins the U.S. presidency race, Mexico could suffer.

Of course, the joke out of Mexico is that Trump can build his wall because the Mexicans, who have a history of being tunnel builders, will just dig under it!

Bond Markets

Tracy Alloway of *Bloomberg News* recently noted that, "Analysts are pointing to the flattening U.S. yield curve – that is, interest rates across different maturities of debt are becoming more similar – as evidence of slowing expectations of economic growth."

"Meanwhile, a Federal Reserve Bank of New York measure of the 10-year term premium – a gauge of the supposed riskiness of longer-dated debt – has fallen to negative 0.66%, eclipsing an all-time low last seen when Bob Dylan released his first album."

These are signals that as the yield curve flattens (short-term rates are similar to long-term), the economy is at risk of slowing down or slipping into recession. If so, that's bad news for the stock market.

Tim Kiladze, in a recent *Globe & Mail* article, wrote that "Roughly $12-trillion (U.S.) worth of sovereign debt – that is, bonds issued by governments – now pays negative interest rates. In Switzerland, 50-year bond yields turned negative in July, meaning investors must pay the government a small sum to simply safeguard the funds for half a century."

Investors needing income are now the new breed of dividend investors because there's so little return to be made in bonds and GICs. That's because, after tax, inflation and fees, the real return is negative, meaning spending power declines. One dollar today is worth less next year.

2-year Bond Yields		
Country	**Standard & Poors Credit Rating**	**Current Yield**
Brazil	BB	12.36%
Greece	B(Low)	6.40%
Mexico	BBB (High)	5.13%
New Zealand	AA	1.99%
Australia	AAA	1.62%
United States	AA (High)	0.67%
Canada	AAA	0.56%
United Kingdom	AA	0.15%
Spain	BBB(High)	-0.13%
Japan	A (High)	-0.24%

Data Courtesy of Bloomberg LLP

Looking at 2-year government bonds, chasing yield continues to be the rage, thanks to negative rates in Japan and most of Europe (*only Portugal (+0.67%) and Greece (+6.40%) have positive 2-year rates*).

As a result, investors are putting money into emerging market countries, most who have a positive balance of trade and/or a high amount of foreign currency reserves. Mexico, Indonesia, India, Colombia and South Africa all have 2-year yields greater than 5%.

Preferred Shares

2016 YTD Returns (at June 30, 2016)	
Type of Preferred Share	Gain/Loss %
Canadian Perpetual Preferred Shares	+2.36%
Canadian Variable Rate Reset Preferred Shares	-9.42%
BofA Merrill Lynch US Perpetual Preferred Index	+4.94%

As interest rates continued to decline in 2016, perpetual preferred shares performed well. That's because with a fixed coupon and falling rates, investors will pay more to get the higher rate guarantee.

Meantime, the rate reset preferred shares fell because their coupons reset at lower rates, leading to a drop in price for these securities.

To deal with this risk, Liberty's ownership of preferred shares is about 75% in perpetual preferred shares and 25% in rate resets.

Finally, U.S. preferred shares are up year-to-date but are now trading at a premium to their $25 par values and not worth owning until those prices fall below par.

2. Our Views on the British Referendum

Here's a famous Vladimir Lenin comment: "There are decades where nothing happens, and there are weeks where decades happen." Except in the case of Brexit, the time frame was hours, not weeks.

The most noteworthy item from the vote was that the youth preferred to stay while the older folks voted to leave. Unfortunately, it will be the kids who will be left to deal with the whole mess.

At Liberty, our investment stance has been to look beyond the short-term and stay focused on long-term opportunities. That's because companies will adapt to whatever the politicians throw at them.

Where a company derives its revenue stream is more important than where it is domiciled. At the height of the Greek financial crisis in 2011, we chose our European stocks to have no more than 40% of their revenue streams from Europe (it's currently at 35%). The Brexit vote didn't sway our thesis.

Here's a chart of a breakdown of the revenues derived by geographic region, sorted by the Liberty Canadian, U.S. and international names:

Revenue Mix by Geography				
Domicile of Company	**North American Revenues**	**European Revenues**	**Asia Revenues**	**Other Revenues**
Canadian Companies	82%	10%	5%	3%
US Companies	72%	9%	7%	12%
International Companies	33%	35%	20%	12%
Overall Liberty Revenue Mix	62%	18%	11%	9%

Since 82% of Canadian companies' revenues are confined to North America, it's important that investors seriously consider investing globally. That's because international returns over a 20-year time horizon have been 2% higher compounded annually, adding another 50% in value to investor portfolios.

3. FUN WITH MATH: Chasing Returns - A Common Investment Mistake

Some investors chase returns of fund managers, hoping that they've latched on to the next Warren Buffett. Unfortunately, past returns may not predict future returns and may leave some investors disappointed (or broke).

Here are some things that investors need to consider before they chase returns and put money into the hottest fund:

- ***How do the returns compare to the underlying benchmarks?***

If the fund earns a 30% return in one year while the market benchmark is up 10%, was this due to the portfolio manager's talent or because they took on 3 times more risk than the market? That's where the Sharpe ratio comes into play. How much return was made for each dollar of risk taken on?

- ***Are the fees higher than average and what can you imply from that?***

Some hedge funds have a fee schedule called "2 and 20". This means the annual fee is 2% with a 20% "performance" fee based on the percentage the fund exceeds the underlying index.

For example, if a fund makes 30% and the index is up 10%, the fund would be paid a flat 2% management fee plus a 4% performance fee (20% x 20% performance above the index).

Note that this type of fee structure inspires gambling, meaning the fund may make a few sizeable bets that, if they pay off, can make the fund managers quite wealthy. It fulfills the "Greed is good" attitude of the industry, also known as "playing with other people's money".

Big bets, however, can also lead to big disasters. There once was a fund that, from 2003-2007, advertised 30+ percent annual returns that attracted many investors. Those who put money into the fund in 2007, sadly, saw their capital plunge 75% in 2008.

Think about it. Every $1.00 invested in 2007 dropped to $0.25 cents in 2008. That meant the fund would have had to make a 400% return to get back to break even. There's little chance this would happen in anyone's lifetime.

The tragic thing is it wiped out the investors' capital. Worse still, the portfolio managers were able to move on, raise more capital and start a new fund. Moreover, because it's a new fund, they don't have to post their past performance returns.

- ***What caused the big performance years? Will this continue?***

Was the big performance earned when the fund was just $50 million in assets under management? Were the bet sizes larger-than-average such as a 40% ownership in a fast-rising stock like Valeant Pharmaceuticals? Were the investments in illiquid names where few shares were traded daily and one trade could move the price?

If any or all of these occurred, the odds are that the fund grew exponentially in asset size as investors jumped on board to participate in the "hot" fund. Eventually, a reversion to the mean should occur, causing lower returns for future investors.

Unfortunately, returns aren't linear and investors shouldn't expect that. The asset mix and the portfolio risk will determine a "range" of returns. For example, a balanced fund of 50% stocks and 50% fixed income should provide a range of returns of plus or minus 20% in any one year.

- ***What's the size of the fund today compared to the size when it first began?***

Often, when a fund reaches $1 billion in assets in Canada, its returns begin to mirror the index. The portfolio managers can no longer own the small-cap stocks they may have preferred in the beginning because they can't buy and sell quickly. They have to invest in more "known" companies such as the banks, telecoms or utilities which have slower growth profiles, thus reducing future returns.

Now for the math.

Think of an investor who was 62 in 2015, had $1 million in investable assets, wanted to retire in 3 years but needed $100,000 before taxes to live on.

If a perceived safe, annual drawdown is 4% of their assets ($40,000), they'll be short $60,000 to get the $100,000 a year they need, meaning they'll have to eat into the capital, increasing the odds that the money may disappear before they die.

Therefore, they may believe they need a bigger return to achieve their goal. They look at a performance prospectus for a fund and see these numbers:

Value of $1 million invested ***(less $100,000 annual drawdown*** **and** ***2 & 20 fee structure)***			
Year	**Fund Return**	**Index Return**	**Year End Balance**
2009	88.17%	35.04%	$1,781,700
2010	22.94%	17.57%	$1,813,859
2011	5.31%	-8.72%	$1,751,533
2012	9.22%	6.16%	$1,721,085
2013	51.63%	14.06%	$2,441,516
2014	22.68%	10.82%	$2,610,284

Based on these returns, the investor could envision the ability to take out $100,000 a year to cover living expenses and still make good money. It may have caused them to sign up in 2015 with the expectation that they could accomplish their goals.

Instead of the returns above, however, they got this:

Value of $1 million invested ***(less $100,000 drawdown less 2 & 20 fee structure)***			
Year	**Fund Return**	**Index Return**	**Year End Balance**
2015	4.06%	-8.32%	$898,498
2016	-5.63%	9.83%	$732,955

If the future performance continues to be poor, the investor would certainly be at risk of running out of money in their lifetime. What hurts more is that in just 1 ½ years, a total of $57,059 in fees was paid, an annual fee average of 2.60%.

If you think that's bad, the first illustration from 2009-2014 produced fees of ***$910,999***, or an annual rate of 3.57%, equivalent to half the growth in the portfolio. The manager made as much as the investor.

This is why regulators have to get rid of 2 and 20 fee plans altogether. The argument may be that these funds are for "accredited" investors, those who have enough net worth to take the hit if things go badly.

What the regulators are missing out on is the fact that the 2 and 20 fee plan is just a cash grab for greedy fund managers and it may cause an entire generation of investors to run out of money in their lifetime. That doesn't sound like investor suitability to me.

The moral of the story is this:

1) Stop chasing returns. If the posted returns are well above-average, ask yourself why and at what risk?

2) Fees can kill overall returns and may prevent you from achieving your investment goals.
3) Usually when posted returns are high in any one year, the fund size may be small.
4) Past performance is no indication of future returns. It's more important to have an investment philosophy and objective that accomplishes your goals over time, not in one year.

4. Client Questions

1) Despite the appearance of an expensive stock market, could it still go higher?

The answer is yes. Momentum investors chase returns (it's happening in today's markets) and momentum strategies can last for a year or two before they die a painful death. If you believe, like we do, that equity valuations are stretched, it's important to be cautious and prudent.

Some strategies that we use during these times are:

A) Buy gradually. If you have $10,000 to allocate to a stock, spend $5,000 instead and wait for a better opportunity. If the stock goes higher and reaches the $10,000 limit on its own, then you can use the $5,000 you had left over on something else.

B) Use limit orders to buy stocks. A limit order is a market order at a specific price. We did this before the Brexit vote, hoping to buy European stocks at a 20% discount. Unfortunately, it didn't work because there was no market capitulation – prices didn't drop 20%.

C) Don't buy everything at once. If you're just starting to buy stocks for a 30-stock portfolio, you don't have to buy all 30 today. Note a price you're willing to pay for a stock and wait to buy it at that level.

D) Selling put options can be an effective buying strategy. Selling a put is really an order to buy a stock at a lower price than it is today. The added bonus is that you receive a cash premium from the put buyer. If the stock price falls to that level, the put option is exercised and you buy the stock at that price. Your cost is the price less the premium received for writing the put.

For example, say you wish to own CIBC shares. You could buy it today at $98.49 and get a yield of 4.91%. If, however, you sold a put on CIBC shares at $94 that expires on January 20, 2017, you would receive $3.80 for doing so.

If, before January 2017, the stock falls to $94, the put would be exercised and you would own the shares. Your cost would be $90.20 ($94 - $3.80) and the yield would be 5.4%, a more attractive trade than just buying the shares today.

At Liberty, we don't trade options because they're too risky and client mandates are to not take on this type of risk. For other investors, selling put options is the only one of the four options trades that we'd ever recommend. The other option strategies lose 83% of the time because of the high costs of trading commissions and bid/offer spreads involved.

2) *Gold and silver are going higher. Shouldn't we have some in the portfolio?*

Here we go chasing returns again.

On a fundamental basis, we're not currently enamoured with owning gold and silver stocks because they have lousy balance sheets, high levels of debt and huge operating costs. The only thing propping up their share prices today is the rise in the spot price of gold and silver.

Also, many of these companies do business in third-world countries that add another level of risk to the investment. If a country's government decides to retroactively pull the company's mining permit, shareholders will be out of luck.

In case there might be a better alternative, we recently looked at an exchange-traded fund (ETF) called the Spider Gold Shares Trust (GLD NYSE). The investment objective of the Trust is for the shares to reflect the performance of the price of gold bullion, less the Trust's expenses. The expense ratio is 0.40%.

The Trust holds gold and is expected from time to time to issue Baskets in exchange for deposits of gold and to distribute gold in connection with redemptions of Baskets.

As of this writing, the spot price of gold was up 26% year-to-date but GLD was up only 25%. Owners of GLD are earning 4% less than the gold spot price.
My guess is there are transaction costs on top of the 0.40% expense ratio when baskets of bullion are added or redeemed. Therefore, this ETF is not a perfect match to the price of gold.

Instead, I would prefer that if investors really want to own gold, they should buy some gold wafers and store it in their safe deposit boxes. They'll pay a commission up front for the purchase and there will be annual safekeeping fees but those costs should be lower than the cost of owning the ETF.

If you have any further questions, let me know.

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