CIBC Wood Gundy | Papau Armstrong Schmidt Financial Group

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2016 Positive for Stocks Despite Political Risks

After the U.S. presidential election on November 8, one prominent and partisan economist predicted that the stock market would "never" recover and that a "global recession" was a probable outcome.[1] The actual short-term stock market outcome has been quite positive. Many investors now believe that the U.S. will adopt expansionary fiscal policies, including tax cuts and aggressive spending on infrastructure. It has been encouraging to see many of our core holdings rise in value, but it is quite possible that the stock market has gotten ahead of itself. Our hope for 2017 is a business-friendly U.S. government that shows restraint in other areas.

The U.S. election was one of many events in a 2016 that was far from boring. The year began with a sharp selloff in stocks. 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.[2] Investors then faced the political risk of Brexit. Consensus predictions were spectacularly wrong on these events. Investors were frequently reminded that the media has fractured into countless biased or partisan outlets. If there ever was any political impartiality in the media, it is now gone. We now often find that media reports have no value, or even negative value to investors. The intent of much of what is called "news" is now to persuade the audience to adopt a political viewpoint, or simply to shock, scare or entertain. The goal of providing unbiased information is now way down the list of priorities. Whether it is financial news or other topics, it is now more important than ever for all of us to carefully evaluate information before we absorb it.

In this fourth quarter (Q4) edition of our Newsletter, we are going to review three key industry sectors that impacted client portfolios in 2016 – the financial sector, energy sector and real estate sector. We continue to maintain substantial weightings in these sectors today.

The Financial Sector – Some Profit Taking Required

For diversification purposes, we restrict the allocation to any single industry sector to a maximum of 35% in our model portfolios. The financial sector weighting in our Total Return Portfolio was approaching this limit at the end of 2016 due to substantial gains in our U.S. and Canadian banks and insurers. In response, we have trimmed our holdings in Manulife Financial Corp. (TSX:MFC)[3], Bank of America Corp. (NYSE:BAC) and Berkshire Hathaway Inc. (NYSE:BRK.B). Each of those companies now has approximately a 6.5% weighting in the Total Return Portfolio, and the financial sector as a whole is now just below the 35% limit. The financial sector weightings in the High Yield Portfolio and the Balanced Portfolio are also considerable but remain below 35%.

We generally view the gains in our U.S. and Canadian banks and insurers as supported by the underlying fundamentals. Especially in the case of our U.S. banks, we have viewed them as undervalued for several years, and have continually discussed the possibility of large gains. It has been interesting to watch other investors change their minds about these banks over time. From 2012-2014, when we started to accumulate positions in U.S. banks, many investors were concerned that they would be overwhelmed by mortgage defaults and litigation. More recently, investors have worried about low rates, heavy-handed regulation, weak securities trading revenues and weak investment banking revenues. Today it is clear that the environment has vastly improved. While a near-term pullback is likely, we believe further gains are possible for our U.S. banks over the next 12-24 months.

The Energy Sector – Sticking to High Quality

Two years ago, we devoted almost our entire Q4 Newsletter to the causes and consequences of the 2014 oil price crash. At that point, West Texas Intermediate (WTI) crude was trading just above US$50, having declined from as high as US$107 in July of 2014. Now, two years later, WTI crude is still trading at the same level - just above US$50. While this lack of a strong recovery has to be disappointing for oil investors, at least the price has rallied off of the extreme February 2016 lows of US$26.

Recently, the Organization of the Petroleum Exporting Countries (OPEC) agreed to cut output by 1.2 million barrels per day to 32.5 million barrels per day for the first six months of 2017. In addition, Russia and other independent producers agreed to cut by 558,000 barrels per day.[4] While this is positive for the energy sector, we have not taken any immediate action in response.

Over the past two years, we have kept our portfolios somewhat underweight the energy sector relative to the S&P/TSX Composite Index, which currently consists of approximately 21% energy companies.[5] We have stuck to large, high-quality, dividend-paying companies such as Suncor Energy Inc. (TSX:SU)[6], Vermilion Energy Inc. (TSX:VET)[7], TransCanada Corp. (TSX: TRP)[8] and Schlumberger Ltd. (NYSE:SLB). Former Total Return Portfolio holding Canadian Natural Resources Ltd. (TSX:CNQ)[9] also falls into the high-quality category. We decided to take profits in that company mid-way through the year, after it rallied strongly.

These high-quality energy companies performed quite well in 2016. For example, Suncor gained approximately 23% in 2016, not counting dividends.[10] The downside of sticking to the larger high-quality companies is that we did not benefit from the 50%+ gains in many of the smaller Canadian oil and gas production companies. This is a consequence we can easily accept, because staying conservative allowed us to manage through the previous years' oil price decline with minimal damage to client portfolios.

At the moment, we do not anticipate radical changes to our energy sector weightings in 2017. We do not want to reduce energy holdings down to a minimal level, as oil prices could easily rise from here. There is now commentary suggesting that a lack of investment in bringing on new oil supplies could cause an undersupplied market in a couple of years. We also do not want to expose client portfolios to a lot of potential downside volatility by increasing our exposure to energy, when we are able to find ideas in other sectors that are less cyclical and have the same or better potential returns. Over the long term, energy efficiency and alternative energy technology will likely keep improving, so we are looking for signs that oil is being displaced as a transportation fuel. Changing fundamentals may require us to reduce our energy sector exposure substantially over the next decade.

The Real Estate Sector – New in 2016

In late August of 2016, a new stock market sector was born – the real estate sector. Previously, real estate investment trusts (REITs) and real estate management and development companies were contained within the financial sector. We were happy to see this change, as we agree that real estate companies have many characteristics that are distinct from traditional financial sector companies like banks and insurers. During 2016, we added various Canadian REITs to client portfolios as multi-year investments.

As some clients know, a typical publicly-listed Canadian REIT holds a diversified portfolio of commercial properties through a trust structure. REITs are typically owned by income-oriented investors, as they often pay attractive cash distributions on a monthly or quarterly basis. In addition, REITs have some tax advantages over regular corporations, as they are generally not required to pay Canadian income tax if they distribute all of their taxable income to unitholders.

In recent years, Canadian REITs have faced some headwinds in the form of economic weakness and somewhat weaker occupancy, but the particular REITs we have been buying are large, well-established businesses that we believe will successfully navigate this environment. We currently hold moderate weightings in Canadian REIT (TSX:REF.un)[11], RioCan REIT (TSX:REI.un)[12], Canadian Apartment Properties REIT (TSX:CAR.un)[13] and H&R REIT (TSX:HR.un) in the Total Return Portfolio, High Yield Portfolio and Balanced Portfolio. They trade at reasonable valuations and provide clients with attractive cash distributions. As we have noted in past editions, it is possible for interest rate increases to hurt the REITs. However, that potential risk is mitigated by portfolio exposure to banks and insurers. It is also likely that rising rates could be accompanied by an improving economy.

Conclusion

We cannot predict all of the change that is no doubt coming in 2017, but our philosophy of buying high-quality businesses trading at undervalued prices has proven to be durable through many different environments. We believe that this approach will continue to yield good results for clients over long periods of time. As always, we look forward to communicating with you and answering any questions you may have about your personal circumstances, our discretionary model portfolios or other topics of interest. Thank you for reading our Q4 Newsletter, and 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] http://www.nytimes.com/interactive/projects/cp/opinion/election-night-2016/paul-krugman-the-economic-fallout
[2] https://qz.com/598758/it-really-is-the-stock-markets-worst-year-ever/
[3] This company is a client for which a CIBC World Markets company has performed investment banking services in the past 12 months. CIBC World Markets Inc. has managed or co-managed a public offering of securities for this company in the past 12 months. CIBC World Markets Inc. has received compensation for investment banking services from this company in the past 12 months. CIBC World Markets Inc. expects to receive or intends to seek compensation for investment banking services from this company in the next 3 months. CIBC World Markets Corp., CIBC World Markets Inc., and their affiliates, in the aggregate, beneficially own 1% or more of a class of equity securities issued by this company.
[4] http://www.reuters.com/article/us-iea-opec-oil-idUSKBN14Z0LB?feedType=RSS&feedName=topNews
[5] CIBC Wood Gundy Investment Strategy Group Index Return Monitor dated January 11, 2017 p. 4.
[6] This company is a client for which a CIBC World Markets company has performed investment banking services in the past 12 months. CIBC World Markets Inc. has managed or co-managed a public offering of securities for this company in the past 12 months. CIBC World Markets Inc. has received compensation for investment banking services from this company in the past 12 months. CIBC World Markets Inc. expects to receive or intends to seek compensation for investment banking services from this company in the next 3 months. CIBC World Markets Corp., CIBC World Markets Inc., and their affiliates, in the aggregate, beneficially own 1% or more of a class of equity securities issued by this company.
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member or director of Canadian Imperial Bank of Commerce ("CIBC"), the parent company to CIBC World Markets Inc. and CIBC World Markets Corp., or a member of his/her household is an officer, director or advisory board member of this company or one of its subsidiaries.
[10] Suncor closed 2015 at $35.72 and closed 2016 at $43.90, having gained 22.9%.
[11] CIBC World Markets Inc. expects to receive or intends to seek compensation for investment banking services from this company in the next 3 months. CIBC World Markets Corp., CIBC World Markets Inc., and their affiliates, in the aggregate, beneficially own 1% or more of a class of equity securities issued by this company.
[12] CIBC World Markets Inc. expects to receive or intends to seek compensation for investment banking services from this company in the next 3 months. CIBC World Markets Corp., CIBC World Markets Inc., and their affiliates, in the aggregate, beneficially own 1% or more of a class of equity securities issued by this company.
[13] This company is a client for which a CIBC World Markets company has performed investment banking services in the past 12 months. CIBC World Markets Inc. has managed or co-managed a public offering of securities for this company in the past 12 months. CIBC World Markets Inc. has received compensation for investment banking services from this company in the past 12 months. CIBC World Markets Inc. expects to receive or intends to seek compensation for investment banking services from this company in the next 3 months. CIBC World Markets Corp., CIBC World Markets Inc., and their affiliates, in the aggregate, beneficially own 1% or more of a class of equity securities issued by this company.

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