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Third Quarter 2016

In the third quarter the MSCI World Index recovered from the Brexit surprise to gain 5.9% in Canadian dollars, 4.4% in US\$. Utility stocks (example Fortis), Staples (Loblaw's), Real Estate Investment Trusts (Canadian Apartments Trust), and Telecoms (Verizon), all of which are popular with dividend seekers, were rather weak (expensive defensives they've been called). More economically sensitive sectors, such as Transportation (Air Canada, Canadian National Railways), and Technology (Microsoft) were somewhat stronger. All in all it was an uneventful quarter. Interest rates remain frightfully low. Five year Canada bonds yield only 0.66%, 5 year US Treasuries just about twice as much although there is growing speculation that the Federal Reserve may finally raise short term interest rates from near zero after the election.

Speaking of the election, it is not for me to speculate on how markets will respond to the outcome. I've often observed that the importance of politics to markets is easily exaggerated. In particular the power of the President which is constrained by the separation of powers and an obstreperous Congress. It is noteworthy that both candidates seem to advocate more fiscal stimulus via spending on infrastructure to spur economic activity.

There are of course points of difference; Trump is more negative on trade, although Clinton is also cautious on new trade deals. Clinton on the other hand has been more critical on drug pricing. I am not planning on making any changes to our investment lineup based on



changing polls. However the election turns out, this too will pass. I am keeping an eye out for any overreactions.

Some 15 trillion worth of government bonds have negative yields. Central banks are undertaking a great social experiment. Ten year Japanese sovereign bonds yield -0.06% and, Eurozone 10 year government bond yields just moved up to -0.04%. That is not a hyphen; it is indeed a negative sign. In today's world we can talk about ten year yields moving up to a minus figure. Bill Gross (Investment Outlook, Oct. 4, Janus) argues that negative and near zero yields are perverting capitalism by distorting normal incentives.

Our argument is that NIMs (net interest margins) for banks, and the solvency of insurance companies and pension funds with long dated and underfunded liabilities, have been negatively affected and that ultimately, the continuation of current monetary policies will lead to capital destruction as opposed to capital creation. Central bankers counter with the cavalier attitude of "let them (savers) eat cake (buy stocks)". – *Bill Gross, October 4th, 2016, Investment Outlook*

In these circumstances government bond yields can only be valued for their liquidity and insurance properties, in which case they might as well be short term. The optionality of cash is often overlooked. I always want to have some cash available and if not cash then a security that is near to cash. Dividend paying stocks have been described as the new bonds because they have higher yields. I'm resistant to abandoning fixed income and cash equivalent investments altogether. Central banks' near ZIRP (Zero Interest Rate Policy) has led to TINA (There Is No Alternative) to stocks. I feel almost subversive by resisting that pressure.

When looking at the 12 month returns of the portfolios I was somewhat surprised. Caution is warranted with rolling 12 month returns. We report them because everybody does and 12 months is a decent interval. However, when thinking about rates of return it is important to



consider the starting date of the measurement period. We track rolling 12 month returns every month and I can tell you they jump around quite a bit. It just so happens that October 1, 2015 was somewhat of a low point which makes the 12 months to this September look better. We always report calendar year returns and year to date returns too because those are most comparable to alternatives. After a number of years a list of calendar year returns can really illustrate how much risk is in the portfolio. We don't want to be cherry picking start dates and you can't mess with January 1. Reporting time weighted returns gives a good measurement of the performance of your investment manager.

Happy Thanksgiving. Our families' weekend included both sailing and hockey. We have much to be thankful for.

Sincerely,

George Stedman, CFA
Portfolio Manager, Vice-President
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