

MARKET UPDATE

September 30, 2017

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YEAR-TO-DATE PERFORMANCE

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

Equity Markets

I'll begin by saying that the higher this market moves, the grumpier I get. That's because there's little to buy at a decent valuation.

2017 Returns – Q1

COUNTRY	STOCK INDEXES	TOTAL RETURN	
		(with dividends re-invested in native currency)	(with dividends re-invested in Canadian Dollars)
Brazil	Ibovespa	+23.36%	+17.08%
India	S&P BSE Sensex 30	+18.84%	+14.74%
United States	S&P 500	+14.24%	+6.03%
Mexico	Mexican Bolsa	+11.76%	+17.99%
Europe	Stoxx 600	+10.49%	+14.76%
China	Shanghai Composite	+10.12%	+6.90%
Japan	Nikkei	+8.18%	+3.99%
Australia	S&P / ASX 200	+7.75%	+6.00%
Canada	S&P/TSX	+3.86%	+4.73%

Data Courtesy of Bloomberg LLP

The summer rally highlighted the massive movement of the emerging market indexes, with Brazil, India and Mexico among the big movers. It's also an example why investors should always think globally – those that invested only in the North American markets lagged in performance. In Canadian dollars, the U.S. S&P 500 Index was up only 6% (far right column) and the Canadian TSX rose only 4%, the worst of the nine indexes above.

Since the TSX is dominated by resource and financial stocks, the Canadian malaise can be explained by lower commodity prices and a slowdown in bank growth. To date, WTI oil prices are down 8%, natural gas is down 23% and corn prices are down a further 1% from an already low price.

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

Corporate earnings in the U.S. posted the first back-to-back double-digit quarterly advance in six years. That has kept price-to-earnings ratios stable amid the rally.

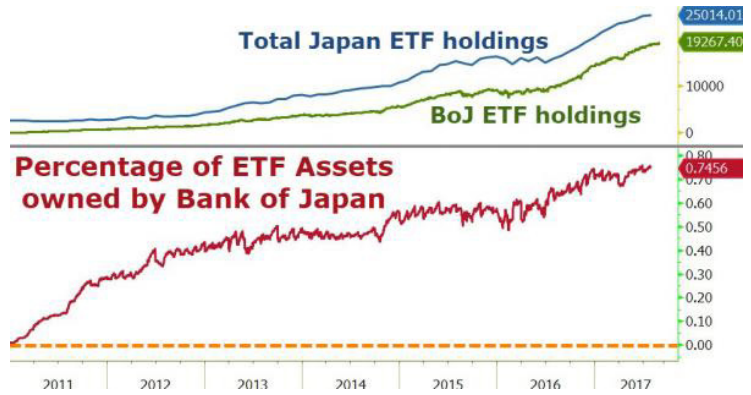
In addition to setting low interest rates, the Bank of Japan has also been busy buying equities in the Japanese stock market. When central banks are willing and able to take such actions, one can only expect that stock prices and P/E ratios will be higher than they were in past periods.

On September 11, 2017, Financial blog Zerohedge.com noted, “The Bank of Japan appears to have thrown every textbook out of the window and cranked their plunge-protection to ‘11’, as Bloomberg reports (his emphasis), *The Bank of Japan now holds 75% of the nation’s ETFs.*”

“Since December 2010 - when The Bank of Japan held no ETFs at all - the central bank has been buying ETFs (doubling its annual buying target to 6 trillion yen in July 2016) as part of an unprecedented economic stimulus. In fact, in a circular vicious cycle, the Bank

of Japan's purchases have helped assets managed by ETFs surge almost 10-fold since the end of 2010 to 25 trillion yen (\$230 billion).”

As the chart below shows, the central bank now owns three quarters of such funds by market value.



“Once it decides to stop buying, or even start selling, it’s not clear what the stock market impact will be or who will buy that amount of ETFs.”

Price/Earnings Multiples			
INDEX	COUNTRY	P/E RATIO Current	P/E RATIO Before Outstanding Items
S&P TSX	Canada	17.63	19.33
S&P 500	United States	19.33	23.92
Euro Stoxx 600	Europe	16.14	21.69
MSCI World Index	Global	17.71	22.24

Data Courtesy of Bloomberg LLP

What's keeping the market buoyant has been the anticipated Trump corporate tax cuts. A study by the Tax Policy Center in Washington estimated that over several years, more than half the benefits provided by the Trump administration's planned tax cuts would go to the top one percent of taxpayers.

Another key part of the plan would allow U.S. companies to bring home some \$2.6 trillion they've stockpiled offshore, a move analysts say could lead to increased share buybacks and dividends.

At the other end of the spectrum is the cyclically adjusted price-to-earnings ratio, commonly known as CAPE. It's a valuation measure usually applied to the US S&P 500 equity market. It is defined as price divided by the average of ten years of earnings (the moving average), adjusted for inflation.

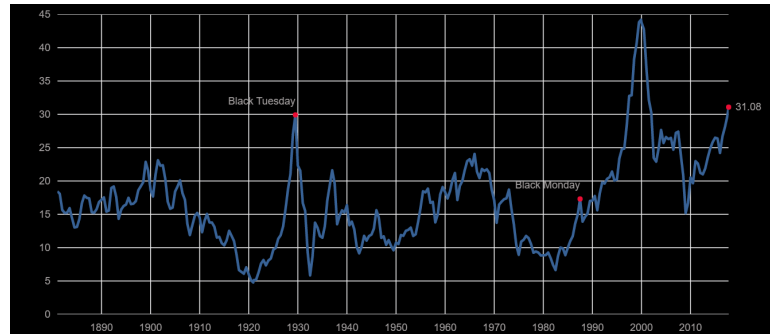
As such, it is used to assess likely future returns from equities over timescales of 10 to 20 years, with higher than average CAPE values implying lower than average long-term annual average returns.

Cape Ratio:

1. A ratio used to gauge whether a stock is undervalued or overvalued by comparing its current market price to its inflation adjusted historical earnings record.
2. It is a variant of the more popular price-to-earnings ratio and is calculated by dividing the current price of an index by its average inflation adjusted earnings over the last 10 years.
3. Using average earnings over the last decade helps to smooth out the impact of business cycles and other events and gives a better picture of a company's sustainable earning power.
4. The ratio was invented by American economist Robert Shiller.
5. It is not intended as an indicator of impending market crashes, although high CAPE values have been associated with such events.

Below is a chart of the CAPE calculations based on data from economist Robert Shiller's website, as of 8/4/2015. The 26.45 measure was 93rd percentile, meaning 93%

of the time investors paid less for stocks overall relative to earnings.



Data and explanations courtesy of Wikipedia

The graph above shows the current CAPE ratio at 31.1 times earnings (24 times earnings is often marked as the peak in an economic cycle), seen only on two other occasions:

- In 1929 prior to the October Black Tuesday sell-off
- From 1997 to 2000 prior to the bursting of the Technology bubble.

This is why we're managing portfolios cautiously. We're currently holding 20% cash for all-equity accounts or 20% times the equity weight in other portfolios. For example, if the asset mix is 60% equities and 40% fixed income, the cash weighting will be 12% (60% equities x 20% cash).

To me, this is the prudent direction to take. If the market goes higher, clients will still participate in the move higher. And if the market falls, corrects or collapses, we have cash available to buy at lower prices and I'll be a happier fellow.

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.	+73%	Gemalto NV	-31%
Intertek Group plc	+43%	J.M. Smucker	-18%
Thermo Fisher Scientific	+34%	Alimentation Couche-Tard	-7%
Roper Technologies	+33%	Balchem Corp.	-3%
Novozymes A/S	+33%	Essilor International	-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 of the individual stocks noted above:

- **Cognex Corp.** (CGNX US) 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 73%, compared to Apple's 33% return.
- **Intertek plc** (ITRK LN) is a British company that tests products from toys, food, clothing, oil and gas equipment, etc. that must pass government quality regulations. As demand grows, so has its revenues. The company also benefits from a falling British pound as its global revenues account for more than its domestic sales. It also increased its dividend by 20% this year, a reflection of greater expected free cash flows.
- **Thermo Fisher Scientific** (TMO US) is a life sciences company that sells laboratory equipment (electron microscopes and mass spectrometers) and

consumable products used in experiments to universities, biotech and pharmaceutical firms. Recent acquisitions have helped spur margin, profit and free cash flow growth.

- **Roper Technologies** (ROP US) 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.

On the negative side:

- **Gemalto NV** (GTO NA) is a technology company that caters to cybersecurity and encryption. It provides chip technology for credit cards, SIM cards for smartphones, hologram technology for passports and drivers' licenses, encryption technology for the cloud and iris and fingerprint scanning technology.

This year, the company suffered a drop in sales in its SIM business as consumers already own a smartphone and demand for SIM cards has declined. In the U.S., consumers aren't using credit cards with chip technology. As a result, the firm took a 400 million euro write-down, causing the stock to plummet.

While the company trades at a low P/E multiple, Gemalto will have to prove to investors that future earnings will be better than they are currently.

- **J.M. Smucker** (SJM US), like other consumer staple companies, is facing increased competition from two fronts - price deflation and competition. Companies like Wal-Mart and Amazon are squeezing margins by demanding lower prices. Also, small e-commerce start-ups are taking away business and eroding pricing power. The largest

consumer companies in the world (KraftHeinz, Mondelez, Nestle, Procter & Gamble, Colgate-Palmolive, et al.) have lost about 3% of global market share in 2017 to digital competition.

That's why Unilever bought Dollar Shave Club and Seventh Generation. This has led to little organic growth and difficult pricing alternatives. For Smuckers, their largest holdings are in sweetened

products, coffee and pet food. Thanks to lower prices and sales, margins have fallen precipitously, putting continued downward pressure on its valuation and stock price.

Smucker has been sold from the portfolio while Gemalto may be used as a tax-loss in 2017 to offset prior capital gains taken.

Currency Markets

Canadian Dollar vs.			
CURRENCY	DEC. 31, 2016	SEPT. 30, 2017	GAIN/LOSS %
US Dollar	\$1.3435	\$1.2472	+7.7%
South African Rand	\$0.0978	\$0.0920	+6.3%
Japanese Yen	\$0.0115	\$0.0111	+3.9%
New Zealand Dollar	\$0.9305	\$0.8989	+3.5%
Swiss Franc	\$1.3215	\$1.2879	+2.6%
Norwegian Krone	\$0.1555	\$0.1566	-0.7%
British Pound	\$1.6594	\$1.6712	-0.7%
Australian Dollar	\$0.9677	\$0.9770	-1.0%
Swedish Krona	\$0.1479	\$0.1531	-3.4%
Danish Krone	\$0.1904	\$0.1980	-3.8%
Euro	\$1.4153	\$1.4736	-4.0%
Mexican Peso	\$0.0648	\$0.0683	-5.1%
Average Gain			+0.4%

Data Courtesy of Bloomberg LLP

The chart above is determined as follows: On December 31st, 2016, one US dollar bought \$1.3435 Canadian Dollars. By September 30, 2017, it bought only \$1.2472 Canadian dollars, meaning the Canadian Dollar strengthened by almost 8% against the U.S. dollar.

This year, the story has been more about the decline in the U.S. dollar versus other global currencies. With that drop, emerging market economies enjoyed a stronger

currency and higher foreign reserves. Their spending power grew and that helped improve their economies.

For Canada, the rise in oil prices helped the Canadian dollar, along with two interest rate increases of ¼ percent each.

The rise in the Canadian dollar also negatively impacts performance numbers for our global portfolios because roughly 80% of the stocks are foreign. With an 8% increase in the Canadian dollar, performance numbers for all-equity portfolios would be reduced by about 6%.

Despite this, investors should always pay attention to the unconverted numbers. That's because, since year 2000, the average annual change in the Canadian currency versus the U.S. dollar has been only a positive 0.4%. Against the euro, the Canadian dollar has weakened annually by 0.5%.

The moral of the story here is that over a 10-to-20-year timeframe, currency risk is benign. Therefore, when the Canadian dollar is strong, investors should buy foreign investments and when the Canadian dollar is weak, they should buy Canadian instruments.

Bond Markets

Not only has the Bank of Canada's two ¼ percent rate hikes helped the Canadian dollar move higher, it's also moved yields higher and helped retirees with increased income.

10-Year Bond Yields		
COUNTRY	MOODY'S SOVEREIGN CREDIT RATING	CURRENT YIELD
Argentina	B-Low	+ 5.61%
Greece	CCC-Mid	+ 5.47%
Turkey	BB-High	+ 4.96%
Brazil	BB-Mid	+ 4.43%
Russia	BB-High	+ 4.01%
Mexico	A-Low	+ 3.50%
Indonesia	BBB-Low	+ 3.44%
New Zealand	AAA-Mid	+ 2.97%
Australia	AAA-Mid	+ 2.84%
United States	AAA-Mid	+ 2.33%
Canada	AAA-Mid	+ 2.11%
United Kingdom	AA-Mid	+ 1.32%
Germany	AAA-Mid	+ 0.45%
Japan	A-High	+ 0.07%

Data Courtesy of Bloomberg LLP

Our idea throughout the year was to use a barbell strategy for bonds, where we could find opportunities at the short end of the yield curve through Canadian high-yield debt (rated B to BB-high) and US debt at the long end of the curve (20+ years of bonds rated BBB to A).

This has paid off to date but now, with 10-year rates moving higher, we're starting to see BBB and A-rated bonds of that duration move toward 4% yields. And if the Bank of Canada continues to raise rates (albeit at a leisurely pace – one more this year, maybe two more in 2018), we may see greater opportunity in the middle of the barbell (the 7 to 10-year maturity range).

For example, Real Estate Investment Trust (REIT) bond yields, as a whole, have crept higher to 4% or

greater over fears of a decline in demand for brick and mortar stores. Cominar REIT is a Quebec-based REIT of commercial and retail properties whose 5-year bond maturing in 2022 now yields 4.35%.

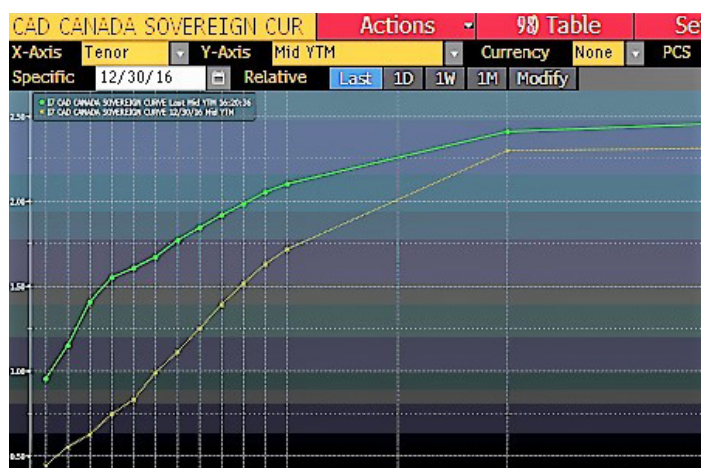
Pipelines, too, have seen their yields pop. AltaGas bonds maturing in 2027 have nearly reached 4 per cent in yield. Pembina and Enbridge are other pipelines whose bonds trade in a similar range.

Companies in other sectors such as BCE, Brookfield Renewable Power, Fairfax Financial and Molson Coors are also nearing 4 per cent yields.

I mention 4 per cent as important because after tax and inflation, real returns are now starting to turn positive, an important benchmark for investors. That's because at that level, their spending power continues to grow instead of decline.

At the long end of the curve, yields haven't yet begun the march to 5 or 6 per cent so the risk / reward is getting out of whack.

And if the yield curve rises only at the short end and not the long end, an inverted curve usually signals a recession – where short-term rates are higher than long-term rates. The chart below shows two yield curves. The yellow yield curve is from the beginning of the year, while the green yield curve is where it currently stands.



Data courtesy of Bloomberg LP

If the yield curve becomes inverted (short-term rates are higher than long-term rates), a recession can occur because short-term rates are more attractive than owning stocks because stocks would offer bond-like returns with equity risk.

For example, if a 5-year AT&T bond offers a 5% yield and its stock also yields 5%, three things can happen to the equity investor:

→ Interest rates go down, bond yields fall and stock prices rise because the equity offers a higher return

- Interest rates go sideways, keeping equity stock prices from rising as there's a better alternative by owning the bond – similar returns but with half the risk (bonds historically are half as risky as stocks)
- Interest rates go up – the bondholder gets repaid their principal at maturity but the equity shareholder suffers a drop in the stock price.

This is yet another reason why we're skeptical that stock prices can continue higher – bond yields are becoming more attractive.

Preferred Shares

TYPE OF PREFERRED SHARE	YEAR-TO-DATE PRICE CHANGE
Canadian Perpetual Preferred Shares	+ 0.57%
Canadian Variable Rate Reset Preferred Shares	+ 11.58%
BofA Merrill Lynch US Perpetual Preferred Index	+ 10.11%

Data Courtesy of Bloomberg LLP

With the rise in Canadian interest rates, rate-reset preferred share prices shot higher, up an average of 11.58% in 2017. This compares with their counterpart, the perpetual preferred shares, as those share prices have stayed virtually flat during the year.

Rate-reset preferred shares are marked at a premium to the 5-year Government of Canada (GOC) bonds. For example, Enbridge Inc. had a 4% rate-reset preferred share that reset in August at the GOC rate plus 3%. With the GOC 5-year rate at 1.88%, the new reset for the next five years became 4.88%. The increase in the new rate also sent the share price higher because of the higher expected income.

If Canadian interest rates continue to rise in 2018, yields and prices for rate-reset preferred shares should move higher.

The way to think of the two types of preferred shares is as follows:

- Perpetual preferred shares do well when interest rates fall or stay the same
- Rate-reset preferred shares do well when interest rates rise
- Both preferred shares do poorly when stock markets fall because preferred shares are deemed to be quasi-equity.

The last point is important and it's why we don't just buy preferred shares for taxable, non-registered accounts.

When thinking of a company's demise and potential bankruptcy, monetary claims would be in the following order:

- Secured creditors would have a claim on the hard assets of the firm (plant and equipment).
- Bondholders would get most of whatever's left, usually about 10-20 cents on the dollar.
- If there's still anything left, preferred shareholders might get a few cents on the dollar.

→ Common shareholders get nothing.

When the stock market fell 40% during the financial crisis in 2008, the price of many perpetual preferred shares of financial institutions fell more than that. For example, Brookfield Asset Management 4.75% preferreds, Series 17, dropped from \$22 a share to \$8.65 (down 61%) and yielded 20%.

For the disciplined investor, it was an opportunity similar to what Warren Buffett secured from firms like Goldman Sachs, Bank of America and Wells Fargo. However, it's not for the faint-of-heart.

Finally, because preferred shares have a preferential tax treatment, some investors or accountants may deem it preferable to use them as the only fixed income in their taxable, non-registered accounts.

At Liberty, we have a different opinion to prevent the tax tail from wagging the investment dog. Of fixed income in the non-registered accounts, we'll invest half in bonds and half in preferred shares. That's because if the stock market drops, preferred shares will fall but the bonds should hold their own value, thus insuring against a large loss in the account.

And, depending on the market environment, we'll decide on the proper weighting in both perpetual and rate-reset preferred shares.

For this article, I'm stepping aside to introduce two members of our research team, Thomas Zagrobelny and Brett Girard, CPA, who have written a piece about financial shenanigans, or the games that some companies play to hide the truth or manipulate the numbers.

Uncovering tricks and manipulations

“
...companies
with a long-
term strategic
focus and strong
free cash flow
generation
avoid playing
with 'glamour'
figures...”

The market has come to a sensitive point where valuations are historically high without the growth to support it. Prices are driven even higher by economic conditions like ultra-low interest rates (there's nowhere else to invest but in equities). In order to keep pace and meet Wall Street expectations in this environment, company management does everything it can to increase profits. It's at times like this when accounting dishonesty may arise.

At Liberty, we invest in companies that generate consistent and rising free cash flows. Inherently, they shouldn't need to play accounting games as there shouldn't be anything to hide.

Our research team looks for tricks that managers may use to show better performance than reality. A large part of the analysis involves reading and interpreting data from the company's financial statements. They include the Balance Sheet, the Income Statement and the Statement of Cash Flows.

These three reports are interrelated and give a quantitative sense of how the company performed in the last quarter or year. The goal of these statements is to provide readers with usable and transparent information but there may be an inherent conflict. More usability tends toward oversimplification and opacity, while transparency leads to more nuanced accounting and complex notes and disclosures that are harder to use.

As a result, accounting standards have been created to outline the minimum disclosures and accounting rules that publicly-listed entities must follow. Since no two businesses are the same, these standards and principles must act as guidelines with room for judgement and interpretation for unique contexts.

This flexibility introduces an opportunity for companies to manipulate the story their statements tell. The balance sheet (assets) and income statement (net income) are especially susceptible to manipulation.

Assets like inventories and popular rules-of-thumb like price-to-earnings are easy to manipulate but cash-flow driven numbers like free-cash-flow are somewhat more resilient. A common saying in finance is that cash is real but earnings are artificial. It helps to keep this in mind.

In this article, we'd like to provide five examples of these manipulations in action. They include:

- Non-GAAP Measures – Twitter
- Borrowing to pay dividends – Chevron
- Determining pension expenses – IBM
- Accounting for goodwill – Valeant
- Adjusted funds from operations – American Realty Capital Properties

1) Non-GAAP Measures

A look at Twitter Inc.'s 2016 Annual Report shows an unusual bottom line:

	Year Ended December 31,				
	2016	2015	2014	2013	2012
	(In thousands, except per share data)				
Adjusted EBITDA.....	\$ 751,493	\$ 557,807	\$ 300,896	\$ 75,430	\$ 21,164
Non-GAAP net income (loss).....	\$ 405,996	\$ 276,629	\$ 101,071	\$ (34,330)	\$ (35,191)

Despite some rough early years of company losses, Twitter showed a huge turnaround in fortunes in 2016, posting a non-GAAP, \$405 million profit (GAAP stands for Generally Accepted Accounting Principles).

Net loss.....	\$ (456,873)	\$ (521,031)	\$ (577,820)	\$ (645,323)	\$ (79,399)
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However, the company de-emphasized the required net income calculation (above), which was buried in the middle of the statement of operations. Twitter effectively turned a \$456 million loss into a \$405 million profit (see above).

Since going public in 2013, the “accounting reality” is that Twitter has had negative income. In response, Twitter has tried to find a creative way to offset worrying numbers. The difference between net loss and non-GAAP income was driven mostly by backing out stock-based employee compensation under the claim that ignoring this expense helped identify “underlying trends” in performance.

Twitter would like readers to believe that increasing stock compensation from \$25 million to \$615 million had no cost to the underlying business.

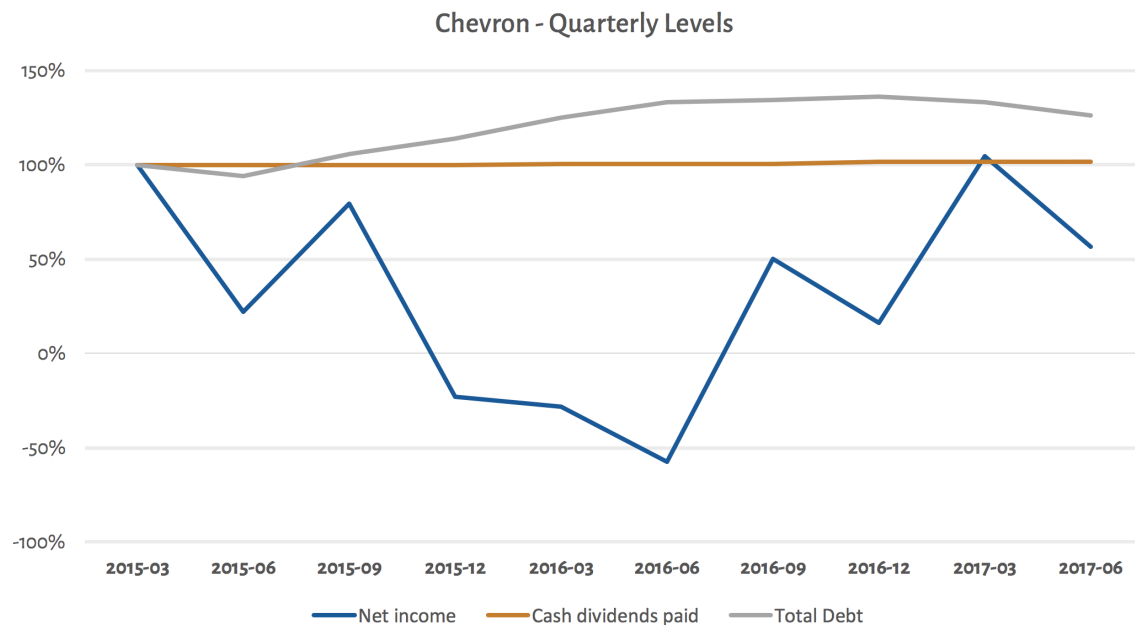
These non-GAAP measures are non-comparable, highly discretionary and are often used to hide, mislead or at least colour reality. These manipulations follow the theme of targeting popular bottom-line numbers that analysts use as short-cuts like price-to-earnings and net income.

A central idea in avoiding misleading figures is to look carefully at adjusted or estimated (pro-forma) figures the company uses and understand why the company is using them. Are they honestly showing a subtle economic reality or just painting a different picture than accounting rules would force them to?

2) Borrowing to pay dividends

Investors like to see a consistent dividend. The market often punishes companies that cut their dividends to the point where firms have learned to avoid dividend cuts. This market policing can quickly get out of hand if circumstances worsen, such as a prolonged drop in oil prices.

In the chart below is an example where Chevron Corp. kept dividends steady from quarter to quarter by increasing its debt levels as income dropped.



Why is this bad? Companies face a fundamental choice with its money. It can take profits and re-invest it in projects and assets to help grow the firm, or it can pay out profits to the shareholders (usually in the form of dividends).

A quickly growing firm will usually not pay a dividend as most of the profits are directed back into the company for growth, while a stable, mature firm will usually pay a large and steady dividend because it doesn't have as many value-adding opportunities to invest profits. When it comes to borrowing money to pay a dividend, companies are not foregoing growth to share earnings – they are sacrificing future growth, and, because of the interest payments, at a higher cost than usual.

This debt is highly limiting because the company cannot make an intelligent choice under current circumstances. The debt must be paid on a fixed schedule. In other words, welcome to the three Ds of investing: Debt Doesn't Disappear.

Companies that take on debt to pay dividends are usually more concerned with the short-term image shareholders have of it than the financial reality that will be best for the company's future. This is another reason why looking at the long-term reality of a company is more reliable than popular financial metrics.

3) Pension expense

There are two common types of pensions that companies offer employees: Defined contribution (DC) and Defined Benefit (DB).

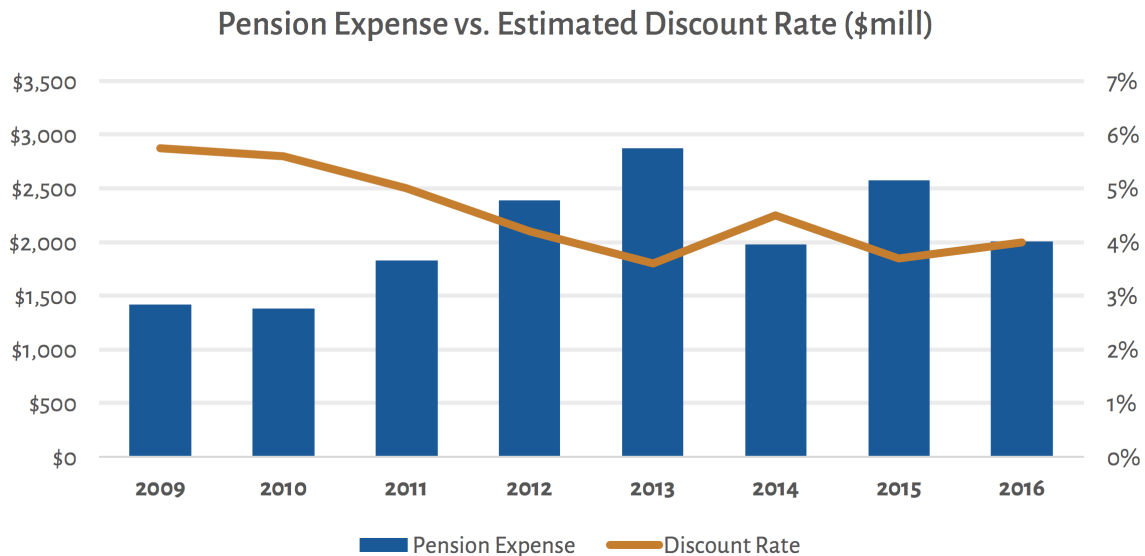
Defined contribution accounting is pretty straightforward. The company pays a specific amount each year into the pension and that amount is expensed to the income statement. This cost can be taken as a given – it is what it is.

Defined benefit, however, is much more complicated. To account for the annual expense, a company must estimate things like years worked, ending salary and future interest rates. While many companies do this honestly, adjusting pension estimates is another

avenue for firms to massage the reported numbers in their favour.

Consider International Business Machines Corp. (IBM), a company with pension obligations at \$52 billion dollars (US). Their pension expense has changed as much as \$600 million in a given year. In the chart below, note the inverse relationship between the expense and the estimated discount rate over time.

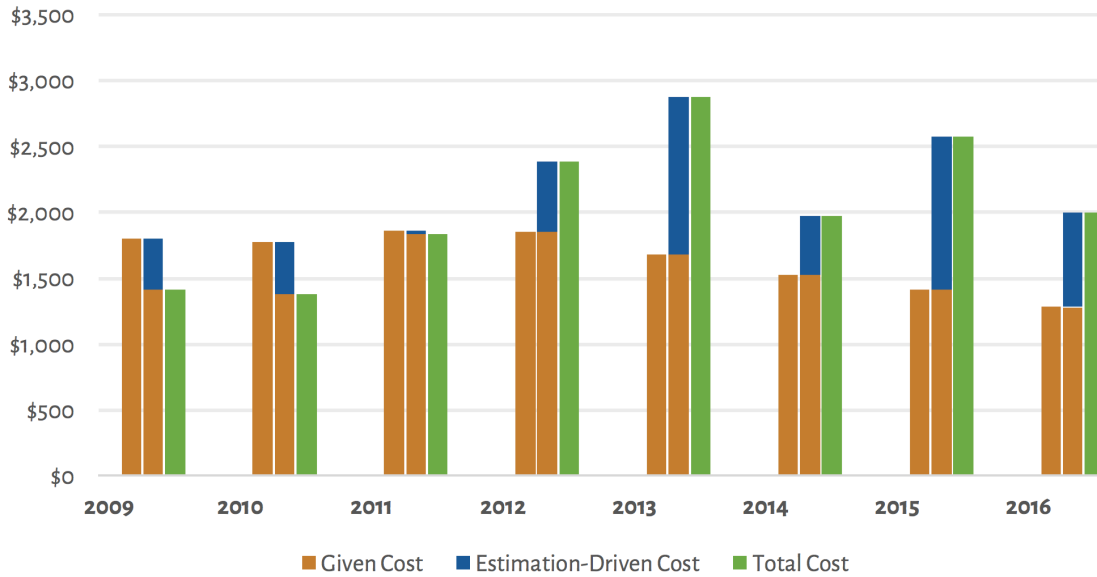
A warning sign to look for is the large pension expense in 2013 followed by an increase in the interest rate used in 2014 to bring the pension expense back to historical levels. Is the increase and degree justified or was IBM attempting to smooth out the liability (pension expense)?



While IBM has both defined benefit and defined contribution pensions, the chart below shows that the defined contribution plan expenses are significantly

more stable. The major changes were driven by the company's defined benefit pension estimates.

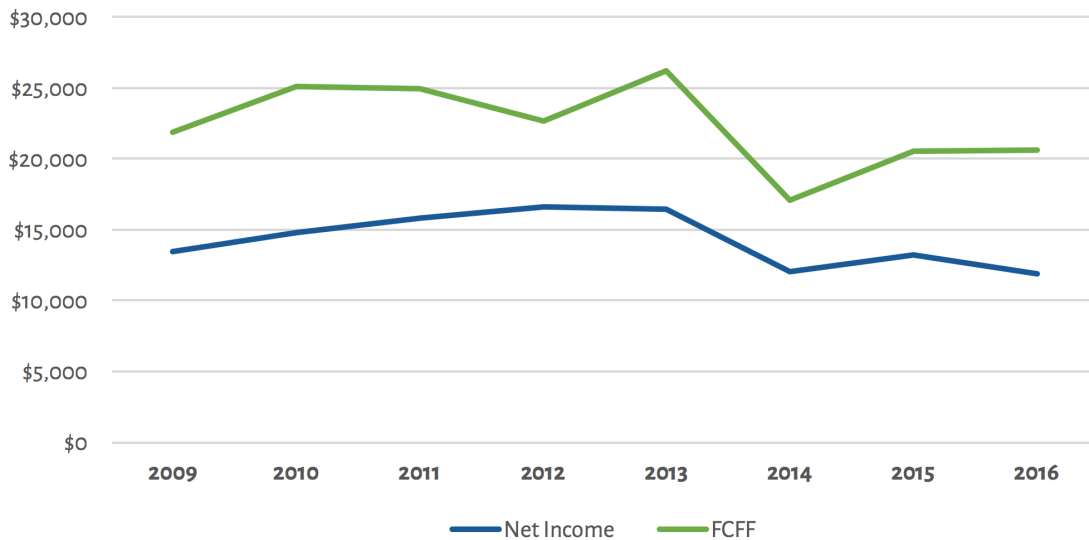
Components of Pension Expense (\$mill)



The most obvious use for adjusting estimates is earnings smoothing, since predictable and consistent earnings are rewarded by markets. This is where

focusing on free cash flow pays off. As financial statement numbers are subtly re-arranged to tell a certain story, free cash flow can tell a different one.

Net Income vs. Free Cash Flow (\$mill)



In 2012, the estimated expense turned positive for the first time in years. If it hadn't, net income would have been even higher that year before dropping again in

2013. Instead, total costs crept higher and the period was smooth.

On the other hand, free cash flow decreased in 2012 and showed that the year was not as smooth and simple as the bottom line looked.

Sometimes estimates can legitimately change. The pension amount, the consistency of estimates and the

4) Mergers & Acquisitions Accounts (M&A)

Mergers and acquisitions are another opportunity for companies to manipulate statements. Since business combinations can be complicated, there are many different ways to hide or adjust information. Companies can front-load expenses to pump up results after the merger, it can overstate goodwill to bloat assets or it can hide stagnation with combined revenues.

One of the major issues with M&A is timing. When a firm is acquired, revenues and assets are combined immediately, with the excess of the purchase price over identifiable assets put into an intangible asset called goodwill.

Goodwill is maintained at “cost” until it is impaired, when it flows into the income statement as an expense, thereby reducing the net income. This means that a company can push goodwill as high as possible and avoid impairing it to immediately improve performance.

This “phantom” asset acts like a time bomb – overstated goodwill is inherently worthless and is a

5) Adjusted funds from operations (AFFO)

The problems with accounting become more complex as the underlying company does, too. While a simple manufacturing company is rooted in making sales with certain expenses to arrive at a net income figure, these traditional numbers become less useful for a real estate investment trust (REIT).

REITs are popular as an accessible way to invest in real estate. These trusts pool money and invest in real

story being told are all factors to look at. As always, though, the long-term story told by free cash flow is the only one to really consider.

looming expense that should have modified combined income from the very beginning.

A recent example of questionable M&A accounting was Valeant Pharmaceuticals International Inc., a company that made 16 acquisitions in the past five years, some of which had goodwill account for over 90% of the purchase price!

After booking huge acquisitions and posting its financial statements, Valeant adjusted the goodwill value downward and claimed that the change was not large enough to re-state the inflated and inaccurate prior periods. Despite these adjustments adding up to \$345 million, Valeant did not correct any numbers that included these values. This allowed the company to exaggerate its financial position.

In light of Valeant's weak organic growth, these frequent and exaggerated acquisitions appeared to be attempts to drive profit numbers higher without economic justification.

estate ventures that it has the expertise to manage, with the resulting profits paid back to investors (after fees, of course).

Since they don't have a typical business structure, the revenue-less-expenses approach isn't as useful. Instead, investors look to a cash-flow driven calculation called “Funds From Operations” (FFO). Essentially, net income is adjusted by non-cash figures like

depreciation and non-cash taxes to get a picture of the cash remaining for investors.

Two immediate problems are that every company might have different non-cash figures to adjust by, which hurts comparability, and the non-GAAP measure has less official oversight.

The problem with FFO gets worse as investors look at Adjusted Funds From Operations (AFFO), which deducts recurring capital expenditures (maintenance costs for properties is one example) to get a more useful figure of the cash left for investors.

While the logic works, this adds another layer of discretionary and non-comparable calculations. For example, the portion of expenditures devoted to recurring maintenance is ultimately estimated by management. If they have an interest in achieving a target, there is a lot of room to do so, with very little oversight – and the calculations are complex enough that investors may have a hard time following.

All of this brings us back to a fundamental problem in investing: Market pressure can be short-sighted and myopic and managers can act badly to appease the market. A recent example is American Realty Capital Properties Inc., whose CFO, Brian Block, was convicted of falsifying the AFFO calculation in June, 2017.

Closing Thoughts

There is a temptation to look at famous cases of financial fraud – like Enron – as examples of what to avoid but an important takeaway here is that even reliable household names can massage the numbers to tell a certain story.

The market has very specific and short-sighted expectations and is quick to punish companies for specific behaviours. When analyzing any company, it is important to realize how these pressures affect reporting and to look for long-sighted and well-

In testimony, employees described an overwhelming focus on the FFO targets (they had mousepads with the target printed on them) and Block's bonuses depended on hitting higher targets. This set-up was a recipe for problematic behaviour.

It began with an error in the AFFO calculation in 2014 that was discovered after the fact – which is not surprising given the convoluted adjustments involved – but led to positive momentum expectations from the market that brought the accountants to fabricate the numbers.

The CFO knew that if he adjusted AFFO downward, the company share price would plummet, so he tried to avoid the punishment by lying. Obviously, in extreme cases like this, it ends up coming to light, but it's important to realize that management always has incentive and the ability to massage the numbers to meet market expectations.

At Liberty, we avoid investing in REITs, partially because of these issues. The fees and non-standard reporting and misaligned incentives and overall opacity all add up to unnecessary risks without a worthwhile return profile.

managed companies that focus on running a great firm first before appeasing Wall Street.

Even well-intentioned companies have biased perspectives and discretion on estimates. The cases listed above show only a few of the ways that investors must stay diligent and take the time to really understand a company and what drives its performance. There are no shortcuts for that.

QUESTIONS

- 16 I'm a new client. How and when are you going to invest my money?
- 16 Why does the market take off at the end of the day and what, as investors, can we do about it?
- 17 You've seen my portfolio. What's the biggest risk you notice?
- 18 Why don't we hedge our currency risk?
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I'm a new client. How and when are you going to invest my money?

Given that, in our opinion, the markets are expensive, we take our time with new clients' money. Some firms may invest all the money immediately because they counsel against trying to time the market but in times like this, we believe that some prudence is required. Usually ½ positions are purchased in equities, with the remaining 50% allocated depending on what happens later in the market.

According to Lu Wang of Bloomberg News on October 1, 2017: "Theories abound as to why the fourth quarter is so often the best one for equity bulls. Fund managers need to catch up, holiday spending spreads cheer, investors celebrate the January effect in December."

"Or maybe it's just dumb luck. Whatever the case, the S&P 500 Index has risen seven times in the last eight years between October and December. And while calendar effects just took a beating with a volatility-free September, betting against any form of momentum remains a losing trade until proven otherwise."

Also, as noted above, calendar returns from October to October rather than January to December tend to be above-average, especially among the small-cap stocks.

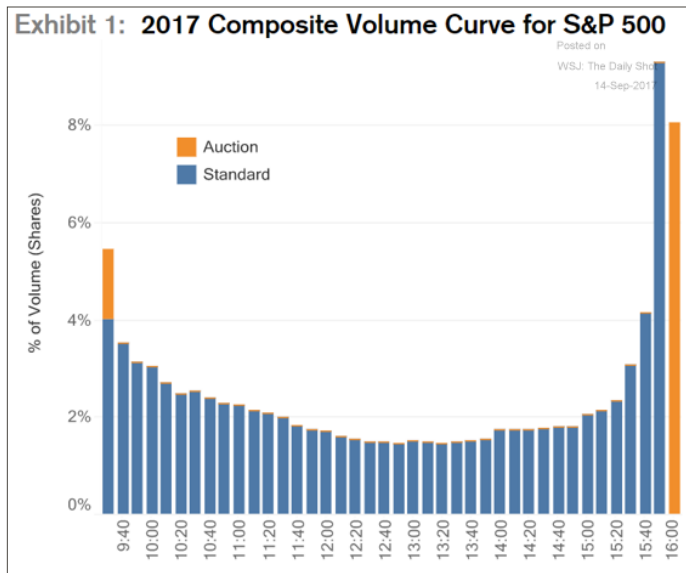
Looking at our global stock holdings, the average growth rate from October to October since 1990 has been around 21%. This compares to the index averages of 8%. We believe that's a significant number.

Does it always grow at this rate if money is added each October? No, the success rate of the past 27 years has been about 75% (18 of 27 years) but the odds do favour the investor.

Why does the market take off at the end of the day and what, as investors, can we do about it?

Near the end of the trading day, about 2:30 p.m., markets can pick up in both volume and breadth. That's because Exchange-Traded Funds (ETFs) have to execute their buys and sells based on cash received or demanded during the day.

Below is a chart that shows trading volumes on the S&P 500 during the average trading day.



Source: Courtesy of Credit Suisse

You've seen my portfolio. What's the biggest risk you notice?

Here's a commentary by Cormac Mullen of Bloomberg News on September 14, 2017 about "cluster" risk.

"Cluster risk, occurring when performance patterns become correlated among a group of stocks with similar business profiles yet different sector classifications, is a hazard that can often slip under a risk manager's radar, AB's David Dalgas, Klaus Ingemann and Thomas Christensen wrote in a blog post."

"Facebook Inc., Amazon.com Inc., Apple Inc., Netflix Inc. and Google owner Alphabet Inc. -- collectively known as the FAANGs -- are a prime example, AB said. Together the mega-cap stocks accounted for more than a quarter of the gains in the S&P 500 from the beginning of the year through August and have become increasingly correlated."

It's important, therefore, that investors understand this relationship. If they, too, are buying during periods of high trading volume, they may pay more for their stocks than expected.

For example, if trading volumes increase, the bid/offer spread could widen. Instead of paying an extra five cents a share to buy or sell, it could change to 10 cents a share.

Investors should also avoid trading in the first hour after the market opens as that is another volume surge.

We prefer to trade when volumes are lower and there's more consistency in the markets.

The danger of this correlation risk is when the market falls, this group will fall together with similar losses. It's also like owning all the Canadian bank stocks.

The moral of the story is to buy one but not all the FAANG stocks or Canadian banks. Most do-it-yourself investors and even some professionals fail to protect their overall portfolio risk by owning stocks that are similar in nature to each other.

It's better to have a compilation of names that are in different industries, different countries and are of a different size. This diversification should help protect the risk of a big loss. After all, investing is not about how much you make but how much you avoid losing. It's the latter statement that keeps you in the game for the long term.

Why don't we hedge our currency risk?

Currency hedging is designed to eliminate the effect of fluctuating exchange rates. ETFs using this strategy employ instruments called currency forward contracts which allow them to lock in a specific exchange rate on a future date.

If the foreign currency has declined by the time that date rolls around, the fund will enjoy a gain on the value of the forward contract. If the foreign currency rises, the value of the contract goes down by a similar amount. The net result, then, is that the impact of exchange rate gets washed out. The only risk that remains comes from the stocks themselves.

Some of the risks involved with hedging are:

- Forward currency contracts must be renewed or “rolled over” every month, meaning higher costs and lower returns. Hedging could hurt returns by as much as 1% a year, eroding long-term performance.

Why do you prefer CN Rail over CP Rail?

When we go through the investment process looking for suitable candidates, our first sweep is for companies that have consistently growing free cash flows. This provides them with the financial flexibility to stay relevant and grow faster over time than an average stock.

Tangible evidence from the financial statements starts out by looking at cash flow from operations and deducting capital expenditures and dividends paid to arrive at a free cash flow number. We then can look at the trends of each of the four above items on a 5, 10 or 15-year average. The numbers can be revealing because trends can point out improving or deteriorating financial conditions:

1. A drop in Cash Flow from Operations could indicate a company may need to borrow money for future investments or they're weak in their

- A large fluctuation in the currency in a short period of time may prove the forward contract useless and costly.
- Adding multiple currencies may reduce portfolio volatility, especially for Canadian investors because the Canadian dollar, as a minor global currency, is more volatile than the major currencies of the US dollar, Euro and Japanese yen.

While the Canadian dollar trades a notional amount of about \$1 billion daily, the major currencies trade notionally about \$1 trillion, or 1,000 times more. The lower is the notional amount, the less liquidity there'll be in the trade and the greater risk the investor assumes.

management of capital including inventory, receivables and / or payables.

2. A drop in Capital Expenditures could signal that a company is cutting back on future investments to keep their costs under control. This way, they may be sacrificing future growth for potential short-term gains.
3. A reduction in dividend growth could also indicate an attempt to preserve cash if organic revenues are not rising.

Comparing the free cash flow numbers between CP Rail and CN Rail, we found that:

- CP Rail's cash dividends have grown only 6% in the past five years. This compares with CN Rail's cash dividend growth of 20%.

- CP Rail's capital expenditure growth has declined from 7% (15-year average) to 5% (10-year average) to 1% (5-year average). Meanwhile, CN Rail's capital expenditures have grown from 11% (10-year average) to 13% (5-year average). As a result, CN has been putting more capital into future growth than CP.
- CP Rail's revenue growth has averaged 4% to 5% for the past 15 years; CN Rail's revenue growth has averaged 7% to 8%.

- CP Rail's cash from operations has been lumpy, having grown from \$1.3 billion in 2012 to \$2.4 billion in 2015, only to drop to \$2.0 billion in 2016. CN Rail's cash from operations has grown consistently every year during that period, from \$3.0 billion in 2012 to \$5.2 billion in 2016.

By looking at free cash flow trends, investors have a better chance to find good companies for potential investments or avoid ones with declining trends.

If you have any further questions, let me know.

David Driscoll

President & CEO

Liberty International Investment Management Inc.

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