

MARKET UPDATE

Q2 | June 30, 2018

IN THIS ISSUE:

- 1 Year-to-Date Performance:** Performances for stocks, currencies, bonds, and preferred shares.
- 11 Fun with Math:** Regression Analysis: Why we own companies that generate free cash flow.
- 15** How advisors are still ripping off their clients.
- 17 Client Q&A:** David Driscoll answers your questions.

YEAR-TO-DATE PERFORMANCE

- 1** Equity Markets
- 7** Currency Markets
- 8** Bond Markets
- 10** Preferred Shares

The Markets – January 1st to June 30th, 2018

As you can see from the table below, 2018 returns are muted globally, especially for investors involved only in the North American markets. The TSX index, notwithstanding the rise in oil prices, hasn't brought much glee to investors this year, or in many years (see [page 14](#) for TSX returns).

Equity Markets

2018 First-Half Returns

COUNTRY	STOCK INDEXES	TOTAL RETURN	
		(with dividends re-invested in native currency)	(with dividends re-invested in Canadian Dollars)
India	S&P BSE Sensex 30	+5.44%	+2.89%
Australia	S&P / ASX 200	+4.28%	+3.57%
United States	S&P 500	+2.64%	+7.71%
Canada	S&P/TSX	+1.94%	+1.94%
Europe	Stoxx 600	+0.58%	+1.98%
Japan	Nikkei	-1.05%	+5.50%
Mexico	Mexican Bolsa	-2.29%	+1.95%
Brazil	Ibovespa	-4.76%	-14.91%
China	Shanghai Composite	-12.01%	-9.31%

Data Courtesy of Bloomberg LLP

The causes of these stock market doldrums are:

- Rising interest rates
- Tariffs and trade wars
- The United States' energy dependency
- Poor uses of corporate capital
- High equity valuations

Rising interest rates

Rising interest rates hurt equities via increasing opportunity costs of not holding bonds and money market instruments. For example, five-year U.S. investment grade (BBB and higher) corporate bond yields have risen above 4%, while the longer-dated 30-year bonds exceed 5%. That's similar to stock dividend yields. And with two more rate hikes by the U.S. Federal Reserve expected in 2018, the appeal of bonds relative to equities should improve.

Also, money market instruments now yield 1.5% in Canada and 2% in the United States. After earning nothing on their cash for the better part of a decade, investors now view the risk-free asset as a viable alternative to equities.

Tariffs and trade wars

Tariffs and trade wars are basically a tax on consumers as they eventually lead to higher prices, which, naturally, creates price inflation. That, too, can cause an economic slowdown as consumers, already allocating a larger percentage of their discretionary income toward debt repayment because of higher mortgage rates, should find themselves with even less spending capacity. As a result, consumers have been extending their debt payment terms.

In Q1, the average loan term for a new car exceeded 69 months, the second straight quarter it's ever been over that level, says credit-reporting firm Experian. Furthermore, new car loans with 73-month to 84-month

repayment periods accounted for more than a third of total new car loans, up from 7% in late 2009.

As a comparison, car loan repayment periods in the 1980s usually lasted from 24 to 48 months. Consumer debt is piling up, keeping consumers in debt longer.

Another problem that U.S. president Donald Trump and his White House cronies don't grasp is that China, America's largest trading partner, holds the bulk of the U.S. debt (Japan is the second-largest holding of U.S. Treasuries).

If China stops buying that debt, the U.S. Treasury would need to raise interest rates, leading to accelerating deficits, killing the economy and most of President Trump's economic reforms.

Also, Trump can't negotiate with countries as if they're individual companies. China, in particular, has a 200-year mandate / time horizon, while Mr. Trump can only remain in power as late as 2024. It's much easier for countries to ignore his demands, knowing that time is on their side.

John Butters, FactSet's senior earnings analyst, split the companies in the S&P 500 into two groups — those that generate 50 percent or more of their sales outside the U.S. (multinationals) and those that don't (domestic firms).

According to Butters' numbers, an estimated 60 percent of the sales growth of the multinationals come from overseas markets. If a trade war chokes that off, it's hard to see how stocks stay at current heights.

Also, the U.S. dollar is up about 5 percent in the past three months versus other global currencies; that's more bad news for U.S. exporters, making their goods more expensive overseas.

That's why the tariffs matter so much. The S&P 500 has a price-to-earnings ratio of 16.9 based on next year's earnings. That market valuation is based on a steady sales growth rate at least in the high single digits, if

not higher. But if sales growth declines, downward pressure on stock prices should be expected.

The United States is still energy dependant

The U.S. still imports more than 2.5 million barrels a day of crude oil and refined products on a net basis.

Both East and West Coasts in the U.S. depend on shipments of foreign oil to offset the logistical hurdles of getting oil from the Midwest. Meanwhile, certain grades of oil, especially heavier ones craved by Gulf-Coast refineries, must be imported.

If oil prices move higher, it would help choke U.S. growth. Think of the 1970s during the OPEC oil embargo on the United States. U.S. gasoline supplies dried up, prices soared, there were long lineups at gas stations and an era of stagflation—a stagnant economy with hyperinflation—ensued.

Poor Uses of Corporate Capital

"Corporate cash is going to find a home, and it's either going to be in buybacks, dividends or Mergers & Acquisitions (M&A). What it's not going to be in capital expenditures (capex)," said Art Hogan, chief market strategist at B. Riley FBR.

If corporations aren't going to allocate capital to growth, this is not good news for global economies. Currently, there's almost \$2.1 trillion in cash in company coffers. According to market research firm TrimTabs, there were \$433.6 billion in share repurchases during the period, nearly doubling the previous record of \$242.1 billion in the first quarter.

Unfortunately, buying back shares at market tops is a huge waste of shareholder capital. Naturally, the only reason for the buybacks is to boost earnings per share – the fewer the shares outstanding, the higher the earnings. This is great for executives who can capture higher compensation but lousy for investors.

Dow components Nike and Walgreens Boots Alliance led the most recent surge in buybacks, with \$15 billion and \$10 billion, respectively. Sadly, 31 companies announced buybacks in excess of \$1 billion in the month of June alone.

M&A activity also is surging, with dollar volume for the three months ending May 31 at \$726.3 billion, more than doubling the same period in 2018, FactSet reported.

This is a concern to us because most of the low-hanging fruit has already been picked and companies are paying more to acquire than ever before.

For example, Fortive Inc., an American conglomerate, paid nearly 14 times EBITDA (earnings before interest, taxes, depreciation and amortization) recently. In this deal, it relaxed its own return requirements to make the deal, targeting a 10% Return on Invested Capital in Year 4 instead of its typical Year 3 target. In other words, the more companies pay, the longer will be the eventual payback.

Meantime, capital spending (capex) is expected to rise at a more modest pace—6.6% in 2018 and 5% in 2019, according to mid-June estimates from The Conference Board.

Earnings Quality: How reliable are earnings?

The old investment adage is that earnings are artificial while only cash is real. After sifting through 315 earnings reports for the latest quarter, we're not seeing organic earnings or sales growth at the levels that the analysts are touting (18% for Q2), 10% for all of 2018 and 9% for 2019.

For example, McCormick & Company (MCK), a maker of spices and condiments, reported sales up 19% in its second quarter. However, 3% of sales came from a foreign exchange tailwind and 13% from its acquisitions of condiment makers Frank's Hot Sauce and French's. Organic revenue growth, therefore, was

only 3%, mostly from the Asia Pacific region, while North American sales were flat.

Price/Earnings Multiples			
INDEX	COUNTRY	P/E RATIO Estimated	P/E RATIO Before Outstanding Items
S&P TSX	Canada	17.89	17.88
S&P 500	United States	20.72	23.13
Euro Stoxx 600	Europe	16.00	16.21
MSCI World Index	Global	18.52	19.40
Shiller CAPE Ratio	S&P 500 Index	32.30	N/A

Data Courtesy of Bloomberg LLP

That's why we have difficulty believing the numbers in the table above. We believe this market is extremely expensive and continue to hold 20% in cash multiplied by the equity weighting. If a client is 100% stocks, they are only 80% invested with 20% in cash.

If the client asset mix is 60% stocks and 40% fixed income, they currently hold 12% cash and just 48% in equities.

ROBERT SHILLER'S CAPE RATIO

The Cape Ratio was created by Robert Shiller, a Sterling Professor of Economics at Yale University. The Price / Earnings ratio is based on the average inflation-adjusted earnings from the previous 10 years, known as the Cyclically Adjusted PE Ratio (CAPE Ratio) Because earnings from the previous ten years are used, it is less prone to wild swings in any one year.

The table below shows the CAPE Ratio of the three most extreme markets of the S&P 500 Index in the past 89 years. The current equity market (2018) is number two on that list.

DATE	CAPE RATIO
January 1, 2000	43.77
June 30, 2018	32.30
January 1, 1929	27.06

Some pundits would argue that the CAPE Ratio is flawed as its predictive powers and limitations surfaced notably in the last decade. In 1999 and 2000, the prices of certain stocks reached absurd levels, and Shiller's ratio proved to be an excellent indicator. Then in the 2008-2009 period, corporate earnings collapsed and P/E ratios soared. The events, almost polar opposites, occurred twice in the same decade.

However, a look at the FAANMG stocks below (Facebook, Amazon, Apple, Netflix, Microsoft and Google), this year's market darlings, show that investors are more concerned about owning companies because of their "disruptive" characteristics, not because they trade at decent values.

COMPANT	CURRENT BETA	CURRENT P/E	ESTIMATED P/E 2018
Netflix (NFLX)	1.24	248.58	137.34
Amazon (AMZN)	1.05	267.72	136.17
Microsoft (MSFT)	1.05	27.66	26.33
Google (GOOGL)	1.27	30.29	25.71
Facebook (FB)	1.12	28.54	25.43
Apple (AAPL)	0.99	18.05	16.06

These "Disruptors" are the sole reason why this market has continued higher. An article in Bloomberg by Jim Bianco on July 3, 2018, noted that the FAANMG stocks are in a "zero sum" game relative to the rest of the S&P 500 Index.

"Upon its announcement that Amazon had bought online pharmacy company PillPack, its share price promptly soared, pushing its stock market value up by \$20 billion to \$825.6 billion on the day. Alternatively, Walgreens Boots Alliance Inc., Rite-Aid Corp., Cardinal Health Inc., AmerisourceBergen Corp., CVS Health Corp. and Walmart Inc. saw their values drop by a collective \$17.5 billion, while FedEx Corp. and United Parcel Service Inc. declined \$3 billion – thus the "zero-sum" trade."

Mr. Bianco notes that, “This is not just a U.S. phenomenon, either. If you add Twitter Inc., Tesla Inc., Alibaba Group Holding Ltd., Baidu Inc., Nvidia Corp. and Tencent Holdings Ltd. to the FAANMGs, you get a group called “The Disruptors.”

“Since the start of November, this group pushed up the MSCI World Stock Index by 1.61 percent. Every other stock on the planet was collectively down 1.07 percent. Overall the MSCI was up just 0.54 percent.”

“How big are these 12 stocks? They have a combined market cap of more than \$5 trillion and are approaching the size of the Japanese stock market, the third-largest in the world behind the U.S. and Chinese markets. The six FAANMG stocks are just under \$4 trillion in value, more than the U.K. stock market, which is the fifth-largest in the world.”

“The five largest stocks of a single industry never accounted for more than 9 percent of the S&P 500. That changed after 2013, probably due to the mass adoption of fast LTE mobile phones. The Disruptors account for a record industry concentration of 15.4 percent of the S&P 500.”

Performers / Non-performers

For the Liberty global stock portfolio, the 5 best/worst performers in the first half of 2018 were:

Year-to-date Price Performance (in native currency and dividends not included) As of June 30, 2018.			
TOP 5	% GAIN	BOTTOM 5	% LOSS
Dassault Systemes	+36%	Cognex Corp.	-27%
Coloplast A/S	+29%	Chubb Ltd.	-13%
Balchem Corp.	+22%	Novo-Nordisk NV	-12%
Heico Corp.	+21%	Novozymes A/S	-9%
Littelfuse Inc.	+15%	Fomento Economico Mexicano	-7%

Data Courtesy of Bloomberg LLP

For the first half, our equities ended up ahead of all of our relevant benchmarks.

Here are some comments on the individual stocks noted above:

- **Dassault Systemes (DSY FP)** is a French software company that provides design technology using CAD/CAM systems. A company can use Dassault's software to design the most efficient and least-costly way to build a product. They're also using Artificial Intelligence and machine-to-machine technology to improve its software and make it more relevant for its clients.
- **Coloplast A/S (COLOB DC)** is a Danish healthcare firm that sells colostomy bags, catheters and other gastrointestinal products. The stock fell in 2017 because of a decline in sales but it introduced new products in 2018 and revenues and profits have returned to its historical norm, causing the stock to rebound.
- **Balchem Corp. (BCPC US)** is a specialty chemical company that makes choline chloride (vitamin B12) as a nutritional additive for humans (especially babies) and livestock. Choline tablets, using Balchem's VitaCholine® branded product, are now available for sale across many Walmart and Target stores in the United States.
- **Heico Corp. (HEI US)** makes and designs parts and systems for the aerospace industry. Unlike Boeing Inc., that may suffer from Chinese tariffs, Heico does no business in Asia. Most of its sales are domestic, leaving it to benefit from the low US corporate tax environment and government trade policies. It recently announced its second 5-for-4 stock split for 2018.
- **Littelfuse Inc. (LFUS US)** is the #1 circuit protection brand in the world with advancing platforms in power control and sensor technologies. It engineers

custom-design fuses, sensors and LED lighting for various industries. It works with manufacturers to build safer, more reliable and more efficient products for the connected world in virtually every market that uses electrical energy.

It appears that analysts still haven't been able to figure out the growth trajectory of this firm (which is good for us). After falling a penny short of its earnings in Q4 of 2017, the stock fell almost 25% as analysts recommended investors sell the stock. In its Q1 of 2018, the company announced a 41% jump in profits and the stock rose \$50 to its new high of around \$235 a share.

On the negative side:

→ **Cognex Corp. (CGNX US)** is a robotics firm that makes cameras (the eyes of the robot) that can read information along the assembly line or read barcodes at airports to direct luggage to the proper carousel.

The company's share price has lagged the market this year as the demand for smartphones has dropped (Apple is Cognex's largest customer), indicating Cognex's revenues and earnings will be lower than anticipated.

However, manufacturing and warehousing logistics demand is growing, providing continued opportunities for Cognex products.

→ **Chubb Ltd. (CB US)** is a global property and casualty insurance company. The stock is down because of catastrophe losses from hurricanes, floods and wildfires and lower premiums caused by competitive pricing.

However, Chubb's combined ratio (claims paid compared to premiums received) is still the lowest in the industry, evidence of its underwriting strength. The company is trading at its book value so, in an expensive stock market, we believe it offers good long-term value.

→ **Novo-Nordisk (NOVOB DC)** is a Danish pharmaceutical firm that makes insulin to help fight diabetes. While the company has introduced new products to fight diabetes and help reduce obesity, U.S. sales are down as prices are under pressure. The stock will probably stay in a trading range until the company can increase its international revenues, particularly in India and China, to bolster its earnings.

→ **Novozymes A/S (NZYMB DC)** is a Danish biotech firm that makes enzymes for multiple applications including ethanol, laundry detergent and yeast for baking. Its share price has moved lower caused by a Price/Earnings multiple contraction from 40 times earnings to roughly 30 times.

→ **Fomento Economico Mexicano (FMX US)**, or Femsa, is a Mexican consumer company that is the largest non-U.S. bottler of Coca-Cola products. It also owns gas stations, convenience stores under the OXXO brand and pharmacies throughout Latin and South America.

The stock was down because of a drop in the Mexican peso and fears of a far left-wing election victory. The latter came to fruition, as Andres Manuel Lopez Obrador (AMLO), a former mayor of Mexico City, gained power. However, he has stated that he has no intention of upsetting the status quo in Mexico and Femsa's shares have recently rebounded off its lows.

We continue to own all the stocks on the list and are buying more – although half-positions only for new accounts because of higher-than-average market valuations.

Currency Markets

Canadian Dollar vs.			
CURRENCY	DEC. 31, 2017	JUNE 30, 2018	GAIN/LOSS %
South African Rand	\$0.1017	\$0.1088	+ 6.3%
Swedish Krona	\$0.1534	\$0.1532	+ 4.4%
Australian Dollar	\$0.9812	\$0.9895	+ 0.9%
New Zealand Dollar	\$0.8910	\$0.9316	+ 0.2%
Danish Krone	\$0.2026	\$0.2126	- 1.6%
Euro	\$1.5088	\$1.5853	- 1.7%
British Pound	\$1.6978	\$1.8074	- 2.1%
Swiss Franc	\$1.2898	\$1.3475	- 2.7%
Mexican Peso	\$0.0640	\$0.0660	- 3.0%
US Dollar	\$1.2574	\$1.3133	- 4.3%
Norwegian Krone	\$0.1531	\$0.1612	- 5.0%
Japanese Yen	\$0.0112	\$0.0119	- 5.9%
Average Loss			- 1.2%

Data Courtesy of Bloomberg LLP

The chart above is determined as follows: On December 31st, 2017, one US dollar bought \$1.2574 Canadian Dollars. By June 30, 2018, it bought \$1.3133 Canadian dollars, meaning the Canadian Dollar fell by 4.3% against the U.S. dollar.

In the first half of 2018, the Canadian dollar fell an average of 1.2% versus its international counterparts, leaving Canadian investors with less spending power.

The currency's weakness may be explained by:

- Fears of a change in NAFTA that may be detrimental to the Canadian economy
- Fears of the introduction of U.S. tariffs on Canadian exports
- A weakening in the Canadian economy, especially in the automotive and construction sectors
- A “risk-off” trade whereby investors are selling the minor currencies like the Canadian dollar to own the major currencies of the U.S. dollar, the Japanese Yen and the Swiss Franc

While oil prices spike to new highs, we may have seen the weakest of the Loonie and expect the trading range to stay in the 75-80 cent range.

Bond Markets

10-Year Bond Yields			
COUNTRY	COUPON	PRICE	CURRENT YIELD
Emerging Markets			
Argentina	5.88%	\$82.25	+ 8.65%
Turkey	5.13%	\$88.39	+ 6.79%
Brazil	4.63%	\$90.42	+ 5.96%
Russia	4.38%	\$97.11	+ 4.72%
Mexico	3.75%	\$94.77	+ 4.43%
Indonesia	3.50%	\$92.85	+ 4.43%
Greece	3.75%	\$98.80	+ 3.90%
China	3.69%	\$101.82	+ 3.47%
Developed Markets			
United States	2.88%	\$100.04	+ 2.86%
New Zealand	3.00%	\$101.56	+ 2.83%
Australia	2.25%	\$96.73	+ 2.63%
Canada	2.00%	\$98.55	+ 2.16%
United Kingdom	4.25%	\$126.35	+ 1.28%
Germany	0.50%	\$101.92	+ 0.30%
Japan	0.10%	\$100.76	+ 0.02%

Data Courtesy of Bloomberg LLP

For this version of the newsletter, I thought it pertinent to show the differences in yields between the developed and emerging markets. Above are the coupons, prices and yields for each country's 10-year sovereign bonds.

Note the yields in the emerging markets are higher, but so are the risks. We often talk about risk vs. reward and this table illustrates it well.

If an investor wishes to chase yield, they have to consider the underlying currency of the home country. If you think you're doing well in Argentine, Turkish or Russian bonds, the currencies would cause an overall loss in the investment.

For example, if you purchased the 10-year Argentine bond, you'd get an 8.65% yield. However, because the Argentine peso has dropped 39% versus the U.S. dollar in 2018, you'd have a total loss of 30.35%.

The only way to alleviate this situation is to decide ahead of time:

- What percentage of your portfolio you wish to own in each country's bonds. Outside of North America, we own no more than 2% to 5% of bonds in any one currency.
- Whether or not you wish to convert the bond when it matures or roll it over into another bond of that country. That way, you avoid currency risk but always have to deal with inflation risk.

Change in Yields (Canada vs. United States)

SHORT-TERM	CANADA	YIELD CHANGE	UNITED STATES	YIELD CHANGE
3-months	1.26%	+ 0.20%	1.91%	+ 0.53%
6-months	1.49%	+ 0.27%	2.11%	+ 0.58%
1-year	1.72%	+ 0.20%	2.31%	+ 0.58%
LONG-TERM	CANADA	YIELD CHANGE	UNITED STATES	YIELD CHANGE
2-years	1.91%	+ 0.22%	2.53%	+ 0.65%
5-years	2.07%	+ 0.20%	2.74%	+ 0.53%
7-years	2.14%	+ 0.19%	2.82%	+ 0.49%
10-years	2.17%	+ 0.13%	2.86%	+ 0.46%
30-years	2.20%	- 0.07%	2.99%	+ 0.25%

Data Courtesy of Bloomberg LLP

The table above illustrates the direction and acceleration of interest rates in Canada and the United States and also shows the difference between the 2-year and 10-year rates.

Since 2017, both the Canadian and U.S. central banks have been in a tightening phase caused by strengthening economies to help ward off the potential for inflation. They have control over short-term monetary policy (less than 1 year), while the bond market dictates longer-term rates.

As you can see from the chart, short-term rates have risen faster than long-term rates. In fact, the Canadian 30-year bond has actually fallen by seven basis points (0.07%) this year. That cause is two-fold:

First, it indicates that inflation isn't a huge factor. That's because technology disruption has effectively been deflationary, with prices continuing to fall. Also, the substitution factor of robots over human workers has helped keep wages in check.

Second, insurance companies and pension plans need to own 30-year bonds because their biggest liabilities, annuities and pension payouts to retirees, may last for 30 years. Unfortunately, there isn't much supply available, so when a government entity or corporation issues 30-year bonds, the supply is absorbed quickly.

Finally, the yield curve has flattened since rates have risen at the short-end but not as much at the long-end. This is a liability for corporations as they borrow at the short-end of the curve to fund their operations. As short-term rates rise, the cost of borrowing rises, making it more expensive for corporations to function.

That's why market pundits talk about the difference between the 2-year and the 10-year curve as being important. They posit that if the 2-year rate surges above the 10-year rate, the yield curve is “inverted”, usually causing a recession.

At the end of June, the difference in the two rates in Canada was 26 basis points, while in the U.S., it was 33 basis points. That's the narrowest it's been since 2009, the last time both economies were in recession.

Pressures in the corporate bond market

If you're looking for a channel through which this market cycle ends—outside of an exogenous shock—keep an eye on the corporate side.

According to Bloomberg, “The steady widening in U.S. investment grade spreads this year could already be viewed as ominous. Recently, investors had to absorb the second-largest offering of the year—twice! when Bayer tapped the market for a \$15-billion deal and then Wal-Mart came with a \$16-billion offering.”

“The debt load for U.S. corporations has reached a record \$6.3T, according to S&P Global, as Wall Street investors brace for a stricter rate environment even as cash hoarding reaches a peak. The good news is that U.S. companies have a record \$2.1T in cash to service that debt, however most of that cash is in the hands of a few giant corporations and sitting offshore.”

Preferred Shares

TYPE OF PREFERRED SHARE	YEAR-TO-DATE PRICE CHANGE
Canadian Perpetual Preferred Shares	-1.40%
Canadian Variable Rate Reset Preferred Shares	-1.44%
BMO US Preferred Share Index ETF (in USD)	-1.87%

Data Courtesy of Bloomberg LLP

Rising rates have caused negative returns for preferred shares as they follow a similar price sensitivity as bonds. When interest rates rise, prices fall and vice versa.

Also, preferred shares are deemed to be “quasi-equity” so when the stock market corrects, preferred shares usually react negatively.

Back in 2008, when the stock market dropped 40%, Brookfield Asset Management's 4.75% perpetual preferred share fell from \$22 to \$8.65 a share, a price loss of 61%, leaving it with a yield of 20%.

Because of that “quasi-equity” risk, we take a different strategy than most when dealing with taxable, non-registered accounts. We may lose some of the advantages of the dividend tax credit that preferred shares provide but the trade-off is that we reduce the risk in those accounts.

For new clients who have a 60% equity / 40% fixed income allocation for their non-registered taxable accounts, we'll allocate the fixed income as follows:

- A 15% allocation to bonds
- A 5% allocation to inflation-protected bonds (both Canadian and U.S.)
- A 20% allocation to preferred shares

From a tax standpoint, there's more tax to pay in interest income but the risk protection is worth it. If the stock market collapses as it did in 2008, the fixed income side of the portfolio won't suffer as much because the bonds would hold their value or rise in price while the stocks and preferred shares fell.

Also, if a retiree needs to bridge their retirement by living off their non-registered account until they turn 72 and start receiving income from their RRIF, the lower risk helps ensure the non-registered account doesn't run out of money before that time.

Regression Analysis: Why we own free cash flow companies

“
The stronger
the free cash
flow, the better
was their credit
rating and
the lower was
their cost of
borrowing.”

About 25 years ago, I worked at Dominion Bond Rating Service (DBRS) and had the opportunity to meet with the CEOs, CFOs and Treasurers of some of North America's corporations. In most discussions, and what kept getting drummed in my head, was the importance of free cash flow.

The corporation's credit ratings and, therefore, their cost of borrowing, was predicated on the quality of their financial statements. The stronger their free cash flow, the better was their credit rating and the lower was their cost of borrowing.

For example, a company such as Johnson & Johnson carries a Triple-AAA credit rating because it's a stable healthcare products company that generates consistent free cash flows. The coupon on its 10-year bonds are 2.9%, yielding 3.43%.

Compare this to a company whose financial statements aren't as pristine as Johnson & Johnson's. Teva Pharmaceuticals' credit rating is BB and deemed to be high-yield or “junk”. Its cost of debt for an equal 10-year term is 6.75%, yielding 6.59%, a difference of 3.16%. On \$60 billion of debt, the cost of carrying that debt is an extra \$1.9 billion.

Intuitively, then, the better the credit rating, the better should be the quality of the company. And, the better the free cash flows, the better the long-term performance.

The formula we use to calculate Free Cash Flow is:

(Cash From Operations - Cash Dividends Paid - Capital Expenditures) = Free Cash Flow

In an individual's case, if there's money left over after the bills are paid, that's known as “free cash flow”. That person has the financial flexibility to take that excess cash and save it, spend it, or invest it.

The same can be said for a corporation. With its free cash flow, it can:

- Raise its dividend
- Buy back shares

- Pay down debt
- Hire employees for continued growth
- Upgrade its plant or equipment to stay modern
- Make acquisitions
- Invest in research and development to innovate and stay relevant

The rest of this article was prepared and written by Liberty's in-house mathematician, Thomas Zagrobelny. He's going to discuss why corporations rely on free cash flow to make their business decisions and why we at Liberty rely on free cash flow figures as the first step in determining what companies we wish to invest in.

The following is an optional “Regression Analysis 101”—how we rely on certain statistical methods to determine the importance of free cash flow to eventual equity returns.

Why we use Regression Analysis

While there is a financial justification for free cash flow, we can also look at it quantitatively to ascertain if we're “barking up the right tree” to ensure that our philosophy and methodology will make money for our clients.

If free cash flow really is a driver of price, we would expect to find a statistically significant relationship over time. The approach that we use to check that relationship is called **linear regression**. It tries to quantify the effect that a change in free cash flow has on a stock's price.

It is worth noting that linear regression is generally invalid for data based on time. Some of the underlying mathematical assumptions are violated and the results end up exaggerated and useless. In this case, we have tested that an important condition called co-integration is met. Co-integration allows for accurate regression results.

To see if this relationship is true for stocks in general, we cannot just look at a handful of companies and extrapolate out to every other company. In this case, we are looking at the price level of the Russell 3000 Index (it includes 99% of the U.S. equity market) against the aggregate free cash flow of all of the companies in the index, using quarterly data for the past 10 years. We also use the logarithm of the price to undo the typical exponential movement in price caused by compounding growth, since regression works best when comparing linear data.

The key results of the regression are:

Log(Price) = α + β (Free cash flow)		
Coefficients	Estimate	p-value
Intercept (α)	5.813756	< 2x10 ⁻¹⁶ ***
Free cash flow (β)	0.021522	< 5x10 ⁻¹² ***
Multiple R-squared: 70.11%		
F-statistic p-value: < 5x10 ⁻¹²		

The near zero **F-statistic p-value** on the free cash flow co-efficient shows us that it is a statistically significant predictor of price over time—statistical significance gauges the confidence we can have that an apparent relationship is not just caused by chance. Confidence can be measured as (100% - p-value). In this case, we can be nearly 100% confident that there is a statistical relationship between the two variables.

The **Multiple R-squared** essentially tells us that 70.11% of the movement we see in the logarithm of price can be explained by the movement in free cash flow. However, other variables can and do interact with this relationship. For example, net income helps determine free cash flow, so movements in net income are implicitly embedded in the relationship quantified above.

A Caution on Regression

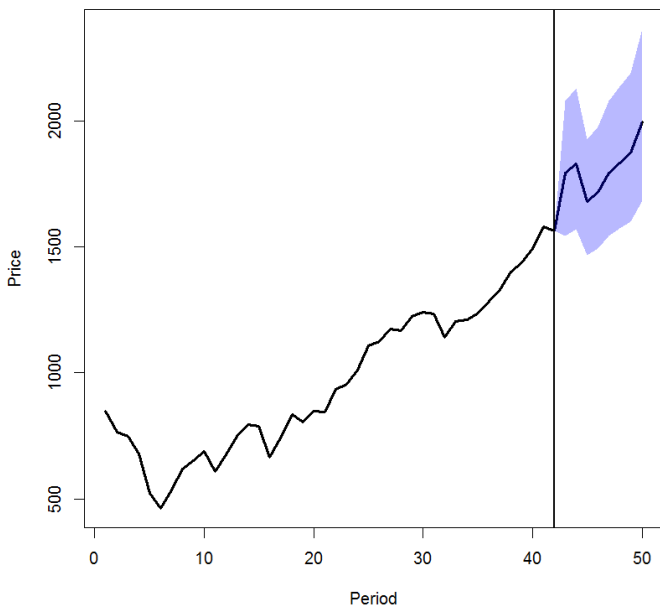
While an R-Squared of 70% is an impressive relationship for real data, there are limitations to the approach,

including the interaction of other variables not explicitly considered, as mentioned above.

Perhaps most importantly, the regression measures a **long-term relationship**. It is more than possible for a company to release results where free cash flow increases but the stock price decreases. We can only expect the relationship to hold in general and in the long run.

It is even possible for the relationship to change over time as the market changes its priorities and the economic landscape changes. This also limits predictive value.

Free cash flow is not a magic bullet to predict next quarter's share price. Extrapolating the data above by assuming a 5% growth in free cash flow next quarter, with a fluctuating increase thereafter, leads to the price range prediction shown in blue below:



We can clearly expect price to increase along with free cash flow, overall, but not accurately enough to hit a guaranteed price target, or even to guarantee the direction of change at any point in time. The virtue of long-term investing is that if you find a company that can consistently grow its free cash flow over time, then short-term divergences from

expectations do not matter much – we can still expect the price to grow eventually.

This is why we pay attention to Free Cash Flow at Liberty

Given its economic and statistical basis, free cash flow and its drivers are a useful part of research. Free cash flow can be used to filter out underperforming companies or gauge a firm's financial health alongside other metrics, such as Return on Invested Capital (ROIC) – especially when compared to the cost of capital. However, an understanding of the company, its industry and the economy are just as important a part of research.

One figure at one point in time will never tell the whole story, but, at Liberty, we like to know that each aspect of our analysis is rational and justified.

How have Free Cash Flow stocks fared in the past decade?

If you'd like some evidence that free-cash-flow rich companies are good investments, the table on the next page exhibits the Year-to-Date, 1-year, 3-year, 5-year and 10-year returns (dividends included but not fees) of some of our model portfolios versus their underlying benchmarks. We went back 10 years to include the 2008 market correction.

Note that these numbers are not indicative of any client or firm performance because:

- We haven't owned all the model stocks for 10 years
- Client portfolios are customized and may own holdings that aren't part of the model
- Fees aren't included because not all clients pay the same fee
- Transaction costs and taxes are not included
- There is no turnover in the portfolios—No stock changes have been made during the time periods

Instead, we're just trying to illustrate that companies that consistently grow their free cash flow should provide an opportunity for better investment odds for investors. Liberty models are highlighted in green and bold while relevant Benchmarks are highlighted in blue.

Performance numbers of Free Cash Flow stocks:

MODEL	YEAR-TO-DATE	1 YEAR	3 YEAR	5 YEAR	10 YEAR
Small-Cap Model	10%	22%	20%	19%	18%
Russell 2000 Index	9%	18%	11%	12%	11%
Canadian Equity Model	4%	12%	15%	17%	16%
S&P/TSX Index	2%	10%	7%	9%	4%
US Equity Model	10%	25%	21%	20%	18%
S&P 500 Index	2%	14%	12%	13%	10%
Global Model	8%	20%	19%	20%	18%
MSCI Global Index	0%	12%	9%	11%	7%

Data Courtesy of Bloomberg LLP

We believe the numbers make intuitive sense. Who has the financial flexibility to overcome financial hardship or capitalize on an investment opportunity—companies with money left over after the bills are paid or ones that must borrow to cut spending in other areas?

HOW ADVISORS ARE STILL RIPPING OFF THEIR CLIENTS:

“
The term “caveat emptor”... is still important today when deciding on an advisor and why it's so important to ask pertinent questions.
”

The Ontario Securities Commission (OSC), the regulator over advisors and mutual funds in this province, has been taking action against firms for various violations (see below). Hopefully, the word “transparency” finally emerges into the industry's lexicon, along with the phrases “fiduciary duty” and “prudent man rule”.

The stories below underscore the need for a regulator with teeth. Here we are in 2018 and advisor firms and mutual funds are still playing with other people's money and/or taking advantage of clients who don't know the games firms are playing behind the scenes.

Case #1: Conflict-of-interest on Commissions

The enforcement branch of the Ontario Securities Commission (OSC) alleged that over a period of almost four years, Caldwell Investment Management Ltd. “failed in its obligation to provide best execution of equity and bond trades for its clients, which resulted in overpayments by its clients.”

According to the OSC, Caldwell Investment steered most of its client trades to its own investment dealer, Caldwell Securities Ltd., “placing it in a clear conflict of interest.” The OSC's enforcement arm is requesting fines, disgorgement of any commissions that came from breaking the rules and termination, suspension or restriction of Caldwell Investment's registration, which could shut down the mutual fund firm.

After reviewing Caldwell Investment's buying and selling of blue-chip stocks such as BCE Inc., Bank of Nova Scotia and Onex Corp., the OSC alleged the fund paid Caldwell Securities commissions that ranged from 4.4 to 13.4 times the fees it paid to unaffiliated dealers. The OSC said the fund manager's trading decisions “ultimately conferred a benefit on Caldwell Financial Ltd., the common shareholder of Caldwell Investment and Caldwell Securities.

Case #2: Insider Trading

The Ontario Securities Commission reached a settlement agreement with former star Bay Street money manager Ben Cheng, following allegations that he broke securities laws by leaking confidential information about a multibillion-dollar takeover deal involving online gambling company Amaya Inc.

Last year, the OSC alleged that in 2014, when Mr. Cheng was co-chief investment officer of Aston Hill Asset Management Inc., he learned about the US\$4.9-billion takeover by Amaya of the owner of PokerStars before it was announced.

He shared the details with a co-worker, John David Rothstein, who traded on the information. The OSC also alleged that Mr. Cheng attempted to cover up his transgressions when confronted by the regulator.

Case #3: Royal Bank's Financial Inducements to sell its Mutual Funds

Royal Mutual Funds Inc. agreed recently to pay more than \$1-million in fines after investment regulators found the mutual fund company was offering higher commissions to Royal advisers to sell its own proprietary funds.

The OSC alleged that during November, 2011, to October, 2016, the fund dealer contravened regulatory rules by offering and paying representatives 10 basis points more in commissions for the sale of units in its RBC Portfolio Solutions funds than for the sale of units of third-party funds.

Case #4: Taking Spreads on Client Foreign Exchange Transactions

When converting foreign exchange for clients, some firms tack on a spread to the price they pay the broker. The client never knows that the firm is earning extra fees.

For example, if a client wants to buy \$100,000 US dollars and the broker quote is \$1.3300, the firm tacks on a spread of \$0.0025 so the total cost is \$1.3325. The client

pays \$133,250 instead of \$133,000 and the firm pockets \$250. It doesn't sound like much but if the firm has 1,000 clients, that's \$250,000 of potentially ill-gotten gains.

Other Transgressions that we've seen

- There are some newsletter writers who are neither licensed nor registered with the regulators. This is a requirement in Canada to invest others' money. Their "model" returns have no truth to them as there's no investing going on—no official purchase price, no transaction costs, no management fees, no foreign exchange, no tax, no cash in / cash out, no stock weightings, etc. Therefore, the performance returns are meaningless.
- Some firms show their mutual fund performances without the appropriate benchmark used. For example, one recently used the S&P/TSX index as their benchmark and thus showed their outperformance against the TSX. However, the top five holdings were U.S. stocks. The fund should have used the S&P 500 Index as the benchmark. If so, the performance would have been sorely lacking.

The term "caveat emptor" or, "let the buyer beware" is still important today when deciding on an advisor and why it's so important to ask pertinent questions before making the investment.

QUESTIONS

17 Why are you buying bonds when interest rates are rising? When interest rates rise, don't bond prices fall? Shouldn't we just wait until rates stop going higher?

18 Why don't you own resource stocks or late-cycle stocks?

19 Who cares about utilities? Why don't we just own tech stocks?

19 Have you considered alternative investments for our portfolios?

Why are you buying bonds when interest rates are rising? When interest rates rise, don't bond prices fall? Shouldn't we just wait until rates stop going higher?

Because investors usually have long investment time horizons, it's irrelevant what happens to bond prices in the short-term because the income earned coupled with maturing bonds will provide future capital to invest at higher rates and thus, higher incomes.

Duration, or the sensitivity of the bond portfolio to changes in interest rates, impacts bond ETFs and bond mutual funds. As a result, individual investors are better off not owning those investment vehicles and are better off doing it themselves.

A recent article by Douglas J. Peebles, an analyst at AllianceBernstein, provides a pertinent example why individual investors need not worry about rising interest rates.

Mr. Peebles wrote, "It seems intuitive that if interest rates are rising, bond prices will fall, so you should put your money someplace else. The problem is, what's intuitive isn't always correct. In fact, investors who put their money into cash or similar strategies at this point in the rate cycle will find themselves quickly underperforming those who stuck to their bond strategy."

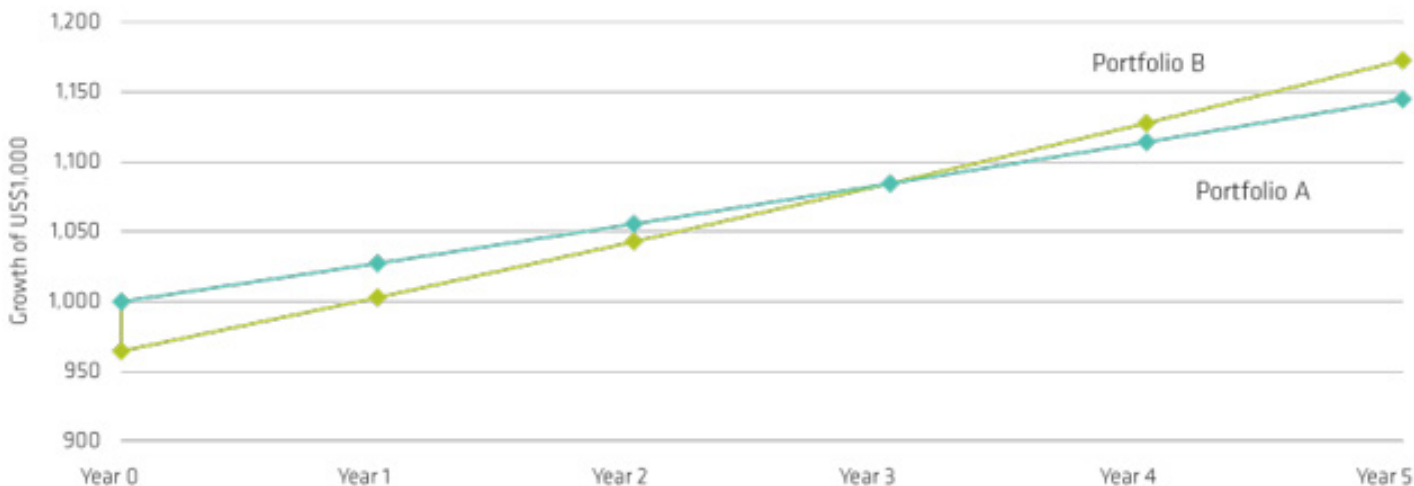
"Bond returns come from two places: changes in price and coupon income. When interest rates rise, prices fall, which causes a short-term loss. But in the long run, rising rates are good for bond investors, and here's why: the income they generate in the form of coupon payments gets reinvested at new, and higher, rates."

"Also, it's worth keeping in mind that a bond's price tends to drift back toward par as it moves closer to maturity. This, too, can cushion the impact of escalating rates and falling prices."

"But let's walk through an example to show what the actual impact of rising rates might be on a bond portfolio. We've modeled a simple portfolio of Treasury bonds and "shocked" it by assuming a sudden 125 basis point rise in rates. What would its immediate performance look like? And then, how would the following years unfold?"

A Rising-Rate Portfolio Soon Outpaces a No-Rate-Rise Portfolio

Portfolio A Assumes No Rate Increase, While Portfolio B Assumes Rates Rise 125 b.p. on Day One and Remain Stable Thereafter



As of June 1, 2018

For illustrative purposes only.

Source: US Department of the Treasury and AllianceBernstein (AB)

“At first, the portfolio sees an initial price loss—an undeniably painful experience. Even so, the portfolio still generates income, and investors who stay the course can reinvest that income at a higher yield. This helps to make up for the price loss and eventually offsets it altogether; before a year is out, our portfolio is back in the black. And by year three, the portfolio has not only caught up to where it would have been had rates never risen, but thereafter, it’s worth more and is growing faster. After this point, you’ll be better off having stayed invested.”

Why don't you own resource stocks or late-cycle stocks?

We don't own these types of companies because we believe they're investments of a lesser quality. They're called cyclicals simply because they make all their money in the good years and lose it all in the bad ones, leaving investors with weaker long-term returns. As a result, we deem these securities as riskier investments.

And since the long-term returns are lower than the free cash flow companies, you can begin to understand the difference in quality versus

For Liberty clients, all you need to do is look at your statement. The far-right column shows the yield-at-cost on each bond. That number indicates the yield you will receive each and every year until the bond matures. In the interim, the price may fluctuate, but as it moves toward maturity, the price should gravitate toward its maturing par value.

mediocrity. Besides, some of the stocks that we own, like CN Rail and TransCanada Corp. do business with the cyclicals so we're not missing out completely.

The chart on the next page shows the performance of a few of these sectors over the past 10 years versus the underlying benchmark. We've included some global cyclical sectors such as airlines, oil and gas, metals and mining and steel and compared it against the MSCI Global Index:

Cyclical stock performances:

MODEL	YEAR-TO-DATE	1 YEAR	3 YEAR	5 YEAR	10 YEAR
Airlines	-13%	-2%	+8%	+14%	+6%
Oil & Gas	+7%	+27%	+7%	+4%	+0%
Metals & Mining	-4%	+26%	+11%	+4%	-6%
Steel	-10%	+13%	+4%	+6%	-8%
MSCI Global Index	+0%	+12%	+11%	+9%	+7%

Data Courtesy of Bloomberg LLP

As you can see to the left, there's not much to gain in the long-run by owning cyclical stocks. Instead, if you focus on free cash flow companies, you'll have a better chance at making money and avoiding losses.

Who cares about utilities? Why don't we just own tech stocks?

Here's a client quote, "I don't want utility stocks, I want tech stocks. We have to own tech stocks!"

If you think this was a conversation I had recently with a client, you're partly right. The quote was actually from both 1999, right before the tech bubble burst, and also this past May from the same client. I didn't invest all in technology stocks then and I'm not about to start now.

I believe it's just another reminder of where we are in both the economic cycle and the stock market cycle.

Have you considered alternative investments for our portfolios?

According to a client update seen by Bloomberg, David Einhorn's main hedge fund at Greenlight Capital fell 7.7 percent in June, bringing losses for the first half of this year to almost 19 percent. That's why we don't own any alternative investments in our portfolios. They have not proven to add value and with a fee schedule of 2% plus a 20% performance fee, it's doubtful they ever will.

Greenlight has posted lackluster returns in recent years as markets, especially for growth stocks, have risen while the hedge fund stuck to its value-investing

Reality no longer exists in investors' minds.

It's also a perfect example of how emotions can get in the way of managing risk in a portfolio through proper diversification. Investing should be mechanical, not emotional. Once you let your emotions get in the way of your investment decisions, losses should eventually follow.

strategy. Einhorn's losses this year bring the decline for New York-based Greenlight since the end of 2014 to roughly 28 percent, one of the worst showings among his peers. Investors have bolted, pulling almost \$3 billion out of the firm in the last two years, Bloomberg reported in May. At \$5.5 billion, Einhorn's assets were less than half of where they were at their peak.

Instead, a better recipe for investment success is to pay lower fees, invest in free cash flow companies and keep the turnover low (trade less).

IN SUMMARY:

With increased volatility in the market and most major indices flat or in negative territory in 2018, it's important to:

- **Diversify properly.** That's done by diversifying by country, industry and size of company, keeping the individual stock weightings equal. If it's a 30-stock portfolio, the average company holding should be 3.3%.
- **Avoid correlation risk.** Owning all the Canadian and U.S. banks hasn't been a money-winner this year. At Liberty, we own 3 banks and a large Asian conglomerate that owns a financial arm as a subsidiary.
TD Bank covers North America, Svenska Handelsbanken covers off Europe, HDFC Bank is an Indian bank and Jardine Matheson has financial subsidiaries that cover off the Asia Pacific regions.

- **Don't chase yield.** The appeal of a high dividend yield may make sense for income investors but that yield is high for a reason.

Investors in AT&T Inc. may find the 6.12% dividend yield attractive but that's about all you're going to get. The share price has fallen in recent years from a high of \$56.63 USD to its current price of \$32.68 so there's been no price growth. And the dividend increase has averaged only 3% in the past decade, leaving little if no return after inflation.

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.