ELAINE'S NEWS & VIEWS

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Topics in this newsletter:

Bitcoin and Cannabis

Questions from clients about investing in Bitcoin have died off in favour of questions about cannabis stock. It was only Dec 2017 when Bitcoin was almost $20,000 and everyone was excited about it. It is now down about 80% and it may drop further. In fact, some of the bitcoin data miners are shutting down because their electricity costs are prohibitive. If the number of data miners decreases too much, Bitcoin could become a viable target for hackers and that could spell the end of Bitcoin and other cryptocurrencies. The blockchain technology that made Bitcoin possible however is starting to be used in various industries, in companies like Sony and Walmart.

Pot stocks had a rough ride in the stock market this fall as profits didn't meet expectations. And now Jordan tells me that there may be a way to manufacture the chemicals that are key to marijuana through DNA insertion into yeast, the same way they manufacture insulin. And in Hamilton a fish farm has found a way to grow marijuana too. Won't that be a game changer to the companies investing in fields and big grow op buildings? It's hard to see who will make the profits on marijuana.

There is lots of talk about whether buying pot stocks is investing or gambling. It turns out that people who have lots of money sitting in cash or near cash (like GICs), because the market it too volatile for them, are frequently the ones buying marijuana companies. So these nervous people are moving some of their money from what is the least unpredictable to what is perhaps the most risky in the market, yet they are too scared to invest in companies like Johnson & Johnson, Visa, Samsung, or Dollarama. It sounds like gambling to me.

Factor Investing in ETFs and Funds

Have you seen that ad on TV for Fidelity where they advertise that they have "Factor" ETFs? Fidelity explains that they use computers and smart people to figure out what characteristics drive company profitability and then use algorithms to figure out what companies have these factors and should be invested in. In fact, Fidelity tracks 3000 different factors and other companies track factors too.

According to research presented by Andrew Clee at the ETF Conference in Burlington in November, the average excess return compared to the market between Jan 98 and Jul 18 can be broken out by “factors”. Not every factor outperforms at all times or over all parts of the market cycle.

	Ave Yrly Excess Retn	Early Cycle	Mid Cycle	Late Cycle	Recession
Value	3.10%	Very Strong	Very Strong		
Dividends	2.10%	Very Strong			
Momentum	2.10%		Very Strong	Strong	
Quality	1.70%			Strong	Strong
Low Volatility	0.80%	Very Poor	Poor		
Size	0.60%	Strong	Strong		

It’s important to remember that an investment style doesn’t have to include only one style. Growth at A Reasonable Price (GARP) is a blend of Value and Momentum and always includes a filter for Quality. Any manager we like uses at least 2 of the above filters, more often 3 or sometimes even 4. The study quoted above shows why it is so important to include value more often than not in your fund style choices, but that adding a touch of momentum and of course quality will help at other times.

By the way, value has been out of favour as a style since 2015, however our funds have done fine. That must be thanks to the Quality aspect and the growth tilt within the value category. But you can also see why we may not want to stick with low volatility funds when the next recession seems to be at an end.

By the 60’s Warren combined value with growth to get GARP, Growth at a Reasonable Price. And when he describes his search for GARP, he never fails to mention quality, strong management, competitive advantages, and being hard to duplicate (which he calls having a moat around your business). So factor investing is something you have been participating in since you first got into mutual funds.

When I went to a seminar last week to hear one of my favourite managers, a Fidelity fund manager who loves Value, Growth and Quality, and who has succeeded in achieving low volatility such that his fund only dropped about 20% as much as the market in the Oct/Nov downturn, I asked him what the attraction was for his top holding. He told me something that no computer is going to figure out just by filtering numbers and which most other managers haven’t uncovered in their research either (which is his competitive advantage and one reason he is one of my favourite managers). There is something to be said for interviewing management and truly studying and analyzing a company’s business. This manager has 2 other advantages over the Factor ETFs too. First, he will make a change in his portfolio the moment a stock price gets too high, or there is new information that changes the outlook for their profits, or he finds something even more attractive. Factor ETFs change their holdings once a year, or do a bit of re-jigging once every 3 months. Secondly, fund managers can decide to hold onto cash if there is nothing attractive to buy. That’s why their funds may not fall much when the market has a price correction and they might have a whack of cash on hand to buy stocks after their prices have fallen to attractive levels. ETFs have to have all their cash invested at all times.

So Factor investing may be new to ETFs, but not to the managers we use and we still believe the managers we have will outperform ETFs.

So why do people invest in ETFs so much these days? To get low fees. At an ETF Conference I went to recently to learn what the latest developments have been with them, I saw a chart about how the best performing ETF with the lowest fees got the most new purchases. The **worst** performing ETF with the lowest fees got the next highest amount of new purchases. The second best performing ETF with higher fees got less new money invested in it. **People went after the lower fees without regard to where they could actually get the best returns and make the most money!** Low fees are nice, but higher returns net of fees (given the same volatility) are way better.

The largest global smart beta ETF, Vanguard's Global Value Factor ETF, is up about 1.4% over the last 12 months (this is before any transaction costs or paying for any planning advice). Another mega-size ETF , the iShares MSCI World Index ETF, is up 1.4% with no screening factors. The ETF just replicates the market as best it can. The super popular iShares Core MSCI Global Quality Dividend Index ETF, a multi-factor ETF, made 1.9% over the last year. The 5 actively managed global funds that I most commonly use are up 2.1, 5.6, 1.1, 2.1, and 3.8% after all fees and costs have been accounted for. So despite having to pay for an active manager and the fund companies paying advisors to give the fund investors planning advice, 80% of my favourite fund managers made more money for their investors over the last 12 difficult months than the cheap fee ETFs, whether they were factor ETFs or index clone ETFs. So I'm sticking with my favourite funds.

<u>Oh, Canada, or is it Woe, Canada</u>

Things aren't looking good for the Canadian stock market. Canadian bank stocks are down this year because of fears that they can't increase their loans, because Canadians are already at their maximum debt level.

Oil companies are down because there is a glut of oil in the world and especially in Canada, because producers can't get it transported to refineries in the U.S. West Texas Crude, Western Canadian Select and some kind of Mexican oil all require the same temperature in the refining process and should cost the same to refine. As I write this though, West Texas Crude was selling in the mid $50's per barrel. Mexican oil was selling for about $63 per barrel and Western Canadian Select was selling for under $20 per barrel (all in USD). How on earth can Canadian companies make money at that price? So I don't see much hope for a recovery in Canadian oil company prices any time soon.

We are continuing to recommend underweighting investment in Canadian markets.

<u>How Long Till the Market Recovers?</u>

Corrections, like we are in, where Canadian, U.S. and Global markets have fallen 16.0, 19.7 and 20.8% respectively from peak to trough (as I write this) in the last 3 months, are normal. (The U.S. Nasdaq mostly-high-tech index was briefly in bear market territory when it reached the -20%+ mark and MSCI World Index hit the bear market point as well.) What was different about this correction was that, according to market watchers, up to 80% of daily trading during this period was initiated by algorithms. The decisions were made by machines. There was no analysis of fundamentals, no discretion, just reactions to trends. Such mechanical trading just exacerbates the speed and severity of the market fall.

How long will the market be down? Of course we don't have a crystal ball, but we can learn a lot from history. According to research by Stone Investment Group, "since World War II, we've had 56 "pullbacks" (declines of 5%-9.9%), 22 "corrections" (10%-19.9%) and 12 "bear market" (>20%). Markets recovered all their losses within two months of a pullback and four months after a correction. And 80% of market corrections since 1974 didn't become bear markets." As long as we aren't on the precipice of a recession, markets should recover at least by May 2019. Economic fundamentals aren't indicating a recession is too imminent, but this could be the first recession in history caused solely by political blunders like Brexit and a trade war with China.

The portfolios I have looked at so far show that our clients fell significantly less than the market. And some of the managers we typically use had up to 40% cash when the correction hit. They were thrilled that finally prices had come down to the discount prices they like to buy at. Value managers typically like volatility like we just had, because it means somebody is selling at prices the managers like to buy at and previously were buying at prices our managers like to sell at. It should mean that some of our funds which were lagging when the high tech companies were pulling up the U.S. market earlier this year and which outperformed during the downturn should be set for good gains when the market recovers.

As for what we suggest going forward, there are a couple of things. We don't expect a recession or bear market for at least 12 months, probably not for much longer. But this recent market volatility was a good warning of what will be coming someday. While studies have shown that we are best to stay in the market and ride it out through all the pullbacks, corrections and bear markets, IF YOU WERE PANICKING over this last market correction, you need to act now to get more conservative. You will probably lose out on short term and ultimately long term profits, but the rollercoaster ride that the market can take us on, will not make you sick, or worse, make you panic and pull out at the bottom of the market. If you do that, you may never recover. So ask yourself now if you can stomach more volatility than we just had. If you can't, give us a call after this market recovers but before there is time for the next downturn to start to adjust your portfolio. Our Value or Growth at A Reasonable Price and Low Volatility styles usually do well going into recessions and through low periods, but even the drops funds with these styles have are painful. And 3 of our more aggressive funds actually did fall 11-15% peak to trough in the correction (3/4 as much as their markets fell). Of course they were generally the ones that were up the most before the crash, so the pullback didn't even wipe out all their profits. We weren't disappointed with these funds because they met our number one criteria: they fell less than they went up. We like funds that only go up 80% as much as the market as long as they only fall 60% as much. We also like funds that go up 120% if they only fall 100%. It is important for long-term returns to have a good differential between the upside and the downside. We try to limit the funds that fall more than 2/3 as much as the market either to a small portion of an investor's portfolio or to the portfolios of more confident, aggressive investors.

During this correction, we have spent a lot of time analysing our fund picks to make sure that they all performed as expected. Did the ones we felt were conservative go down less than our average picks? Did our average picks go down less than the market? And we were glad to see that all our funds performed as expected this time. This gives us reason to expect they will perform the same way in the next correction or bear market. The managers were practicing the investment style they advertised and those investment styles worked the way we expected. So, we don't plan to change the funds we use. However, if this turns into a recession or whenever a recession does occur, and the markets are down over 20% and our funds are only down a fraction as much, we might call you to make changes. We might be suggesting to you that you move from some of the most conservative funds that fell the least and are probably are only going to go up a fraction as much as the market, to some that will go up 100% as much. We are telling you now, because you may need to get used to the idea. It will take courage to go more aggressive in the middle or hopefully near the end of a bear market, but that is a potential opportunity to make more. And, low volatility investing does not do terrifically in recovering markets, so we may not want to stay there for what could be years till the next bear market.

Random Interesting Fact

As I was Christmas shopping, I found out that the leather suits that motorcycle racers wear now come with either built in or optional air bag systems! Really. The suit determines if the rider is going over 50 kilometers an hour and if they are about to have a violent fall (like going over the handlebars as opposed to falling a foot and sliding to a stop) and if those 2 factors are in play, the suit will deploy air bags around the neck, chest and shoulders. Who knew! Well, the mother of someone who qualified for the Canadian National Amateur Superbike Championships sure found out.

Tax Free Savings Account (TFSA) Contribution Changes

Thanks to inflation, the amount you can contribute to your TFSA for 2019 is now $6,000. So if you were 18 by 2009, your total cumulative contribution room as of 2019 would be $63,500. You can check on "My Account" through the CRA website by at least mid-January to see how much unused TFSA contribution room you have. If you have had more than one TFSA or have ever made a withdrawal, this is the safest place to find out how much you can contribute. CRA (Canada Revenue Agency) can fine you for over-contributions, so it is worth checking.

Changing World Leadership and What Danger our OAS Is In

You have probably read lots of articles too about how the Chinese economy will surpass the American economy. Some people predict it will happen in the mid 2020's. An article on Bloomberg.com from Sept 2 written by Daniel Moss quotes the OECD (Organization for Economic Cooperation and Development) as saying it would happen by 2030, but that world economic dominance will only last about 20 yrs. Then India will surpass China and Indonesia may become a close second in economic might. China's downfall is predicted to be the one-child policy that China had from 1979 to 2015. As their parents get too old to work, there won't be enough young people to replace them and keep the economy going strongly. The U.S. and most developed nations, especially Japan, that have had low birth rates since about the 70's, will have the same problem and I expect our economies to shrink. In emerging markets, the birth rate has been much stronger and that will bode well for their economies. All of this is one of the reasons why I am glad that Canada has much more immigration per capita than the U.S. We need more younger people, young taxpayers for selfish reasons, not to mention humanitarian reasons..

CPP is funded by payroll deductions throughout our working years. Still, in the 1990s there was fear that not enough was being saved to make the payouts last through people's retirements. Then, thanks to Paul Martin when he was the finance minister before becoming prime miniser, the investment policy changed from relying solely on fixed income (bond type) investments to include significant equity investments. Now CPP is considered to e fully funded, and should pay out the pension income promised till death. (By the way, it only has 8% exposure to Canadian stocks. That's a strategy we support, which is why our portfolios don't have much Canadian exposure. Thank goodness for that this year, because the Canadian market lost enough to wipe out last year's gains in the Canadian market too.)

OAS (Old Age Security) is another matter though. There are no payroll deductions for it. It isn't a contributory plan. It pays out to all Canadians over 65 for life and is funded from current income taxes receipts. So what will happen when there are significantly fewer people in the workforce, paying taxes, and are significantly more retirees collecting OAS? Let's hope there are enough new young immigrants working and paying taxes in Canada to support the OAS payments. So the next time you hear someone railing against all the new immigrants who are changing and "ruining" our country, remember not only that this country was built by immigrants, but that new immigrants are necessary for Canada's economic future.

By the way, here is the amount of economic growth that various countries have had between 2010 and 2017. Now we just have to plan for your investments to profit from this. We should be thinking about the countries listed in the upper left corner for the future!

China	527%	Australia	100%
India	352%	Mexico	92%
Indonesia	220%	US	88%
Turkey	214%	UK	81%
Saudi Arabia	157%	Spain	80%
Russia	150%	Germany	75%
Korea	150%	France	65%
Iran	129%	Japan	59%
Brazil	100%	Italy	44%
Canada	100%		

<u>Your Heirs' Expectations or Ideas about Your Inheritance</u>

I recently heard a story about an executor who liquidated their parents' house and investments and paid out the proceeds equally to all the siblings, per the will. One sibling thought that the parents had more wealth that they actually had and kicked up a big fuss. The parents and children had never discussed how much the parents were worth, and maybe the one sibling was really counting on the inheritance and needed it to be bigger than it was. I know that some families never discuss money. Parents guard their privacy, or maybe are embarrassed by their lack of riches. The children don't want to appear greedy or bring up a topic that will make their parents uncomfortable. I'd like to share with you some things I have learned from my clients. First, if you don't want your kids to fight after you are gone (I have seen lots of siblings have major fights after their parents die), talk to your kids before you pass on, let them know what to expect and set it up as much as you can so there is nothing they are going to fight over. If you promised some possession to one child, let the others know. Maybe ask all the kids if there is anything they want left specifically to them. Let them know the order of magnitude of your potential estate and whether you might deplete all your capital to maintain your lifestyle. If you aren't splitting the estate equally, let the kids know in advance and tell them why. Otherwise you could poison your children's relationships with each other for decades after you pass on.

If you are expecting to receive an inheritance, be careful. I recently heard about a couple who took 63 cruises in retirement and spend every dime of their savings. In fact I would say close to half of our clients say that they have no estate objective and would like to pass on with only a dime left in the bank. So don't count on something that may not be available. And if you can, find out if your parents will need financial support **from you** before they pass on, or if they have any special wishes for what is done with any residue. Also try to find out where all the critical documents are kept, for taxes, the will, etc.

Filing Taxes and Getting Duplicate Tax Slips

You can download all the tax slips CRA has received for you from "My Account" and either print them if you were missing one, get a duplicate if you have lost a slip, and you can get the data on the slips automatically entered into any tax preparation software to save time and errors. **HOWEVER**, not all mutual fund T3 and T5 slips may have been sent out before the end of March. So you might want to wait till early April to file your taxes if you have any unregistered accounts. The account numbers of unregistered accounts at Manulife Securities Incorporated end in the letter A, E or F, so you can tell from the Portfolio Reviews I mail out whether or not you have any unregistered accounts. Don't forget to save any confirmation slips you get for unregistered accounts too, since technically those slips should be used to calculate any gains or losses when you sell a holding.

By the way, if you are registering for "My Account" for the first time, don't leave it till the last minute when you need your tax slips. The password is posted to you. So you need to register about a week before you will need information from the website. The website also has past tax return and notice of assessment information on it, plus you can get to a CPP contribution summary and find other useful information on the site.

Also, when you get reports in January from fund companies, sometimes there is a T3 or T5 buried in the last page. Please check those mailings, so you don't miss a slip.

The last date for making an RRSP contribution that can be applied to 2018 is March 1, 2019.

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