Summer 2016

Investment Management

A difference of opinion

I thought I'd do something different with this edition of our investment outlook, and refer you to Scotia Wealth Management's most recent print of "Here's What We're Thinking" (you can also find a copy via our website under Knowledge Centre/Ideas & Inspiration). Scotia Wealth Management does a good job of covering all the issues, but I thought I'd highlight The Navigation Team's opinion and the resulting investment strategy.

Global capital markets have staged an impressive recovery over the past month, thanks to a string of better than expected US economic data, and better than feared second quarter earnings reports. 'Brexit' fears are subsiding, and governments are increasingly turning towards fiscal policy measures to boost economic growth while central banks continue to ease monetary policy. The thing to keep in mind is that the US earnings beat is largely the result of lowered earnings expectations, the dramatic drop in the US dollar, and consumers/corporations borrowing to finance spending; and now it looks like the US government is once again going to increase debt to finance fiscal spending. As other central banks and governments pursue the same strategy, this is going to result in uncertainty in the currency markets and continued low, or even negative interest rates. While this might result in asset valuations moving higher in the short-run, expect more volatility as yield trades get more crowded, or growth fails to materialize. We agree with Scotia Wealth Management favouring value; where we differ is that we're looking to take profits on gains instead of deploying cash on pullbacks.

It is my understanding, that for the first time in history, the bond market and stock market in the US reached all-time highs at the same time. In a low (and even negative) interest rate world, global investors are being herded into higher yielding, but riskier trades. Dividend yields are higher than bonds yields, which in my opinion should be the norm as compensation for more risk; but while earnings yields are three times that of bond yields, it's important to look at the quality of the earnings. Many companies are borrowing to finance the buy-back of their stock; this financial engineering pushes up earnings per share (EPS) which also partially explains the earnings beat. It's debatable whether-or-not stocks are cheap/expensive, but we will continue to own stocks with quality balance sheets, sustainable dividend yields, growing earnings, and that trade at a reasonable price. We would agree with Scotia Wealth Management that interest rates will remain contained over the medium/long-term by global macro-economic factors, perhaps even falling further; as a result, we're investing in long-bonds and high yield bonds. All else being equal, this enhances the yield we receive, while partially offsetting the effect of a rise/fall in interest rates in the short-term.

Scotia Wealth Management™

The Navigation Team
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When it comes to our recommended asset allocation, we do prefer stocks over bonds, for the reasons mentioned above. US stocks look more attractive than CDN stocks from a valuation standpoint, and we're leaning towards an infrastructure theme when investing in international stocks. In general, we continue to remain underweight in bonds, but we're overweight corporate bonds, and we're looking to tactically add to long bonds and high yield bonds. We don't have any direct exposure to the preferred share market. Currency markets have been tougher to navigate this year amid possible policy intervention by central banks, but in general, we're bullish on the US dollar, and we're looking to increase our exposure. As an alternative to holding cash, we've initiated a small position in gold and silver bullion.

Gordon Bell
Portfolio Manager

Real estate or stocks?

This is always a lively debate. I've been in the investment business since 1993, and so my default has always been to argue in defence of the stock market. There have been times when it's been an uphill battle: the tech crash of 2000, the great recession of 2008, or 2011 which was just plain bad. While the markets have come back considerably, the beginning of this year was a disaster for stock owners as well, particularly if you were in energy or metals.

Moves in the equity markets as we like to call stocks, tend to be faster and more volatile. Watching house prices is a bit like watching paint dry. There's nowhere to get daily values. Unlike your stock account where you can check at all hours of the day and get an up to the minute valuation, you must order an appraisal to determine the value of your property. Alternatively, you can use the rule of thumb method using your assessed value, or the guesstimate: comparing your house to the most recent sale in your neighbourhood, and adding or subtracting where you think you're better or worse.

At best, it's not an easy comparison to make as they often serve different purposes, a stock portfolio can be for investment purposes or a means to generate income; a home, while also an investment is a place to live, a vehicle to generate income or a means to grow your investment dollars.

That said, let's try and compare some of the obvious differences between the two. I'll stick to the ones we can measure and leave the intangibles to someone else.

Liquidity
Stocks win this one hands down; you can liquidate a position immediately and have the cash in three days. Selling your house is a whole different process. Unless you're in a market like Vancouver, you'll need to hire an agent, get an appraisal, list it, market it, show it and after all that hope that someone agrees with you on the price you're asking. It's all trial and error really; if you set a price and get an offer right away, you're concerned that you listed it too low, if you get no showings you've probably listed too high. Stock market one, real estate zero.

Taxation

Here's where real estate starts to blossom. If it's your primary residence you don't pay any tax on potential gains (assuming you've lived there longer than 12 months). If it's an investment property that you're collecting rent on, it gets more complicated. While repairs, taxes, interest, maintenance and utilities may be tax deductible, rents and capital gains are usually taxable. With stocks, unless you've purchased the investments in a registered account, all deemed dispositions other than at your cost base are considered gains or losses for tax purposes. Most equity distributions are taxable unless they are returns of capital (dividends, interest, or in the case of some mutual funds, capital gains). Interest on loans for investment purposes is generally deductible whether it's real estate or stocks. If we're simply assuming that your choice is to put your capital into a stock portfolio or your principal residence, real estate takes the round. Stock market one, real estate one.

Utility

Let's face it, while stocks represent a proportionate ownership in a company, there's not much else you can do with your share certificates other than follow the price and vote at the annual general meeting. If you doubt that statement, think about the box your old Nortel certificates are in. Real estate on the other hand is a tangible investment. You can live in it, grow vegetables in your back yard, raise your kids in it or rent it out. One way or the other it exists in a form that can be used for something other than investing. Stocks for the average investor simply represent the opportunity to grow their initial investment, to earn a dividend from the company, or both. Real estate two, stock market one.

Ease of ownership

Owning stocks cost you nothing once you've made the initial purchase. No property purchase tax, no strata fees, no property tax, no new roof and no insurance. You don't have to get up at three in the morning to fix your tenants plugged toilet in your stock portfolio. Real estate two, stocks two.

Rate of return

So let's look at the bottom line, what are the real rates of return all other issues aside? Let's leave out the specifics of anomalies like the current Vancouver real estate insanity, the US meltdown in 2007 and 2008, the dotcom bubble leading up to 2000 and all the other deviations from the long term rates of return that we've experienced.

> *National price data from the Canadian Real Estate Association shows an average annual gain of 5.4 per cent nationally from 2004 through 2013 for resale homes. The comparable average return from stocks was just under 8 per cent. If we go back 20 years, we get an 8.3 per cent gain from Canadian stocks and an increase of 4.5 per cent in the average national house price. Over 30 years, stocks made 8.5 per cent and houses 5.5 per cent.*
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> -Rob Carrick, The Globe and Mail, Friday, Apr. 04, 2014

The difference is timing. Depending on the period you choose to measure your returns over, you could make a case for either investment over the other. For those of us not arguing the relative value of these two investments, the advice is always the same; the best way to protect your investments is to diversify them. So the answer, as convenient as it might sound, is that if you're able, own both.

Jeff Stathopulos
Portfolio Manager

Important dates to remember

September 5th, 2016 - LABOUR DAY

Gordon Bell, MBA, CFA, CAIA
Portfolio Manager
Tel: 250.868.5522
gordon.bell@scotiawealth.com

David Allard, MBA, CFA, CFP, MFA
Portfolio Manager
Tel: 250.868.5525
david.allard@scotiawealth.com

Jeff Stathopulos, CIM, CFP
Portfolio Manager
Tel: 250.868.5521
jeff.stathopulos@scotiawealth.com

Lynette Kimmich, CIM
Senior Associate
Tel: 250.868.5517
lynette.kimmich@scotiawealth.com

Alanna Cooper, CIM
Senior Associate
Tel: 250.868.5519
alanna.cooper@scotiawealth.com

www.yourlifeyourplan.ca