Manulife Securities

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Dear Clients

I know I just sent you a newsletter in mid-Oct at statement time. But since I wrote that newsletter at the end of Sept, the markets have been volatile and I wanted to comment on them, even though you have all been terrific during this turbulence. We haven't had one panic call from someone trying to liquidate assets at low prices. In fact some of you have called, as many also did in Mar, to buy while stocks were on sale.

In the last 9.5 years, since the Mar 2009 market low of the Great Recession, there have been 19 occasions of the market dropping at least 5%, -8.9% on average. The drops lasted on average 43 days. The only thing strange about these drops is that none of them occurred in 2017. That made it harder for our value managers to make good returns, because the value style depends on the volatility that happens when people sell stocks at sale prices and later buy them at high prices. Another side effect of the super low volatility of 2017 was that people got used to markets being pretty stable. So the Feb-Mar market turbulence was a real jolt. Then this Oct market drop got many people quite worried (especially those owning marijuana stocks since that sector of the market fell about 3 times harder than the market in general). I want you to know that drops like these are *usually* just temporary bouts of market worry or of prices correcting after prices rose faster than profits. In the case of the Oct market drop, it was precipitated by the American Federal Reserve Chairman announcing on Oct 3 that interest rates would keep rising, perhaps more or more quickly than the market wanted to hear. Too often excessive rises in interest rates have been the cause of recessions in the past (like when interest rates in Canada rose from 7% to 14% in 6 months in 1994). Uncertainty over Trump's policies are also causing businesses, governments and markets to worry.

It is important to note that this is not likely to be the start of a market crash (a drop of at least 20%) in the U.S. where we are mostly invested, but rather just a correction (a drop of at least 10%). I say this because the signs of a recession or of a major bubble are not apparent. Corporate profits in the U.S. are still growing, just at a decelerated rate. In fact the price of U.S. stocks compared to their earnings (which is a common measure of how expensive a stock or the market is) is at a lower value than when Trump was elected almost 2 yrs ago. Third quarter GDP growth was a pretty strong 3.5% annualized (far stronger than Canada's). Purchasing managers world-wide (except in South Africa and Indonesia) are forecasting that they will purchase more in the next 2 yrs than they have been buying. That bodes well for the economy going forward. And there has been no 9 month inversion of the yield curve, which is the surest precursor of a recession. Inflation is creeping up, but is not runaway. Unemployment is still very strong in the U.S. and the other traditional signs of a coming recession are not evident. So analysts are not calling for a recession (which would take the market down for a sustained period) for at least a year or possibly two. There are some who say we'll have **many** more years of strong economic and market growth. The truth is no one really knows, but the signs of a looming recession aren't visible.

I'm not saying all is rosy in the world, economically. There are some cracks appearing in the U.S. and world economies. Trump is disrupting world trade through tariffs and agreement changes. The housing market in the U.S., which has never resumed its growth rate of the late 90's and early 2000's, is hurting, possibly because of interest rate changes, but in the Northeast U.S. also because of a tax change Trump put in. The housing and auto markets are key to the U.S. economy, so this is very important. China is having trouble with too much debt and a trade war with the U.S. won't help. There's still Brexit and Italy. Canadian consumer debt is a huge risk to our economy. All of this is to say that it's not a time to take outsized investing risk, like investing in things just because they have been popular and going up in price (Momentum Investing) or not worrying about buying things cheaply, counting on profit growth to justify the price paid or not keeping a supply of lower volatility assets to withdraw an income. It's more important than ever to stay on the quality, value, low volatility side of investing.

After the ugly markets of Oct, we have checked the behaviour of most of the funds our clients (and we ourselves) have. The balanced funds, which were supposed to have low to medium volatility, did indeed drop about 30 to 50% as much as the market. A few of the equity funds which had been lagging for the last year, because they were holding a lot of cash, also went down pretty minimally (good thing we don't abandon great managers or proven styles because of a little underperformance!). Most of our favourite pure equity mutual funds, with Growth At a Reasonable Price (GARP) or Low Volatility styles, also fell less than the markets, but more like 60-80% as much. A few of the more concentrated equity funds (holding a low number of stocks), which have often had the highest returns and may again in the future, fell as much as the market. So all our funds performed pretty much as expected, and I expect them to fully recover. And those managers who had cash (up to 40% before the correction started), will be busy buying at the newly reduced prices. The fund managers we have heard from are downright excited about finally getting a chance to buy at better prices. That should bring us extra good returns coming out of this correction. This volatility is the friend of value and GARP managers.

Let's project forward to when the market actually does have its next 20%+ crash. You will see your portfolios fall at least twice as much as they fell in October and they will stay down for quite a while. However, if you are taking out an income stream and we knew you would be and we prepared for it, you will have some funds that fall a much smaller percentage or some high interest savings that didn't fall at all, from which we can pull your income stream without locking in any great losses for years. This is the strategy I call Income Matching. It is a strategy that worked in the Tech Crash for 2000-2001 and the Great Recession of 2008-2009. So, **don't be alarmed when the next "crash" finally comes**. Just stay the course and **keep to our plan**. And if you aren't taking an income stream from your investments or aren't on the verge of doing so, then still stick with your investments and buy more while they are on sale, if you can. If you think you might be needing a withdrawal or a regular income stream in the next few years and you haven't told us or we haven't set up for it, don't wait to share the news with us. We need to set up the Income Matching Strategy.

Even though economists are getting better at predicting recessions and bubbles, no can predict when a market crash will actually start. People like Buffett called for the Tech Wreck to happen years before it actually did. People could see it coming, but no one knew when. It's been proven that trying to time the market, by trying to get out just before a crash and hoping you'll have the wisdom and courage to get back in in time to catch the recovery, rarely works, and even those lucky enough to have been successful at it once have never been able to repeatedly do it. Most of the time people either get out of the market way too early and miss a lot of growth or get out way to late at the bottom of the market to crystallize the maximum amount of losses. Then people wait too long to get back in the market. So the best we can do, in my opinion, is to stay in the market and stick with quality companies and value type strategies to guard against permanent losses, and when we see a market is down (something that **can** be concretely measured), have the courage to take advantage of it - buy more. Maybe the market will drop even more after you put more money into it, but at least you will have ensured that you got some equities below peak prices and before the next market recovery.

I know this isn't new to you, because it's what I've been writing about and saying in meetings for years. Stick with the strategy and trust in quality equities for the long-term. And for now while we are in the midst of or have just finished this correction, just be patient and let the managers of your funds do what they have experience doing: Investing in quality businesses at good prices to make money without permanent losses over the long-term.

That's really what I wanted to remind you of. But if you did find yourself too anxious during this time of market volatility, maybe we need to reposition your portfolio after the recovery, but before the next correction. You can give up some long-term returns by switching into lower volatility holdings so the next corrections and recessions won't be too hard to bear. It's better not to be greedy than to let yourself get stressed during a market downturn. Give me and/or my partner, Jordan, a call and we can talk about it.

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