Quadrant

ASSET MANAGEMENT

The Fall of Oil

QAM Perspectives – Nov/December 2014

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

"In investing, what is comfortable is rarely profitable."
Rob Arnott,
CEO - Research Affiliates

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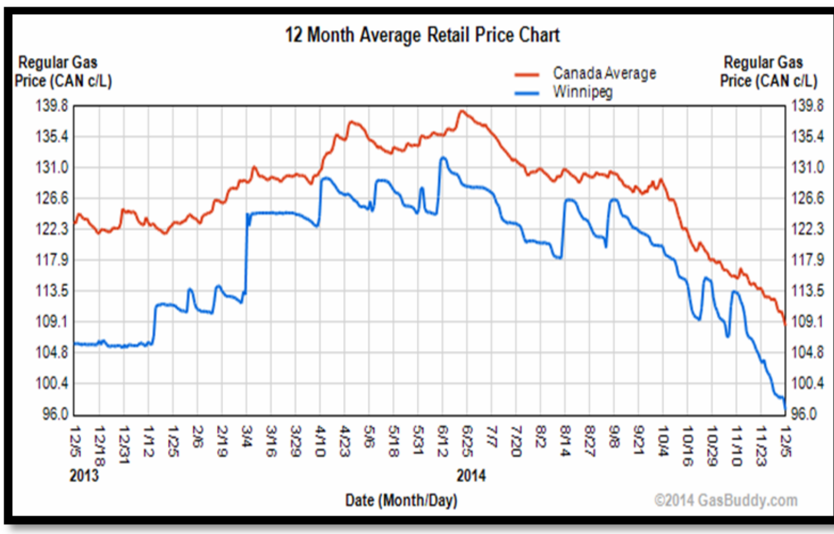
Undoubtedly you've heard about the recent collapse in oil prices. If not, then you've likely just returned from a desolate part of the world. Either way, we've seen a dramatic 30% decline in the price of crude oil over the past few months. In our last QAM Perspectives piece entitled "What Just Happened?" we discussed some of the underlying factors driving energy prices down, so we won't get into that aspect again. However, you're probably wondering: how has this affected my portfolio? And what are some of the benefits & costs to Canadians?

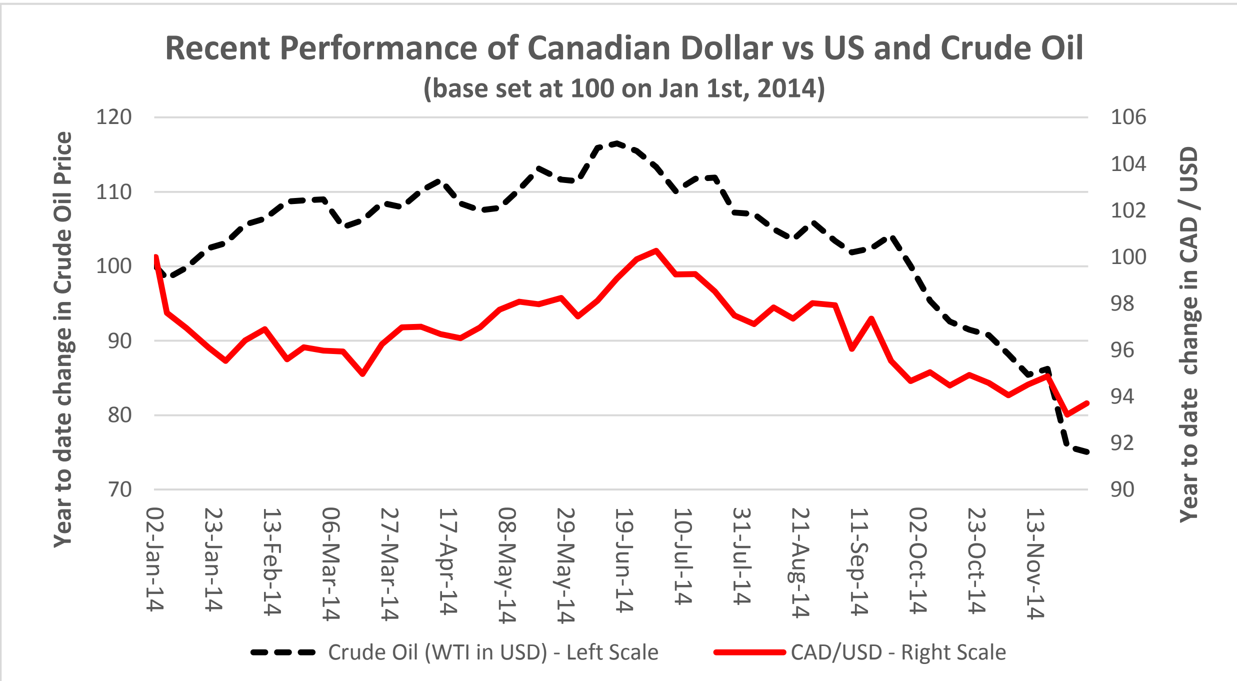
While the decline in oil has not helped portfolio returns, what we intend to show is that a well-diversified portfolio, with international exposure, will be better insulated to a shock like this than a portfolio with a large weight in Canadian stocks.

The first thing we might think of when oil prices change is, how will this impact the cost to fill my gas tank? Certainly a steep decline in oil prices has had a positive impact for consumers at the pump. The following chart demonstrates the dramatic change in gas prices not only in Winnipeg, but across Canada.



Given that every dollar we can save on gasoline equates into a dollar that can be spent on other items, our thoughts may then turn to how this will impact retail sales. In a recent piece from Guggenheim Partners[i], they estimated that for every 50 cents that gas prices decline, there's an increase of $2.8 billion (US) in retail sales. This will certainly boost the economy, but there are counterbalancing factors as well. For instance, Canada is still fairly resource intensive and a long lasting drop in oil will impact GDP, employment and the dollar.

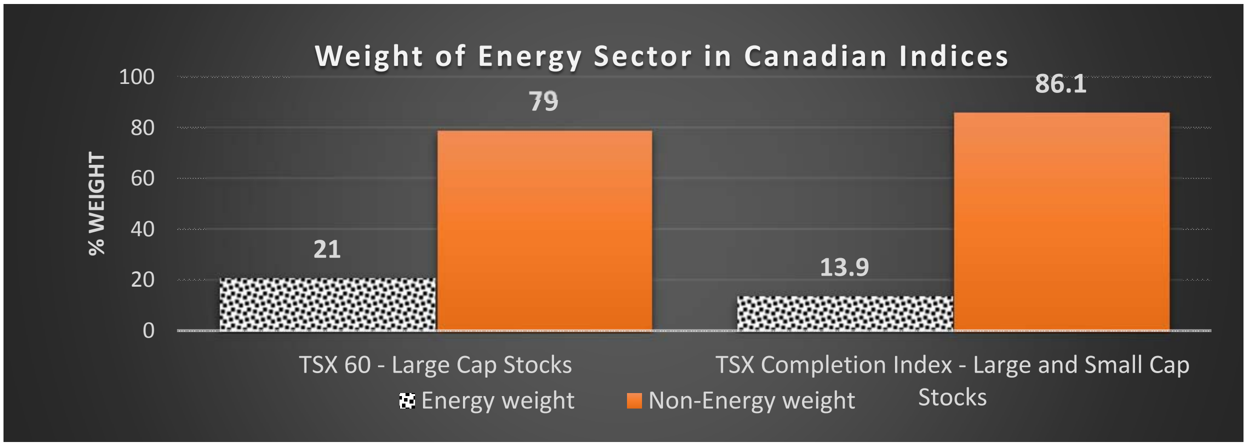
Year to date, the Canadian dollar has declined versus the U.S. dollar by approximately 6.3%[ii]. The high correlation between the Canadian dollar and the price of oil is clear to see from the chart below.

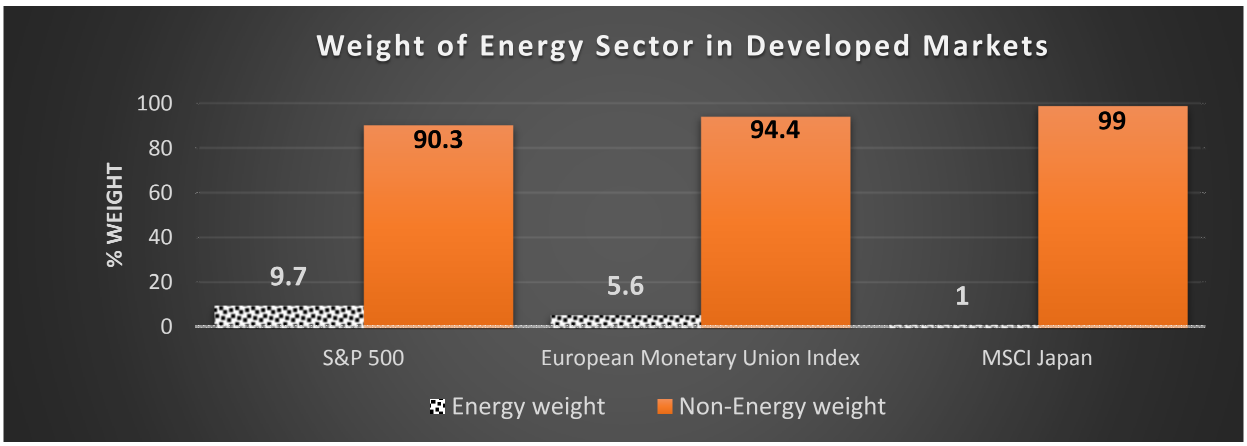


A weak Canadian dollar means different things to different people. For many of us, it means that shopping and vacations south of the border will become more expensive. To exporters it means the cost of the goods they'll be exporting will be cheaper and that should propel revenues. For investors who hold U.S. equities or bonds, the dollar's decline is actually a good thing. First of all, it should be noted that we advocate having a portfolio with international diversification because it will reduce portfolio risk. It just makes sense to avoid over-concentration in particular economies and sectors as well as currencies. That being said, an investor holding a broad basket of U.S. equities[iii] is up 13.4% year to date (as of December 8th) in U.S. dollar terms, but up 22.5% in Canadian dollar terms.

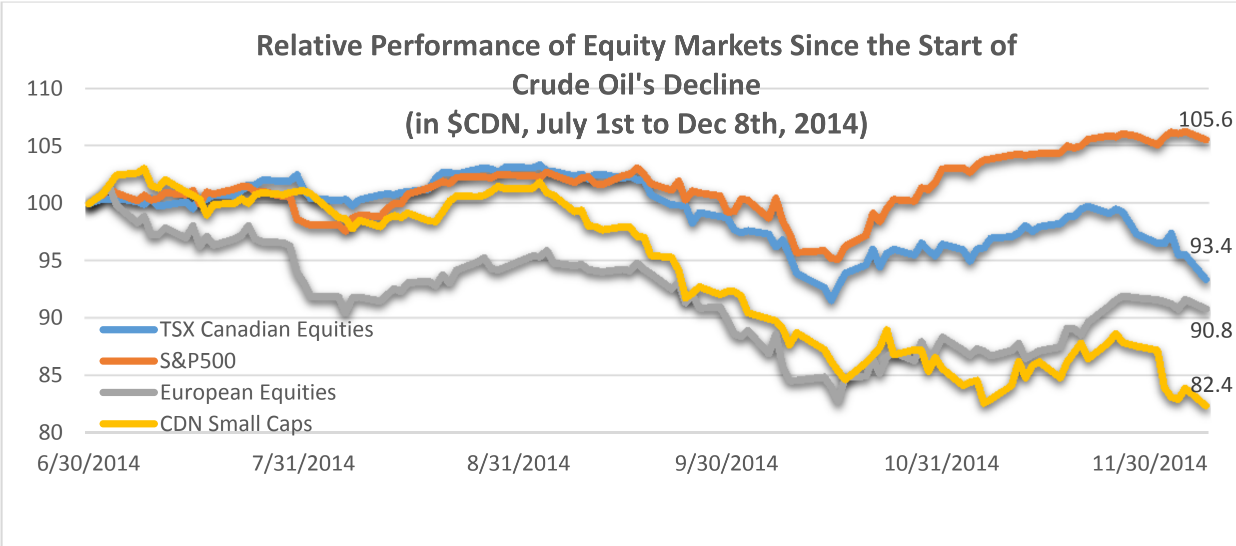
Expanding on this concept of international diversification, it's well known that the Canadian stock market has a large weight in the materials and energy sectors. Therefore, an investor who is solely invested in Canada or has a large portfolio weight in Canada, is exposed to the ups and downs of those volatile sectors. The impact of a decline in the price of oil will likely trickle down to other sectors in the economy as energy companies cut back on spending. Recently, Stephen Poloz, the Governor of the Bank of Canada has mentioned that the fall in oil prices may cut Canadian GDP by 0.33% in 2015[iv]. This expectation has already begun to weigh down on the entire Canadian stock market.

While Canada has a large exposure to commodities, other markets around the world do not have this same sector concentration. For instance, the weight of the energy sector in Japan, Europe and the United States is fairly low as the charts below indicate.

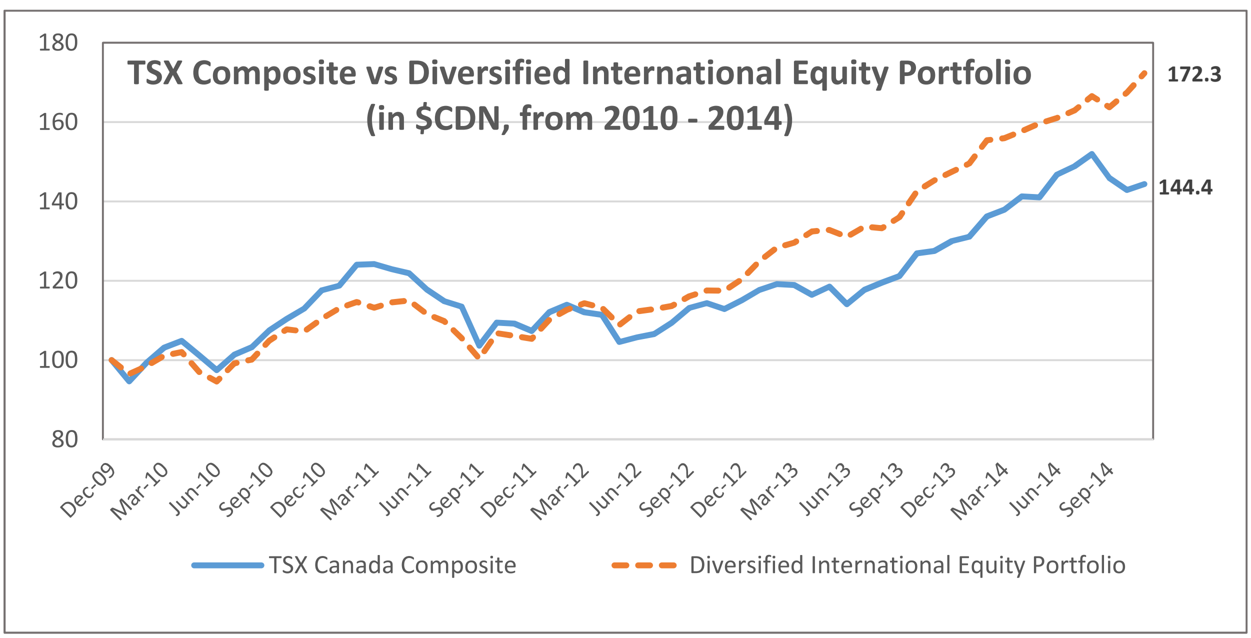




Given the structure of the Canadian market and the size of equity markets in other parts of the world, we advocate that the majority of equity holdings for a client be in international markets. For a typical client, the breakdown of just the equity part of their portfolio will approximately be 30% in Canadian equities, 30% U.S. equities, 25% international equities and 15% in international real estate. By creating a diversified global portfolio we are able to generate higher returns, with lower risk. The recent volatility in Canadian markets is a perfect example. Canadian equities, especially Canadian small cap equities, have declined significantly since oil began to plummet in July of this year (as shown below).



This recent bout of weakness, while significant, should be looked at from a broader perspective. A portfolio should be measured and managed with a long term horizon in mind. Simply because energy stocks are underperforming at the moment isn't a sufficient enough argument for owning a diversified global portfolio. A better argument is to show, roughly using the weights we use for our clients in the equity portion of their portfolio, that a portfolio with all of its equity weight in Canada has dramatically underperformed a globally diversified portfolio. Furthermore, as the chart of relative performance below shows, this is not a recent phenomenon. In fact a globally diversified portfolio has been producing better absolute, and risk adjusted, returns than a Canada focused portfolio for a number of years[v].



There will undoubtedly be market gyrations in the future. At the moment it's oil; next time around it will be some other sector or region of the world that is experiencing difficulties. These issues should certainly be monitored and risks to investment portfolios should be continually examined. Ultimately however these issues should always lead back to discussions on the fundamentals of portfolio management. The purpose of diversification is to minimize the risk from any one stock, sector or region. The benefits of this approach are lower volatility and higher returns and the data really speaks for itself.

Happy Holidays

Markets are always on the move and 2014 has been no exception! It has been a year with ups and downs, surprises and shocks. However, at the end of the day we have not changed how we manage our clients' portfolio, nor is there a need to. We like to echo the motto of one of our sub-advisors (Mawer Investment Management), which is "Be boring. Make money."

Quadrant is always here to help you with your financial plans based on the proven investment tenets of diversification, discipline, long-term focus and capital preservation.

We thank all our clients for their continued support and trust. We wish you a happy holiday and healthy, peaceful and prosperous 2015.

Disclosures

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[i] "The Dark Side to Falling Oil Prices", Guggenheim Partners, Dec 4th, 2014 - http://guggenheimpartners.com/perspectives/macroview/the-dark-side-to-falling-oil-prices

[ii] As of December 8th, 2014.

[iii] As measured by using the SPY S&P 500 SPDR ETF which tracks the largest 500 stocks in the U.S.

[iv] "Bank of Canada Sees Oil Shaving a Bigger Slice of GDP", The Globe and Mail, Dec 5th. http://www.theglobeandmail.com/report-on-business/bank-of-canada-sees-oil-shaving-a-bigger-slice-from-gdp/article21974022/

[v] The diversified equity portfolio is made of up: 30% in the TSX Composite, 30% in the S&P 500, 25% in MSCI EAFE Index and 15% in the iShare Cohen & Steers Global Realty Majors ETF. All returns are in Canadian dollar terms. This basket is representative of the weights in international markets that a typical QAM client might hold. It is not indicative of the actual performance or holdings that they would have incurred over this time period. This is due to the fact that QAM engages both passive and active investment options depending on whichever adds the most value to clients. It is also due to the fact that indices are theoretical holdings and can't be owned and also come with no fees.