Winter 2017

Investment management

As 'value' investors, we expect to beat our benchmarks over the long-term, as value compounds over time. The challenge with value investing is managing underperformance in the short-term. We've been fortunate that our adaptive core-satellite processes have enabled us to beat our benchmarks in recent years, but that wasn't the case in 2016. While it may not be realistic to win every year, we hate not winning. So where did we get off track in 2016?

Overweighting stocks in general and underweighting bonds was a winning decision, as was overweighting credits; however, increasing our international equity exposure while not hedging currency proved to be a drag on performance. Despite arguably poor fundamentals and a high valuation, the S&P/TSX Composite Index was one of the best performing markets in the world along with the CDN$. While interest rates were in free-fall for much of the year, the surge higher post US election wiped out most of the gains in government bonds by year-end.

We started 2016 believing that stocks, on average, would outperform bonds, based on comparable earnings yields at the time; however, North American equity markets were arguably overvalued. There was better value to be found in international equities- particularly in emerging markets. Economic fundamentals, monetary policy bias, and the geo-political environment continued to favor the US$, while the demand/supply fundamentals for physical commodities were still unbalanced. Therefore, we kept our exposure to foreign currencies- particularly the US$ and maintained our boycott of resource stocks. That looked to be the right call at the start, but by mid-February resource prices got a speculative bid, and so did Canadian stocks and the CDN$. By May, we had hedged half our US$ exposure back into CDN$, followed shortly by hedging our international currency exposure. We managed to get back on track relative to our asset mix benchmarks in the second half, and while we were able to beat our bond benchmark, we weren't able to catch up to our equity benchmark by year end.

Our risk management focus has always helped us side-step market sell-offs, which is a good thing in the long-run. While we tend to be slow out of the gates when it comes to the start of new bull markets, we've responded with strong finishes. The bounce off the bottom in 2009 reinforced the idea that markets can move higher without fundamental support. As a result, we started using technical analysis and tactical asset mix ranges to bring us to the party earlier while we wait for the fundamentals to catch up. 2016 has reinforced the significance of momentum, and if interest rates have finally bottomed and are on a secular path higher, quality is likely to become a significant factor going forward. So what's new for the year ahead?

I recently tweeted (follow us on Twitter @NavigationTeam) a summary presentation “Will Your Factors Deliver?” by Jason Hsu, Ph.D. of Research Affiliates, on the robustness of certain factors to deliver returns. This presentation, along with the supporting research paper, has given us new definitions to screen for value, quality, low volatility, and momentum. When it comes to value, we will focus on relative price/equity (P/E) and dividend yield (D/P). Our ROE will be our measure for quality, relative beta for volatility, and we now have a simple definition of momentum we can screen for. We’ve adjusted our buy/sell discipline around target prices and stop-losses to better manage and balance the costs/benefits of turnover and rebalancing – adaptive asset allocation that lets our winners run while cutting our losers early. As a result, here’s how we’re positioned to start 2017 and here’s what we currently expect:

- We’re fully invested with an overweight in equities and an underweight in bonds. We believe the earnings yield on equities and the current monetary policy and interest rate environment supports this. We prefer North American stocks over international stocks, and we prefer credits over government bonds. We’re still boycotting resource stocks in our core holdings, but we have invested in resources as part of our tactical range based on seasonality and momentum. The currency landscape is getting tougher to manage given recent geo-political developments, so we’re hedging most of our foreign currency exposure, including the US$, back into the CDN$. Infrastructure spending continues to be a global theme, and represents a significant part of our equity positioning.

- ‘Brexit’ and President Donald J. Trump represent a growing nationalist movement in response to the social disruption and displacement of globalization. We believe this movement represents at most a pause/rebalance to globalization, not an end, but the economic equation is more confusing. It still appears that economic growth is the focus of policy makers so that everyone will at least get a piece of the pie. Whether everyone gets their fair share of the pie will likely depend on what are the right regulatory/trade/tax policies versus having more/less policies. In the short-run, the rest of the world will likely be in a wait-and-see mode, reacting to President Trump’s ability to implement policy. In the short-run, it’s expected his domestic regulatory and tax policies will be good for jobs and corporate profits, so US stocks are at the top of our list. Stock selection will be tricky based on President Trump’s demonstrated willingness to single out individual companies and sectors.

In summary, our wealth management processes, focused on client objectives, and our adaptive investment management processes, focused on risk management, are appropriate given the increased uncertainty ahead.

Gordon Bell
Portfolio Manager

Any color you want
Most people misunderstand marketing. It’s usually thrown in with sales and assumed to be just another way for some company to sell you whatever it is they’re selling. The truth is marketing is the natural evolution of the standard sales approach. Henry Ford, when referring to color selection on the Model T offered, "Any customer can have a car painted any colour that he wants so long as it is black." Today the consumer is king; the sheer number of possibilities is mindboggling. If you go into a retail clothing store today to purchase a pair of jeans, the days of single wash Levis 501s are over. You have a selection of washes from faded out to almost black. You have straight cut, boot cut, tapered fit and skinny jean. Go to a restaurant today and try an order a burger: whole wheat, regular or gluten free; how would you like it cooked; fries salad or half and half?

In virtually every industry the range of selection and the ability for people to have an active role in the process has increased exponentially. Financial services is no exception, the delivery systems, investment choices, fee or cost options and service levels are all part of the decision making process, or at least they should be. For many in the full service side of the industry though, there is still a desire to offer clients, not necessarily what they want or need but what is best for them to offer. This attitude tends to go with the cookie cutter approach to wealth and financial management. The one size fits all solution.

As clients become more knowledgeable about their options, they begin to ask more questions and want a more detailed, transparent approach to help them make decisions. They want to know all of their options and what are of the best solutions for them.

Unfortunately, taking the time to do the back work and produce a proposal that helps clients to make decisions eats into the profitability of the old practice models - as they say, time is money. I remember a conversation with a friend of mine after the 2008 market meltdown. We would often debate the industry and the markets, while they were only involved as an investor, they enjoyed the conversation. Her comments have stayed with me for a number of years. She said that prior to 2008 we were willing to pay our Wealth Advisor the fees because we believed he could protect us from an event just like this one. After going through this correction we've realized that he didn't have the ability to protect us, in fact no-one does, and it's just a question of managing the risks, not avoiding them. The question then is why should we pay these fees if they can't protect us from the markets?

The simple answer is that managing your financial future is about more than absolute returns. Certainly there are steps one can take to minimize the downside of the markets, but the price is lesser upside. Having a successful retirement isn't only about the money; it's about lifestyle, health, accommodations, personal legacy, social networks and interests. It's about the peace of mind that comes from knowing you have yourself on track.

There are many people in the industry who understand this shift and have created processes to make sure that not only are their clients well informed but also comfortable with the solutions; that they have been part of the process and understand they're investing their money the way they are. The discussion should start at, *what is it you're looking to achieve*, *what kind of lifestyle would you like to live, what are your hopes and dreams*? These are all legitimate questions when planning your financial future. It doesn't guarantee you'll get to where you want to go but it does increase the likelihood of arriving there and it also gives you a clear picture of what it is you will need to do.

Selecting the right investment products shouldn't center around, "what was the best performer last year, or which fund has the lowest MER?" Don't get me wrong, these are important factors for sure but they must be taken in context with considerations like your time frame, your risk parameters, your income needs, the amount of participation you want to have, your reporting expectations and your financial situation. There is a right solution out there for everyone; the key is to understand that it isn't the *same* solution. It's different for each client and if you're being told that it isn't, what they're really saying is that it's easier this way.

You're being told that you are welcome to any colour you want as long as it's black.

Jeff Stathopulos
Portfolio Manager

Important dates to remember

Tuesday, February 14th – Valentine's day
Monday, February 13th – BC day

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