Quadrant
ASSET MANAGEMENT

# The "Uneventful" Quarter

## QAM Perspectives – October 2016

Quadrant's regular newsletter that highlights topics we believe will affect markets or are important in understanding them.

*" Yes, how many times can a man turn his head*
*Pretending he just doesn't see?*
*The answer my friend is blowin' in the wind*
*The answer is blowin' in the wind."*
Bob Dylan (2016 Nobel Prize in Literature winner)

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### Q3 2016 in Review

Brexit seems to be a distant memory. The Brexit vote to withdraw from the European Union introduced heightened volatility near the end of Q2. Most equity markets have risen since the initial alarm.

The S&P/TSX Composite Index in Canada returned 5.4% (including dividends) over the quarter. The energy and financial services sectors were the biggest contributors to Canadian stock market performance, while the basic materials sector was a detractor. The MSCI EAFE Index returned 7.6% (including dividends) in Canadian dollars.

The S&P 500 Index in the U.S. reached an all-time high of 2,190.15 on August 15$^{th}$ but has moved sideways since then amid speculation on the path of interest rates and lackluster economic data. The index delivered a 4.9% return (including dividends) in Canadian dollars for the quarter.

The FTSE TMX Canada Universe Bond Index returned 1.2% for the quarter with corporate bonds outperforming government bonds as credit spreads continued to compress.

At a high level, the risk/return trade-off in bonds remains confusingly unattractive. Real yields (the yield after accounting for inflation) on government bonds are around zero.

As we have mentioned in previous communications, central bank manipulation plays a major part in this and we, at QAM, continue to position clients' portfolios with the premise that this form of intervention is not sustainable.

"It would only take a 100 bp rise in Treasury yields to trigger the worst price decline in bonds since the 1981 crash." – Ray Dalio recently wrote on LinkedIn[1].

"Our financial markets have become a Vegas/Macau/Monte Carlo casino, wagering that an unlimited supply of credit generated by central banks can successfully reflate global economies and reinvigorate nominal GDP growth to lower but acceptable norms in today's highly levered world." – Bill Gross (Formerly known as The Bond King) recently stated in his investment newsletter[2].

Preferred shares advanced close to 5% over the quarter (including dividends). Given available yields and credit risks, this asset class still offers good value in our opinion. Since the Bank of Canada implied a more stable overnight rate in its meeting last January, the preferred share market has experienced substantial returns.

Market valuations in general are not seen as cheap but are also not overly expensive either.

Having said that, in 2016, as with most recent years, gains have come mostly from an expanding market multiple. At QAM we consider that this is not sustainable. We could easily see a market multiple contraction if bond yields move higher.

Based on S&P 500 earnings back to the mid-1930s, the average P/E multiple for the S&P 500 has been close to 15.2x, which would put the current 17x a little on the expensive side. Even if it is within one standard deviation, meaning that this is not an abnormal valuation, a market correction wouldn't be surprising considering the number of potential market shocks (that are constantly mentioned by the media): European Banks that continue to sink, rate hikes from the Federal Reserve, China's economy, oil prices, geopolitical instability, rising populist sentiment and modest global growth among others.

For long term investors it always pays to look at the many aspects that could go right as well.

As at the time of writing, 23% of the companies in the S&P 500 reported earnings for Q3 2016. After several quarters of year-over-year declines, analysts currently expect revenue growth to return in Q3 2016 and earnings growth to return in Q4 2016. In terms of earnings, the growth rates for Q3 2016 and Q4 2016 are -0.3% and 5.5%. In terms of revenues, the growth rates for Q3 2016 and Q4 2016 are 2.6% and 5.2%.

In the post-meeting statement, the Fed described risks to the U.S. economic outlook as being "roughly balanced", a departure from a more anxious tone at the end of the second quarter as the U.S. labor market has strengthened. China's economy grew 6.7% in the second quarter, as in the first quarter, which is a healthier pace than many investors expected. Members of the Organization of Petroleum Exporting Countries (OPEC) agreed to limit output. Oil prices are up around 23 percent year-to-date after a dramatic plunge since the middle of 2014. OPEC's reluctance to cut output has been seen as a key reason behind the fall.

Some analysts have called Q3 a solid but "uneventful" quarter. We continue to believe that long-term investors are going to be well served by investing in a well-diversified portfolio that reflects their risk tolerance, time horizon, and income and liquidity needs – in "uneventful" quarters and "eventful" ones.

| **Equity Market Total Returns (in CAD dollars)** | Q3 - 2016 | YTD | 1 Yr | 3 Yr | 5 Yr |
|---|---|---|---|---|---|
| Canada (S&P/TSX Composite) | 5.45% | 15.83% | 14.20% | 7.99% | 8.05% |
| S&P/TSX Capped REIT Index | -3.62% | 16.91% | 12.56% | 8.19% | 7.59% |
| U.S. Large Caps (S&P 500) | 4.95% | 2.29% | 13.00% | 20.50% | 21.90% |
| U.S. Small Caps (Russell 2000) | 10.20% | 5.72% | 13.03% | 15.68% | 21.33% |
| MSCI EAFE | 7.62% | -3.05% | 4.85% | 9.53% | 13.11% |
| Germany (DAX) | 11.27% | -4.91% | 6.96% | 8.94% | 15.00% |
| MSCI Emerging Markets | 10.29% | 10.31% | 14.74% | 8.16% | 8.29% |

| **Fixed Income Total Returns (in CAD dollars)** | Q3 - 2016 | YTD | 1 Yr | 3 Yr | 5 Yr |
|---|---|---|---|---|---|
| Canada Universe Bond Index | 1.19% | 5.28% | 6.31% | 5.98% | 4.38% |
| Canada Real Return Bond Index | 2.21% | 7.64% | 8.89% | 7.08% | 3.58% |
| US Investment Grade Index | 1.45% | 0.27% | 2.96% | 12.78% | 7.88% |
| US High Yield Bond Index | 5.56% | 7.16% | 7.41% | 11.97% | 12.02% |
| US Treasury Inflation Protected Index | 2.23% | 2.64% | 4.95% | 11.14% | 6.70% |

Source: Bloomberg – as of September 30, 2016

**Investors’ biases, Alpha and the Capital Markets**

In the Investment management field, Alpha is considered the active return on an investment or the excess returns of a fund relative to the return of a benchmark index.

Investors all over the world are constantly searching for Alpha. Alpha has been called the “holy grail” of investing and, as such, receives a lot of attention from investors and advisors, but because the same term can apply to investments of such differing natures, there is a tendency for people to attempt to use Alpha values to compare different kinds of funds or portfolios with one another.

Because of the intricacies of large funds and portfolios, as well as other forms of investing in general, comparing Alpha values is only useful when the investments contain assets in the same asset class.

Aside from the fact that this outperformance has been proven by many academic studies to be difficult to achieve after accounting for the risk taken and commissions and fees in the long-term, it is even more difficult to get in a multi-asset class particularly when combined with market timing and jumping from one asset class to another, as many retail investors are prone to do.

QAM thinks that the constant chase of Alpha is more often than not a dangerous game where investors have more chances of losing than winning. As a matter of fact, QAM sees itself in many regards as a protector of clients from their own temptation to play in this dangerous field.

By the same token, QAM is equally convinced that there are many other ways investors can add value to their portfolio without trying to constantly beat the market or avoid every correction (by trying to time it).

Here are some other forms of Alpha that are frequently ignored, but can have a huge impact on a portfolio’s long-term performance and where QAM directs a significant part of its efforts:

1. Savings Value - Financial planning more often than not is many times more important to long-term results than market Alpha.
2. Tax Value - “The avoidance of taxes is the only intellectual pursuit that still carries any reward.” Sir John Maynard Keynes once said. Taxes matter much more than classic Alpha to the taxable investor even if most investors don’t spend any time analyzing this aspect.
3. Bear Market Value - Having the ability to stay invested and not overreact during market corrections can provide investors with a huge advantage over the long-term. Rebalancing and even taking advantage of market corrections (at the total system level or just in particular asset classes) is the most powerful and safest way to achieve superior long-term results.
4. Administrative Value. The way to achieve the above-mentioned Alphas is by having a comprehensive plan and process in place to follow so you can understand what to do when stressful markets inexorably come. This requires a documented investment plan with specific goals and asset mixes in place and to focus on that plan before emotions take over and comparisons are made with other people’s plans or results.

Successfully investing in the stock market is simple but can be very challenging. To do it in a formal way and in a professional fashion typically involves years of training. Outside perceptions of this training typically consists of valuation ratios, financial statements, and the like. The emotional and psychological discipline required to stay calm and make rational decisions in turbulent environments is often overlooked.

Left unchecked, our emotions can negatively influence our behaviour. Investors' behavioural biases are many, including: loss aversion/anchoring, herding, confirmation bias, recency bias and outcome bias. We all feel the temptation of each at certain times.

Recency bias refers to the assumption that something that has happened in the recent past will repeat itself in the near future. We have seen investors struggle with this on many occasions. It is difficult to find investments with expected returns that warrant their risk after they had a terrific run. It is equally difficult for investors many times to invest in a value proposition when it has fell into the “unloved” category.

Outcome bias is the one responsible for much of the arrogance in the industry. It refers to the satisfaction of getting an investment right, even if it was for the wrong reasons. Scott Barlow from The Globe and Mail recently highlighted in an article that stock prices can only go one of two ways, so we have a 50% shot at getting any given investment's directional price movement correct. It is refreshing to hear an investor say "we got lucky on that one", sometimes that is all it is, yet it is not heard all that frequently.

Investment performance is best measured over the long term where the consistency of sound decision making presents itself.

Successful investing would be a much easier task if we were heartless robots, but, investing is wrought with emotions that we all are susceptible to. Dealing with them appropriately is something that requires focused effort and attention.

Whatever the long-term asset allocation is, investors have to remember that rebalancing back to original target weights will almost always mean going against the crowd.

[1] https://www.linkedin.com/pulse/remarks-40th-annual-central-banking-seminar-ray-dalio

[2] https://www.janus.com/insights/bill-gross-investment-outlook

If you or someone you know could benefit from our services, please have them contact our offices at 204-944-8124 or email us at inquiries@quadasset.com.

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