Portfolio Managers Commentary – Q1 2016

"I will not abandon a previous approach whose logic I understand even though it may mean forgoing large, and apparently easy, profits to embrace an approach which I don't fully understand, have not practiced successfully and which, possibly, could lead to substantial permanent loss of capital." - Warren Buffett

Calmer waters are welcome

Probably the simplest reasons anyone invests in stocks are to make money (capital gains), generate income (dividends), or some combination of the two. Of course, that really is putting it in the simplest of terms.

Many of you have chosen to follow our recommendations to place a portion of your nest egg in a diversified portfolio that includes equities, because the stock market has historically offered superior long-term returns.

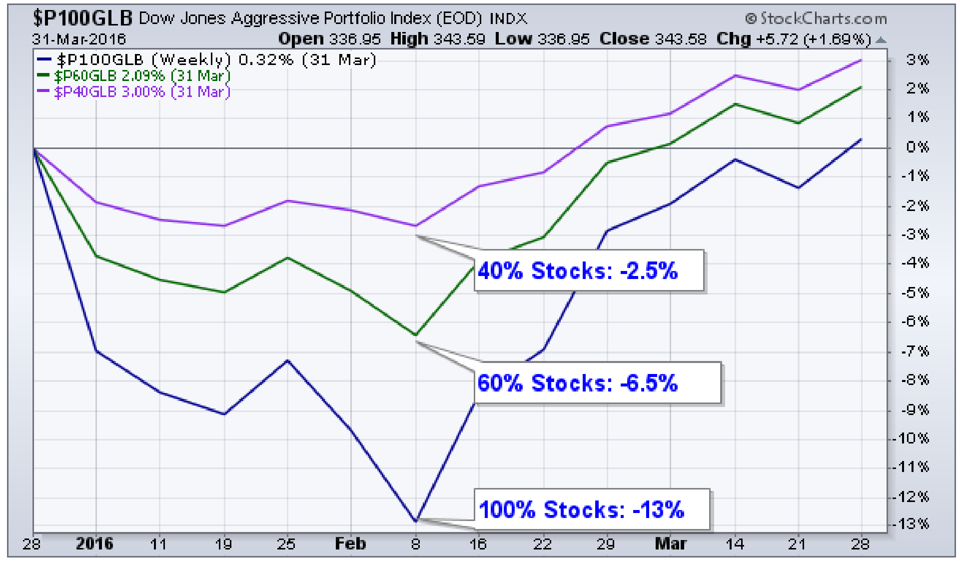
For investors that are already retired and are making regular withdrawals from their accounts, research suggests that it is prudent to reduce the equity exposure to help tolerate market declines. Proper asset allocation can maximize the portfolio value, decrease the probability of depletion and increase the portfolio life. At the same time, a conservative stock portfolio will not only generate income, but also allows for some growth.

While it's not a strategy that guarantees against short-term losses in the equity portion of your investments, limiting exposure to the market mitigates much of the risk to your entire nest egg.

The chart below illustrates the importance of asset allocation in managing risk and how it relates to drawdowns in account values during market declines like we experienced in the first quarter of 2016.

The purple line represents a globally diversified portfolio with 40% allocated to equities and declined by only -2.5% at the February low. The green line represents a portfolio with 60% equity exposure but declined by -6.5%. The blue line is a 100% equity portfolio which declined by -13.0% at the low point.

Market Commentary



This chart visually demonstrates how a diversified portfolio of cash, bonds, and stocks anchor overall returns, i.e., you won't see the highs in bull markets but you won't sink to the lows in down markets either.

Collective wisdom, market volatility, and how stocks are priced

There is an enormous amount of research that has gone into how stocks are priced. Whether we are reviewing an individual stock or a broad measure of equities such as the S&P 500 Index or S&P/TSX Composite Index, in reality the current price is a gauge of market sentiment that takes into account the collective wisdom of all market participants.

These participants include everyone from the small investor to sophisticated institutions that have created complex models to value stocks. Simply put, they incorporate all publicly available information; collectively generating what they believe is a fair price for the stock or industry metric at that moment. As sentiment shifts, so does the price.

These participants are all "putting their money where their collective mouths are," so to speak. Since information is so readily available and is so quickly distributed, analysts and academics like to say that markets are efficient. While I would argue in favor of market efficiency, I believe the collective wisdom of investors can sometimes misprice risk, especially when emotions come into play.

Still, I strongly encourage you to avoid trying to time the market. No matter what article you have seen that seems to have special insights into the future says; no one has a crystal ball that consistently calls highs and lows.

That brings us to the upside and downside volatility in the market we've recently experienced. In some respects, the declines of just over 10% in the late summer 2015 selloff and the early 2016 selloff really weren't particularly significant. Market corrections in the broader context of a bull market will happen from time to time. Our goal is to manage and mitigate risk, but we can't eliminate it.

Economically speaking

One recent fear is that the economy was set to slip into a recession. Recessions will take a big bite out of corporate profits, and profits are the biggest medium and long-term factor that affects stock prices. While recent data are not suggesting the economy is running on all cylinders, it does signal that the expansion is muddling along at a modest pace.

Yet, that's not what stocks seemed to be telegraphing early this year. Everything from China worries, falling oil prices, and fears about earnings seemed to be suggesting the economy was set to stall. While markets typically process information efficiently, once in a while the collective wisdom overshoots to the upside or the downside. However, this is only evident in hindsight.

Expect to see headlines screaming of an impending bear market or even a market crash. They really don't offer much in the way of solid market analysis, but they are designed to get "eyeballs," or page clicks. The old news adage, "If it bleeds, it leads," applies to sensational financial articles, too.

The case of China

China provides an excellent case in point. U.S. exports to China account for just under 1.0% of U.S. GDP, but China just seems to have this way of creeping into investor psychology with scary headlines.

While China doesn't appear to have its problems under control, its economy avoided the proverbial brick wall. Its currency, the yuan, has stabilized and has even begun to appreciate against the U.S dollar, rising to roughly a four-month high.

More importantly, stocks have closely tracked crude oil in recent months, and the uptick in oil has benefited stocks, particularly in Canada.

On the subject of oil…

What's been going on in oil has really been counterintuitive and has defied the predictions of most analysts. The belief was that oil was supposed to act like a huge tax cut for consumers, fueling spending and growth. In reality, it's not a tax cut. Instead, it's a transfer of wealth from producers to consumers. However, what we've seen so far is energy producers slashing spending and firing employees, without a corresponding pick up in spending by consumers.

While I must admit that filling up for less than$1 per litre is satisfying, we've simply witnessed some economic pain without the economic gain. And it's spilled over into the broader stock market as steep declines in energy company's earnings has pulled down profits in both Canada and the U.S., wreaking havoc on high-yield bonds.

In the past few months the recovery we've seen in oil, as it moved from $27-41 a barrel, has actually aided stocks. As we head into late spring and summer, we are entering what has traditionally been a strong period for oil so we still may see further gains. Yet the recovery in oil still feels fragile? While the steep drop in prices since 2014 is starting to impact production in Alberta and the more costly U.S. shale fields, oil output has been far more resilient than many had anticipated due to credit innovations and efficiencies gained over the past year.

And talk of a deal to freeze or cut production among key global producers remains just that – talk.

The dollar dip

Finally, investors are also trying to price in the impact from the recent dip in the U.S. dollar into stocks, especially the larger industrials that do a fair amount of business overseas.

Remember, the collective wisdom of the market? It is millions of investors, both large and small, quickly pricing new information into buy/sell decisions. In turn, it's reflected in changing prices.

A stronger U.S. dollar is a big benefit to those traveling overseas, and it helps keep a lid on the price of imported goods. But companies doing business abroad must translate those foreign sales back into more expensive dollars, which hurts earnings.

Notably, the rise in stocks last month was inversely correlated to changes in the dollar as investors cautiously anticipate that U.S. dollar headwinds will abate when multinationals begin reporting Q1 earnings later in the month.

Bottom line

Markets will experience periods of tranquility and markets will experience periods of volatility. In some respects, it's much like the weather. Even then, I might put more faith in the three-month temperature outlook then I'd put in the many and varied forecasts for stocks. It's simply noise and is best to be avoided.

Market Commentary

All of you have financial goals. If you are to achieve your goals, then a well thought out plan or financial roadmap, is crucial. Imagine starting out on a vacation without a roadmap? You may not be happy with where you end up.

Unless new circumstances have arisen in your life, I strongly encourage you to stick with the plan that we have both agreed upon. This includes an agreed upon level of exposure to stocks.

I hope you've found this commentary to be educational and helpful. As I always emphasize, it is my job to assist you! If you have any questions or would like to discuss any matters, please feel free to give me or any of my team members a call.

Thank you very much for the trust and confidence you've place in my team and my firm.

Sincerely,

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Canaccord Genuity Wealth Management

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P.S. - I don't often ask for referrals, but during these unsettling times you might have a friend, relative, or co-worker who is in need of level-headed counsel on investing. Give me a call if you think I can help.

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