LIBERTY
International Investment Management

MARKET UPDATE

Q3 | September 30, 2018

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The Markets—January 1st to September 30th, 2018

Equity Markets

As you can see from the table below, 2018 stock market performances looked okay at the end of the third quarter (third column from the left).

2018 Returns (through Sept. 30)

COUNTRY	STOCK INDEXES	TOTAL RETURN (with dividends re-invested in native currency)	TOTAL RETURN (with dividends re-invested in Canadian Dollars)
United States	S&P 500	+10.56%	+14.20%
India	S&P BSE Sensex 30	+8.21%	-1.89%
Japan	Nikkei	+7.68%	+10.32%
Australia	S&P / ASX 200	+5.87%	+1.28%
Brazil	Ibovespa	+3.85%	-12.27%
Mexico	Mexican Bolsa	+1.86%	+10.68%
Europe	Stoxx 600	+1.38%	+1.16%
Canada	S&P/TSX	+1.37%	+1.37%
China	Shanghai Composite	-12.82%	-14.70%

Data Courtesy of *Bloomberg* LLP

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Gains were pushed higher in the last week of September when it appeared that the United States and China were going to negotiate better trading terms and reduce the tariffs on imported goods. When that didn't happen, markets turned down sharply in October.

Note the emerging market returns in Canadian dollars (the column at the far right above) of India, Brazil and China. Their currencies, like those of other emerging market countries, have been battered by the economic shocks explained further below.

While the emerging market economies have been the first to be hit, it appears that all markets are suffering from:

→ Rising interest rates

→ Tariffs and trade wars

→ Weakened currencies

Rising interest rates

On September 24th, the U.S. Federal Reserve raised its benchmark rate for the third time this year. The Federal Funds rate now sits in a range of 2.00% to 2.25%; it had been anchored at virtually zero for seven years following the 2008 financial crisis.

Higher interest rates generally hurt stock prices for a few reasons. One is that higher rates make it more expensive to borrow, which puts pressure on corporate profits and taps the brakes on economic growth. Another is that higher yields make bonds more attractive investments, which can siphon buyers away from stocks.

With U.S. economic growth strong, unemployment at 3.9 percent and inflation near the Fed's 2% goal, further gradual interest rate rises are likely to be appropriate over the next year or two, Fed Governor Lael Brainard recently told The Detroit Economic Club.

But Brainard went further, laying out in detail the thinking behind a rate hike cycle that could continue "over the next year or two," rather than pausing next year as policymakers including the Dallas and Atlanta Fed chiefs have said could make sense.

In her view, stimulus from tax cuts and government spending under U.S. President Donald Trump are lifting the short-term neutral level of interest rates, a theoretical level of borrowing costs that allows investment and hiring to continue unimpeded in a healthy economy.

While short-term rates are impacted by the Federal Reserve, the bond market dictates long-term rates. In a *CNBC* story, "The 10-year US government bond rate is used as a benchmark for many other types of debt, including corporate and agency bonds such as Fannie Mae and Freddie Mac. The rate is also a barometer for 30-year fixed-rate mortgages, auto loans, student loans and credit card annual percentage rates."

Rising rates may be good for retirees seeking more income but it's bad for the X-gen and Millennial groups who hold large mortgages, car loans and credit card balances.

For example, if they purchased their home 5 years ago and held a $500,000 mortgage at 3%, their monthly payment was $2,371.

With ½ of fixed rate mortgages in Canada coming due in the next year, mortgagees will swallow a higher payment rate. If we tack on an additional 1% to the mortgage rate at the next renewal (the Bank of Canada expects to raise interest rates another 1% for 2018-19), the monthly payment on a 4% mortgage jumps to $2,639, roughly an extra $270 monthly, or $3,250 annually.

Note that this doesn't include higher property taxes that are sure to take root in the coming years as municipalities need working capital.

Those thinking of taking on a large mortgage should heed the words of Warren Buffett who was once quoted in reference to investors and leverage, "It's only when the tide goes out do we see who's swimming naked."

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Tariffs & Trade Wars

A July 28, 2018 article in *Business Insider* magazine noted that tariffs and trade wars have been a sticking point with U.S. President Donald Trump going all the way back to the 1980s.

“The then-real estate mogul railed against the U.S.'s trade deficit and warned of "other countries ripping off the United States." In a 1990 *Playboy* interview, Trump was asked about his first action if he ever became president. “Many things. A toughness of attitude would prevail," Trump said. "I'd throw a tax on every Mercedes-Benz rolling into this country and on all Japanese products, and we'd have wonderful allies again."

In a recent *Financial Times* article, Gabriel Sterne, head of macro research at the consultancy Oxford Economics, calculates that, “even if recent threats come to pass, high duties would still apply to just 4 per cent of world imports. However, Mr. Sterne estimates that an escalation of the trade conflict could lead to a cumulative loss of 0.7% in global gross domestic product (GDP) by 2020.”

Again, from *Business Insider* – “While the tariffs may provide a boost to concentrated industries like steel production, the losses will far outstrip the gains, economists say.”

“For instance, *The Trade Partnership* — an industry group that analyzes free trade — found that steel and aluminum tariffs would result in approximately 400,000 lost U.S. jobs. Layoffs from the cost increase at manufacturers that use the metals could be far larger than the roughly 30,000 jobs in steel and aluminum production that could be gained.”

“These cost cuts, price increases, and layoffs will add up, economists say. The ultimate result: A slowdown of U.S. GDP growth, and pain for the economy.”

Trump's trade war: tariffs enacted or threatened

Enacted		Threatened or pending	
25%	on $34 billion worth of Chinese goods	25%	on another $16 billion worth of Chinese goods
20%	on washing machines		
30%	on solar energy modules	10%	on up to $400 billion worth of Chinese goods
25%	on steel		
10%	on aluminum	20%	on all imported cars, trucks, and auto parts

BUSINESS INSIDER

Source: Shayanne Gal/*Business Insider*

Emerging Markets' Weakened Currencies

Some emerging market countries have seen their economies sink because of a rise in oil prices, a stronger U.S. dollar, a decline in the value of their own currencies and a dependence on U.S. dollar debt.

Countries such as Argentina, Brazil, Turkey, South Africa, India and Indonesia and their stock and bond markets have been routed in the past year for the reasons noted above.

The Guardian notes that, “Argentina's $50 billion bailout by the IMF, the Washington-based lender of last resort, is the most extreme event so far, but it sits alongside the dramatic collapse of the Turkish lira, a recession in South Africa and dire economic predictions for the Philippines, Indonesia and Mexico.”

Here's a sample of how their economies have been hurt (at September 30th):

COUNTRY	% PRICE CHANGE IN 10-YEAR BOND	INFLATION RATE	% CHANGE IN CURRENCY VALUE	% STOCK MARKET CHANGE
Argentina	-20%	34%	-55%	-9%
Brazil	-2%	5%	-12%	+4%
Turkey	-31%	25%	-37%	-10%
South Africa	-1%	5%	-14%	-6%
India	-9%	4%	-13%	+8%
Indonesia	-22%	3%	-9%	-4%

Data Courtesy of *Bloomberg* LLP

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"In response, the stock markets of many developing nations have slumped in value, leaving investors to ask themselves whether they are witnessing an emerging-markets meltdown akin to the Asian crisis of 1997: A panic that wrecked the finances of several hedge funds and proved to be an hors d'oeuvre before the dotcom crash of 1999 and the global financial crisis of 2008."

Will this be the first domino to fall as a prelude to another global recession akin to 2008? At Liberty, we believe the pressures exist that, over time, a global slowdown is imminent.

With higher short-term interest rates, corporations will see higher borrowing costs and, as a result, will slow their expansion, their pace of hiring, their allocation to research and development and their business acquisitions.

That's why we're still holding cash for our current clients. For new customers, we're only putting ½ of the equity allocation into the market to start and buying gradually until they reach their planned cash position.

And if the S&P 500, currently in the 2800 to 2900 range, ever rose to 3700 (a 25% increase), we'd raise about 10% more cash as the valuation levels would be similar to Year 2000 and 1929 when the markets were at historical peaks and the downside risk would rise from 20% to between 40% and 50%.

Performers / Non-performers

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

Year-to-date Price Performance
(in native currency and dividends not included)
As of September 30, 2018.

TOP 5	% GAIN	BOTTOM 5	% LOSS
Heico Corp.	+53%	A.O. Smith	-13%
Dassault Systemes	+45%	Novo-Nordisk NV	-10%
Balchem Corp.	+39%	Cognex Corp.	-9%
Coloplast A/S	+33%	Chubb Ltd.	-9%
Rollins Inc.	+30%	HDFC Bank Ltd.	-7%

Data Courtesy of *Bloomberg* LLP

Through September 30th, our equities ended up well ahead of all of our relevant benchmarks. As shown in the table above, all it takes is for a few winners to pull along the stocks that are down.

Here are some comments on the individual stocks noted above:

→ **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. Its domestic sales don't expose it to foreign exchange risk, it has no debt and its profits have highly benefitted from the U.S. corporate tax cuts.

→ **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.

→ **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. It, too, sells mostly within the United States and, therefore, shares similar profitability characteristics with Heico.

→ **Coloplast A/S (COLOB DC)** is a Danish healthcare firm that sells colostomy bags, catheters and other gastrointestinal products. The company is benefitting from the introduction of new products to a growing, but aging demographic.

→ **Rollins Inc. (ROL US)** is a pest control company, best known under the Orkin brand. Insects on this planet have been around much longer than humans and

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critters such as ants, termites, rats, mice and bats are the targets of their fumigation efforts.

On the negative side:

- **A.O. Smith (AOS US)** makes commercial and residential energy-efficient water heaters and air and water purification systems in North America, India and China. Aquasana, A.O. Smith and Lochinvar are some of their notable brands. The stock has dropped because of the political fallout between China and the United States.

  However, products made in China are staying in China for re-sale. There should be no impact from the trade wars, but the company's stock is being treated unfairly that way.

  The one downside for the company is that higher steel prices have raised its input costs.

- **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 (*Ozempic*), U.S. sales are down as prices remain under pressure. Recently, competitor Eli Lilly announced new products in the same space that will provide competition.

  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.

- **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.

- **HDFC Bank (HDB US)** serves nearly 30 million customers worldwide and provides a variety of wholesale, retail and depository financial services through more than 3,400 branches and some 11,500 ATMS throughout India.

  According to Indian broker *Reliance Securities*, "The Indian banking sector has suffered in 2018 by a bank default (IL&FS), while the benchmark bond yield rose by 10bps to 8% owing to deteriorating macroeconomic indicators and tightening liquidity in the banking system.

  Also, excess rainfall with widespread monsoons had a negative impact. Finally, a sharp depreciation in the Indian currency has negatively affected all banks' fee incomes."

Currency Markets

While some journalists and even our peers in the financial services industry prefer that Canadians own mostly Canadian investments, we believe just the opposite. It's a decline in the Canadian dollar that puts

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many Canadians' retirements at risk, as a falling Loonie reduces an investor's spending power.

But, knowing that currency risk disappears over time, it's a better strategy to invest mostly in U.S. and international instruments to provide Canadian dollar protection.

Think of it this way. In your own lives, you have Canadian dollar income and Canadian dollar expenses. If the Canadian dollar falls, your spending power is reduced because all the imported goods that you buy (food, clothing, etc.) cost more.

Having more international investments in your portfolio provides a natural hedge against this happening. When the Canadian dollar is strong, your personal global buying power rises but your portfolio suffers. When the Loonie weakens, your spending power weakens as well but is reduced by a rise in the value of your foreign investments.

Below is a table showing the relationship between the U.S. dollar and the Canadian dollar going all the way back to year 2000.

Currency Movement of the U.S. dollar vs. the Canadian dollar since 2000

YEAR	VALUE ON JAN. 1	VALUE ON DEC. 31	DIFFERENCE
2000	$1.4461	$1.4991	**+3.7%**
2001	$1.4991	$1.5930	**+6.3%**
2002	$1.5930	$1.5718	-1.3%
2003	$1.5718	$1.2970	-17.5%
2004	$1.2970	$1.2019	-7.3%
2005	$1.2019	$1.1620	-3.3%
2006	$1.1620	$1.1657	**+0.3%**
2007	$1.1657	$0.9984	-14.4%
2008	$0.9984	$1.2188	**+22.1%**
2009	$1.2188	$1.0532	-13.6%
2010	$1.0532	$0.9980	-5.2
2011	$0.9980	$1.0213	**+2.3%**
2012	$1.0213	$0.9921	-2.9%
2013	$0.9921	$1.0623	**+7.1%**
2014	$1.0623	$1.1621	**+9,4%**
2015	$1.1621	$1.3839	**+19.1%**
2016	$1.3839	$1.3435	-2.9%
2017	$1.3435	$1.2574	-6.4%
2018	$1.2574	$1.2908	**+2.6%**
Average Annual Net Change			-0.1%

How to Read the Chart:

The percentages in **Red** in the far-right column above are years when the Canadian dollar strengthened; percentages in **Black** denote years when the Canadian dollar fell.

For example, in Year 2000, one U.S. dollar bought $1.4461 Canadian dollars. By the end of the year, that same U.S. dollar bought $1.4991, a 3.7% weakness in the Canadian dollar.

Since the Canadian dollar is still seen as a petrocurrency, its strength can be noted from 2003 to 2007 as oil prices rose to $100 USD a barrel.

In 2008, the Canadian dollar plummeted during the financial crisis as investors ran for cover by buying the major global currencies such as the US dollar, the Swiss Franc, the Euro and the Japanese Yen and by selling minor global currencies such as the Canadian dollar, the Australian dollar or the New Zealand dollar.

From 2013 to 2015, the Canadian dollar fell again from par against the U.S. dollar as a result of an oil price decline from $100 USD a barrel to around $35.

Since then, the Canadian currency has muddled along. It was weaker in 2018 before the new USMCA (United States / Mexico / Canada Agreement) replaced NAFTA (North American Free Trade Agreement) but has since recovered.

After 18 years, the average annual change has been just 0.1%. And if you go back 47 years, you can note the cycle:

- A high of $1.00 to the U.S. Dollar (price-point parity in 1971)

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- A low of 60 cents after the 1995 Quebec Referendum
- A high of $1.00 to the U.S. Dollar with $100 a barrel of oil
- A low of 73 cents after the drop to $35 a barrel of oil

If you think it's a U.S. Dollar / Canadian dollar phenomenon, the Euro / Canadian dollar difference during that similar time was just 0.5% in favour of the Euro.

The moral of the story, therefore, is this:

Knowing that currencies are cyclical in nature (as are all investment instruments), when the Canadian dollar is strong, buy foreign. Conversely, when the Canadian dollar is weak, buy more Canadian.

The chart above illustrates why we have a hard time accepting the foreign exchange policies of many companies.

They essentially pay a bank about 2% to 3% a year to hedge their currency books when they don't need to. The banks make money but the shareholders lose out as the company often flushes between $50 million and $100 million down the foreign exchange toilet in foreign exchange losses each year.

Bond Markets

10-Year Bond Yields

COUNTRY	COUPON	PRICE	CURRENT YIELD
Emerging Markets			
Argentina	5.88%	$79.82	+9.15%
Turkey	5.13%	$85.69	+7.26%
Brazil	4.63%	$91.91	+5.76%
Russia	4.38%	$96.34	+4.82%
Indonesia	3.50%	$93.45	+4.37%
Mexico	3.75%	$95.41	+4.36%
Greece	3.75%	$97.17	+4.12%
China	3.54%	$99.41	+3.61%
Developed Markets			
United States	2.88%	$98.13	+3.06%
Australia	2.25%	$96.49	+2.67%
New Zealand	3.00%	$103.69	+2.60%
Canada	2.00%	$96.38	+2.42%
United Kingdom	1.63%	$100.50	+1.57%
Germany	0.25%	$97.90	+0.47%
Japan	0.10%	$99.84	+0.12%

Data Courtesy of *Bloomberg* LLP

To the left are the differences in yields between the developed and emerging markets. It shows 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.

Reaching for yield is OK if you manage your portfolio accordingly and are disciplined. If you wish to own emerging market bonds, keep the percentage holdings within a manageable range, such as no more than 5% of your fixed income holdings in emerging market debt.

That way, if those bonds tumble in price, you won't be put out of business by losing all your money. The discipline of managing your risk keeps you in the investing game.

Speaking of risk, we're reminded of a hedge fund that once started out with a similar disciplined bent. They had 10 strategies overall and allocated 10% of the funds to each of them. If one blew up, they weren't put out of business as the other 90% invested would still have value.

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However, greed got the best of this firm. One of the strategies involved trading natural gas futures, a very risky venture as only 5% of capital is required, making the leverage 20 times the investment (the reciprocal of the 5% capital investment).

Because of the leverage, the firm's natural gas trader made hundreds of millions of dollars in profits, eventually making that strategy worth 90% of the firm's assets. Instead of paring back the gains to maintain its 10% risk allocation, the firm let the trader go on trading because the fees earned (2% plus a 20% performance fee) made everyone at the firm filthy rich.

Unfortunately, the trader eventually got on the wrong side of the trade and it bankrupted the company because it owed 20 times more than the company had in capital. It was then that the firm learned that leverage works both ways.

For Liberty investors, we maintain the discipline below so our investors don't go broke and can stay in the game, regardless of market movements:

1. Have no more than 5% in any country bond market outside of North America.
2. Have no more than 2% in any one bond or preferred share.
3. Hold roughly 30-40 names in bonds and preferred shares. If one goes bankrupt, it won't have any effect on performance or capital.
4. Hold an average weight of 3% per stock. If it becomes 6% of the stock portfolio, sell half and re-balance by allocating the profits to more shares of those stocks that are less than a 3% weight.

Bonds

TYPE OF BOND	YEAR-TO-DATE PRICE CHANGE
BMO Mid Corporate Bond Index ETF - Canada	-2.91%
BMO Long Corporate Bond Index ETF - Canada	-4.44%
Vanguard Long-term Corporate Bond ETF - USD	-8.10%

Data Courtesy of *Bloomberg* LLP

Since the above table shows bond price losses across the board, what should we, as investors, do with our bond investments?

→ Other than holding cash, it's still prudent to own bonds but with a move to higher quality ones.

Rather than focus on BBB-rated securities, we can now buy bonds rated A (three notches better than BBB) and get similar yields. If the bond markets fall, the A-rated bonds' prices will hold up better than the BBB bonds because of the higher quality.

→ We can buy bonds at a discount to par. This helps guarantee the yield to maturity and the annual bond returns. If held to maturity, there are no capital losses.

→ We can buy inflation-protected bonds, both Canadian and U.S. types. This protects you from inflation jumping to 18% as it did in the late 1970s.

These types of bonds are the only protection against inflation in a fixed-income portfolio, which is why 5% of the Liberty fixed income portfolios are invested in these securities.

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Preferred Shares

TYPE OF PREFERRED SHARE	YEAR-TO-DATE PRICE CHANGE
Canadian Perpetual Preferred Shares	-2.24%
Canadian Variable Rate Reset Preferred Shares	-0.76%
BMO US Preferred Share Index ETF (in USD)	-3.02%

Data Courtesy of *Bloomberg* LLP

As in the table above, preferred share performances are also linked to rising interest rates. Rising rates can be offset by owning Rate-Reset preferred shares but they are still no protection against inflation.

Our strategy to deal with preferred share risk is to have about two-thirds of our preferred shares invested in these rate-reset shares, while the other one-third is invested in perpetual preferreds. As rates rise, the rate-resets should do well. When rates go sideways or drop, the perpetuals should be able to hold their own.

The reward to own preferred shares is to earn roughly a 7% pre-tax yield. Compared to 5-year government of Canada bond yields of roughly 2.25%, the 5% or so pickup in income is worth the risk.

Inflation-Protected Bonds

TYPE OF INFLATION-PROTECTED BOND	YEAR-TO-DATE PRICE CHANGE
Canadian Government 3% RRB due Dec. 1, 2036	-3.09%
US Government 2.125% TIPs due Feb. 15, 2040	-6.97%

Data Courtesy of *Bloomberg* LLP

The prices of the inflation-protected bonds have fallen this year (table above) because they're defined as long-term securities and trade like 30-year bonds. As short-term rates rise, these bonds' prices have dropped more than the shorter-term securities.

However, we don't care about price movement as we plan to own them for the rest of the clients' lives. And if inflation is running 3% in both Canada and the United States, the Canada Government bond pays a 3% coupon plus the 3% CPI for a total payout of 6%. For the U.S. Treasury Inflation-protected security (TIPs), the payout would be 5.125% in US dollars.

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How Chief Financial Officers (CFOs) Earn Their Keep

My Liberty colleagues, Brett Girard CPA, CA and Thomas Zagrobelny, have written this article on how Chief Financial Officers (CFOs) earn their keep.

Essentially, if a company can earn more from its capital investments compared to how much it costs to earn that return, the firm should be profitable today, tomorrow and in the future. And if the returns are above-average, then the odds for shareholders' investment success improves.

And, now, to Brett's and Thomas' research:

Part of investing in a company for the long term is being able to determine if management is adept at consistently increasing shareholder value. Our research has shown that free cash flow growth is a good proxy for increasing shareholder value.

While measuring free cash flow growth is important, what if there was a tool to predict if cash flow will grow before it does? It turns out there is: Compare Return on Invested Capital (ROIC) to the Weighted Average Cost of Capital (WACC).

While the financial media has probably familiarized you with ratios like Price-to-Earnings, it's unlikely you've heard of the comparison of ROIC to WACC. It's a powerful tool used to evaluate the profitability of a given capital allocation or investment.

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For example, imagine you have the opportunity to purchase a residential multiplex. The purchase price, or invested capital, is $1,000,000, annual rents are $100,000 and annual expenses are $30,000.

Based on this math, you would earn a net profit, or return, of $70,000 annually. A return of $70,000 on invested capital of $1,000,000 translates into a Return on Invested Capital, or ROIC, of 7% ($70,000/$1,000,000).

Now, 7% sounds good but we need more context – what if the interest rate at which the bank will lend us money is 10%? In that case, borrowing at 10% to invest at 7% does not sound attractive.

The borrowing rate is one component of the WACC. The other component of the WACC is the opportunity cost of the funds being invested. Opportunity

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cost can be thought of as the implied amount of return we are foregoing by making an investment.

Using the example above, you could buy the multiplex and earn 7% or you could invest in your neighbour's bakery and earn 5% - by investing in the multiplex you forego the ability to invest in the bakery.

Returning to the original example of $1,000,000 invested to purchase the multiplex, if we are going to write a cheque for $200,000 and borrow the balance ($800,000) from the bank, our weighting of equity (our investment) to debt (bank borrowing) is 20% and 80%, respectively.

Let us then assume that the borrowing rate (cost of debt) is 3% and the opportunity cost (cost of equity is 5%). If we insert these figures into the formula below we can arrive at our Weighted Average Cost of Capital, or WACC.

WEIGHT OF DEBT		COST OF DEBT		WEIGHT OF EQUITY		COST OF EQUITY		WACC
$\frac{\$800,000}{\$1,000,000}$	x	3%	+	$\frac{\$200,000}{\$1,000,000}$	x	5%	=	3.4%

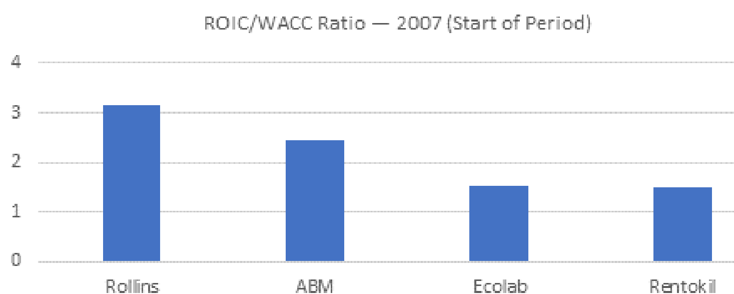
In this example, the WACC of 3.4% allows us to make a binary decision as to whether we should invest in a project or not.

If the expected return, or ROIC, is greater than 3.4%, we cover our cost of capital and will generate a return if we proceed with the investment, whereas if our ROIC is less than 3.4%, we will lose money on the investment and should not proceed.

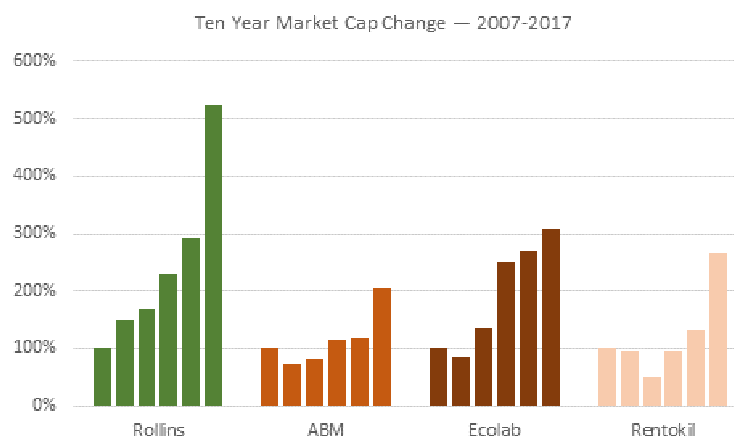
This type of decision is made by CFOs and management teams every day. If a proposed investment, be it a new product line, purchasing a competitor, or buying a new piece of machinery shows an ROIC to WACC ratio of greater than 1, management can proceed, trusting that the returns generated will be accretive to shareholders.

Switching from the theory to a "real world" application, we have completed the analysis to the right on Rollins Inc., one of the largest pest control companies in the world and a stock that some of our clients own.

Looking at Rollins's ROIC to WACC relative to their competitors demonstrates that the company is able to generate superior returns on invested capital. The chart below shows that for each $1 invested, Rollins is able to generate roughly $3 while its competitors make only $2. If this relationship holds over a decade, Rollins will be able to turn $1 into almost $20,000 while the competitors will turn that same $1 into about $500.



From the chart below, displaying Market Capitalization (the market value of the company), we can see how powerful a superior ROIC to WACC is to shareholder value.



Over the 10-year period from 2007 to 2017, Rollins earned a compound annual return of 20%, while its three competitors earned returns between 7% (Rentokil) and 11% (Ecolabs).

Things to consider about Return on Invested Capital (ROIC)

→ Asset intensity is a factor

The denominator of the ROIC calculation varies across industries. If you compare a brick and mortar business

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that has an asset-rich balance sheet, like TransCanada, to an asset-light service-based business with large amounts of goodwill and intangibles such as Rollins, the denominator in the equation will be substantially less for the latter, making ROIC look artificially high.

- Overall industry growth is a factor

Young or fast-growing industries, on balance, will have higher ROIC expectations since there is new market share to acquire. This differs from mature and more stable industries where gains in market share are zero-sum and must be taken from a competitor.

For the companies in the young or fast-growing industries, this can be a double-edged sword, as high expectations lead to high stock valuations - any 'slip-ups' along the way can severely punish the firm's stock price.

Things to consider about Weighted Average Cost of Capital (WACC)

- Weighted Average Cost of Capital is based on risk.

The higher the risk of an investment, the higher the cost of capital that investors need to be compensated for taking more risk. All things equal, some of the drivers of WACC are as follows:

Generally, the larger a company, the more stable are its operations (think of Domino's Pizza relative to the local pizza shop down the street). If you were lending money or making an investment, you would require a lower return from Domino's, given the lower risk profile of the investment.

If the market perceives a company to have a sustainable competitive advantage, or economic moat in the parlance of Warren Buffett, then the expected risk of an investment will be lower relative to the competition. This reduces the required return investors expect, thereby lowering the cost of capital.

- Consider the company's capital structure, or how the assets are funded.

If a company is debt-free and then decides to issue debt, the likelihood of the debt being serviced is high. Compare this to a company that has a debt-to-equity ratio of 4-to-1, where for each dollar of equity invested they have borrowed $4.

The ability of the more indebted, or highly-levered company to repay the debt is worse than the debt-free company as it already has a lot of debt on the books.

- Industry cyclicality is a factor.

Certain industries involved in technology or industrials tend to be more cyclical than defensive industries like healthcare or financials. This riskiness factors into capital costs - companies in the latter, less risky categories can generally access funds from the capital markets at a lower rate.

- The influence of interest rates

WACC is also influenced by interest rates. If you think back to the example of using bank financing to purchase an investment property, the mortgage rate will be dependant in part on what the underlying interest rate is. In practical terms, a spread is placed above the central bank reference rate leading to a percent for percent adjustment of WACC as interest rates fluctuate upwards and downwards.

When using research methods of both free-cash flow generation and combining it with an analysis of ROIC vs. WACC, investors can get a sense of what makes a quality company.

Companies that can illustrate these two qualities have the financial flexibility to compete effectively and make shareholders happy by consistently raising their dividends. This should, therefore, help improve their chances of investment success. That's why it's such an important metric in Liberty's research efforts.

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“That's why Elder Care is currently one of the OSC's (Ontario Securities Commission) top concerns.”

The life expectancy of the average Canadian is 82.2 years[1]. Unfortunately, this longevity is giving rise to an unprecedented increase in age-related cognitive decline. The simple fact is that although people are living longer, their brains do not always keep up.

According to the Alzheimer's Association of Canada, the number of Canadians with dementia is rising sharply. As of July 2018, there were over half a million Canadians living with dementia. By 2031, that number is expected to rise to 937,000, an increase of 87%.

This is significant when accounting for Canada's expected population in 2031 of 40,600,000, as it translates into about 2.3% of the population or 1 in about 44 people being afflicted with dementia. This cohort will be particularly at risk of forgetfulness, fraud and costly mistakes.

That's why Elder Care is currently one of the OSC's (Ontario Securities Commission) top concerns. How will investment management firms like Liberty deal with the potential onset of dementia with one of their clients?

We need to work with our clients in two ways:

1. Regular contact by phone or in face-to-face meetings.
2. Copies of wills and powers of attorney (both medical and financial) on file to deal with whatever may transpire.

To keep the elderly safe and protected as they age, we encourage you to consider the following financial planning steps:

1. Ensure there is a trusted point person who knows the whole story

At least once a year, sit down with a trusted party and go over your finances: Balance Sheet (assets and liabilities) and Income Statement (income and expenses).

On the balance sheet side, care should be taken to collect and keep any documents detailing ownership (e.g. deeds or shareholder agreements) as well as any financial accounts (e.g. investments or life insurance policies).

1. https://en.wikipedia.org/wiki/List_of_countries_by_life_expectancy

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When possible, obtain contact information and make that relationship known to any third parties, like Liberty, to assist in the future if contact is made on that person's behalf.

On the income statement side, this is a good opportunity to scrutinize expenses for validity. Taking time to understand if recurring bills are necessary can conserve the finite resource of retirement savings.

Often, this 'point person' is a family member but if the family dynamics do not permit this relationship, outside counsel should be involved at a pre-negotiated fee.

2. Speak to an estate lawyer

While the sky is the limit on setting up legal structures and agreements to protect one's every whim, at a bare minimum, investors should have a Will in place. It should detail: Medical and financial powers of attorney and the name of the executor to the estate.

For those with affairs that are more complicated, a lawyer can also advise on establishing a vehicle like a Trust to retain ownership and benefits of assets but relinquish control to another party.

3. Speak to an accountant

There is no limit to the fees that can be accumulated putting structures in place to minimize taxes. For most people, the Pareto or 80-20 principle applies, whereby a little bit of tax planning can go a long way. Ensuring spousal assets (e.g. primary residence or investment accounts) are held in Joint with Right of Survivorship (JWROS) status allows the tax bill to be deferred until the passing of the second spouse.

Other structures like a spousal trust can reduce the amount of probate levied on an estate. In addition, for those with American assets, the U.S. estate tax can apply to a Canadian citizen's entire asset base if certain wealth thresholds are met at the time of passing.

4. Develop a plan

As the old axiom goes: Hope for the best but plan for the worst. The common thread throughout the messages above are to find someone you trust and to work with specialists. Developing and revisiting a plan while cognitive function is high will ensure that your wishes will be followed, and will protect you and your interests into the future.

If records are kept and those involved are organized, the items above in aggregate might take little more than an hour or two once a year. This small investment of time will return big dividends in peace of mind and allow the focus to be on the family.

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QUESTIONS

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Why are you holding cash?

Strategic use of cash is to provide capital preservation, especially after a decade of rising stock prices. Investment success comes from avoiding the big losses, not from investment gains.

It's simple math. Say you have a $1 million portfolio. If the market drops 40%, your $1 million falls to $600,000. To return to break-even, you have to generate a 67% gain, not 40%. This may take a number of years, a time horizon that most investors can't afford to experience.

By holding cash these past few years, we've probably given up 1% to 2% of gains each year but we don't mind paying the price to preserve capital.

Most investment counselling firms are always fully invested. If the market drops 40%, they'll have to sell securities to raise cash which compounds the losses. That action may also trigger capital gains in taxable accounts, meaning clients may have a one-year loss of 20% ***and*** have capital gains tax to pay – not a prudent situation.

At Liberty, that won't be an issue because the cash is already available, so no triggering of capital gains should occur and cash is available to take advantage of lower prices.

And with rising interest rates, our clients' cash holdings are currently earning 2% or more.

How do you show comparable performance? Why doesn't my broker?

By law, we must show our performance by comparing to benchmarks that are apples-to-apples for stocks, bonds and preferred shares. For example, our equity performance is compared to the equivalent of our holdings: 20% Canada (TSX Index), 40% United States (S&P 500 Index) and 40% Europe (Europe-600 Index).

Unfortunately, this doesn't appear to be the case in the brokerage industry. In the past 6 months, we've seen the statements of four different prospective clients who were at four different brokerage firms.

In all cases, the brokers have shown their performance since inception, for the year and for the quarter. What's missing, however, and required by law, is the "*Compared to What?*" provision.

For example, one of the portfolios was 100% equity invested in a mix of Canadian, U.S. and international stocks and ETFs.

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The broker showed a 3% compound annual return over an 11-year period, which, compared to the benchmarks was extremely weak, given that time period was one of the strongest bull markets known to mankind - the S&P 500 Index tripled.

Remember, if your advisor provides you with performance but no equivalent comparisons, demand one. Opaque explanations instead of cold, hard facts are ways brokers like to obfuscate their poor performances. If they don't provide it, fire them. They're not doing you any favours and they may be hurting your potential investment success.

Why do markets rally near the end of a calendar quarter (March / June / September / December)?

Many mutual funds and institutional money managers tend to re-allocate capital to the big winners of the moment and cause a short-term rally into the end of a calendar quarter.

This is known as "window-dressing" because these funds don't want their investors to think that they are missing out on all the stocks currently in the news.

In a 2010 study by *Dalbar*, a leading independent, unbiased financial institution, it found that the average turnover rate of all Canadian equity mutual funds was 120%. This means that by October of every year, the funds had bought and sold every stock in the portfolio.

As a result, the fund incurred higher transaction costs and greater taxes. Add in the high management expense ratios (MERs) and you can understand why almost 85% of mutual funds never beat their benchmarks.

It's also important to understand the value of time and compounding. Warren Buffett certainly did. In a 2014 HBO documentary on Buffett, he stated that he was a billionaire today because, at the age of 10, he understood this fundamental of stock investing.

As a boy, he earned money three ways:

A. He was a paperboy for the Washington Post.

B. He rented out pinball machines to barber shop owners.

C. He returned pop bottles for the 5-cent refund.

When he amassed a certain amount of money, he'd then buy shares in a company.

Of course, he was also investing during one of the greatest investment eras of his generation. The post-war United States had no competition because Europe and Japan were decimated by war and their economies were in ruin. This helps explain why he was able to find good businesses at compelling prices.

For example, his ownership of Coca-Cola since the 1950s illustrates two things:

A. The growth in the dividends over 60-odd years provides the capital for his future acquisitions at Berkshire Hathaway.

B. His yield-at-cost (dividend income divided by the cost of the investment) is his return, plus or minus the price movement of Coke stock each year. If the yield-at-cost is 25%, for example, the total return is 25% plus or minus the price movement.

This means that if his Coke stock goes up 10%, his total return for that one security will be 35% for the year. And if it falls 10%, he still makes 15%.

From a portfolio perspective, it's this yield-at-cost that allows investors to outperform markets in good times and help protect their capital during market corrections.

That's why two-thirds of all stock investment performance comes from rising dividends and the re-investment of those dividends, ***not*** stock price movement.

And it's why we keep our turnover rate to less than 10% a year, well below the 120% of the mutual fund cowboys. It also explains why we invest in businesses and why we don't trade stock prices.

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As a result, we can outperform the benchmarks over time and let the nickels and dimes accrue to the clients, not to the brokers.

Why don't you invest in alternative investments such as bitcoin, marijuana or hedge funds?

There's an acronym that's popular in today's media: FOMO. It stands for "Fear of Missing Out".

This is behavioural science at its best and it's been prevalent all the way back to the Tulip Craze in the Netherlands during 1636-37 when the price of tulips soared and then collapsed after the reality set in that tulips were just pretty flowers.

The way to approach "concept stocks" like Bitcoin and marijuana names is:

1. When you've doubled your money, sell half. That way you at least walk away with your original investment.
2. Buy 10 names in the hopes that 2 of them will pay for the other 8 that go bust. That percentage rings true in the stock market but also at the casino because the house wins 80% of the time.

Both strategies are simply a professional use of cash that prevents investors from losing all their money.

Bitcoin has already collapsed in value, leading us to believe that marijuana stocks will probably move in the same direction because:

A. It's a crop and the price will be dictated by supply and demand.

B. The provincial and federal governments will apply hefty taxes similar to tobacco and liquor, leaving the marijuana companies' margins razor-thin.

C. Not all marijuana companies will be successful. Some are poorly run and their financial statements illustrate that fact.

D. The publicly-listed marijuana stocks are using their share prices as a currency to make their next acquisition(s). Let's not forget the largest market-cap stock during Year 2000 was Nortel. It, too, was busy using its hefty stock price as a currency to make redundant acquisitions that, by 2002, helped cause its bankruptcy.

E. If marijuana demand takes hold, there's nothing stopping other countries from getting into the game.

At Liberty, we are not interested in speculating in concept stocks like marijuana. Our clients have already built their nest eggs. It's our job not to lose it.

Is it possible that stock and bond markets could fall in tandem?

Something that investors haven't seen since the 1970s, and a reason why returns for the next decade could be downright awful, is the one-two punch of both stock and bond prices falling in tandem.

From *Business Insider*, "In October 1973, the United States experienced an oil shock when the Organization of Petroleum Exporting Countries (OPEC) placed an embargo on oil exports to the U.S. As oil prices skyrocketed and gasoline shortages struck, inflation began to soar, too."

"The U.S. economy, which was already struggling with large budget deficits caused by the costs of the Vietnam War, fell into recession in November 1973.

Shocked by double-digit inflation figures, central bankers hiked rates for five months in March 1974, introducing a monetary policy known as "stop-go," in which the Federal Reserve would alternate between fighting inflation by raising interest rates and then trying to revive economic growth by cutting them again."

"By 1980, one-year Treasury bonds were paying more than 16 percent - a number that might be dumbfounding to contemporary investors who have seen rates closer to 0.1 percent to 0.4 percent on bonds of the same duration over the last year." Bond prices fell as rates continued to rise.

As for the equity markets, from 1973 to 1975, the S&P 500 Index fell 22%. Over the course of 8 years (1972 to

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1980), the S&P 500 Index annual return was just 1.7% (2.4% with dividends re-invested).

An age-old axiom is the three Ds of investing: "Debt doesn't disappear" and this is what has us concerned about the bond market.

Howard Marks, head of investment firm Oaktree Capital Management L.P., commented recently in his regular newsletter about the levels of corporate debt:

→ From the *Financial Times*: Between 2007 and 2017, the ratio of global debt to GDP has jumped from 179% to 217%, according to the Bank for International Settlements."

→ From *Bloomberg*: "Global companies with a debt-to-equity ratio of five times or greater have reached 37% in 2017 compared to 32% in 2007, according to S&P Global Ratings."

→ From S&P Global Market Intelligence: "Total leveraged debt outstanding (high-yield bonds and leveraged loans) is now $2.5 trillion USD, exactly double the amount in 2007."

→ From the International Monetary Fund (IMF): "BBB-rated bonds, the lowest investment grade category, now stand at $1.4 trillion in the U.S. and constitute the largest component of the investment grade universe (roughly 47% in both the U.S. and Europe, up from 35% and 19%, respectively, ten years ago)."

If this ever does occur, the chances of early retirement disappear and we should forget about the slogan coined by *London Life* in the 1980s of "Freedom 55". It would turn out to be a myth.

Instead, the important thing for investors to remember is that successful investing requires many years so that time and compounding can take hold. There is no short-term cure.

So, as interest and dividends grow in the portfolio, the money should be re-invested, waiting for the return of better times. Investors should just continue on as though markets weren't being hammered.

Or consider the old Buffett axiom, "Be fearful when people are greedy and greedy when people are fearful.

We're currently fearful.

IN SUMMARY:

1. Don't pay to hedge your portfolios. It's a waste of your money.
2. Invest in businesses. Don't trade stock prices. Only the brokers make money in that scenario.
3. Demand an apples-to-apples comparison when discussing portfolio performance. Beware opaque information from brokers.
4. Understand the idea of risk vs. reward (ROIC vs. WACC).
5. Make time to put your estate in order.
6. Pray like hell we don't have to endure another stagflation scenario as in the 1970s.

If you have any further questions, let me know.

David Driscoll

President & CEO
Liberty International Investment Management Inc.

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