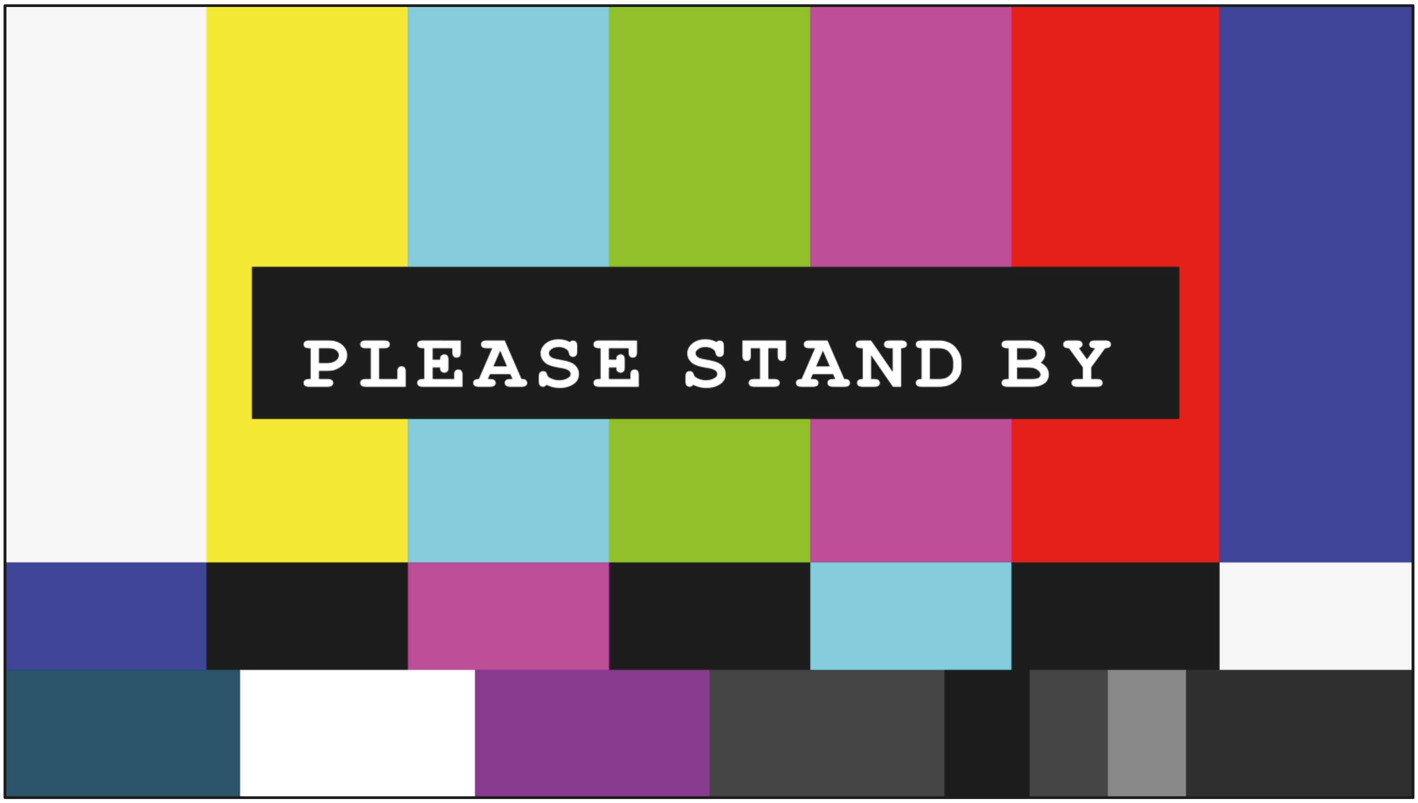
Navigating Change

Murray Leith, CFA
Executive Vice President,
Director, Investment Research



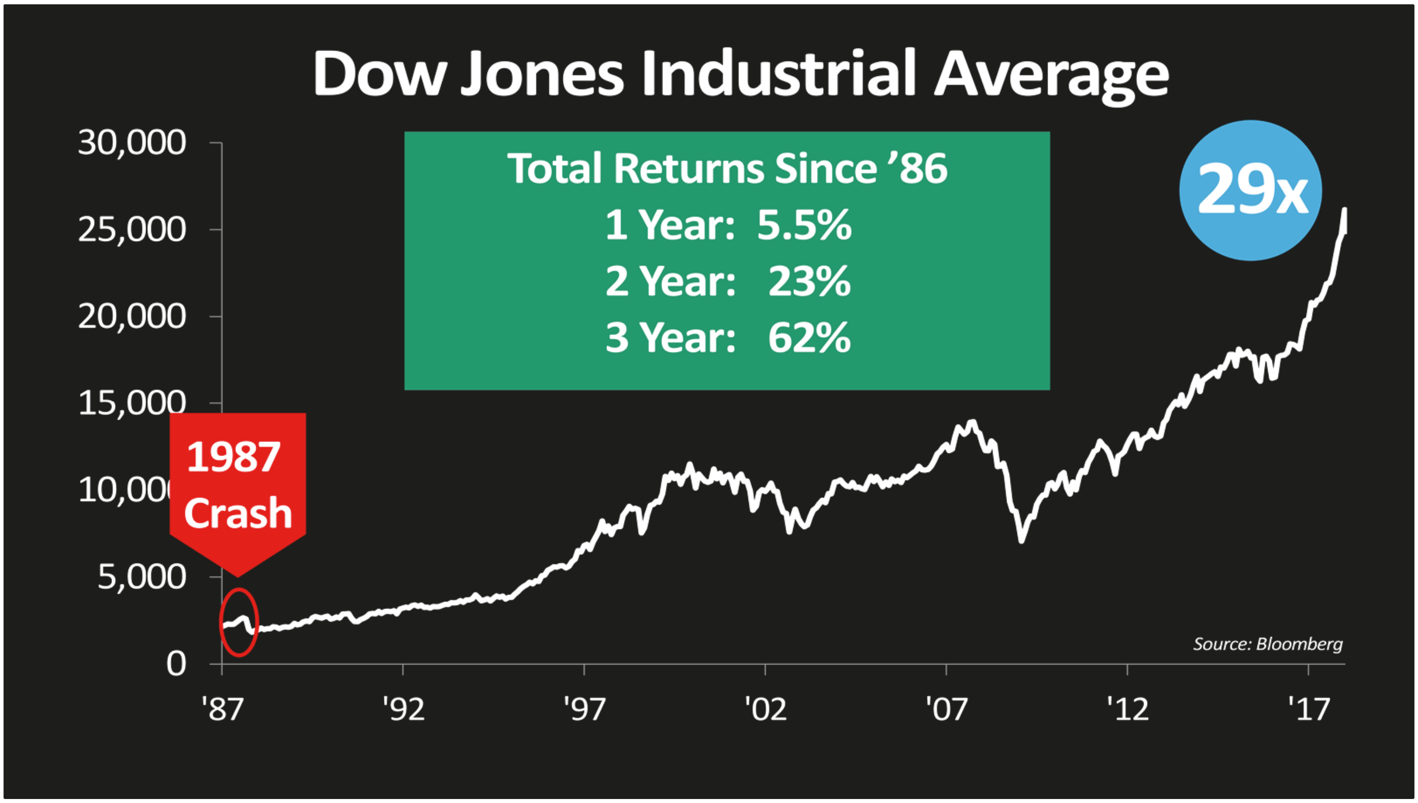
Unfortunately, we had to make a change to our planned presentation given the big swings in the market recently.

I suspect some of you are a little nervous, and I don't blame you given how the media sensationalizes the market action with alarming statements like the "Dow Jones Industrial Average has its biggest daily point drop in history."

A little perspective is in order. It's percentages, not index points that matter. While the Dow's 1,175 point decline on Monday, February 5th was indeed the biggest ever, it was less than 5% in percentage terms – far from the worst!

The Black Monday crash in 1987 was less than half the Dow points – 508 – but in percentage terms, the decline was almost 5 times as bad at 23%.

That was the biggest one-day drop in history! From peak-to-trough, the Dow experienced a 36% correction in 1987. The recent correction was about 10%.



This is a long-term chart of the Dow Jones Industrial Average, which tracks the performance of 30 well-known U.S. companies including Apple, McDonald's, Coca-Cola and Visa.

Looking back, the '87 crash is merely a blip in a long march upward. Despite the correction, the Dow still returned 5.5% in 1987, including dividends. Over 2 years, the return was 23%; in 3 years, it was 62%. And, if you were lucky enough to hold the Dow to today, and reinvested the dividends along the way, you would have a 29-fold gain.

I make the comparison to 1987 because the economic backdrop and investor attitudes were similar to conditions today. The economy was strong, inflation was picking up, and the Fed was raising interest rates. The market had a huge run up in 1987, similar in magnitude to the advance since Trump was elected, and people got used to a one-way market. When a turn came, too many people tried to rush for the exits at the same time and that caused people to panic.

The market recovered in 1987 because the underlying economy was strong, and we think the same will be true this time. Now that you know you that you don't need to panic, let's get back to the regularly scheduled program.

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The theme for our Annual Address is “Change,” and the opportunities and challenges it creates. We are faced with a lot of change in the world today, whether it be political, economic, technological or environmental, and we are bombarded with information and advice on how we should react.

The interesting thing, when we look back on 2017, is we have never reacted less. The turnover in our all-equity Model Portfolio was a record low 7% last year – *we only did 8 trades!*

Our turnover is generally pretty low because we believe in owning great companies for the long term, and don’t like to pay capital gains tax along the way. But turnover was particularly low last year, because we didn’t see reasons or the opportunity to add value by making changes. We simply like the hand we are holding, and until the economic outlook changes dramatically, or valuations increase significantly, or other stocks look more attractive than the ones we own, the best strategy is to do nothing.

I don’t want to give you the wrong impression. We think it is important to be mindful of emerging trends and changes, and we are going to speak about a number of things that are in the headlines and possibly on your minds today, including the economic cycle, President Trump, the legalization of marijuana, Bitcoin, investor attitudes, exchange rates, oil and the impact of electric vehicles on oil markets, self-driving cars and artificial intelligence.

Before we get to that, I want to talk about the two things in our world that really don't change (like the rain in Vancouver) – human nature and sound investment strategy.

Human beings are not good investors, because we are emotionally hard-wired to do the wrong thing in the face of volatile markets. It is easy to say "buy low and sell high," but our emotions often cause us to do the opposite. We are more comfortable and confident buying stocks when the economy is doing well and stocks are rising, and we tend panic and sell when the opposite is true.

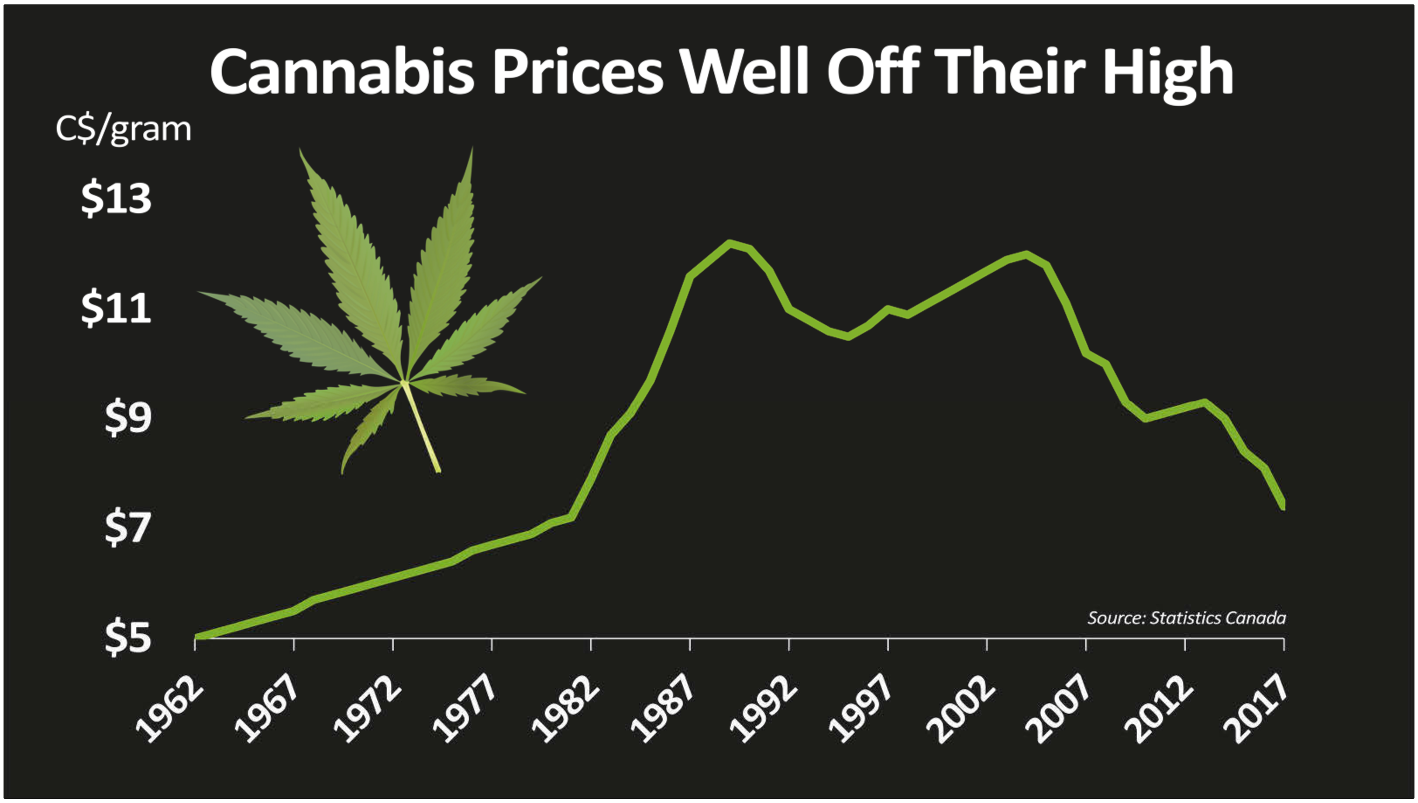
Investment success comes from adhering to a few time-tested principles and not letting your emotions get the best of you.

Have a Plan. Figure out the long-term asset mix – stocks, bonds, real estate and cash – that makes sense for you relative to your goals and tolerance for risk. This mix can change slowly over time, as you age and circumstances change, but it shouldn't change meaningfully year-to-year.

Know What You Own. The stock market can be bumpy, and the more familiar and comfortable you are with the businesses that you own, the greater the chance you won't sell at the wrong time. It's also important to know what you don't know. I've spent my career specializing in conservative blue chip investing, and that is what we do best at Odlum Brown. We are not venture capitalists, and we don't speculate in early stage businesses or industries.

Recently, we have fielded many questions about the marijuana industry, given the pending legalization of pot in Canada and the fact that the stocks in the sector are riding high. We don't doubt that there will be some big winners in the sector, but there will be big losers as well. It is very speculative and the risk profile of speculative investing is much different than the risk profile of blue chip investing.

Think about the massive buildout of the Internet at the turn of the century, all the excitement that it created around dot-com companies, and all the carnage that followed.



While there is no doubt that the legalization of marijuana will increase demand, there is also a ton of new supply on the way. Investors are assuming that the big growers will have fat margins, yet we are not sure that is a fair assumption. Pot prices have fallen 30% over the last 10 years, and the trend will likely continue with all the new supply. In any event, we are not recommending marijuana stocks because early stage investing is not our businesses.

We feel the same way about cryptocurrencies like Bitcoin. They are speculative, impossible to value, and not our game. On the other hand, we are interested in blockchain, the underlying technology that supports cryptocurrencies. It has the potential to significantly lower costs for many of the financial companies that we own.

I used to invest in speculative ventures from time-to-time, but got tired of doing worse than our clients. Experience has taught me that slow and steady wins the long-term race, which is the third important principle.

Think Long Term. In this day and age, we are overwhelmed with advice on what is going to happen next week or next month. Everyone is trying to outsmart the other guy, and nobody is consistently good at it. Ignore the hype and think about where the economy and businesses are going to be in 3 - 5 years, or even longer-term.

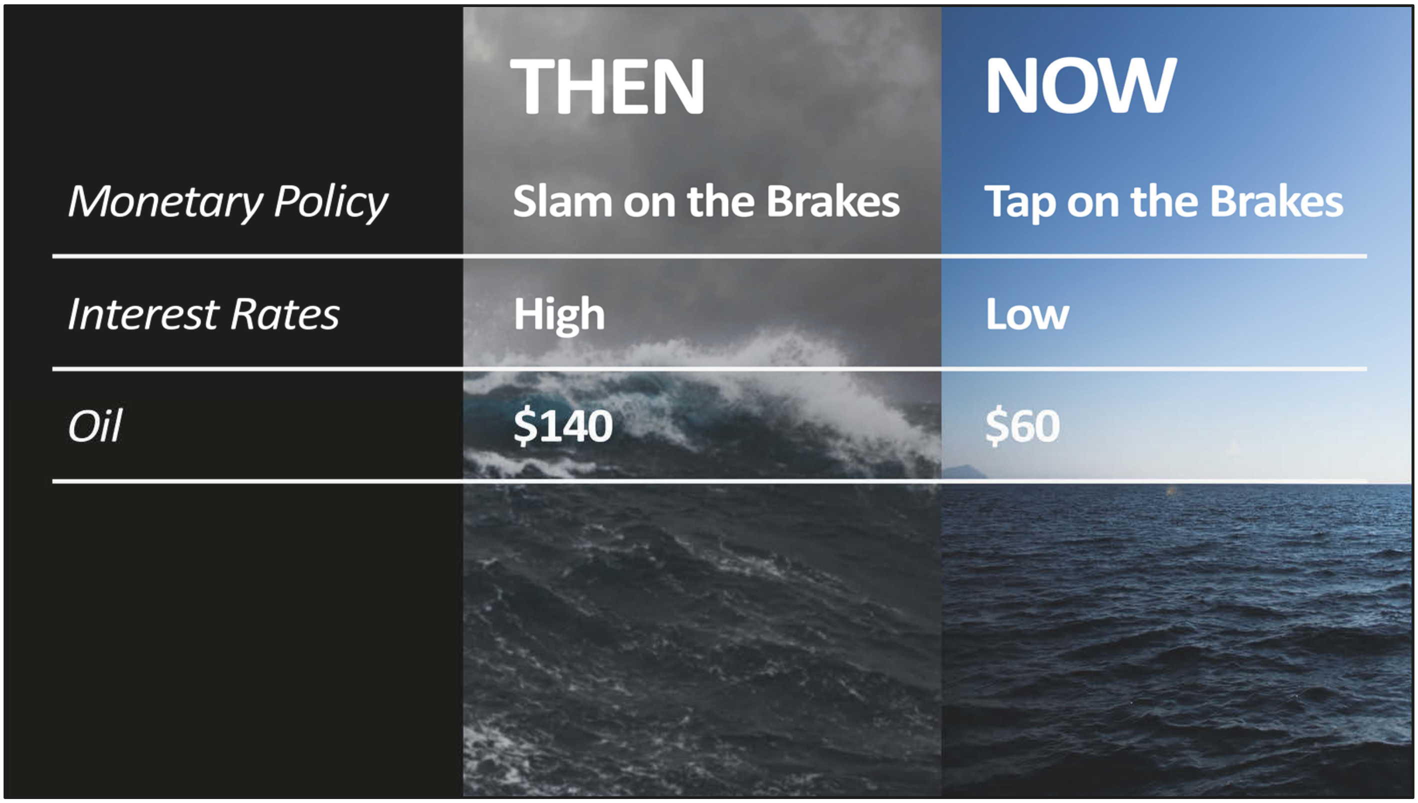
Don't Time the Market. Those who jump in and out of the market, trying to avoid the next recession or market correction, invariably do much worse than those who stay invested because they spend too much time missing out. You might make a few good calls over a lifetime, but you will blow it enough times to significantly undermine your long-term returns.

Have Reasonable Expectations. If you are going to invest in stocks, you are going to own some losers. It's the batting average that matters, and you will do very well over time if you have more winners than losers. The best year for our Model Portfolio was the year 2000. We were up more than 40%, yet we had lost money on one-third of the stocks in the portfolio that year. You also have to expect corrections from time-to-time. We have a great 23-year track-record, and not once did we tell clients to get out before a correction.

That doesn't mean that we don't worry or have strong views from time to time. We do, and I'll tell you about some of our strong opinions in a moment.

First, let me explain why we are not particularly worried about the economy by comparing our current thoughts with those that we held 10 years ago in 2008, before the Great Financial Crisis.

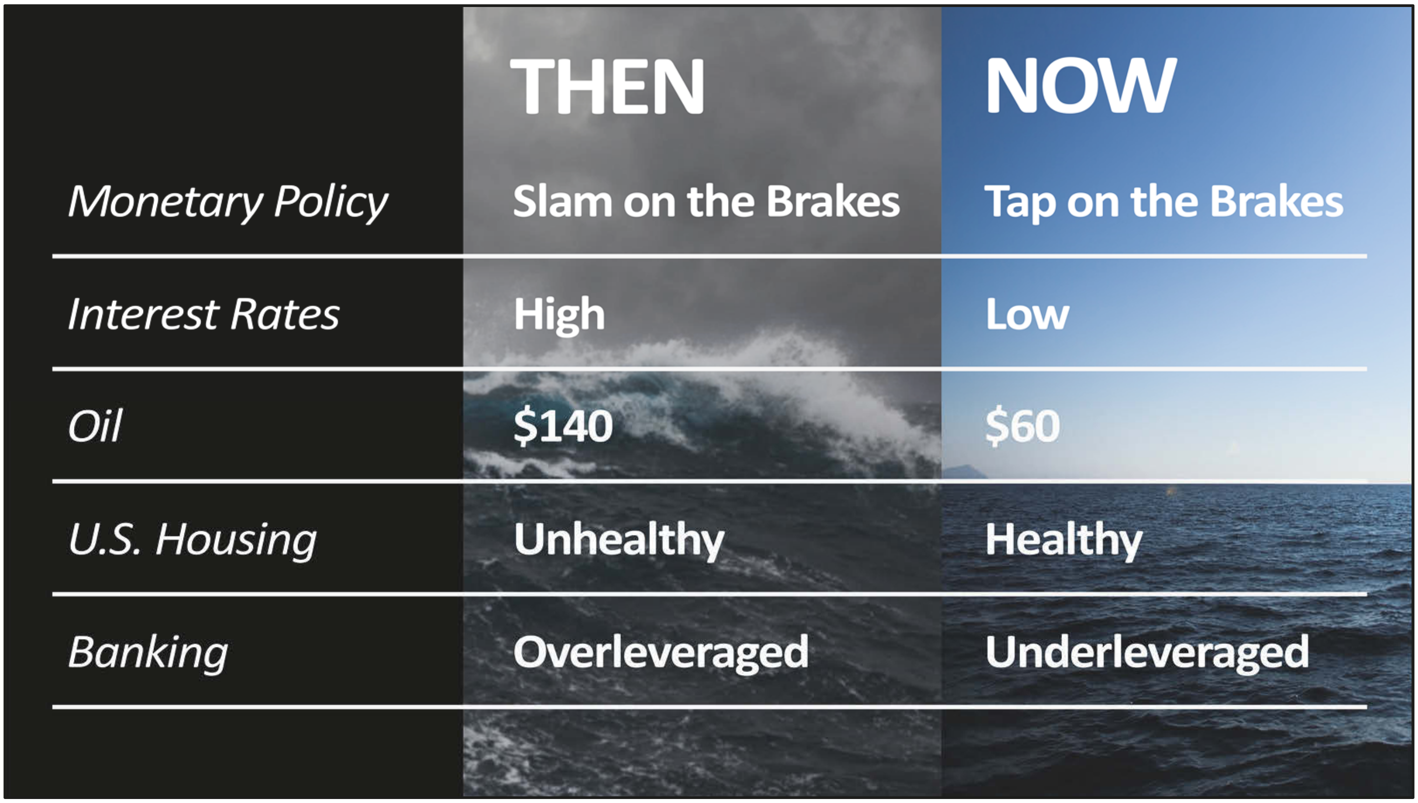
In 2008, there were storm clouds on the horizon; whereas, the skies look pretty blue today. Let me go through the list of things that are different.



In 2008, monetary policy was a big negative, as central banks had really slammed on the economic brakes by raising interest rates. Between 2004 and 2006, the U.S. Federal Reserve increase administered interest rates by 4.25%, from 1% to 5.25%. This cycle, the Fed is tapping on the brakes and has only increased interest rates from 0.25% to 1.5%.

The general level of interest rates was much higher back then. Both short-term and long-term U.S. interest rates were close to 5%; today, the U.S. 10-year bond yield is less than 3%, and T-Bill yields are just 1.5%.

Oil was $140 10 years ago and that really hurt consumers and businesses. Oil prices are $60 today, less than half that level.



The U.S. housing market was extremely frothy in 2008 and a disaster waiting to happen. Lending standards were ridiculously lax and it was widely expected that a lot of homeowners were going to run into trouble when adjustable rate mortgages reset to significantly higher interest rates. Today, the U.S. housing market is healthy – homes are affordable and lending standards are prudent.

The banking industry was weak in 2008 because it was under-regulated and overleveraged. Today, we'd argue that it is over-regulated and underleveraged.

The one thing that does warrant some caution is the level of debt in the world. Debt levels were high in 2008, and unfortunately they are even higher today. While we are comforted by the fact that banks are better capitalized, the leverage in the world has caused us to be more conservative in recent years, and favour higher quality and stable businesses over lower quality and cyclical businesses.

Historically, we have worried when investor attitudes were out-of-sync with economic reality.

That is not the case today, but it was during the technology mania at the turn of the century and the resource boom prior to the 2008/09 financial crisis. Conventional wisdom in those cycles was inconsistent with economic fundamentals.

In 1999, the vast majority of the popular dot-com companies didn't have the revenue, profits and prospects to justify sky-high valuations. Canadians were also paying ridiculous prices for blue chip American stocks like Johnson & Johnson, and Coca-Cola in the late 1990s, with deeply depressed 65-cent Canadian dollars to boot, and that didn't make any sense either.

Similarly, it didn't make sense to love cyclical resource stocks in 2008, when the combination of restrictive monetary policy, crippling oil prices and a crumbling U.S. housing market was going to slow global growth.

We didn't forecast the financial crisis a decade ago, but we did anticipate a slowdown.

In fact, the 2008 outlook in our January *Odlum Brown Report* was titled, "Stubbornly Defensive." We said, "we feel like a broken record. For two years, we have been predicting slower economic growth."

Because we favoured high-quality, less cyclical blue chip American stocks over cyclical Canadian resource stocks heading into the slowdown and crisis, we were in a better position – both financially and emotionally – to survive the storm.

For a dozen years now, we have favoured high-quality business – companies like Amazon, Google, Starbucks, TD Bank and BCE – and in recent years, the investing crowd has progressively come around to our way of thinking. We live in a higher-risk, lower-growth world, and it makes sense that investors should favour the best businesses. They are the ones with the resources and business models to succeed.

Unfortunately, increased popularity has translated into higher valuations, and that has caused us to lower our return expectations. Still, it's hard to make a case to alter our investment strategy. Global growth has picked up, and yet inflation and interest rates remain relatively low and supportive of further economic expansion, growth in business profits and higher stock prices.

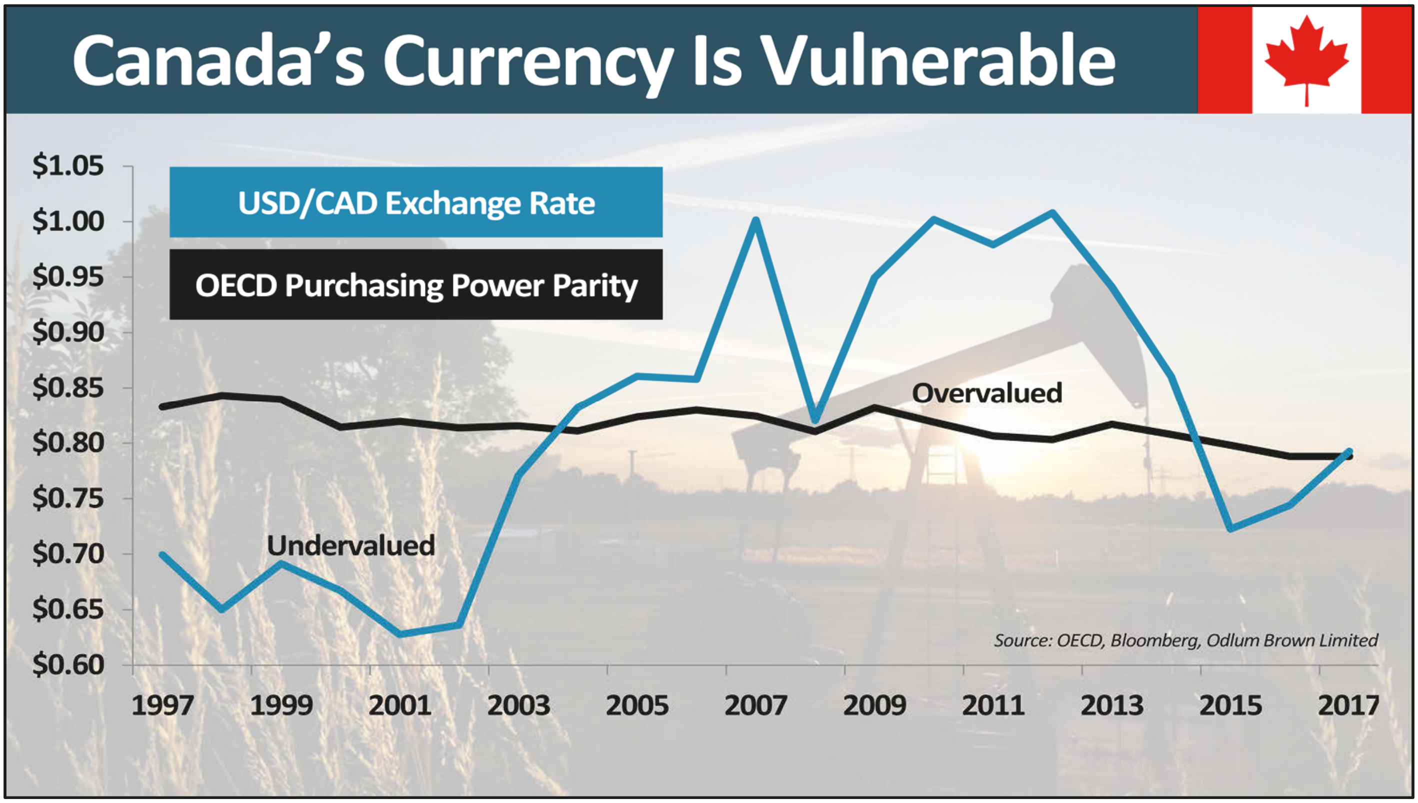
Let me put stock valuations in perspective and provide a counter-argument to those who worry that stocks are too expensive.

The U.S. stock market traded at about 20x expected earnings before the recent correction – and that is only modestly more than the 17x multiple a decade ago when there were significant storm clouds on the horizon.

Not only should valuations be higher when the economic outlook is better, but they should be higher when interest rates are lower. Stocks react to interest rates the same way housing prices are influenced by mortgage rates. With long-term interest rates roughly half their level 10 years ago, one could argue that much higher valuations could be justified.

Trump is the other big reason some people worry about the market. They say “stocks aren’t discounting the fact that there is a lunatic in the White House.” We disagree. If there was a less controversial President, we think valuations would be higher, and perhaps a lot higher.

I know Trump scares some people, and he worries me too. But there are a lot of checks and balances in the U.S. political system, and America still has one of the most dynamic, productive economies in the world. Trump won’t be President forever. We are focused on where the economy and stocks will be in 3 - 5 years, and odds are there will be a different President by then. Trump had the lowest approval rating of any President in his first year.



We always get asked about currency risk, so let me tell you why we are not losing sleep about the exchange rate.

Last year, currency appreciation reduced the value of our U.S. investments by about 7%, with our dollar increasing from 75 cents to 79 cents. Still, our U.S. investments helped us do better than the Canadian stock market because the U.S. equities went up more than twice as much – 22% versus 9%.

At around 80 cents today, the Canadian dollar is fairly-valued relative to its purchasing power, and therefore we don't think currency should be a big consideration in cross-border investment decisions. Other factors matter more, including the fact that it is a lot easier to find high-quality businesses at reasonable prices south of the border. Canada is simply a small market with limited opportunities.

The case for investing outside the country is even stronger when you think about relative economic prospects over the medium term. Over the next several years, we think the exchange rate has more downside risk than upside potential. That is because the Canadian economy is more vulnerable than the U.S. economy.

Our reasoning is fourfold:

1. Canadian consumer debt is at a record level, and much higher than it is in the U.S.

2. We never had a big credit cycle like they did in the U.S. and Europe, and we will one day.

3. Our housing market is frothy and hasn't had a cycle for a long time.

4. NAFTA is on the table and at best, the trade outlook with the U.S. is neutral.

Consequently, we think it makes sense to be diversified outside of Canada.

Let me conclude by saying we are very comfortable with our strategy and don't see reasons to significantly alter investment plans.

It's been a long recovery, yet there aren't ominous clouds on the horizon. The economy is still expanding, corporate profits are rising, and we own great businesses that will continue to do well.

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