Portfolio Managers Commentary – Q4 2018

"It is almost impossible to do well in equities over time if you go to bed every night thinking about the price of them." – Warren Buffett

2018 Year in Review and 2019 Outlook

U.S. Market

Two thousand eighteen was perhaps the strangest year I've experienced in my career as a financial advisor. Most importantly, it was one of the truly great years in the history of the American economy, and by far the best one since the global financial crisis of 10 years past. Paradoxically, it was also a year in which the equity market could not get out of its own way.

It is almost impossible to cite all the major metrics of the economy which blazed ahead in 2018. Worker productivity, which is the long-run key to economic growth and a higher standard of living, surged. Wage growth accelerated in response to a rapidly falling unemployment rate. U.S. Household net worth rose above $100 trillion for the first time, yet household debt relative to net worth remained historically low. Finally—and to me this sums up the entire remarkable year—for the first time in American history, the number of open job listings exceeded the number of persons unemployed.

Earnings of the S&P 500 companies, paced by robust GDP growth and significant corporate tax reform, leaped upward by more than 20%. Cash dividends set a new record; indeed, total cash returned to shareholders from dividends and share repurchases since the trough of the Great Panic reached $7 trillion.

But the equity market had other things on its mind. Having gone straight up without a correction throughout 2017, the S&P 500 came roaring into 2018 at 2,674—probably somewhat ahead of itself, as it seemed to be discounting the entire future effect of corporate tax cuts in one gulp. There ensued in February a 10% correction, followed by several months of consolidation. The advance resumed as summer waned, with the Index reaching a new all-time high of 2,931 in late September. It then gave way to a second correction with the market declining -20% in 90 days, reaching a selling climax the day before Christmas. However, since recording the December low we've seen a pretty good bounce in stock prices. While market volatility was abnormally low in 2017, 2018 is a reminder that it never went away!

The major economic and market imponderable as the year turns is trade policy, which in the larger sense is an inquiry into the mind of President Trump. I think it fair to say, as the economist Scott Grannis recently did, that "Trump has managed to reduce tax and regulatory burdens in impressive fashion, but his tweets and his tariff threats have created unnecessary distractions and unfortunate uncertainties, not to mention higher prices for an array of imported consumer goods."

These and other uncertainties—perhaps chief among them Fed policy and an aging expansion—were weighing heavily on investor psychology as the year drew to a close. For whatever it may be worth, my experience has been that negative investor sentiment—and the resulting equity price weakness—have usually presented the patient, disciplined long-term investor with enhanced opportunity. As the wise and witty Sage of Omaha wrote in his 1994 shareholder letter, "Fear is the foe of the faddist, but the friend of the fundamentalist."

Canadian Market

While the U.S. economy has pretty much been the global leader over the past several years, the same cannot be said for Canada. Canadian political leadership has been moving in the opposite direction of our neighbors down south. Instead of allowing the economy to thrive, our government has stifled the economy by raising taxes, running massive deficits, growing the debt burden and piling on the regulations. It's become very difficult to invest large sums of capital in this country due to political and regulatory risk. Foreign investors couldn't be bothered anymore and are seeking to invest in other friendlier jurisdictions. And the consequences of implementing the new carbon tax will likely be the final nail in the coffin.

Until there's a change in leadership in this country, the U.S. will likely continue to outperform. Below I've highlighted some additional risks to the Canadian economy in 2019.

Oil

The price of oil plays a significant role in the fortunes of Canada's economy. Naturally, one of the most dominant storylines of 2018 was the extreme volatility we saw in the oil market.

The oldest economic law in the world is the law of supply and demand. As you know, when the *demand* for something is greater than its *supply*, prices go up. When supply is greater than demand, prices drop. Currently, the world is experiencing something of a glut in supply, with Saudi Arabia ramping up production in 2018 and the U.S. enjoying a shale oil boom. A possible slowdown in demand driven by fears of a declining global economy may also play a role.

Canada faces another challenge: Getting oil out of the country. Oil is largely shipped via pipelines, but most existing pipelines are at or near capacity. For a variety of reasons – most of them political, which I won't get into here – new pipeline projects have largely failed or stalled in recent years. As everyone knows, it's hard to sell what you can't ship, which drives prices even lower.

Many oil companies have turned to rail to move their product, while OPEC – the Organization of Petroleum Exporting Countries – has vowed to cut production in 2019. This could help the oversupply problem. Nevertheless, we'll be watching oil prices very closely this year.

Debt

Household debt continues to be a serious problem for many Canadians. In the third quarter of 2018 alone, the average person owed nearly $1.78 in credit market debt – credit cards, mortgages, other loans, etc. – for every dollar of disposable (after-tax) income they earned.

That's a debt-to-income ratio of close to *180%*!

Given how much our economy is fueled by consumer spending, that's not exactly a good thing. The more people are in debt, the less they can spend. The less they spend, the less our economy can grow. That's especially true if the Bank of Canada continues to raise interest rates in 2019.

Housing Market

Another source of economic fuel is the housing market. Real estate prices have skyrocketed in recent years, but they experienced a slowdown in 2018, especially in the largest cities like Toronto and Vancouver. There are many reasons for this, including rising interest rates and stricter rules on mortgage loans. So, what does that mean for this year?

Predicting housing prices is a fool's errand. That said, while it doesn't appear a housing *crash* is in the works, the factors that caused the slowdown are still in place. Furthermore, if interest rates and household debt both continue to rise, real estate prices could be dragged down even further. Given that residential investment accounts for 7.5% of the economy, just off a record high, any further slowdown will certainly have a negative effect on the economy.

General Principles

It will be worth restating, even in the context of a letter primarily focused on the year just past, my overall philosophy of investment advice. It is goal-focused and planning-driven, as sharply distinguished from an approach that is market-focused and current-events-driven. Every successful investor I've ever known was ***acting continuously on a plan***; failed investors, in my experience, get that way by ***reacting to current events in the economy and the markets.***

I neither forecast the economy, nor attempt to time the markets, nor predict which market sectors will "outperform" which others over the next block of time.

Once a client family and I have a plan in place—and have funded it with what have historically been the most appropriate types of investments—I'll hardly ever recommend changing the portfolio ***so long as your long-term goals haven't changed.*** We may adjust the mix of the various classes to manage risk but will always stay within the agreed upon range set out in the Investment Policy Statement.

As a general statement, I've found that the more often investors change their portfolios (in response to the market fears or fads of the moment), the worse their long-term results.

In sum, my essential principles of portfolio management are fourfold. (1) The performance of a portfolio relative to a benchmark is largely irrelevant to long-term financial success. (2) The only benchmark we should care about is the one that indicates whether you are on track to accomplish your financial goals. (3) Risk should be measured as the probability that you won't achieve your goals. (4) Investing should have the exclusive objective of *minimizing that risk.*

I hope you've found this review to be educational and of value. Once again, let me emphasize that 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 placed in my team and my firm.

Sincerely,

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