LIBERTY
International Investment Management

MARKET UPDATE

June 30, 2017

YEAR-TO-DATE PERFORMANCE

The Markets – January 1st to June 30th, 2017

Equity Markets

Last year, the high-flying indexes were Brazil and Canada. In 2017, however, they are the fourth-worst and worst indexes. That's mainly because they are nations that are heavily dependent on resources. It hasn't helped that

2017 Returns – Q1

COUNTRY	STOCK INDEXES	TOTAL RETURN (with dividends re-invested in native currency)	TOTAL RETURN (with dividends re-invested in Canadian Dollars)
India	S&P BSE Sensex 30	+14.68%	+21.59%
Mexico	Mexican Bolsa	+10.36%	+21.71%
United States	S&P 500	+9.34%	+5.61%
Europe	Stoxx 600	+7.54%	+12.39%
Japan	Nikkei	+5.78%	+6.07%
Brazil	Ibovespa	+4.44%	-1.30%
China	Shanghai Composite	+3.62%	+2.66%
Australia	S&P / ASX 200	+3.16%	+6.00%
Canada	S&P/TSX	+0.73%	+0.73%

Data Courtesy of Bloomberg LLP

oil prices are down 14%, natural gas is down 19% and, notably for Brazil, coffee and soybean prices are down 9% and 5% respectively.

For the Canadian stock market, the past 2 ½ years have been difficult for investors. In 2015, the TSX fell 11%, in 2016 it jumped 21% and in 2017 it's done nothing – the year-to-date return is 0.73%.

If you take $1 and drop 11% in 2015, gain 21% in 2016 and gain 0.7% in 2017, you net a total return of $1.08, a 2 ½ year average return of 4%, barely keeping ahead of inflation.

P/E multiples have fallen as earnings per share have risen

A rise in profits, an increase in the denominator part of the Price / Earnings ratio, has caused the estimated P/E ratio to fall. However, when outstanding items are considered, the P/E ratio still hovers near its historical peak for all the different indexes. This type of correlation makes us uncomfortable because there's nowhere to hide among global stock markets if a sell-off occurs.

Price/Earnings Multiples

INDEX	COUNTRY	P/E RATIO Current	P/E RATIO Before Outstanding Items
S&P TSX	Canada	20.86	22.33
S&P 500	United States	18.65	23.82
Euro Stoxx 600	Europe	15.64	24.45
MSCI World Index	Global	17.30	23.04

Data Courtesy of Bloomberg LLP

It also explains the popularity in Exchange Traded Funds (ETFs). With the demise of active mutual funds and their high fees (think 2% and up), investors have moved into ETFs in a big way

According to a *Bloomberg LP* article, "the impact of the flood of money into these passive vehicles can't be overstated as ETFs now account for 35% of mutual funds' stock investments, a figure that Vanguard Group Inc. founder Jack Bogle says could rise to 45% over the next five years."

"ETFs will no doubt continue to benefit if that trend continues, having already jumped from USD $400 billion in assets a decade ago to about USD $2.9 trillion today. Active mutual funds, meanwhile, have stalled at about USD $10 trillion in the United States."

Banks, insurance companies and mutual fund firms have found ETF religion and unleashed their marketing departments on the naïve investor to ensure they keep their market share in investment products. Unfortunately, in their literature, they don't explain fully the downside to ETFs, namely:

- Fees for some concentrated ETFs remain high.
- The ETF funds are always fully invested – when the market corrects, there's no downside protection – investors will go down the full extent of the market loss plus the fee.
- If it's a big market correction, it may take 5 years or so to make the money back (such as after the 2008 market crash).

For the Liberty stock portfolio, the 5 best/worst performers so far in 2017 are:

Year-to-date Price Performance
(dividends not included)

TOP 5	% GAIN	BOTTOM 5	% LOSS
Cognex Corp.	+33%	J.M. Smucker	-7%
Femsa	+29%	Balchem Corp.	-7%
Roper Technologies	+26%	Paychex Inc.	-7%
Thermo Fisher Scientific	+24%	Gemalto NV	-4%
Unilever NV	+24%	TD Bank	-2%

Data Courtesy of Bloomberg LLP

The chart above illustrates why we've outperformed all our pertinent indexes this year as the winners have done better than the losers.

Here are some comments on the individual stocks noted above:

- **Cognex Corp.** is the "eyes" of the robot and can measure products on the assembly line in milliseconds with its 2D and 3D technology. Or, it can read the baggage tags at an airport and divert the luggage to the proper carousel faster than humans can.

  Apple Inc. is Cognex's largest customer but Cognex has outperformed Apple in 2017, with a gain of 33%, compared to Apple's 24% return.

- **Femsa's** rebound in 2017 reflects a recovery in the Mexican peso (see Currency Markets below) and the fact that it does little business in the United States. Femsa owns convenience stores, gas stations and pharmacies in Mexico, Latin and South America and is the largest Coca-Cola bottler outside the U.S.

- **Roper Technologies** may be described as a "serial acquirer" that has grown by purchasing firms. Its product line is mostly computer software for hospital medical systems and tag systems for toll roads in New York state, Florida and Texas.

  The company's acquisitions have created excess cash flow that is greater than its net income. This keeps the company flush with cash to pay down its debt quickly and provide the leverage to do even larger acquisitions.

  Blackstone Group, Danaher, Stantec, Heico Corp. and Thermo Fisher Scientific are examples of other Liberty names that fall into the category of "serial acquirers".

- **Unilever** was the target of a failed takeover by KraftHeinz but the stock price still trades around the takeover offer. It's now up to Unilever management to prove the valuation is legitimate.

- Like many of the consumer stocks, **Smuckers** has suffered from lower revenues as consumers appear to have changed their eating habits. They're also dealing with cost-cutting at their pet foods operations, a recent takeover.

The other four stocks in the table above are suffering from valuation issues whereby the stocks moved up too fast and the earnings will have to catch up to the prices before they can move higher.

Looking ahead to the rest of 2017, if earnings continue growing at the current pace, the market may move higher. Until the anticipated fiscal policy changes come to bear, however, the market may just move sideways.

Or, we could get an unhappy surprise if the technical analysts are to be believed. The "Phi" and "Fibonacci" trend chartists predict a market rise to November 2017 and then a significant market drop until January 2020, a three-year correction that would mark the next recession.

Whatever the outcome, we're letting the cash build up in client portfolios. If the market moves higher, the portfolios should continue to perform well. If the market drops, we have cash to take advantage of any buying opportunities. When it comes to investing, that's the best of both worlds.

Currency Markets

Canadian Dollar vs.			
CURRENCY	**DEC. 31, 2016**	**JUNE 30, 2017**	**GAIN/LOSS %**
US Dollar	$1.3435	$1.2964	+3.6%
Norwegian Krone	$0.1555	$0.1553	+0.1%
Japanese Yen	$0.0115	$0.0115	-0.2%
South African Rand	$0.0978	$0.0990	-1.2%
British Pound	$1.6594	$1.6885	-1.7%
New Zealand Dollar	$0.9305	$0.9506	-2.1%
Swiss Franc	$1.3215	$1.3534	-2.4%
Australian Dollar	$0.9677	$0.9968	-2.9%
Swedish Krona	$0.1479	$0.1537	-3.8%
Danish Krone	$0.1904	$0.1992	-4.4%
Euro	$1.4153	$1.4813	-4.5%
Mexican Peso	$0.0648	$0.0715	-9.4%
Average Loss			-2.4%

Data Courtesy of Bloomberg LLP

The chart above is determined as follows: On December 31st, 2016, one British Pound bought $1.6594 Canadian Dollars. By June 30, 2017, it bought $1.6885 Canadian dollars, meaning the Canadian Dollar weakened by almost 2% against the Pound.

Last year, the Loonie rose 6.3% against this basket of currencies but has inched lower in 2017 by 2.4% because of its close ties to the price of oil and natural gas (down 14% and 18% respectively). Lately, the Canadian dollar has risen 3% on expectations that interest rates in Canada should start moving higher, in line with U.S. rates. And with it should go mortgage rates.

The impact on mortgages for the Canadian homeowner if interest rates rise 1% would be:

On a $500,000 mortgage with a 5-year fixed rate / 20-year amortization / weekly payments, the extra payment would be $68 weekly, or $3,536 a year. For those with a $1 million mortgage, the payment would be double, equalling an extra $7,072.

This means that homeowners would have to allocate more of their income for debt repayment and less toward consumer spending. This would hurt economic growth because consumer spending accounts for the largest part of Canada's GDP growth (Gross Domestic Product).

Bond Markets

So far in 2017, short-term interest rates in Canada (3 months to 7 years) have jumped about ¼ of a percent. In the U.S. it's been about ½ of a percent, indicative of the Federal Reserve's rate increases.

Historically, Canadian rates tend to follow U.S. rates because Canada is so tied to the U.S. economy. The first 7 countries in the table below are "emerging markets" while the bottom 7 are the established economies. It's easy to see how much room there is for rates to rise in the established economies.

10-Year Bond Yields		
COUNTRY	**MOODY'S SOVEREIGN CREDIT RATING**	**CURRENT YIELD**
Argentina	B-Low	+6.32%
Greece	CCC-Mid	+5.30%
Turkey	BB-High	+5.10%
Brazil	BB-Mid	+4.85%
Russia	BB-High	+4.23%
Mexico	A-Low	+3.67%
Indonesia	BBB-Low	+3.64%

Data Courtesy of Bloomberg LLP

10-Year Bond Yields		
New Zealand	AAA-Mid	+2.96%
Australia	AAA-Mid	+2.59%
United States	AAA-Mid	+2.30%
Canada	AAA-Mid	+1.76%
United Kingdom	AA-High	+1.25%
Germany	AAA-Mid	+0.46%
Japan	A-High	+0.07%

Data Courtesy of Bloomberg LLP

Our Current strategy

As a result, our bond portfolios have been following what's known as a "Barbell Strategy". If you think of a barbell, there are weights at either end and just the bar in the middle – it's the same for our bond holdings.

→ The weights at one end are the 1-5 year high-yield investments. These bonds are rated less than BBB or investment grade and yield in the 5% to 7% range. After tax, inflation and fees, the real returns are positive, meaning we're comfortable taking on the risk so clients' spending power can continue to climb.

Though these bonds are non-investment grade, the quality of the balance sheets is good enough to continue to receive payments to their maturity dates.

→ The middle of the barbell is only the bar itself, meaning we have few investments in the 5 to 20-year range but enough to keep the 10-year bond ladder in place. That's because there's little return for the risk taken as the average yields are 2% to 3%, meaning the real returns are negative. However, if rates begin to rise in the 10-year area, we'll probably find a better risk-reward opportunity for bonds of this duration.

→ At the other end of the barbell are the weights of 20 to 40-year investment grade US bonds where we can get a 5% yield. The added benefit is that if the stock market collapses, the long bonds, which are the most price sensitive, should have the greatest price rise and help offset equity losses.

Why bonds are not like GICs

While Guaranteed Investment Certificates (GICs) provide a stated coupon for a certain period, bonds are a bit different because their prices move around depending on:

→ Interest rate moves over the duration of the bond

→ Credit rating changes

→ Currency moves

→ Liquidity and the mispricing of individual bonds

→ Interest rate spreads between government, provincial and corporate bonds.

As a result, there are opportunities to make money in the bond market that may be greater than the bond's stated coupon. Here are two examples:

1. Standard Chartered plc 5.7% USD due March 26, 2044. This British bank carries a strong "A" credit rating. In the spring, the bond traded as low as $101 per $100 par value, likely because of a weak earnings quarter or perhaps because another institution had to sell it to raise cash to cover a redemption. This provided the opportunity to buy a mispriced asset.

   The bond now trades at $113.64, an unrealized price gain of 13% for a total unrealized performance of 14.4% (13% plus ¼ of the 5.7% coupon).

2. Tesco plc Real Return Bond 1.982% GBP due March 24, 2036. It is an inflation-protected bond whereby the client is paid 1.982% + the annual British inflation rate (currently 2.5%) to maturity - the inflation multiplier will compound over the next 19 years. It was bought for the following reasons:

- → To take advantage of a weak British pound versus the Canadian dollar.
- → To enjoy higher inflation protection caused by the weak Pound.
- → The company, rated BB (High) wants its BBB credit rating back and has been aggressively paying down debt. If this occurs, pension funds and insurance companies could own it again and should push the bond price higher.

Since the original purchase, the bond's performance has been:

TESCO PLC 1.982% RRB	2016	2017	CHANGE
Price	$126.56	$129.81	+3%
Currency GBP / CAD	$1.60	$1.67	+4%
Inflation Rate	1.5%	2.5%	+1%
Total Unrealized Return			+8%

To summarize, rates may be low but there are opportunities to buy bonds with the potential to earn more than 2% or 3%. It doesn't happen often but the potential rewards make it worthwhile to look every day to see what is offered.

Preferred Shares

TYPE OF PREFERRED SHARE	YEAR-TO-DATE PRICE CHANGE
Canadian Perpetual Preferred Shares	+3.76%
Canadian Variable Rate Reset Preferred Shares	+8.92%
BofA Merrill Lynch US Perpetual Preferred Index	+8.73%

Data Courtesy of Bloomberg LLP

With Canadian interest rates on the rise, variable rate preferred shares, or rate-reset preferred shares, have enjoyed the greatest price movement.

As the 5-year Government of Canada bond yield has risen from 0.50% in July of 2016 to 1.44% today, variable rate preferred shares have started to pay out a higher rate of income as they reset.

For example, clients who own the Enbridge Inc. 4% USD rate reset preferred share enjoyed a higher coupon after the company reset the preferred share in June to 4.887% for the next five-year period. Naturally, the price has also risen to reflect the higher income now paid.

Meantime, perpetual preferred shares are paid the same coupon in perpetuity and will see their prices stay steady or fall if rates continue to rise.

To leverage or not to leverage?

Some of our younger Liberty clients are at the beginning of their home ownership phase and are curious to know the best way to deal with it. After all, having a mortgage is the highest, after-tax debt they'll face in their lifetime. Therefore, the sooner they pay it off, the more money they can accumulate prior to retirement. In other words, it's important to stop paying the bank and start paying themselves as soon as possible.

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Those who receive commissions / bonuses each year should also consider having an open mortgage with weekly, accelerated payments where they can use the extra income to make lump-sum payments against their mortgage. The accelerated payments also reduce the amortization of the mortgage, meaning it'll be paid off sooner.

For example, a couple who are in their early 30s buy a house for $675,000. They take on a $500,000, 5-year variable rate mortgage at 2.70%, amortized over 15 years with accelerated, weekly payments. They also take their $20,000 annual bonus to pay down the principal.

The weekly payment is $844, or roughly $3,376 a month. Regardless of what happens to interest rates over the term of the mortgage, it should be paid off within 8-10 years.

Now in their 40s, they have two options to consider:

1. Save the monthly payment ($3,376 x 12 = $40,512) and the annual bonus ($20,000), or $60,000 a year for retirement.
2. Borrow against the equity in the home using the same payment schedule in hopes of retiring sooner.

Unfortunately, nothing is set in stone so we must make some assumptions:

- Borrow $500,000 at age 40 on a line of credit at 5% annually.
- Keep the monthly payment the same as the previous mortgage payment with the bonus included in that payment.
- Assume an average return on equity of 7% a year (including dividends).

- Assume an average growth rate on the real estate of 2.5% annually.
- Assume a 10-year time horizon for saving to age 50.

What we found:

The most important conclusion we found was that, given average investment returns, it was better to use the leverage to invest because the total net worth was ultimately higher.

At age 50, the leveraged portfolio (accounting for the after-tax interest amount of almost $69,000 over 10 years) was worth $983,575. Coupled with the rise in real estate value to $1.1 million, the total net worth was $2,089,641.

The savings portfolio was worth $642,000 for a total net worth of $1,748,066.

With a longer time horizon, the leverage pays off more as the loan is retired after 10 years and the extra capital in the investment portfolio keeps growing.

If the investment period is twice as long, taken to age 60, the leveraged portfolio will be worth $1,934,842 and the total net worth will be $3,350,700. The savings portfolio, meantime, will be worth $1,284,000 with the net worth valued at $2,699,858.

How Leverage Can Accelerate Net Worth

	REAL ESTATE VALUE	SAVINGS PORTFOLIO	LEVERAGED PORTFOLIO	SAVINGS NET WORTH	LEVERAGED NET WORTH
At Age 50	$1,106,066	$642,000	$983,575	$1,748,066	$2,089,641
At Age 60	$1,415,858	$1,284,000	$1,934,842	$2,699,858	$3,350,700

Note, however, that several caveats must be attached to these assumptions:

- The first year of stock market returns is critical. If the leverage is done before a market sell-off, the leverage will work against you whereby you continue to pay interest on the loan as the portfolio value declines. You have a better chance of making the leverage useful if you start after a market sell-off.
- Dividends may be cut along the way, reducing the potential growth in the income portion of the portfolio.
- Companies may go bankrupt, wiping out some of the capital while the debt never disappears.
- If the investments are correlated, returns could be negatively affected; the same with concentration risk – if the money's invested in a few stocks, the gains or losses could be huge.

Summary

If done the right way, using leverage to speed up the growth of your net worth can hasten an earlier retirement. However, it requires a disciplined investor and a properly structured investment portfolio to enjoy the potential returns offered.

QUESTIONS

What kind of returns may I expect from my investments?

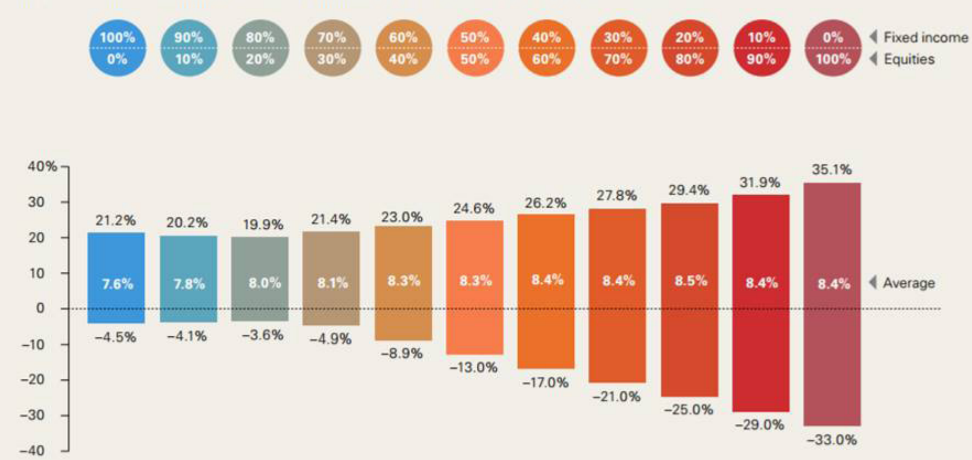
The first thing investors need to understand is that risk and reward walk hand-in-hand. Therefore, the higher the risk, the higher the range the returns should be. Unfortunately, it works both ways – you may earn big returns or suffer big losses.

When considering the appropriate asset mix for your portfolio, check out the table below provided by *The Vanguard Group*. It considers Canadian equity and fixed income returns from 1985 to 2013.

On the far left is an asset mix of 0% equities and 100% fixed income. The range of returns for that mix is +21.2% to -4.5%. This mix would be appropriate for investors who want little to no risk as the greatest downside return is a 4.5% loss in any one year.

As you add equities to the mix, note that the range of returns increases. For a 50% stock / 50% fixed income portfolio, the range of returns widens from +24.6% to -13.0%. And for a 100% equity portfolio, the range of returns becomes the greatest, from +35.1% to -33.0%.

Range of calendar-year returns for various Canadian equity and fixed income allocations, 1985–2013



Source: The Vanguard Group, Inc.

Notes: Equities are represented by the S&P/TSX Composite Index. Fixed income investments are represented by the Citigroup World Government Bond Index from 1985 through 2001 and the Barclays Canadian Issues 300MM Index thereafter. Data are through December 31, 2013.

That's why, generally speaking, those who invest all in equities tend to be under the age of 40 because they have time on their side to enjoy the compounding that 30-50 years provides.

Why don't we own any of the FAANG stocks?

This year, the FAANG stocks (Facebook, Amazon, Apple, Netflix and Google) have enjoyed an average 24% return, well above the market averages. The reason we don't own them is three-fold:

→ They make up a large portion of the Dow Jones Industrial Index and the S&P 500 Index, meaning every ETF owns them. What you usually end up with is a reversion to the mean. The more shares that must be bought with each investor purchase of an index fund, the more the performance tends to follow an "average" return.

→ Stocks like that usually signal their price peak before a precipitous fall. Just ask shareholders of Nortel, Royal Bank and Valeant. They once were the largest holding on the TSX Index but soon fell in value after the peak.

→ We prefer to own stocks that aren't widely held by investors. This gives us a chance to get in early. We can enjoy gains based on the company's own performance and when they are added to an index or grow enough to attract more eyeballs to the stock, the returns can continue to rise at a greater rate for a longer time.

In our US stock portfolios are 5 names that have outperformed the FAANG stocks this year:

FAANG STOCKS	2017 PERFORMANCE	US LIBERTY STOCKS	2017 PERFORMANCE
Facebook	+31%	Cognex Corp.	+33%
Amazon	+29%	Globus Medical	+33%
Apple	+24%	Graco Inc.	+32%
Netflix	+20%	Raven Industries	+32%
Google	+17%	Atrion Inc.	+27%
Average Return	+24%		+31%

Data Courtesy of Bloomberg LLP

How much cash should I hold in my investment account?

With short-term interest rates so low, holding cash appears to be a money-losing strategy. However, it's an investment instrument that's just as important as owning stock, bonds or preferred shares. It was no more evident than in 2008 when the stock market fell 40%.

Some investors may use stock options (selling covered calls or buying puts) to help provide a defense against a market correction. These are known as "Synthetic Shorts".

Unfortunately, transaction costs to buy and sell, along with bid / offer spreads and lack of liquidity often hurt the potential returns that these strategies offer.

Using cash, however, as a synthetic short, costs nothing and the cash can be used quickly to take advantage of opportunities such as during the market low in March 2009.

Here's how a cash "synthetic short" works.

If you have a 100% equity portfolio, the most cash you need to hold is 20%. That's because the cash position is deemed to be "short the market" so if you hold 80% equities and 20% cash, the net "long" position is 60% (80% - 20%).

Therefore, if the market falls 40%, the portfolio return with the 20% cash holding should be down 24% (60% x -40%). That's exactly what happened in 2008 for all-equity client portfolios.

When the cash was re-allocated in 2009, a 30% performance replenished the portfolio value in a year.

For most mutual funds, index funds and ETFs, it took five years to make the money back.

To decide on how much cash to hold after 9 years of “up” markets, multiply the equity percentage in your portfolio x 20%.

For example, if the asset mix is 50% stocks and 50% fixed income, the cash holding should be about 10% (50% stocks x 20% cash).

Why should I own foreign investments?

Canadians face two major problems in the investment world:

- The TSX index isn't diversified – financial and resource stocks make up 65% of the index. Remember that correlation risk is the biggest concern when creating portfolios. The higher the correlation, the greater may be the stock losses.
- The Canadian dollar's dependence on oil and gas prices leads to greater currency volatility. If you earn only Canadian dollar income, whether or not it's employment or pension income, you are exposed to Canadian dollar fluctuations.

For example, the Canadian dollar began its descent in 2014 from one dollar to the USD to today's 77 cents on the back of declining oil prices. As a result, Canadians' spending power relative to the rest of the world fell 23%. In other words, if food costs in 2014 were $1.00, they're now $1.23.

That's where foreign investments help offset the decline in spending power. If your investments are in other currencies and the Canadian dollar falls, those investments will be worth more, thereby creating a natural hedge to your spending power.

The bottom line is this: When the Canadian dollar is strong (at par), buy foreign investments. When the Canadian dollar is weak (as it was in 1995 during the Quebec Referendum at 60 cents), buy Canadian investments and wait for the cycle to turn.

Since 1970 when the Canadian dollar was last at par, it has fallen to 60 cents (1995), risen to par (2014) and fallen to 72 cents (2017). Over time, the “dollar-cost averaging” of the currency should help long-term performance by about 1% to 2% a year.

If you have any further questions, let me know.

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