ELAINE'S NEWS & VIEWS

OCT 2016

Sorry for the delay in sending out this newsletter. It took longer than expected to get permission to use a couple of charts.

U.S. Election Volatility

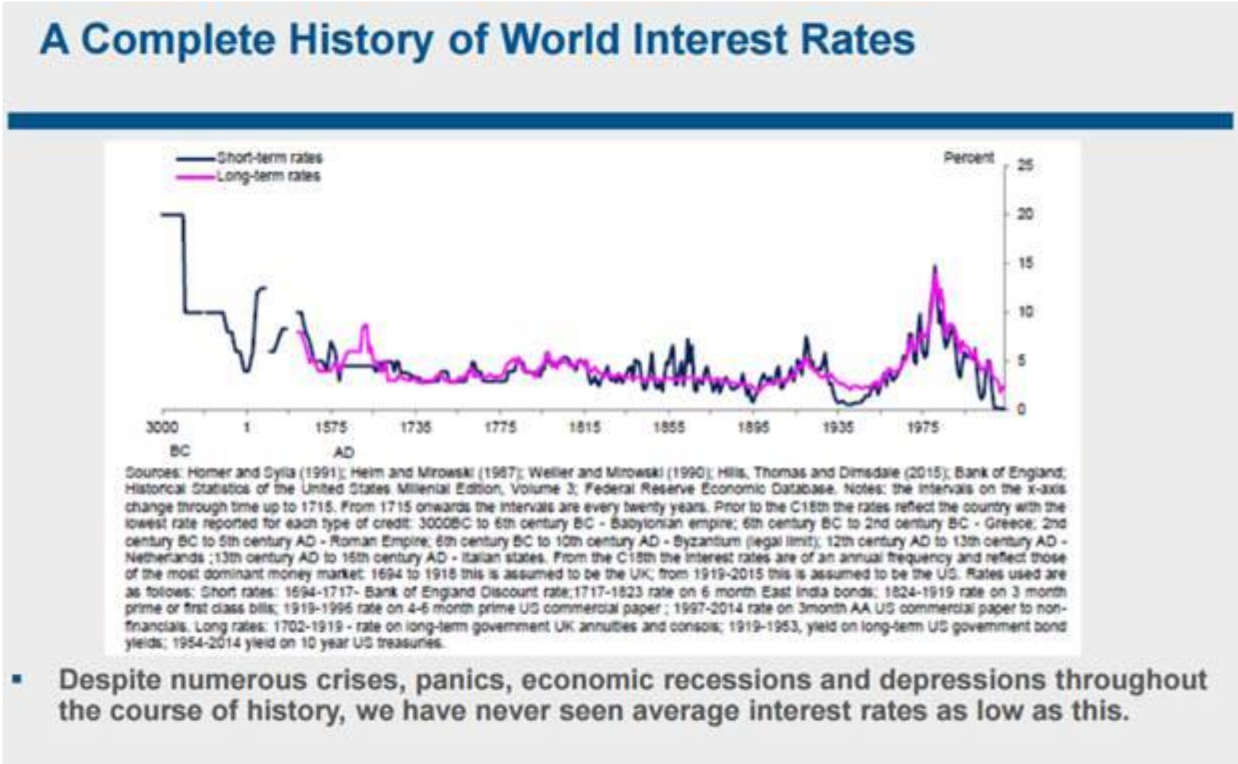
This next quarter we could see a lot of ups and downs in our portfolios. I am expecting a very bumpy ride because of the Nov 8 U.S. election. History has taught us that even wild market swings are a frequently reoccurring experience and shouldn't change our long-term investment strategy. So I warn you that volatility is expected, but I don't plan to take any action to avoid it. People who do exit the market out of fear of expected volatility don't seem to get back into the market at lower prices than when they exited. So they would have been better to have done nothing but ride out the volatility.

The Recency Effect – A Danger to Ourselves as Investors

Researchers have proven that humans exhibit a recency effect. Basically it is where we put more weight on the most recent things we have experienced. So for example, if you had 9 great experiences with a travel route and the 10th experience was poor, you would rate the travel route lower than if you had 1 poor experience followed by 9 good experiences. In both cases you had 90% positive experiences, but the more recent the poor experience was, the more weight it carries.

When it comes to money, we also succumb to the recency effect – often to our detriment. Humans tend to think that whatever trend has been happening recently will continue unabated. (Remember when people thought tech stocks would only continue going up, and at a quick pace too!) In reality, most things in life revert to the mean. In non-mathematical non-exact terms that means that if there is a long term average that something has deviated from (let's say on the high side), it is likely to go back to behaving like the long-term average or swing in the opposite direction to the low side which would bring the recent average in line with the long-term average. Rather than us expecting recent behaviours to continue, we should see how those behaviours fit with history. And for millennials (people who became adults this century), what they have experienced in many areas in the last decade forms a large part of their expectations for the future, because it is almost 100% of their experience. So the following is meant to help everyone, but especially younger people, get a bigger perspective.

First let's look at interest rates. Young people buying houses today cannot imagine a 5% mortgage. I had mortgages at 12 and 14%. Some people had 6 month mortgages at over 21%. The following chart, , shows 5,000 years of short-term interest rates, and about 800 yrs of long-term rates. While 1981 looks like a huge aberration, so do the near zero short-term rates (the dark line) of today. Even in the Great Depression rates didn't get so low, and that looked like a big abnormality in history too. So, we should view current low rates as very abnormal and **be prepared for higher interest rates** in the future.



(Source: Q2 2016 Quarterly Chart Book – Myles Zyblock)

Next let's look at home prices. People under 40 sometimes tell me that you can never lose money on your house because prices only go up, and older people often say that real estate is the best investment in the world. I remember the panic in 1981 when housing prices were rising so fast that people talked about needing to get in the market right away and thinking this would be the last chance they could ever afford to buy. Then in 1982, the Toronto market fell almost in half. I bought a house for $190,000 that had been listed for $350,000 the year before. So real estate can and does fall drastically sometimes.

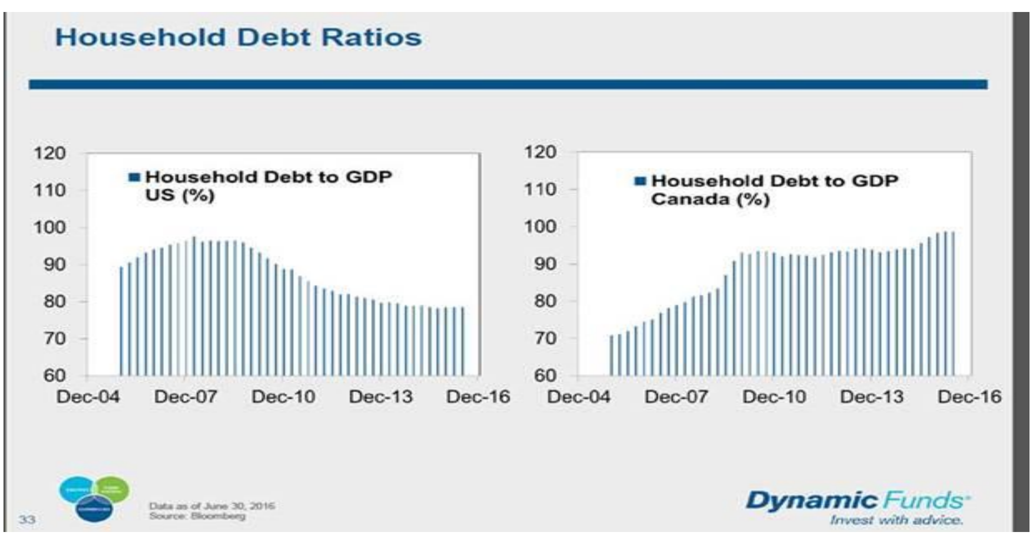
Real estate is great in that it forces people to have the discipline to make at least monthly payments. So people who would not otherwise save any money can build some wealth by taking out a mortgage and being forced to make monthly payments, some of which goes to pay down the loan and increase their equity. But is a home really the best investment? On a recent chart Mackenzie showed me that tracked home price rises in Toronto versus the S&P TSX Composite Index Total Return from 1980 to 2015, an $8000 investment in a home went up elevenfold versus an $8000 investment in the general Canadian stock market index which went up over 2200%. Someone would have made twice as much on their investment in the Canadian stock market. The returns would have been even better for someone who had invested in U.S. markets. The house investor would have gotten shelter, but also would have had repairs and taxes to pay. It's fine to want a house as a lifestyle asset, but calculate first if you could afford that house if you had to renew your mortgage at 5% rates in 5 yrs. And why invest in just real estate (like your home plus rental properties) where you would be undiversified (all your eggs would be in real estate) and when historical returns for that asset class have not nearly equalled returns from stock markets.

Most people remember that U.S. consumer debt was excessive in 2007, right before the banking crisis and the Great Recession of 2008/09. People got loans who shouldn't have and their inability to pay their mortgage fuelled a meltdown in the U.S. real estate market. Canadians were comparative paragons of virtue with reasonable debt, and our banks didn't have to foreclose on a lot of homes for lack of payment. The situation is reversed now. American consumer debt is way down now, which bodes well for U.S. economic recovery. Canadian consumer debt has blossomed out of control to be worse than the American debt was before the market crash. Statistics Canada announced on Sept 15, 2016, that Canadians carry more debt compared to their income than people in the other G7 countries, with the cost of carrying their debt at 167% of their salary (compared to the 147% debt to income ratio that Americans had right before the 2008 housing crash). The Canadian Payroll Association on Sept 7 reported that 40% of respondents to their poll spend all or more than the amount of the net pay cheque each week. (Canadian Press release reported on chumfm.com) The TransUnion credit agency, according to the Financial Post on Sept 12/16, surveyed Canadians and found that over 700,000 people would not have enough cash flow to keep up with their debts if interest rates rose even ¼ of 1%. If rates went up a whole percent, almost 1 Million Canadians would be cash strapped.

While no interest rate rise is expected till late 2017, it's not that far away. Can you imagine the effect on home prices if rates rise and people have to sell their homes on masse because they cannot afford to renew their mortgages? A supply glut in the housing market like that could be what bursts Canada's feared housing bubble. Apparently it isn't a problem confined to lower priced homes either. And if there are foreclosures, the banks share in the financial loss (and bank stocks could really drop in price). And the unfortunate people who only put down a 5% down payment, but have the cash flow to carry their mortgage at a higher rate, might find themselves not being able to renew their mortgages for the whole amount they still owe (which could be far more than the house value too).

Even the Chinese Media is worried about the Canadian housing market On Aug 5, a huffington.ca article quotes from the Chinese media that "This crisis threatens the stability of [the Canadian] financial system" and "The Chinese Media Warns Canada's Housing Crash Will Put U.S. To Shame".

The chart below shows the reversal in U.S. and Canadian debt level trends.



(Source: Q2 2016 Quarterly Chart Book – Myles Zyblock)

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Canadian's have let their debt get out of control because of the super cheap interest rates available. If you have succumbed to the temptation of cheap borrowing, it is time to take drastic action to fix your situation, even if it means downsizing from a house (which could probably sell for a record high price now) before interest rates rise and you are forced to sell the house at a potentially depressed price in the future. It may never be easier than now to pay off your credit card and it may be impossible later without going bankrupt first. (I don't expect a quick or particularly imminent rise in interest rates, but it takes a long time to fix debt problems. So the time to start is now.) RBC's economist Laura Cooper predicts that even a 1% rise in mortgage rates would cost home owners with mortgages 6.2% more of their monthly income to maintain their mortgages. If you have a mortgage, could your budget handle that? And recently RBC and TD have implied that they are reducing their market share of mortgage lending in Canada intentionally, **letting** CIBC do 50% of all new mortgage business in Canada. Why would they do that unless they are worried about the risk of defaults on mortgages? High Canadian consumer debt is one of several reasons why I am underweighting our investments in Canada in favour of the U.S. and why I don't like fund managers with a lot of Canadian bank holdings.

Before stopping my comments on economic news, let's briefly look at the Canadian dollar. Canada's economy is recovering much slower than the U.S.'s economy. We are so dependent on the price of oil and the world oversupply has not abated as predicted, so oil prices may not go up enough to sustain our dollar even at current valuations. And U.S interest rates are expected to rise long before Canadian ones (possibly a whole year earlier). The country with higher interest rates usually attracts more foreign capital which helps that country's dollar to be stronger. So none of these factors seem to favour a strengthening Canadian dollar at present.

Paying for Investing Advice

"Why won't Canadians pay for advice?" was the topic of a Globe and Mail article on Jul 15, 2016. What is ironic is that it was written by Rob Carrick, the columnist (formerly of The Toronto Star and now of The Globe and Mail) who has been the most vocal for 20 years in trying to get people to focus on how much advice is costing them. He now writes, "*It's time for Canadians to get over their hang-ups about paying for financial advice. I accept some blame for the misunderstandings out there about the cost of advice… The net result of our interactions with people is the emergence of a cohort that believes advice just gets in the way of them paying the lowest possible fees*." "*Where my fellow personal finance writers and I went wrong was in hammering away about the cost differential between funds and ETFs, with too little attention to the fact that not everyone can be a successful, self-sufficient DIY [do it yourself] investor. … But what's your plan, Stan? Do you know what rate of return you need to build sufficient retirement savings? Do you know how long your retirement savings might last once you're done working? Have you made an informed choice between tax-free savings accounts and registered retirement savings plans? Do you have any idea of how to turn your retirement savings into a reliable flow of monthly income?"* If you can't or don't want to do all your own planning, you need an advisor. It's just like the fact that some people can pour their own cement sidewalk, build their own kitchen cupboards or change their own oil, and don't need to hire someone for those things. If you aren't interested in or skilled at those things, you hire a professional. It's no different with investing. And Carrick points out that the financial industry "*bears some responsibility for investor discomfort about paying for advice. These geniuses hid the cost of advice in the fees charged to own mutual funds. These fees are taken off the top of fund returns (investors see net gains or losses), so investors have often been ignorant of them*." No one read the prospectuses mailed to them that detailed the fees, and a lot of advisors never explained Management Expense Ratios (MERs). And so there are investors who actually believe that their mutual funds bought at the bank are managed for them for free. (Not true.) Advice always costs something. Manulife Securities has regulatory, supervisory, record keeping, tax reporting, statement production etc expenses to cover, and I have to pay rent, salaries, postage, license fees etc and then still make a living commensurate with my experience, skill and effort. Is it worth paying for all that to get advice? That's for each client to determine for their own situation and based on the service and quality of advice they get from their own advisor. In the aggregate though, the research is clear. Ipsos Reid (the survey company) found that the average net worth of investors with advisors was 3 times that of unadvised people and their investable assets were 4 times greater. Other studies have shown that the difference in net worth was across people from all income groups. So it isn't just that the rich get financial advisors and lower income people don't. Ipsos Reid also found that people with advisors felt more confident that they could get through economic downturns or economic surprises, were more likely to have an RRSP and more likely to have more in equity investments (stocks) and less in cash. So, if you don't remember the diagram I went through with you on how investment firms get paid, or don't understand the fees on your funds, give me a call. You deserve to understand what you pay for advice. Oh and by the way, those who buy funds through a discount broker will find out on their January statement that the fund companies have generally been paying the discount brokers the same trailer fees the fund companies would have paid a full service brokerage, even though the discount brokerage is actually not providing any advice or planning assistance.

Diversification as Protection Against Risk

Let's pretend you are trying to grow your own organic food. You know that some things you plant will flourish in wet summers and some not. Some plants can tolerate cool summers and some not. Since you cannot predict the weather, you decide to plant 10 vegetables, each taking 10% of your field. You think you are diversified enough that you should get a good crop of a variety of vegetables regardless of the weather. But how diversified are you really? For example, let's say that you planted tomatoes, yellow beans, carrots, lima beans, corn, pinto beans, potatoes, green beans, squash, and kidney beans. If you have a bean leaf beetle infestation, you could lose half your crop, since you have 5 kinds of beans. In investing terms, if you bought 10 stocks with 3 of them being banks (since about 30% of the S&P TSX Canadian stock index is in financials) and 4 of them in the resource sector (since about 40% of the S&P TSX Canadian stock index is in resources), one in construction equipment, one in grocery stores and one in transportation, you might be just as under-diversified. If there were a downturn in construction, perhaps your construction equipment stock would suffer, but also the transportation company if it transported a lot of building materials. And the resource companies could suffer if the demand for the lumber, iron and copper they produced dropped. (In fact this isn't that far from what happened when the building boom in China ended.) So one economic event could tank 50% of your portfolio. So you may not necessarily get good diversification even by owning the whole index, if it is concentrated in only a few economic sectors like in Canada, and even owning 30 companies spread across different industries might not provide diversification. For example, owning a candy maker, a clothing company and steel manufacturer might not provide diversification, if all 3 get most of their income from exports and are dependent on the Canadian dollar being low relative to other currencies.

A new strategy I will be supporting uses the concentration-of-risk-across-stocks to measure diversification, which had never been done before. A French math PhD invented the measure and it has been patented. The results of the strategy as implemented for institutions, like the California Pension Fund (Calpers), has been amazing for the past several years. It seems this strategy weeds out the over-popular/over-valued as a by-product of its process and fits in line with the other equity investing strategies I have always used. This strategy is newly available in Canada.

Along that same line of thinking, I continue to be concerned about stock portfolios or mutual funds that are concentrated in Canada's big banks, utilities and railroads. Those may sound like 3 diversified sectors that would not share a common risk factor. The companies in these sectors have traditionally had relatively stable income and paid out steady and high dividends. Investors have flocked to high dividend paying stocks for "safety", because dividend paying stocks are historically less volatile, and also because they couldn't get much return from GIC's compared to these stocks' dividends. However, as investors poured into these stocks, the stock prices rose and those same stocks became a greater proportion of the stock market index. So then the basic ETFs (Exchange Traded Funds that invest in the same proportions as the market value of stocks in the index), had to buy more dividend focused stocks within the ETFs, thus creating greater demand and even higher prices. It becomes a self-reinforcing cycle. The more certain stocks go up, the more they will go up after. I have been worried about overpriced dividend focused stocks for a year and now I see a top Dynamic Funds manager and some managers from Mackenzie are worried about the same thing. So any portfolio mimicking the Canadian market index may get quite hurt if this is a bubble that bursts.

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