LIBERTY
International Investment Management

MARKET UPDATE

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YEAR-TO-DATE PERFORMANCE

The Markets – January 1st to December 31st, 2017

There was a wide difference in equity returns in 2017 (see table below). The spread between the 20% gainers (India, Brazil, the United States and Japan) and the others can be explained easily:

India: There were major structural policy changes in India in 2017 designed to open up their markets, to increase tax revenues and to make the markets more efficient.

According to the *Organization for Economic Co-Operation and Development* (OECD), "Economic growth of around 7½% makes India the fastest-growing G20 economy. The acceleration of structural reforms, the move towards a rule-based policy framework and low commodity prices have provided a strong growth impetus. Recent deregulation measures and efforts to improve the ease of doing business have boosted foreign investment."

Brazil: *The International Banker*'s Alexander Jones (*March, 2017*) wrote, "The worst may be over for the Brazilian economy and that stability is slowly returning, which in turn has steadily boosted Brazil's profile among global investors. With inflation gradually coming under control and interest rates on the decline, confidence among businesses, consumers and investors has returned, which has helped to propel Brazil's stock market to five-year highs."

With a drop in the U.S. dollar against most foreign currencies in 2017, foreign currency reserves were bolstered for emerging markets like Brazil and India. This gave them the spending power to spend on capital goods items and help enhance their GDP. That's why the emerging market indexes had such solid returns last year.

United States: It also explains why the Dow Jones Industrial Average Index (30 of America's largest companies) outperformed the wider-based S&P 500 Index. The large multi-national companies saw profits rise at a higher-than-average clip because of increased buying of goods by emerging market countries.

U.S. markets also jumped on the back of the expected corporate tax cuts from a maximum 35% to a flat 21%. Lower tax rates mean lower expenses and higher profits for U.S. corporations, especially those that do business only within U.S. borders. Chances are that the S&P companies' returns may outperform that of the Dow firms in 2018.

Japan: In Japan, Okasan Securities strategists led by Kenji Abe point to firm global economic conditions, with manufacturing indexes in the U.S., China and Europe at or near multiyear highs to indicate why the Nikkei 225 Index has done so well.

This, they write, will feed through to stronger earnings in Japan and accelerate the return of foreign investors to the market. And the yen will continue to weaken, benefiting the Nikkei's giant exporters, as the Bank of Japan keeps going with easy monetary policy while the Federal Reserve tightens.

It's important to remember that the latest gains in Japanese stocks have mostly been driven by temporary and emergency actions, not real economic growth. Tax increases were abandoned in 2015 and rates continue to be at or near zero per cent.

At Liberty, we don't directly own Japanese stocks today - we're looking, but thus far we've found nothing appealing. The Japanese central bank now owns three quarters of all Japanese Exchange-Traded Funds (ETFs) 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.

Also, it's important for investors to ignore where companies are domiciled - it's where they earn their revenues that count. Since nearly all of the stocks we own do business in Japan, we're not missing out on the economic surge in that country.

Canada: And what of Canada? The TSX gained about ½ of what the bigger indices made in 2017. The banks were up 3% to 10% but the rest of the index struggled, particularly the resource and mining sectors and the interest-rate sensitive telecom, REIT and utility sectors.

Is this important to Canadian investors? It should be, because owning assets in only one country opens the door for the native currency to batter someone's spending power.

For example, if the Canadian dollar drops 20% versus the US dollar as it did from $1.00 in 2013 to 80 cents today, the cost of $100 of goods in 2013 is now $120 today, weakening a person's spending power over time. The solution is to own global investments to create a natural hedge against one's domestic currency risk.

Equity Markets

2017 Returns			
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	+27.91%	+23.74%
Brazil	Ibovespa	+26.85%	+16.20%
United States	S&P 500	+21.82%	+13.46%
Japan	Nikkei	+21.29%	+17.04%
Australia	S&P / ASX 200	+11.79%	+12.70%
Europe	Stoxx 600	+11.18%	+18.03%
Mexico	Mexican Bolsa	+10.10%	+7.51%
Canada	S&P/TSX	+9.08%	+9.08%
China	Shanghai Composite	+8.75%	+8.02%

Data Courtesy of Bloomberg LLP

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

Wall Street stock analysts have raised their profit forecasts in recent weeks, and now expect companies in the S&P 500 will earn $148.3 a share in 2018, compared with $128.6 in 2017, according to *Bloomberg News*' Elena Popina and Sarah Ponczek. The implied 15 percent growth rate compares with a projection of 14 percent at this time last year and would represent the fastest increase since 2010.

Not so fast, however. Using the numbers in the table below and comparing the historical Price-Earnings ratio of the S&P 500 Index of 16.2, the market appears to be 40% overvalued.

And when considering the CAPE ratio (cyclically adjusted price-to-earnings ratio – it was explained in detail in the last newsletter), its 32.2 ratio at the end of 2017 makes the S&P 500 Index 50% overvalued.

The only time the CAPE ratio has been this high in history was in 1929 (the Great Stock Market Crash) and 1999 (the Tech Bubble Crash).

Price/Earnings Multiples			
INDEX	**COUNTRY**	**P/E RATIO** Estimated	**P/E RATIO** Before Outstanding Items
S&P TSX	Canada	19.69	18.74
S&P 500	United States	22.45	24.66
Euro Stoxx 600	Europe	20.81	20.97
MSCI World Index	Global	21.51	22.25

Data Courtesy of Bloomberg LLP

From a historical perspective, we respect the comments made recently by Jeremy Grantham, the chief investment strategist for *Grantham, Mayo, Van Otterloo & Co* (GMO), who opined that, "We are currently showing signs of entering the blow-off or melt-up phase of this very long bull market."

Here's the historical data of the two melt-up phases:

→ From June, 1928 to October, 1929, the S&P 500 Index rose 78%

→ From October 1998 to March, 2000, the index jumped 67%

Since the Trump election in November, 2016, the S&P has moved 28% higher. That means the melt-up to reach those frothy levels would be another 40% higher, or roughly an S&P 500 move from 2673 to 3742.

In a *Bloomberg L.P.* article on January 3, 2018, "Grantham cited the recent acceleration of U.S. equity prices, a concentration of leadership in stocks and growing media coverage of events such as bitcoin's surge and Amazon.com Inc.'s success as signs that the final phase of a bubble could be coming in the next six months to two years."

Regarding our 20% holdings in cash (20% times the equity allocation weight), our stance hasn't changed. For example, if the asset mix is 60% equities and 40% fixed income, the cash weighting will be 12% (60% equities x 20% cash).

We won't make as much on the way up, but we preserve cash better for the long-run (see Question #1 of the Client Q&A below).

For the Liberty global stock portfolio, the 5 best/worst performers in 2017 were:

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

TOP 5	% GAIN	BOTTOM 5	% LOSS
Cognex Corp.	+ 92%	Gemalto NV	- 10%
Intertek Group plc	+ 49%	Inditex SA	- 9%
Novozymes A/S	+ 46%	Balchem Corp.	- 4%
Roper Technologies	+ 41%	J.M. Smucker	- 3%
Halma plc	+ 40%	TransCanada Corp.	+ 1%

Data Courtesy of Bloomberg LLP

The chart above illustrates why we've outperformed all our pertinent indexes this year (even by holding 20% cash) as the winners did far better than the losers. Note that none of the top 5 were Canadian stocks.

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.

After our first purchase in January, 2016, the stock quadrupled, forcing us to re-balance the position in early 2018. We're happy to do so because if this market ever corrects, the high-beta, high-P/E stocks will fall more than the market averages.

→ **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. It also increased its dividend by 20% this year, a reflection of greater expected future free cash flows.

→ **Novozymes A/S** (NZYMB DC) is a Danish company that makes enzymes for sales in ethanol, yeast and detergents. The goal is to improve product efficiencies but also reduce pollution (less detergent using cold water instead of hot and less water needed to clean clothes or dishes).

→ **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.

- **Halma plc** (HLMA LN) is a health and safety sensor group. It makes products that are designed to improve public and personal health and manage water (Environmental and Analysis), detect hazards to protect buildings (Infrastructure Safety) and protect people in industrial work environments (Process Safety).

  Products include medical optics devices, water quality test kits, fire and smoke detectors, elevator safety sensors, access control locks and gas detectors.

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.

  The company was purchased by Thales SA of France for 51 euros a share in December, 2017. It had taken a $400 million write-down of its SIM card assets, which cleaned up the balance sheet and made itself attractive for potential buyers.

- **Inditex SA** (ITX SM) is a Spanish clothes retailer that makes chic fashions, mainly under the Zara brand. It sells both on-line and in retail outlets worldwide. It was recently sold in early 2018 to make room for HDFC Bank, an Indian bank.

- **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 to digital competition.

  Smucker was sold in mid-2017 as our Unilever holding was all that we wanted to keep in the consumer products sector.

- **Balchem Corp** (BCPC US) makes specialty performance ingredients for the food, feed and medical sterilization industries.

  The company has developed a technology that covers or encapsulates ingredients used in food and animal health products (choline chloride). Balchem also provides specialty gases such as ethylene oxide (used to sterilize medical instruments), propylene oxide (used to reduce bacteria in spice treating and chemical processing) and methyl chloride (a refrigerant).

  We continue to own the stock and are buying more.

Currency Markets

Canadian Dollar vs.			
CURRENCY	DEC. 31, 2016	DEC. 31, 2017	GAIN/LOSS %
US Dollar	$1.3435	$1.2574	+ 6.8%
New Zealand Dollar	$0.9305	$0.8910	+ 4.4%
Japanese Yen	$0.0115	$0.0112	+ 3.1%
Swiss Franc	$1.3215	$1.2898	+ 2.5%
Norwegian Krone	$0.1555	$0.1531	+ 1.6%
Mexican Peso	$0.0648	$0.0640	+ 1.3%
Australian Dollar	$0.9677	$0.9812	- 1.4%
British Pound	$1.6594	$1.6978	- 2.3%
Swedish Krona	$0.1479	$0.1534	- 3.6%
South African Rand	$0.0978	$0.1017	- 3.8%
Danish Krone	$0.1904	$0.2026	- 6.0%
Euro	$1.4153	$1.5088	- 6.2%
Average Loss			- 0.3%

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 December 31, 2017, it bought only $1.2574 Canadian dollars, meaning the Canadian Dollar strengthened by almost 7% against the U.S. dollar.

In 2017, the story was 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 outlook for the Canadian dollar in 2018 is to trade in a range of 70 cents to 85 cents to the US dollar. Oil prices are expected to be steady in the USD $60 range per barrel, helping the Canadian dollar but that may be offset by the US tax cuts and higher interest rates south of the border.

Higher US rates attract buyers of US treasuries. Currently US 10-year Treasury rates are 0.32% higher than 10-year Canadian government bonds. If the US Federal Reserve raises rates 3 or even 4 times in 2018, it may be difficult for the Bank of Canada to keep up. If so, this would cause downward pressure on the Loonie.

Bond Markets

10-Year Bond Yields		
COUNTRY	MOODY'S SOVEREIGN CREDIT RATING	CURRENT YIELD
Turkey	BB-High	+ 11.32%
Indonesia	BBB-Low	+ 6.26%
Brazil	BB-Mid	+ 4.52%
Greece	CCC-Mid	+ 4.03%
Russia	BB-High	+ 3.81%
Argentina	B-Low	+ 3.63%

Data Courtesy of Bloomberg LLP

10-Year Bond Yields		
Mexico	A-Low	+ 3.63%
New Zealand	AAA-Mid	+ 2.70%
Australia	AAA-Mid	+2.63%
United States	AAA-Mid	+2.41%
Canada	AAA-Mid	+ 2.04%
United Kingdom	AA-Mid	+ 1.19%
Germany	AAA-Mid	+ 0.42%
Japan	A-High	+ 0.04%

Data Courtesy of Bloomberg LLP

Capital flow into emerging markets wasn't just restricted to equities as bond yields were much higher than in the developed nations, providing real rates (after inflation) that were positive. Bond investors in developed markets couldn't make the same claim as real yields were slightly negative.

It also helps explain the attraction for investors to buy Greek bonds. Once the poor sister of Europe just 6 years ago during the Greek crisis, investors were willing to take on the risk of a CCC credit to get the 4% yield. With European inflation virtually benign, the real yield was almost double those of the developed markets.

And Turkey? Its currency and bonds fell in value during 2017 after the Turkish central bank did not raise interest rates aggressively enough to deal with rising inflation, currently around 13%. Real returns after inflation, therefore, are still negative.

As for Canada, we saw 2 rate increases of ¼ percent each in 2017. This has pushed mortgage rates higher, causing homeowners with mortgages to prepare for higher future payments on their debt.

For example, consider an investor with a $500,000 mortgage who had a 5-year fixed rate of 4.2% in 2013 that matured in 2018. If we use a 20-year amortization and a monthly re-payment schedule, the monthly payment was $3,073.

Add the rate hikes (and bank spreads) and that 5-year fixed rate is now 4.89%, increasing the monthly payment to $3,256. This increases the investor's monthly expenses by $180. If rates continue higher, homeowners with big mortgages should start to feel the squeeze as they'll have to allocate more resources to debt re-payment. Could we finally see a slowdown in the housing sector? We'll find out more in 2018 if interest rates trend higher.

This should also have an impact on the high-yield, or junk bond market, one that we believe is currently unattractive. High-yield debt usually trades about 200-400 basis points above investment grade debt rated BBB to AAA.

Yields of BB credits, or non-investment grade, are currently around 4.25%, about the same as investment grade yields, making the risk much greater than the reward.

And if inflation does raise its ugly head, five percent of our portfolios are invested in inflation-protected bonds, both Canadian (known as real-return bonds, or RRBs) and U.S. (known as TIPs – Treasury inflation-protected securities).

For example, the Government of Canada 3% RRB matures on December 1, 2036. Investors get paid 3% + the inflation rate each year, so if inflation is running at 2%, investors receive a 5% payment. And that inflation rate compounds over time, so you're always protected.

We don't trade these bonds because they're the only true fixed income investment that protects you from inflation. Remember, retirement date isn't the finish line – death is.

Preferred Shares

TYPE OF PREFERRED SHARE	YEAR-TO-DATE PRICE CHANGE
Canadian Perpetual Preferred Shares	+2.50%
Canadian Variable Rate Reset Preferred Shares	+10.00%
BMO US Preferred Share Index ETF (in USD)	+4.78%

Data Courtesy of Bloomberg LLP

With the rise in Canadian interest rates, rate-reset preferred share prices shot higher, rising an average of 10% in 2017. This compares with their counterpart, the perpetual preferred shares, as those share prices rose only 2.5% 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.

However, investors should note that the prices of rate-reset preferreds are nearing their $25 par value so aren't the great investment they were in 2016 when prices were in the mid-teens following a drop in interest rates.

FUN WITH MATH

The Case Against Buying or Even Owning Strip Bonds

For this article, Thomas Zagrobelny of our research team has come up with a case for not holding strip bonds to maturity.

Strip Bonds are a security created by a broker / dealer who purchases a regular coupon-paying bond, then sells off each coupon payment separately to investors.

To the investor, these strips act as simple non-interest-bearing securities. To the dealer, the simple rearrangement has two advantages:

→ A bond is priced using one overall yield but each stripped out coupon has its own yield. Shorter terms mean lower yields and higher prices, so the individual components can be sold for more than the whole. Technically, the strip yield curve is steeper than the nominal yield curve.

- The dealer can charge big commissions for each individual strip sold and earn significantly more money than by just selling a single bond.

It's important to note that these advantages are solely for the dealer, not the investor.

While the first benefit is a consequence of an upward sloping yield curve (which just means that longer terms have higher yields), the upward slope can have the opposite effect for an investor holding a strip to maturity.

When you originally purchase a 5-year strip, the yield is high to offset the long term. A year later, the term drops from 5 years to 4 years, so the yield-to-maturity of the strip also drops.

In general, if the yield curve is upward sloping and fixed, the yield-to-maturity will drop over time. This yield drop actually punishes the holder for holding the strip bond to maturity.

The chart below shows the historical yield-to-maturity of an actual 10.5% Government of Canada strip bond (source: *Bloomberg L.P.*). Over a 10-year time horizon, the yield drops to almost ¼ of its original value.

The better approach for an investor is to buy for a longer maturity than he or she intends to hold, and then sell before maturity. This takes advantage of the higher yield offered by long- dated bonds.

Imagine two investors who want to invest $1,000 for four years. The first investor buys and holds a single 4-year strip, while the second investor buys a 4-year strip and sells it off each year with 3 years until maturity. Using the yield table below, you can see that the first investor earns 1.84% annually, while the second investor earns 2.04% each year. In typical market conditions, holding a strip to maturity is not ideal.

	HOLDING TO MATURITY		SELLING TO MATURITY	
	Activity	Cash Effect	Activity	Cash Effect
Start	Buy 4-year Strip	($929.80)	Buy 4-year Strip	($929.80)
In 1 Year			Sell 3-year Strip Buy 4-year Strip	$949.35 ($929.80)
In 2 Years			Sell 3-year Strip Buy 4-year Strip	$949.35 ($929.80)
In 3 Years			Sell 3-year Strip Buy 4-year Strip	$949.35 ($929.80)
In 4 Years	Strip Matures	$1,000.00	Sell 3-year Strip	$949.35
Total Earned		$70.00		$78.22
Annual Yield		1.84%		2.04%

As you can see, holding to maturity causes you to lose money in the final 2 years. It's better, therefore, to sell before the time value declines.

QUESTIONS

Why are you holding cash when the markets keep rising every day?

A *Globe & Mail* article written by Dale Jackson on November 1, 2017, included a comment by a portfolio manager who made the claim that, "Sitting on cash is one of the dumbest things investors can do."

We disagree. Here's why:

Think of two scenarios, one where a $1 million portfolio (Portfolio A) is fully invested and a second $1 million portfolio (Portfolio B) has 80% invested and holds 20% in cash.

If the market rises 20%, Portfolio A moves 20% higher to $1,200,000, while Portfolio B rises 12% (80% invested - 20% cash = 60% long position x 20% performance = 12% return), and is worth $1,120,000.

If the market then drops 40% after a market "melt-up", Portfolio A's value falls $480,000 to $720,000.

And what about Portfolio B? The 20% cash is deemed to be a "synthetic short" whereby if the portfolio isn't fully invested, the cash is deemed to be short the portfolio. In this case, if 80% is invested and 20% is in cash, or short the market, the actual market exposure is only 60%.

So, when the market drops 40%, Portfolio B is worth $851,200, having fallen only 24% (40% drop x 60% exposure).

Overall Scenario: The market goes up 20%, then falls 40%: Each portfolio starts with $1 million.

PORTFOLIO A		PORTFOLIO B	
(Fully Invested)	Value of 1 Million	**(80% Invested)**	Value of 1 Million
Up 20%	$1,200,000	**Up 12%**	$1,120,000
Then down 40%	$720,000	**Down 24%**	$851,200

And after the correction, the Portfolio B investor has $200,000 cash available to take advantage of cheaper valuations. If fully invested, like Portfolio A, the investor would have to sell stocks in a falling market to raise cash, producing losses on losses.

Since investing is not about how much you make on the upside but how much you avoid losing during market sell-offs, holding cash is not "*dumb*". Instead, we believe it's prudent portfolio management and a better exercise in capital preservation than trying to trade our way through a market correction.

Why don't you buy turnaround stocks like General Electric?

We've always said that when you buy an Exchange Traded Fund (ETF), you'll get a basket of good stocks, mediocre ones and outright lousy firms, so better to be invested in just the good stocks.

We believe that companies that generate consistently growing free cash flows fall under the "good" category and that turnaround ideas should be considered among the group of "lousy" low-quality firms.

The best way to exhibit this is to consider two industrial / aerospace firms: General Electric vs. Heico Corp. Their performance numbers for the past 5 and 10 years are (dividends included):

General Electric:

- 5-year compounded annual return: **- 3.63%**
- 10-year compounded annual return: **- 7.00%**

Heico Corp:

- 5-year compounded return: **+ 27.37%**
- 10-year compounded return: **+ 18.21%**

Let's assume that it's 2007 and you're about to enter retirement at age 65 with a $1 million nest egg, in need of income to live on and with a goal of capital preservation so the money will last until your death.

Because you have no defined benefit pension, you need $50,000 a year to live on, money that will have to come from the portfolio.

You put all that money into one stock, General Electric. You believe the yield is attractive (3.1%) and, because of its size, diversification and AAA credit rating, it should be a "sleep-at-night" blue chip.

The purchase is made on December 31, 2007. You buy 27,012 shares at $37.02 a share. The annual dividend is $1.12 and the income is $30,253.92, meaning in a year, you'll only need to cash in $19,746.08 worth of shares to cover your $50,000 annual spending needs.

The stock market corrects in 2008 and the share price drops to $16.18. Fortunately, the dividend is raised to $1.24 per share, generating more income and requiring a smaller share sale but at a lower price.

The situation begins to worsen in 2009 as the first of two dividend cuts hits GE shareholders. In 2009, the dividend is cut to $0.82 a share and in 2010 it's cut again to $0.42 a share. This reduces your income and forces you to sell more shares to keep the $50,000 expenditure in place.

Fast forward to December 31, 2017 and you have only 9,388 shares left from the original 27,012 and since the dividend is only $0.48 a share, you have eaten into the capital so much that *you'll run out of money by 2021 at age 79.*

Alternatively, if you had invested your $1 million retirement nest egg into Heico Corp. shares, you've been able to sell enough shares each year to live comfortably. Even better, the capital 10 years later is worth $3.6 million.

Buying into a turnaround idea is for gamblers who have time on their hands to wait. Investors, meantime, buy quality companies for the cash flow paid out in the form of a dividend each year and for the capital appreciation to offset inflation and grow the nest egg, providing you with a worry-free retirement.

Of course, we don't suggest you own just one stock but if you have 30 of these types of companies nicely diversified, your odds of success improve.

So, what makes Heico such a good investment? Here's Heico's CEO Larry Mendelson's comments from the last company conference call about the importance of cash flow and how they manage it.

"I've always said that I perceive HEICO not as an aerospace or electronics technology company. Heico is a very strong, well-managed vehicle for generating cash flow. And as I look at Heico, I see a snowball of cash. That's why we are in business."

"I don't want to be in the business of earning just 7%. Some of you know, industrial companies, lots of them, are operating at 7%, 9% and all of that. We are not focused on that. And we don't want to go there."

"We intentionally look for high margin. High margin is what permits us to constantly expand the company. We can take the funds and our operating margin doesn't require us to invest huge amounts of money into receivables or inventories. Other guys who have low margins, they have all their money stuck in non-productive assets and receivables and inventory."

"So, if anything sets Heico apart from other companies, it's that basic philosophy of how to manage that money. And that's the only way we know how to do it is shoot at big margins and grow. And that extra margin is what permits us to re-load and grow. And we are not going to cut it. We are not going to go out and buy a 7% margin company."

General Electric was one of those companies that didn't manage its cash flow well, made bad acquisitions, and left its shareholders with long-term losses, not growth.

What are the important parts of portfolio management that I'm missing?

We're often asked to review portfolios, either from prospective clients or from do-it-yourself investors who would like to have them critiqued, hoping they may improve their investment fortunes.

Here are some ways to avoid the noise and make the investment decisions mechanical, rather than emotional. Remember, investors must leave their emotions at the door before they put any of their hard-earned capital into the market.

Below is a sample 5-stock portfolio showing their market values, % weighting of the portfolio, beta and weighted-average beta:

Stock Performance Off the Bottom Lows in 2016

COMPANY	MARKET VALUE	% WEIGHTING	BETA	WEIGHTED AVERAGE BETA
CN Rail	$84,000	9.8%	0.79	0.08
TD Bank	$18,000	2.1%	1.00	0.02
Royal Bank	$35,000	4.1%	1.14	0.05
Cognex Corp.	$220,000	25.7%	1.65	0.42
Nvidia	$500,000	58.3%	1.88	1.10
TOTALS	**$857,000**	**100%**		**1.67**

A) Dealing with portfolio volatility:

The beta is simply the price movement of a stock relative to its underlying index. For example, Royal Bank's beta is

1.14. This means that for every dollar that the TSX moves up or down, Royal's share price will move up or down by $1.14. Therefore, the greater the spread, the greater the price volatility and the greater the risk.

The weighted-average beta is simply the % weighting times the beta. Add up the column of weighted-average beta and you get the portfolio beta on a weighted-average basis. If the stock market beta is 1.00, this portfolio is 67% riskier and more volatile.

The goal is for the weighted-average beta to be less than 1.00, or less volatile than the overall stock market. That way, you won't see huge daily swings to your portfolio.

B) Dealing with Concentration Risk:

The percent weightings for CN Rail, Cognex and Nvidia are way too high. If you own a 30-stock portfolio, the average weighting should be 3.3%. If one of the stocks becomes a 6.6% weight, it's time to sell half and re-balance the position.

This reduces concentration risk and avoids the Nortel Networks or Valeant Pharmaceuticals rides from $20 to $350 and back to $20 (or zero, in the case of Nortel).

Re-balancing has proven to add 1% to 2% extra compounded performance over a 10-20 year holding period.

C) Dealing with High Betas:

Stocks with high betas tend to collapse quickly. Low beta stocks tend to come from safer industries such as consumer, financial, healthcare and utility. These companies pay out most of their profits in the form of a dividend, creating a greater level of stability. These are known in economics as "inelastic" businesses, meaning that whether or not the economy is strong or weak, demand for their product or service is always there.

Higher beta stocks come from "elastic" businesses such as technology, industrials and resources. An elastic business is one that makes all its money in the good times (demand is high) and loses it all during the bad ones (demand disappears).

Companies with betas greater than 1.50 should be sold or at least re-balanced. In Nvidia's case, if the stock market falls 40%, Nvidia's share price should drop 75%. That one stock could cause the entire portfolio performance to suffer for many years.

We prefer that at least 50% of the stocks come from the inelastic sectors.

D) Dealing with Correlation Risk:

The two banks (TD and Royal) are in the same industry. This is known as correlation risk and should be avoided.

For example, in 2008, it wasn't one Canadian bank stock that fell 40% - they all did. To avoid that kind of disaster, pick one bank stock and stick with it. And with TD's and/or Royal's US divisions, there's no need to own a US bank or US financial.

Correlation risk is the number one cause of running out of money in your lifetime.

Why are you reducing your fees?

The coming storm of lower client fees to hit the investment industry can be equated with what happened in baseball 20 years ago - scouting took a back seat to statistics to quantify the true value of a player. Here's dialogue from the 2002 movie *Moneyball*.

It was written by acclaimed screenwriter Aaron Sorkin (other writing credits include *The West Wing* and *The Newsroom*).

John Henry, the Red Sox owner and a billionaire hedge fund manager, is in discussion with Billy Beane, General Manager (GM) of the Oakland Athletics. He is trying to hire Beane as his next GM.

"One of the great things about money is it buys a lot of things, one of which is the luxury to disregard what baseball likes, doesn't like; what baseball thinks, doesn't think."

"For $41 million, Billy, you built a playoff team. You lost Damon, Giambi, Isringhausen, Pena (to free agency), and you won more games without them than you did with them. You won the exact same number of games that the Yankees won but the Yankees spent $1.4 million per win and you paid $260,000. I know you're taking it on the teeth out there in Oakland but the first guy through the wall, he always gets bloody, always."

"This is threatening, not just a way of doing business but in their mind, it's threating the game. But really what it's threatening is their livelihood - it's threatening their job. It's threatening the way that they do things."

And every time that happens, whether it's a government or a way of doing business (*the investment management business*) or whatever it is, the people who are holding the reins, who have their hands on the switch, they go bat-shit crazy. I mean, anybody who's not tearing their team down right now and rebuilding it using your model, they're dinosaurs. They'll be sitting on their ass, on the sofa, in October, watching my Boston Red Sox win the World Series."

Last month, Liberty reached its first target goal for assets under management. As a result, we chose to reduce the fees for clients whose assets range up to $3 million from 1.25% to 1.00%.

We're reducing the fees because we believe, in general, that client fees are too high in the industry and that the dinosaurs are trying to begrudgingly hold onto the "honey-pot" before it disappears.

Enter Liberty. By driving our fees lower, clients at other firms will either have to get a comparable, lower fee rate from their existing manager or they'll leave and come to Liberty. To us, that's a win-win situation for the clients. And, after all, who's money is it anyway?

If the latter, we can grow our scale faster and reduce the fees at a greater clip. By the time we reach our final target of $1 billion in assets, our fees will range from 0.25% to 0.75% (tax deductible for taxable accounts).

So, why did we cut the fees? Because we can (our fixed costs are lower than the industry average) and because we believe it's the right thing to do.

IN SUMMARY:

The market noise is deafening right now. Everyone and their dog are making predictions – some up, some down, some all around. How do we make sense of this? It's easy if you follow these simple rules:

→ **Avoid the noise –** Historically, seven out of every eight predictions are wrong, so why listen?

→ **Re-balance when necessary –** If stock valuations are at all-time highs, it's prudent to take some profits off the table. We've already done so with the re-balancing of Cognex shares.

→ **Understand the risks with concept stocks** like marijuana / bitcoin / cryptocurrencies / blockchain – bet only what you can afford to lose and take profits if you've doubled your original investment.

→ **Avoid high-yield "junk" bonds –** their prices are too high and so are the risks. Most of these types of debt historically trade 200 to 400 basis points above investment grade bonds – they're currently trading at similar levels to those instruments.

→ **Valuations are nearing all-time highs –** keep some cash available in the event of any market meltdown. Twenty percent of your equity component is appropriate. When you look at the largest ownership of each stock in an index, it will be the ETFs that dominate ownership. Voting proxies, therefore, may become irrelevant, allowing companies to get away with violations, especially with Republican control of both Houses and the Presidency (less regulation and removal of the Ethics Committee are two of their mandates). Remember, the shareholders are the owners, not the management teams.

If you have any further questions, let me know.

David Driscoll

President & CEO
Liberty International Investment Management Inc.

The commentary in this newsletter should be considered general commentary only. The above language is intended for informational purposes only and is not intended to constitute accounting, legal, tax, or investment advice. You should consult directly with a Liberty professional before acting on any information in this newsletter.

