CIBC Wood Gundy

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Why boring, low-yielding bonds will become our best friend at some point

Our thoughts on how stock markets may perform over the next one to three years

With the stock markets' reasonable start to 2015, if this year ends up as a positive year for the stock market, that would make it seven years in a row of up-market conditions. While we should always 'expect the unexpected,' particularly when markets have experienced a long upward climb, we may experience a reasonable stock market for a while yet based on:

1. Stock valuations. The price-to-earnings (P/E) ratio of the average company in the global stock market index is an acceptable 16 times forward earnings. From the P/E, we can then compute the 'earnings yield' of a typical stock (earnings divided by stock price) to be 1/16. This results in a healthy earnings yield of about 6%. Comparing that earnings yield vs. ten-year government bonds (which today yield less than 2%), means the average stock has an above average earnings yield advantage over bonds. In the past hundred years or so, ten-year government bonds have averaged close to 5% while the average earnings yield on stocks has been about 6.5%; thus stocks, while not cheap, look more attractive than average vs. their main competitor, namely bonds.
2. While The US stock market index is trading about 30% above its previous all time high (set in late 2007 prior to big drop in 2008/2009), European, Asian and Canadian markets are just about break even (index wise) over the same time

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period. Thus, if an investor was invested 1/3 Canada, 1/3 Europe and Asia, and 1/3 U.S., index gains would equate to only 10% above 2007 highs. Historically, indexes peak about 30% to 100% higher than previous peaks. Thus, we are not trading near a 'clear high' (in terms of the long-term stock market cycle).

3. The flow of money into stocks (and away from bonds) among retail investors is very strong at present. Few want to accept the low returns on bonds. If markets continue on an upward trend, investors will 'keep doing what they are doing.' This may carry markets to clearly overvalued levels reasonably well above late 2007 highs. If past market history repeats, we will see overvaluation levels in the next two or three years. We are allowed to enjoy the ride, but every cycle will have its end point.

Keep in mind though that while long-term market history tells us markets often perform as described above (going up nicely in the long haul and oscillating from undervalued to overvalued), if history told us what markets would do with high certainty, historians would be a lot wealthier than they are. Markets can always surprise in the short term and if investors get spooked by a series of disappointing economic data (or some political event that shakes investor confidence), large corrections can happen… and smaller (10%) corrections will happen, as we experienced twice, in the second half of last year.

So what's our strategy? Firstly, we need a 'Plan A' based on an optimistic outlook which can in turn generate a decent return in this period of incredibly low yields on risk-free bonds and GICs. Our typical client (age 64) has about 55% stocks, 45% bonds, with about half the bond exposure in high-quality corporate bonds (which today means 'low yielding') and about half in 'medium risk' fixed income, yielding about 4%. Add in the old 'think long term' adage and that can set us up for reasonable return with our 'balanced' approach. Younger clients with very long-term time horizons are typically tilted a bit higher in equity. We are not decreasing equity for these clients, given the poor alternatives in the bond market.

At all times, including now, we still need a 'Plan B' which can handle a down market reasonably well.

Our actions thus far to cushion downside risk are:

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1. Decrease fixed income risk. Over the past four years, we have significantly increased quality in terms of bond issuers we use. At present, we are buying medium-term seven- to nine-year investment grade corporate bonds with yields in the ‘unexciting’ 3% area. Most bonds that you own right now (with less than five years to maturity) are trading at above par prices. Thus, the majority of these bonds now yield only about 2.5% per year, to maturity. We originally locked in about 4% on seven- or eight-year bonds, say two or three years back, but as bond prices have increased in the past few years, returns (if these bonds were sold at today's higher prices) would be in the 7% per year range. That’s the good news. The bad news is the yield to maturity off of today's (now higher bond price) is now only about 2.5%. This is because all existing bonds always trade off of today's market values (which as said have moved up in price based on declining interest rates). As a result of these now lower yields to maturity, expect Registered Retirement Savings Plan (RRSP) and Registered Retirement Income Fund (RRIF) accounts (where almost all these bonds are located) to experience lower returns going forward. The only way to change this is to sell our low-risk bonds and buy higher-risk bonds (no thanks), or sell bonds and buy stock (again, no thanks). There will be a time in the future where we will consider selling some of these now lower yielding bonds (per ‘plan B’). When markets get nasty and deliver us some nice buying opportunities, we will then be very open to re-deploying some of these liquid bonds into stocks or high-yield fixed income.
2. We are about half way through a reduction in ‘high yield bond risk’ by moving out of one of our high-yield bond funds (Trimark), in favor of a safer, more asset-backed monthly income fund (PIMCO). We are not in a rush to do this, as higher-leveraged corporations are doing fine at present in today's ‘low interest rate and slow but ok economy.’ We will finish this trade by the end of 2015. This should be reasonably in advance of any material correction in the high-yield bond market.
3. We have added small positions in stocks that are out of favour (mining–including gold, oil and gas) and we continue to use our defensive, buy-low-sell-high ‘Dogs of the Dow’ strategy. We combine that with stocks/ETFs that have a high-quality tilt, and have lots of country, currency, industry, and company diversification… a.k.a. ‘modern portfolio theory’ with a tilt to the defensive side.
4. Money management costs can have a big impact on long-term rates of return, thus it is important that we keep costs at below industry average levels. All medium to

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larger accounts are set up quite cost effectively, and for smaller clients (where we use some equity mutual funds), we continue to attack cost ratios by using lower cost (mostly index based) funds.

5. Review 're-balancing' with you in our client meetings. In some cases, we have sold stocks per our 5% rule, in others, we have 'let it ride' with a view of selling down stocks over next year or two if 'Plan A' materializes.

What's 'up' with oil?

A brief comment on the latest headline story influencing equity markets--'oil.' I have listened to and read about 50 industry analysts' comments and reports. Predictions range from oil bottoming --at $40 to today's high $50 range-- anywhere from now to a year from now. None of this really matters to us as we are underweight in oil and gas. The 95% of what we own (that is not oil and gas related) is in industries that like low oil prices. Alberta, Saskatchewan, Newfoundland and the Federal government lose; every other Canadian province and almost all consumers win (Gregor Robertson excluded-- but as a fellow cyclist, he's my hero).

What do we like that pays decent cash income?

Real Estate Investment Trusts (REITs): Trading about 7% below net asset value and with an average of 6.5% cash distributions; they look attractive in this low-rate environment.

Preferred shares: We are getting very tax-efficient yields near 4% from quality issuers. All new issues these days pay a fixed dividend for typically about five and half years. After say, five and half year's time, a new dividend yield will be re-set for a further five years. The subsequent dividend will be based on the then 'five-year Canada bond yield plus a premium.' Thus, if interest rates rise over the years ahead, issuers will either redeem at par (at their option) or they will have to pay a higher yield at maturity. There are some quality issuers with low preferred prices right now (we own a few of them). An example would be Shaw Communications 4.5% preferred, which trades right now at just $18 vs. an issue par value price of $25. The reason for the price decline is that in June 2016, the preferred dividend will be reset to pay the new 'five year Canada bond yield plus just 2%.' When the preferred was issued almost four years back, five year Canada

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bonds yielded about 2.5%. The thought back then was that interest rates on these bonds may stay the same or go higher. The opposite has happened as five-year Canada bonds today pay a paltry 0.85%. This decline in interest rates has caused weakening in some preferred share prices (such as Shaw's) as when the dividend resets, it now may pay a lower yield. Looking at this Shaw preferred right now, it looks quite attractive at $18, as investors earn a safe 6.2% current yield (off of today's lower price) to June 2016 and then earn almost 4% (again off of the $18 current share price), even if interest rates stay this low, over a year from now. If interest rates go up, the yield will be better, and this preferred should also gain in price. Most new issues right now have to pay between 2.9% and 3.5% above future five-year Canada's. Today's low bond yields mean issuers now have to pay higher 'spreads.' We are holding all existing preferred share positions and quite like the terms issuers are paying on new issues, thus continue to take down more.

When designing portfolios, we select investments that will perform 'differently' from each other. This helps lower overall portfolio risk. If interest rates rise faster than expected, that will be a negative for our medium-term bonds and REITs; and increasing interest rates may also be negative for stocks. These preferred shares on the other hand, should go up in price if that happens, thus we think of them as a way to hedge away some of our 'portfolio interest rate risk.'

<u>GICs</u>: For very conservative objectives, we will buy them. We broker for about 20 different banks and trust companies, so while rates are low, we can obtain for you the best rates out there. You incur no cost, as we are paid by the issuing bank or trust company.

A return visit to 'what do clients pay CIBC Wood Gundy'

Feedback received in our last client survey said that many clients do not have a clear picture of what and how our industry charges. We have discussed this topic over the years and wrote a detailed report on this topic previously. For more detailed information, please go to www.thepopeteam.ca and locate the May 2014 newsletter. The explanation of fees starts on Page 3.

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We asked some clients in recent meetings here to guess what they pay CIBC Wood Gundy (percentage wise). Some clients guessed as high as 2 to 3% per year, so that tells us we need to do a better job in explaining this topic.

Our average Pope Team client pays CIBC Wood Gundy about ½ % per year (industry average is almost double at close to 1%). As Portfolio Partner® fees (which can be tax deductible) represent a portion of the cost for many clients, the after-tax cost for many clients would be closer to 4/10th of a percent. Equity costs a bit more than fixed income, so higher-equity clients generally pay a bit more than ½%, while lower equity clients pay a bit lower than ½%.

How to avoid a $2,500 CRA penalty

It is very important that any client with more than $100k (in Canadian dollars) of foreign assets ticks 'yes' to that question on their tax form. Someone at CRA dreamed up a complicated T1135 form that now has to be filled out if this applies to you. Foreign assets include U.S. listed stocks and ETFs, not just real estate property. We have mailed out all the information needed (that can be transposed to the CRA form) to any client we feel this applies to. Please contact us if for some reason you did not get the information you require, or you have any questions. CRA can fine filers who do not comply with a whopping $2,500 penalty (ugh!). This year, you can submit the form via NETFILE, or mail by April 30 (I recommend registered mail). And if you file your taxes late like I did last year, ensure you send <u>at least</u> this form in by the April 30 deadline. I did that last year, CRA lost my form, and they still fined me $2,500 (ugh!).

The new TFSA contribution limit for 2015

With the recently proposed federal budget, the Tax-Free Savings Account limit will be increasing from $5,500 to $10,000 per year, effective 2015. For those of you we have spoken to, we will process the further contribution shortly. If you would like to send a cheque for $4,500 to top up your TFSA, feel free to do so.

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A humongous thanks to Cheryl and Sylvia for once again doing a super job getting tax information to clients and accountants. Also, a big thanks Melanie for taking on extra work as those two concentrated on 'tax stuff.'

While some issuer t-slips are always later than we would like, this year seemed a bit better. Only one company issued a late 'amended t-slip,' and that affected just two of our clients.

Some clients may notice monthly account statements are not being consolidated as they were previously. There is a system glitch and a fix should be made by the end of July.

Enjoy our beautiful BC spring and as always, ask us for help anytime.

Regards,
CIBC Wood Gundy

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Yields/rates are as of April 17 2015 and are subject to availability and change without notification. Minimum investment amounts may apply.

For more information about GICs, please contact Neil Pope.

Securities

Shaw Communications Inc.	13,2g,7

Disclaimers

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