CIBC Wood Gundy | Papau Armstrong Schmidt Financial Group

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The Trend Has Not Been Our Friend

2015 was a year to forget in the Canadian stock market. The S&P/TSX Composite Total Return Index declined 8.33% during the year.[1] We managed to generate positive returns for clients in our discretionary model portfolios despite the circumstances. Our Total Return Portfolio returned 6.29%, our High Yield Portfolio returned 6.69% and our Balanced Portfolio returned 2.53% during 2015.[2] In general terms, we can attribute the outperformance to individual stock selection as well as our significant allocation to U.S. assets and the positive currency effects of being invested in U.S. dollars.

Clients should understand that we actively manage our three discretionary model portfolios, and they will often differ widely in composition from the TSX Index. Although we do not tend to trade frequently, we can act quickly to take advantage of market moves. We can also retreat to the sidelines and hold a significant cash weighting, whereas the TSX Index is always fully invested.

The model portfolios are diversified, but not over-diversified, as we typically limit the number of investments in a portfolio to less than 50. We hold only what we consider to be the best investment opportunities. This active management and concentration creates the possibility of outperformance in bad years for the TSX Index, such as 2015. Many of the worst performing components of the TSX Index in 2015 were mid-cap resource companies (both mining and energy) that we usually avoid, as they often do not meet our standards of business quality. Admittedly, deviating widely from the TSX Index also carries with it the risk of underperformance, but we believe clients will be happy with our performance over long time periods.

While we are pleased with our outperformance in 2015, we had little time to enjoy it, as 2016 began with a steep selloff in most markets around the world. For example, after examining data going back to 1897, one U.S. market historian noted that the first 12 days of trading in 2016 were the worst in history for the Dow Jones Industrial Average.[3] Many of the trends contributing to the selloff, which we discuss below, are simply continuations of trends that were in place in 2015.

While sharp declines are unpleasant to endure, they do create long-term opportunities. In our experience, managing through these types of markets is about finding the right balance between action and inaction. If the long-term fundamentals of a company's business deteriorate, then it can be helpful to sell and avoid further loss. However, if a high quality company with good long-term fundamentals declines sharply in value simply for short-term reasons, selling in response typically harms long-term returns. Short-term market action can be deceptive for long-term investors, as a problem highlighted by the media can cause severe short-term declines but become irrelevant 1-2 years later.

Gradually Reducing Exchange Rate Risk

On top of the recent stock market declines, we have also had to deal with volatile exchange rates between the Canadian dollar and U.S. dollar. Normally the exchange rate is fairly stable and we do not have to confront the issue on a daily basis.

Historically, we have never attempted to hedge against fluctuations in the Canadian/U.S. exchange rate. During the 2012-2014 period, we made several investments in large, high quality U.S. companies. Our primary motivation was to purchase undervalued companies with good return potential, not to shift Canadian dollars into U.S. dollars. We were aware of the exchange rate risk inherent in purchasing U.S. companies. We simply felt it was minimal due to the Canadian dollar trading near par with the U.S. dollar.

In recent days, the Canadian dollar has dipped below US$0.70. The exchange rate risk for Canadian investors who buy U.S. assets today is higher than it has been at any time in recent years. Our intention is to incrementally reduce the exposure to the U.S. dollar in client portfolios over the next 1-2 years. We want clients to understand that we do not have a fixed percentage commitment to U.S. investments. We are free to be opportunistic and change our U.S. dollar exposure in whatever manner we believe will contribute the most to long-term returns.

Since January 1, we have executed several transactions which can all be characterized as trimming profitable U.S. dollar-based investments and converting the U.S. dollars on settlement back into Canadian cash. These transactions include:

• the sale of part of our position in General Electric Co. (NYSE:GE) in the Total Return Portfolio;

• the sale of Coca-Cola Co. (NYSE:KO) in our Total Return Portfolio;

• the sale of Toyota Motor Corp. ADR (NYSE:TM) in our Total Return Portfolio;

• the sale of 21st Century Fox Inc. (NYSE:FOXA) in our Total Return Portfolio; and

• the sale of National Grid PLC ADR (NYSE:NGG) in our High Yield Portfolio.

The net result of these transactions is that our cash weightings have risen to approximately 24.5% in our Total Return Portfolio and approximately 23.0% in our High Yield Portfolio, and our U.S. dollar exposure has declined, although it remains substantial.

Our current research efforts are heavily devoted to finding additional high quality undervalued Canadian companies to add to our model portfolios in the coming months. As Canadian investors, we will generally maintain a significant weighting in Canadian investments. That said, despite the current exchange rate, we will remain open to opportunities in the United States and elsewhere in order to reduce risk and generate returns in this low growth environment.

Oil Prices a Drag on Market Performance

Continuing declines in oil prices have contributed to stock market declines and Canadian dollar declines so far in 2016. The WTI crude price briefly dipped below US$30 in recent days. We do not believe these price levels are sustainable. We believe a recovery rally remains likely in the 1-2 year timeframe.

It is likely that many oil producers will simply stop investing in new production. In the U.S., oil production is already dropping and will likely continue to drop for a while. According to the U.S. Energy Information Administration, U.S. crude oil production averaged about 9.4 million barrels per day in 2015 and is forecast to average 8.7 million barrels per day in 2016 and 8.5 million barrels per day in 2017.[4] There is not much incentive for producers to deploy additional drilling rigs at the moment.

One reason there has been no positive reaction to this U.S. data is that Iran is returning to the market. Iran has been under Western sanctions in relation to its nuclear activities. The sanctions have recently been lifted, and Iran intends to add another 500,000 barrels per day of oil to the world market immediately and another 500,000 barrels per day within a year.[5]

All of the current concerns regarding an endless supply glut must be seen in the context of oil demand. The International Energy Agency projects that 2016 global demand will average a record 95.7 million barrels per day.[6] The world now burns through one billion barrels of oil in less than 11 days. Oil production requires constant investment just to stay steady, not to mention grow. Many producers now lack the incentive to make the necessary investment.

For now, we are going to continue to maintain our weightings in the energy sector in our model portfolios. We may rearrange some positions within the sector, if we believe that doing so will contribute to long-term returns.

Europe in Disarray

Europe’s migrant crisis is weighing on stock markets worldwide. In recent months, well over a million refugees and economic migrants from Syria, Iraq, Afghanistan and various other countries have risked their lives to reach the shores of Europe. Their numbers continue to grow, and they could be followed by millions more once the weather improves in the spring.

This massive movement of people is becoming disorderly, as some countries resist accepting any of them and other more hospitable countries are starting to be overwhelmed by their sheer numbers. The situation is already a humanitarian crisis. It threatens to become an economic crisis, as there is open talk of suspending the open borders arrangement within the European Union that allows European citizens to move around freely and helps facilitate trade and tourism.

This crisis reflects quite poorly on the EU, as it is known for hyper-regulating many matters of trivial importance, but it is currently failing to take any coherent action that would balance the interests at stake in this crisis.

China Facing a Difficult Transition

China is going through a difficult transition towards slower economic growth and more domestic consumption. For many years, commodity exporting nations like Canada and Australia benefitted from growth in Chinese demand. Now the indications of slower than expected Chinese growth are often met with selling in commodities and the shares of commodity-producing companies.

Conclusion

We have highlighted several trends that contributed to the decline of the TSX Index in 2015 and continue to weigh on stock prices early in 2016. Despite the negative news, we did outperform and produce positive returns in 2015. 2016 is young, and price declines often lead to great opportunities. Difficult markets are nothing new for us. We can draw upon our previous experience in dealing with downturns. We are always looking for ways to take advantage of market volatility to generate higher long-term returns. We believe that this year in particular will offer up plenty of opportunities for us to make new long-term investments. We look forward to communicating with you and answering any questions you may have about our discretionary model portfolios, your personal circumstances, or other topics of interest. As always, we thank you for your business.

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APPENDIX "A"

DISCRETIONARY MODEL PORFOLIOS

We encourage clients to contact us for more information regarding our three fully discretionary model portfolios, namely the Total Return Portfolio, the High Yield Portfolio and the Balanced Portfolio. Our research efforts are now primarily devoted to finding investment ideas that will suit the criteria established for these portfolios and contribute to their returns.

1) Our Total Return Portfolio is focused on providing clients with an average annual return of around 8-10%, consisting mainly of capital gains and dividends.

2) Our High Yield Portfolio is focused on providing income-seeking clients with an average yield of 4%, plus around 2-3% of annual capital growth.

3) Our Balanced Portfolio is a more conservative portfolio that typically consists of approximately 50% fixed income investments and 50% equity investments.

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[1] Source: Bloomberg: S&P TSX Index Total Return from Dec. 31, 2014 to Dec. 31, 2015 with dividends reinvested in the Index = -8.3256%.

[2] All return numbers discussed are taken from the returns of the model account for each respective discretionary portfolio. These numbers are generated using our software (ADP/Croesus V8), and individual clients' account performance may vary. These return numbers are not a promise of future performance. Returns in the Balanced Portfolio should not be compared to the returns of the S&P/TSX Index, as the Balanced Portfolio will typically hold a substantial weighting in fixed-income assets.

[3] http://qz.com/598758/it-really-is-the-stock-markets-worst-year-ever/

[4] http://www.reuters.com/article/usa-rigs-baker-hughes-idUSL2N15616Z

[5] http://www.wsj.com/articles/iranian-oil-set-to-return-to-europe-next-month-say-officials-1453462239

[6] http://www.bloomberg.com/news/articles/2016-01-19/iea-says-oil-rout-could-deepen-as-market-drowns-in-oversupply

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David Papau, Michael Armstrong and Andrey Schmidt are Investment Advisors with CIBC Wood Gundy in Vancouver. They and their clients may own securities mentioned in this column. Their views do not necessarily reflect those of CIBC World Markets Inc.

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