YEAR-TO-DATE PERFORMANCE

The Markets – January 1st to September 30th, 2016

Equity Markets

The high returns of the Brazilian and Canadian indexes are the opposite of their 2015 performances and provide 2-year annual returns of 5% and 2% consecutively, so not much to crow about.

<table>
<thead>
<tr>
<th>COUNTRY</th>
<th>STOCK INDEXES</th>
<th>TOTAL RETURN (with dividends re-invested in native currency)</th>
<th>TOTAL RETURN (with dividends re-invested in Canadian Dollars)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Brazil</td>
<td>Ibovespa</td>
<td>+34.64%</td>
<td>+55.00%</td>
</tr>
<tr>
<td>Canada</td>
<td>S&amp;P/TSX</td>
<td>+15.83%</td>
<td>+15.83%</td>
</tr>
<tr>
<td>Mexico</td>
<td>Mexican Bolsa</td>
<td>+11.27%</td>
<td>-5.99%</td>
</tr>
<tr>
<td>India</td>
<td>S&amp;P BSE Sensex 30</td>
<td>+8.12%</td>
<td>+1.94%</td>
</tr>
<tr>
<td>United States</td>
<td>S&amp;P 500</td>
<td>+7.84%</td>
<td>+2.29%</td>
</tr>
<tr>
<td>Australia</td>
<td>S&amp;P / ASX 200</td>
<td>+6.28%</td>
<td>+5.98%</td>
</tr>
<tr>
<td>Europe</td>
<td>Stoxx 600</td>
<td>-3.30%</td>
<td>-5.22%</td>
</tr>
<tr>
<td>Japan</td>
<td>Nikkei</td>
<td>-12.12%</td>
<td>-1.31%</td>
</tr>
<tr>
<td>China</td>
<td>Shanghai Composite</td>
<td>-13.36%</td>
<td>-20.02%</td>
</tr>
</tbody>
</table>

Data Courtesy of Bloomberg LLP
For example, the TSX return in 2015 was -11%. If you take $1 and drop 11% in 2015 and gain 16% in 2016, you net a total return of $1.03, a 2-year average return of 1.5%, barely keeping up with inflation.

Most other markets in 2016 have climbed higher as interest rates have trended lower, causing momentum investing to be the “flavour-of-the-day”.

Markets were pushed higher recently by Federal Reserve Chair Janet Yellen’s comments on September 29th when she told bankers in Kansas City that the central bank might have the ability to help the U.S. economy in a future downturn if it could buy stocks and corporate bonds.

Currently, the Fed is barred by law from buying corporate assets. We don't believe this way of thinking is prudent because:

1. It would keep interest rates ultra-low and continue to encourage asset speculation in all markets including stocks, bonds, currencies and real estate.

2. It would suggest that nobody would ever lose money in a public transaction.

3. It would send market valuations through the roof until it created such a bubble that there would be no downside protection when the bubble burst. If you thought 2008 was a tough year, this end-result would be much worse.

4. It would inspire companies to borrow at will. If interest rates stayed negative, corporations would flood the market with new bond issues as they'd essentially be paid to go deeper into debt.

Under Alan Greenspan’s direction, the Federal Reserve ventured outside its mandate of affecting monetary policy (adjusting short-term interest rates). Greenspan’s support of de-regulating the financial industry caused the financial crisis in 2007-08 because there was no oversight of the mortgage business.

Later, Ben Bernanke’s actions through Quantitative Easing (QEs I through III) — buying US Treasuries as a stop-gap measure to provide liquidity — further hurt the economy by forcing interest rates lower, creating the situation we’re in today.

Generally, the Fed would like the short-term Fed Funds rate to range between 3% and 5%, the historical norm. Unfortunately, their reliance on old economic formulas may no longer be useful today.

We’re concerned their economic models may ignore:

1. Destructive technology that has hurt employment (fewer workers needed)

2. Pension plans that have changed from defined benefit (a cost to the corporation) to defined contribution (a cost to the employee – unqualified people making investment decisions about their retirement income)

3. People living longer and the increased stresses on the social welfare system

4. Lower wages with no benefits

5. Corporations cutting costs just to meet quarterly earnings expectations

6. Lower inflation rates than what we’ve seen historically

In equities, a trading mentality has appeared whereby the stocks that continue to “beat” the Street’s earnings estimates are the ones purchased (momentum trading). Those that don’t meet these “priced to perfection” metrics get hammered, leaving a wide gap in performance from one stock to the next.

It shows in the table below. While we thought the P/E multiples in June were high – they’re even higher now at the end of September.
For example, the average Price-Earnings Ratio for the TSX before outstanding items on June 30th was 51.96 times. It’s now 62.28 times, meaning prices have risen much faster than profits (earnings). Compared to three months ago, the other indexes, too, have seen prices rise while profits have fallen. We believe we are indeed in an earnings recession.

For the Liberty stock portfolio, the 5 best/worst performers year-to-date were:

<table>
<thead>
<tr>
<th>TOP 5</th>
<th>% GAIN</th>
<th>BOTTOM 5</th>
<th>% LOSS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cognex Corp.</td>
<td>+57%</td>
<td>Novo-Nordisk A/S</td>
<td>-31%</td>
</tr>
<tr>
<td>TransCanada Corp</td>
<td>+38%</td>
<td>Luxottica Group</td>
<td>-30%</td>
</tr>
<tr>
<td>FEI Company</td>
<td>+35%</td>
<td>Amerisource Bergen</td>
<td>-22%</td>
</tr>
<tr>
<td>A.O. Smith</td>
<td>+29%</td>
<td>Novozymes A/S</td>
<td>-12%</td>
</tr>
<tr>
<td>Balchem Corp.</td>
<td>+28%</td>
<td>Lindt &amp; Spruengli</td>
<td>-10%</td>
</tr>
</tbody>
</table>

The way to think about the chart is to take a dollar and calculate the net performance result of all 10 stocks. In this case, the $1.00 at the beginning of the year is today worth $1.08. Note this is just price movement. It doesn't include dividends re-invested, currency movements, trading commissions or fees.

Despite having losing stocks in a portfolio, the winners can cover off the losers with a positive net return and provide confidence for investors, if they wish, to dollar-cost average and buy more of the losing names. That's what we're currently doing for clients.

Some notes to the above:

1. Cognex is involved in robotics and is a technology disruptor. The stock has been moving up on momentum and future profitability as it sells more of its products.

2. A.O. Smith makes water heaters but also provides water and air purification systems in China and India. Now at $97 a share, the stock will split 2-for-1 on October 5th.

3. For Balchem, a specialty chemical company, the Food & Drug Administration's (FDA) recognition of choline as an essential nutrient should help the company's future profitability.

4. Novo-Nordisk has suffered some headwinds with a drop in insulin prices in the United States, their major market. As a result, recent earnings were below expectations but the company has 3 new products coming to market, any or all of which could be blockbusters.

5. Novozymes has created a new enzyme that should be ready in 2018 to help make biofuel from garbage. This should provide a new energy source and reduce the amount of trash in landfill locations.
Currency Markets

The chart above is determined as follows: On December 31, 2015, one British pound bought $2.043 Canadian dollars. By September 30, 2016, it bought only $1.7021, meaning the Canadian dollar strengthened by 20% against the pound.

Overall, the Loonie is up 2.9% on average against this basket of currencies. The Canadian dollar is currently trading like a petro-currency and should move with the direction of the oil price.

For clients, the 6% gain of the Canadian dollar (CAD) against the US dollar (USD) has provided a headwind against foreign holdings. So, if USD holdings are 40% of the portfolio, it would hurt performance by about 2.5%.

I’m not concerned about this as currency risk becomes benign over a 10-20 year time horizon. And since 2000, the CAD has only hurt performance significantly during 2 of those 16 years (2003 when the CAD rose from $0.65 to $0.85 versus the USD and in 2007 when it jumped from $0.85 to $1.00).

Instead, the stronger Canadian dollar offers the opportunity to buy more shares of a foreign stock, bond or preferred share.

Bond Markets

Interest rates worldwide have fallen to historic lows and even into negative territory. Negative interest rates mean that if you buy a bond with a negative yield, you are essentially paying the issuer to hold your money. The reason investors do this is because they want a return of capital (capital preservation), not a return on their capital (capital appreciation).

From an August 12th article by Lawrence Fuller, managing director of Fuller Asset Management, in Seeking Alpha about the current yield argument, he writes:

“The bulls will argue that historically low bond yields make the case for historically high stock multiples, but history argues otherwise. While it may be true that P/E multiples expand as long-term interest rates decline, this relationship holds up to a certain point. When long-term interest rates fall below 3%, implying extremely low rates of economic growth with the potential for deflation, multiples then contract. At least that is what history has shown.”

“If you question the possibility of deflation today, consider the fact that more than $11 trillion in global sovereign debt has negative yields. This means that investors are guaranteed to recover less in the future than they are investing today, which is the definition of deflation.”
One of the stocks in our TFSA accounts is Fairfax Financial Holdings. It’s there because the company, led by Prem Watsa (deemed by some to be Canada’s version of Warren Buffett), has invested $1 billion in derivative contracts that may pay up to $100 billion if deflation remains persistent for the next 5 years or so.

On days when the market moves higher, Fairfax’s share price usually falls and vice versa. It works as a hedge against potential losses by the other stocks in the TFSA if deflation persists and the market falls.

In its latest quarter, Fairfax noted that it has 19% of its investment portfolio in cash and that it had sold its US municipal bonds in favour of long-dated US Treasury bonds (another strategy to deal with deflation). The Liberty bond portfolios are similar to that strategy, only not as extreme.

Negative interest rates are also hurting banks, insurers and pension funds worldwide. Those in Britain are now stuck between a rock and a hard place.

A Bloomberg.com news article by Anchalee Worrachate on August 11th noted that, “Britain’s new quantitative-easing program, combined with monetary easing around the world, is crushing yields, leaving these long-term investors ever more desperate to hold on to their 20-, 30- and 50-year bonds to meet return targets and liabilities. That forces protagonists like the Bank of England (BOE), which is buying 60 billion pounds of government debt over six months, to bid higher prices – driving yields down ever further.”

“For pension funds, a drop in yields leads to an increase in liabilities. While selling gilts (British bonds) at higher prices would generate a profit for the funds, it would leave them with cash that would need to be re-invested into a shrinking pool of assets offering a sufficient return. Regulations require that defined-benefit retirement plans, which the Pension Protection Fund estimates at 1.4 trillion pounds, meet their liabilities.”

The drop in interest rates over the past 8 years has created re-investment risk for investors. This is what occurs when an investor owns a bond with a 6% coupon that matures and faces new re-investment rates that are a pittance of what they were (see table below). For retirees, this leads to a drop in income.

<table>
<thead>
<tr>
<th>COUNTRY</th>
<th>MOODY’S SOVEREIGN CREDIT RATING</th>
<th>CURRENT YIELD</th>
</tr>
</thead>
<tbody>
<tr>
<td>Greece</td>
<td>CCC-Low</td>
<td>+ 8.10%</td>
</tr>
<tr>
<td>Brazil</td>
<td>BB-Mid</td>
<td>+ 4.51%</td>
</tr>
<tr>
<td>Mexico</td>
<td>A-Low</td>
<td>+ 3.13%</td>
</tr>
<tr>
<td>New Zealand</td>
<td>AAA-Mid</td>
<td>+ 2.25%</td>
</tr>
<tr>
<td>Australia</td>
<td>AAA-Mid</td>
<td>+ 1.91%</td>
</tr>
<tr>
<td>United States</td>
<td>AAA-Mid</td>
<td>+ 1.59%</td>
</tr>
<tr>
<td>Canada</td>
<td>AAA-Mid</td>
<td>+ 0.99%</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>AA-High</td>
<td>+ 0.74%</td>
</tr>
<tr>
<td>Japan</td>
<td>A-High</td>
<td>- 0.10%</td>
</tr>
<tr>
<td>Germany</td>
<td>AAA-Mid</td>
<td>- 0.12%</td>
</tr>
</tbody>
</table>

Data Courtesy of Bloomberg LLP

To get the yield / income they seek, investors are being pushed into lower-quality debt of emerging market countries. To be in sovereign bonds of developed nations (the bottom 7 in the chart), investors (after tax and inflation) are earning negative real returns. Spending power continues to decline.
Preferred Shares

With declining interest rates, investors seeking income have sent preferred share prices higher. The average current yield for Canadian and US perpetual preferred shares, those that pay a fixed coupon in perpetuity, is just over 5%.

If rates decline further, their prices would rise because making 5% is better than earning 0.6% on a 5-year Government of Canada bond.

For rate reset preferred shares, those whose rates are reset every five years, the average yield is just over 6%. That’s because if rates go lower, the share prices of these preferred shares would fall further, making the risk profile of these securities greater than perpetual preferred shares.

<table>
<thead>
<tr>
<th>TYPE OF PREFERRED SHARE</th>
<th>YEAR-TO-DATE PRICE CHANGE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Canadian Perpetual Preferred Shares</td>
<td>+ 7.63%</td>
</tr>
<tr>
<td>Canadian Variable Rate Reset Preferred Shares</td>
<td>- 5.00%</td>
</tr>
<tr>
<td>BofA Merrill Lynch US Perpetual Preferred Index</td>
<td>+ 6.42%</td>
</tr>
</tbody>
</table>

Data Courtesy of Bloomberg LLP

FUN WITH MATH

Moneyball and Investments—Finding an Edge

It’s been over 30 years since I wrote baseball books using statistics to look at the inner workings of the game – this is known as Sabermetrics. Some of this effort led to an explosion of baseball statistics, both good and bad, that are still in use today.

Sabermetrics was the premise behind the Michael Lewis book “Moneyball” and the subsequent movie of the same name. The basic idea was to put a fair market value on the players, just like a stock.

Its use was first incorporated by the Oakland Athletics, whose salary budget was much lower than the big-market teams in New York, Chicago and Los Angeles. Because the A’s had less money to spend, they had to be wiser in how they spent it. Otherwise, they could expect to find themselves mired in last place and out of the playoffs every year.

In 2003, Frank Thomas, known as “The Big Hurt”, was a home run bashing slugger with the Chicago White Sox and a perennial all-star. Unfortunately, injury and age caught up to him. During the 2004 and 2005 seasons,
Thomas managed to play in only 108 of a possible 324 games. At age 38, the White Sox believed his career was over and they let him go to test the free-agent waters.

Oakland took a risk and signed him to a one-year contract for a paltry $500,000. In 2006, Thomas must have found the fountain of youth, along with his home run swing. In a home ballpark (Oakland) that favoured pitchers over hitters, the re-born Thomas belted 39 home runs in 137 games, the fifth-highest total in the American League. The A’s paid $13,000 per home run for his performance ($500,000 divided by 39).

After the 2006 season, he became a free agent again and the Toronto Blue Jays came calling. Forgetting that he was now 39 years of age (players' performances usually peak at age 32), then-general manager J.P. Ricciardi opened the vault and signed Thomas to a 2-year, $18-million contract.

He played a full season in 2007 and hit just 26 round-trippers in a ballpark noted for allowing a lot of home runs.

In 2008, batting just .167 with 3 home runs in 16 games, he was released. Divide the $18 million by his 29 home runs hit for Toronto and the Blue Jays shelled out $620,000 per home run, a far greater sum than the $13,000 that Oakland paid.

The purpose of Sabermetrics was to find an “edge”, to earn a return on investment in each player that was better than the competition.

It’s the same with investing. If you can find the edges that help you outperform the market, retirement should be a happy one.

Investors can gain an edge by doing the following:

Re-balancing stocks when necessary helps avoid concentration risk. For example, if you have 30 stocks in the portfolio, the average weighting should be about 3%.

When one stock becomes 6% of the portfolio, sell half the position and re-allocate the proceeds to those stocks that make up less than 3% of the portfolio. Historically, this strategy has enhanced returns by another 2%.

Maintaining a low turnover (investing in businesses, not trading stock prices) keeps the costs down and allows more capital to be invested. This enhances returns by another 1%.

These three strategies have been around for years and are part of investment theory taught at business schools. I discovered the next strategy long ago when I was looking for an added edge.

Allocating capital in late October / early November provides better calendar returns than adding money in January. This can enhance returns by up to 2% compounded annually.

The Process

Because the greatest stock market crashes have occurred in October (1929, 1987, 2008), I created a spreadsheet that recorded a company’s stock price (and the indexes, too) on October 24th of each year, beginning in 1990. The logic behind using October 24th was it was roughly one to two weeks after a crash and enough time for market volatility to settle down.

I then looked at the calendar performance of each stock from October 24th to October 24th. I chose 1990 as a starting point because the economy was about to fall into a recession and the market was at its high. Beginning at a market top should prevent the data set from showing over-optimistic numbers.
With 25 years of stock price and index data, the results were as follows:

<table>
<thead>
<tr>
<th>PORTFOLIO</th>
<th>AVERAGE RETURN</th>
</tr>
</thead>
<tbody>
<tr>
<td>Liberty Global Stocks</td>
<td>+ 20%</td>
</tr>
<tr>
<td>S&amp;P TSX (Canada)</td>
<td>+ 8%</td>
</tr>
<tr>
<td>S&amp;P 500 (United States)</td>
<td>+ 9%</td>
</tr>
<tr>
<td>Stoxx 600 (Europe)</td>
<td>+ 8%</td>
</tr>
<tr>
<td>MSCI Global</td>
<td>+ 11%</td>
</tr>
</tbody>
</table>

Note that the Liberty global stocks haven’t all been owned since 1990 (some didn’t even exist) so it’s no indication of our performance – this is not a marketing piece. Rather, the outperformance merely shows the quality of the companies and the importance for investors to own firms that generate consistent and growing free-cash flows.

Does it work every year? No, but it has been successful about 75% of the time, so the odds are in your favour.

Among the returns of the 30 stocks in the Liberty group, some of the best October-to-October companies were Alimentation Couche-Tard (up an average of 37% - not including dividends), Balchem Corp. (up 32%) and Roper Technologies (up 31%). However, not all of them provided 20% or better returns. When should the laggards be purchased?

The Next Step

I wondered if there were any particular times when the individual stocks should be purchased versus when it should be avoided.

I recorded prices since 1990 for each month of the calendar year for each company. As it turns out, each stock had a particular month when it performed much better than the other calendar months.

For example, Jardine Matheson, a conglomerate that owns businesses throughout Southeast Asia, had better price performance from September to September (19.3%) than any other month – the worst month was December (10.6%) and the average was 15.9%. To me, this was statistically significant.

It makes sense as Jardine usually announces an interim dividend in late-August / early-September (it pays dividends semi-annually) and its second-half earnings tend to be better than its first-half.

The Final Step

Knowing to buy Jardine Matheson shares in September, which day should it be purchased?

I’m not a big fan of technical analysis. I remember a former colleague regarded technical analysis this way, “Among the shipwrecks at the bottom of the ocean, there lies a chart.”

However, I do use stochastics to determine when to buy and sell a stock. Stochastics measure the velocity of a security's price movement to identify overbought and oversold conditions.

The indicator measures the current price relative to the stock price's highs and lows over a time period. Stochastics can be used to recognize potential turning points to help make buy/sell decisions.

When a stock is oversold, I like to buy. If it’s oversold twice in a month, I like to buy the second dip as it is usually an even lower, more attractive price.

Summary

If you think of the edges described above and use them to construct your portfolios, it creates an added level of discipline and your odds of investing successfully should improve.
**What are DAP trades and why do I have to pay the cost?**

DAP stands for “Delivered at Place”. It’s a securities industry settlement procedure in which the buyer's payment for securities is due at the time of delivery.

The DAP fee is charged when we place trades with brokers other than our custodian. The fee is $20 and the reason we trade away from the custodian's trading desk is to get better access to bonds or preferred shares that aren't in their inventory. Or, we may get a better price fill on the trade and/or have access to greater liquidity at another broker.

Say, for example, we wanted to buy 1,000 shares of a particular preferred share. If the custodian has it in their inventory, they may quote us a price of $24 for a total cost of $24,000 + commission but no DAP fee.

However, if I go to another institution and can buy the same preferred share for $23.50, the cost would only be $23,500 plus the $20 DAP fee, a savings of $480 and worth doing the trade elsewhere. Also, the DAP fee is tax deductible in taxable accounts.

**Why are there only Canadian stocks in my TFSA?**

We hold 20 Canadian names in the TFSA (Tax-free Savings Account) to receive the full amount of the Canadian dividend payment.

Because the TFSA is a registered account, any withholding tax taken against US and international dividends in a TFSA cannot be claimed back on an investor's tax return. Withholding tax may only be claimed in taxable accounts.

As a result, most of our Canadian stock exposure is in the TFSA, while the RRSPs and taxable accounts hold mostly foreign stocks.

**I've had poor returns at another broker / investment counsellor. They said I owned a balanced fund but when I look at balanced fund returns, mine were much lower than the posted returns.**

When I looked at the prospective client's portfolio, the issues jumped out quickly. The investor had a 50% stock / 50% fixed income portfolio but incurred a double-digit loss in a year when both the stock and bond markets rose.
Within the portfolio, there were two major problems:

1. More than 10% of the fixed income allocation was invested in one preferred share that fell 50% in value. This is known as concentration risk. If this preferred share was purchased in equal value to the other preferred shares, the performance would have been much better because the loss would have been reduced.

2. The majority of US stocks were in the financial sector, mostly the big money-center banks. I guess the manager was making a bet that interest rates would rise. Unfortunately, rates didn’t go up and the bank stock returns were negative, creating a larger loss and a poorer return.

This is known as correlation risk. It is avoided through diversification. If a portfolio has 30 names, no two should be similar types of companies such as banks, utilities, etc.

It’s better to own stocks that are out there in the world doing their own thing than to have all the investments in one company, one industry or one country. All the bases are covered. You may not make outlandish gains but you also won’t have extraordinary losses that will force you to work until you’re 80.

**The US dollar is trading at new highs. Why would I buy US stocks and bonds today when the only direction for the US dollar is down?**

Stock prices can go infinitely higher than any upward movement in the underlying currency. Focus should be on making a plan and sticking to it rather than trying to make calls on every security in the portfolio, especially currencies. They’re the most volatile financial instrument on the planet.

**My returns are lower than the benchmark comparison. Why is this?**

This is a common question asked by retirees who are withdrawing money from their portfolio regularly. The easiest way to explain it is to show two situations:

1. A retiree (Investor A) with a $1 million portfolio who withdraws $50,000 annually, a drawdown of 5%.
2. A fully-employed worker (investor B) who has a static portfolio, one where no money is withdrawn.

If they have the same portfolio and the market rises 10%:

1. Investor A, the retiree, will have a return of 5% ($1,000,000 x 1.10 - $50,000) / $1,000,000
2. Investor B, the static portfolio, will be up 10% ($1,000,000 x 1.10)

The 5% return for the retiree is lower than the benchmark index return but remember that this is capital growth after money has been withdrawn.

This is a good thing because after the money is taken out to live on, the capital has continued to grow. If it continued ad infinitum, the retiree would never run out of money which is what the end-game is all about – getting you and your capital to the finish line at the same time.

If you have any further questions, let me know.

**David Driscoll**
President & CEO
Liberty International Investment Management Inc.