LIBERTY
International Investment Management

MARKET UPDATE

Q4 | December 31, 2018

IN THIS ISSUE:

YEAR-TO-DATE PERFORMANCE

The Markets—January 1 to December 31, 2018

Equity Markets

Stock markets worldwide rose in 2018 until this past October when storm clouds gathered and caused a major correction.

2018 Returns

COUNTRY	STOCK INDEXES	TOTAL RETURN (with dividends re-invested in native currency)	TOTAL RETURN (with dividends re-invested in Canadian Dollars)
Brazil	Ibovespa	+15.03%	+6.36%
India	S&P BSE Sensex 30	+7.22%	+6.69%
United States	S&P 500	- 4.39%	+4.07%
Australia	S&P / ASX 200	- 6.90%	- 4.52%
MSCI Global Index	MSCI Global Index	- 8.24%	- 0.22%
Canada	S&P/TSX	- 8.88%	- 8.88%
Europe	Stoxx 600	- 10.30%	- 6.91%
Japan	Nikkei	- 12.08%	- 0.54%
China	Shanghai Composite	- 12.82%	- 14.70%
Mexico	Mexican Bolsa	- 13.81%	-6.17%

Data Courtesy of *Bloomberg* LLP

In the table above, the third column notes country index returns in their own native currency, while the fourth column shows returns converted to Canadian dollars. Because the Canadian dollar fell in 2018 against most major currencies, returns in the far-right column are less bad.

Note that the Brazilian stock market led the way with a 15% domestic return. However, it wasn't up as much in Canadian dollars (column four), meaning that while the stock market did well, the Brazilian Real did not.

Some negative market factors that led to declines in global stock markets in late 2018 included:

- A drop in global economic growth, especially in China
- A drop in Mergers & Acquisitions (M&A) activity
- A slowdown in share buybacks
- A slowdown in earnings growth
- Tariffs and trade wars that caused input prices to rise
- Interest rate increases by the U.S. Federal Reserve that reduced corporate cash flows and, in turn, reduced the ability for companies to buy back shares or make acquisitions
- The continuation of huge U.S. budget deficits – with it go higher interest payments
- The shutdown of U.S. federal government agencies

The Dominoes are falling

In our last newsletter, we talked about how the decline in emerging market growth in 2018 was a signal of the first domino to fall in a global economic slowdown or potential recession. We'll call it the "Chinese contagion".

That's somewhat similar to what happened in 1997 during the "Asian contagion" when Asian countries outside of China saw their economies weaken, along with their currencies and spending power. This ultimately led to a recession and a stock market decline that began in March, 2000 and continued until 2003.

We believe the second domino to fall then was the weakness in technology stocks that prompted the stock market correction from October to December, 2018.

After months of reported supply-chain cuts, tech-bellwether Apple Inc. cited longer upgrade cycles and headwinds in China as causing lower-than-expected iPhone sales. Apple now expects revenue for its fiscal first quarter to be as much as $9 billion lower than previous projections. As of January 3rd, Apple had lost 17 percent of its stock value in the last 12 months, and almost 40 percent from its 52-week high.

As a result, investors in tech stocks or technology index funds experienced the brutality of a stock market selloff (see Nasdaq returns in the table below) as it ruptured their portfolios and caused severe de-valuation.

Global growth is slowing and it's not just China

Stock Market Volatility in Fourth Quarter of 2018

INDEX	TYPE	RETURNS OCT. 1–DEC 23
Nasdaq	Technology	-22%
S&P 500	United States	-19%
MSCI Global	Global	-17%
S&P / TSX	Canada	-14%
Euro 600	Europe	-12%

Data Courtesy of Bloomberg LLP

Morgan Stanley chief U.S. economist Ellen Zentner, in a report on January 2, 2019, stated that, "The U.S. economy is running out of stimulus steam, central banks are less accommodative, and global growth is slowing."

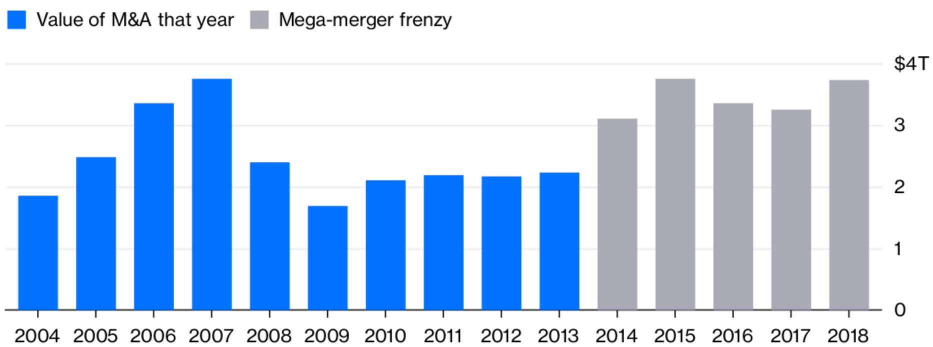
Ms. Zentner forecasts 1.7-per-cent year-over-year U.S. growth domestic product growth for the fourth quarter of 2019, much lower than the consensus estimate of 2.3 per cent and, while not recessionary, this would be the slowest expansion since 2012.

Corporate takeovers should fade

Bristol-Myers Squibb Co. bought biotech Celgene Inc. for $74 billion, a huge discount from Celgene's peak when it was worth $114 billion. This is probably the last mega-deal because the market is saturated with corporate debt and higher interest rates don't make leveraged deals attractive.

Peak Dealmaking

The frenzied pace of megamergers seen during the last few years probably won't be sustained in 2019



Source: Bloomberg

BloombergOpinion

Share buybacks should slow

In a January 10, 2019 article by Sinead Carew of Reuters, she noted that, "many strategists see the lift from buybacks - a major factor behind the bull market - losing some force as earnings growth slows while tax policy bonanzas fizzle out."

Jack Albin, chief investment officer at Cresset Wealth Advisors in Chicago said, "Companies bought back around 2.8 per cent of shares outstanding in 2018. That was a substantial support to the market and bigger than dividends. In 2019, we expect the corporate firepower behind share buybacks to be diminished. The growth in cash flow will be slower."

"Last year will likely go in the books as a record for buybacks. Through the first three quarters of the year, companies bought $583.4 billion of their own stock, just shy of 2007's full-year record of $589.1 billion, according to S&P Dow Jones Indices data."

Capital repatriation also helped the stock market but may not be a catalyst in 2019

From the same Reuters article, "After rushing home some $295 billion of foreign profits in the first quarter of 2018, the pace of repatriation by U.S. multinationals has since slowed sharply, Commerce Department data shows. In the third quarter that was down to about $93 billion."

"About $190 billion, or one-third of repatriated funds were used on buybacks in the first three quarters of 2018, JPMorgan strategist Nikolaos Panigirtzoglou wrote. But if repatriation keeps decelerating, the buyback boost will dissipate," he said.

With the weaker equity markets in the fourth quarter of 2018, investors should be fore-warned. We haven't yet seen total capitulation on behalf of both institutional and private investors. That's why, at Liberty, we continue to hold our cash. It remains at 20% times the equity exposure for each account.

Currency Markets

The Canadian dollar continues on a path that follows the movement of the price of oil. Last year, the Canadian dollar fell versus a group of international currencies on the back of a lower oil price (West Texas Intermediate dropped 21%) and because interest rates rose faster in the United States than in Canada.

In the past 18 years, the Canadian dollar strengthened when the oil price rose; it collapsed when oil prices plummeted or when global stock markets fell.

In 2008, during the financial crisis, the Loonie fell 22% against the U.S. dollar because global investors chose to sell the minor currencies, like the Canadian dollar, to benefit from the liquidity offered by the major currencies like the U.S. dollar, the Euro, the Japanese Yen or the Swiss Franc.

Each day, the Canadian dollar trades about $1 billion notionally. This compares to the U.S. dollar, which trades about $1 trillion on a notional basis, or about 1,000 times more liquidity.

Currently trading around the 75-cent mark, the Canadian dollar could move toward 80 cents if oil can sustain its trading levels. In 2018, the spread between Alberta crude and West Texas Intermediate or Brent prices widened. Given that spreads should return to the mean indicates the Loonie should strengthen this year.

That said, we don't really care about the movement of the Canadian dollar. As shown in our last newsletter, we proved that over a 10 to 20-year time horizon, currency risk becomes benign.

Bond Markets

10-Year Bond Yields

COUNTRY	COUPON	PRICE	CURRENT YIELD
Emerging Markets			
Argentina	5.88%	$72.24	**10.76%**
Mexico	7.50%	$93.30	**8.62%**
Turkey	6.13%	$93.99	**6.98%**
Brazil	4.63%	$96.66	**5.09%**
Russia	4.38%	$95.13	**4.99%**
Indonesia	3.50%	$92.86	**4.47%**
Greece	3.75%	$95.98	**4.29%**
China	3.25%	$99.64	**3.29%**
Developed Markets			
United States	3.13%	$103.25	**2.68%**
New Zealand	3.00%	$105.91	**2.35%**
Australia	2.75%	$103.83	**2.31%**
Canada	2.00%	$100.32	**1.96%**
United Kingdom	1.63%	$103.24	**1.27%**
Germany	0.25%	$100.14	**0.24%**
Japan	0.10%	$101.09	**-0.01%**

Data Courtesy of *Bloomberg* LLP

Above 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.

As emerging market economies have slowed and the risks have increased, bond prices have fallen and the yields on their bonds have risen. That's why their bonds offer a higher yield than the safer, developed markets.

Today, the talk among bond traders is about the yield curve, as it can be a leading indicator for the subsequent direction for the economy.

In the United States, these are the current yields:

U.S. INTEREST RATES	YIELDS
3-month Treasury bills	2.42%
6-month Treasury bills	2.50%
12-month Treasury bills	2.57%
2-year Treasury bonds	2.54%
5-year Treasury bonds	2.52%
7-year Treasury bonds	2.59%
10-year Treasury bonds	2.70%
30-year Treasury bonds	3.04%

Data Courtesy of *Bloomberg* LLP

Because interest rates have been ultra-low for the better part of a decade, the goal of the U.S. Federal Reserve has been to wean companies and consumers off cheap debt. Their goal has been to move rates to 4% to 5% to provide wiggle room if the economy falls into recession and they then have to cut interest rates.

Noted in the table above, the yield curve is important because recessions often occur when the 2-year rate exceeds the 10-year rate (it's currently only 16 basis points apart).

That's because corporations tend to borrow in the short-term to finance their operations. If rates move higher, their costs go up and it prompts them to stop hiring, reduce their spending on research and development (which curtails innovation) and prevents them from making cheaper acquisitions.

So far in 2019, long-term rates (10-30 years) have edged slightly higher to indicate that job growth may be a precursor to higher domestic inflation. Over the past several months, job creation has outstripped the number needed to accommodate population growth. U.S. unemployment in November, 2018 remained at 3.7 per cent, its lowest since 1969.

If we go into recession, expect another stock market drop of anywhere from 10% to 30%. That's why equity investors have to pay attention to the bond market.

Bonds

TYPE OF BOND	2018 PRICE CHANGE
BMO Mid Corporate Bond Index ETF - Canada	-2.66%
BMO Long Corporate Bond Index ETF - Canada	-5.40%
Vanguard Long-term Corporate Bond ETF - USD	-11.04%

Data Courtesy of *Bloomberg* LLP

The negative returns in 2018 shown above for various bonds in Canada and the United States is not surprising. As interest rates rise, bond prices fall because they are the reciprocal of each other.

For example, if an investor owns a bond with a 5% coupon and interest rates rise to 6%, the investor's bond has to drop in price until it equals the bond yielding 6%. People would sell the 5% bond to own the 6% bond to get the higher income.

Conversely, if interest rates fell to 4%, the investor's 5% coupon bond would jump in price because of the higher income they receive relative to the current market.

For our bond portfolios, price movement to us is irrelevant. That's because we buy most of our bonds at par or a discount to par and hold them to maturity. And since most of our clients have a 10 to 70-year time horizon, bond duration (the implied volatility of each bond) is meaningless.

And if you own a laddered bond portfolio, whereby the rung of each ladder represents a consecutive maturity date, say, for 10 consecutive years from 2019 to 2029, you really have nothing to worry about. If interest rates rise, there'll always be a bond maturing that can be rolled over into a higher coupon bond.

Meantime, the concerns over bonds are not the interest rates of these instruments but more about the financial quality of the company, especially with waning economic growth and higher interest payments facing corporations.

A December 31, 2018 article by Kate Duguid of Reuters notes that, "According to the Securities Industry and

Financial Markets Association, U.S. companies feasted on low interest rates in the decade since the financial crisis, leaving corporate balance sheets leveraged to the hilt with some $9.1-trillion of debt, almost double the 2007 total of $4.9-trillion.

Bonds from dozens of formerly high-quality issuers are already trading as though they were no longer investment grade.

Bonds from companies such as General Electric, Ford Motor Co., AT&T Corp., Kinder Morgan, CVS Health, General Motors Co. and Verizon Communications ranked among the weakest performers as calendar 2018 wound down.

Of the bottom 20 performers, 14 were triple-B rated, the lowest tier of investment grade. GE debt has been slashed to BBB+ (from AAA) which is just three steps above junk, and more than a third of GE's bonds are already trading at junk bond levels."

Investors, therefore, would be wise to start paying attention to a few debt metrics which we'll discuss further below in the newsletter. (See page 13 and 14).

Preferred Shares

TYPE OF PREFERRED SHARE	2018 PRICE CHANGE
Canadian Perpetual Preferred Shares	-7.57%
Canadian Variable Rate Reset Preferred Shares	-15.71%
BMO US Preferred Share Index ETF (in USD)	-11.01%

Data Courtesy of *Bloomberg* LLP

If you believe bond returns were bad in 2018, preferred share performances were worse. The reasons are three-fold:

- Falling interest rates (as we saw in late 2018) killed rate-reset preferred share returns
- It's a market for retail investors who were busy doing some tax-loss selling
- The preferred share market is illiquid. If the bids disappear, prices can collapse quickly.

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 1.89%, the 5% or so pickup in income is worth the risk as long as you don't trade them.

The quality of the companies that issue preferred shares, mostly banks, insurance companies and utilities, tend to be good so the payout should continue unencumbered.

Remember, though, preferred shares are "quasi-equity" so they trade like common shares and, depending on the direction of interest rates, can fall more than stocks.

For example, the Brookfield Asset Management Series 17 preferred share is a perpetual preferred, meaning it pays its 4.75% coupon in perpetuity, or as long as the company exists.

In 2008, this preferred share fell 62% to a low of $8.29 (par value is $25) and yielded 14%. In hindsight, this would have been a terrific purchase but it just illustrates how a lack of liquidity can move the price. In this case, it was more than the 40% that the stock market fell.

We continue to buy these securities but we manage the risk by ensuring that no more than 1/5 of any portfolio with fixed income is made up of these securities.

HOW TO CONSISTENTLY BEAT THE MARKET AND THE IMPORTANCE OF "ALPHA"

So, how was your performance in 2018? If you owned any index funds or Exchange-Traded Funds (ETFs), you would have had negative returns last year (see the table above on page 1).

We understand that these types of funds above are adequate for people who have neither the time nor the interest in building their own portfolios. The trade-off by doing so is that they will always earn the market return less investment management fees and they will never do better than the market.

And what they get in those index funds are of various quality: Good (Heico Corp., up 39% in 2018), mediocre (BCE Inc., down 5% in 2018) and lousy companies (General Electric, down 55% in 2018). So, why not just focus on the good and rule out the mediocre and lousy ones?

For those folks who can follow some investment discipline, they can do better than ETFs and index funds. In fact, they could actually have had positive returns last year (many of our clients did on their equity portion).

However, because no two of our client portfolios are the same, their performance numbers are different and that's why we don't show performance on our website.

You could have three investors who all started at the same time with the same investments but with one regularly adding money, one who was static (did nothing) and one taking money out in retirement. Their returns, therefore, would be completely different.

And since we don't manage mutual funds or pooled funds, we're not holding just one account, where showing performance would be easy. Instead, the portfolios have different asset mixes, different mandates and are customized to provide the performance goals for which the clients seek.

That said, we can still have a teaching moment here and illustrate a 30-stock portfolio of companies (we own them in aggregate but not all clients own them). Coupled with the right discipline, they have the potential to make solid, long-term returns.

Before we get to that, we have to bring in the lawyers to provide the usual disclosure that this is a hypothetical portfolio. We haven't owned the stocks for the entire 10-year period below so they're not indicative of our returns nor are there any guarantees that the performances below will continue in the future.

"The portfolio listed below contains hypothetical data. Specifically, returns of the portfolios represent hypothetical rather than actual returns. Hypothetical results differ from actual performance insofar as they have the benefit of hindsight in the selection of securities based upon their actual rather than prospective performance. The following hypothetical performance is for illustrative purposes only and is not a guarantee of future results. This is not a recommendation, nor an offer to sell or buy, the securities described herein."

When investing in the market, stock selection isn't primary. It is secondary. The characteristics of successful investing are:

1. **Make a plan and stick to it.**

Portfolio management is about investing mechanically, not emotionally. When making investments, it's important to leave your emotions at the door. For the average investor, they shouldn't buy a stock until they can answer these three questions:

→ Why are you buying the stock? Before you buy, provide at least 5 reasons why you consider this a good investment.

→ How does it fit in the portfolio? Is it correlated with other holdings? If so, don't buy it.

→ What are the risks? Before you buy, describe at least 5 risks that could ruin the investment.

By diligently paying attention to these three questions, you can reduce any potential disaster.

2. **Pay attention to correlation and concentration risk**

Buying yet another Canadian bank to go with the three you already own is not a good fit. This is known as correlation risk and it can be a recipe for disaster.

In 2008, it wasn't one Canadian bank that fell 40%, they all did. And if you drop 40% in one year, you have to make 67% to get back to break even.

For the Canadian banks, it took 5 years from their 2008 stock price lows to get back to break-even. That can ruin a number of retirement plans if investors have to wait another 5 or 10 years before they can retire, or if in retirement, can cause them to run out of money.

3. **Invest in businesses – don't trade stock prices**

Stock prices are irrelevant except on the day you buy it and the day you sell it. It's the same as your house – all that's important is the price you pay when you buy and the amount you receive when you sell. The rest of the time, the price is meaningless.

Many investors look at their portfolios daily. All this does, especially during a market correction, is get them emotional about how much money they're losing. On the contrary, I only look at my own portfolio once a year to ensure that everything is aligned and where I want it to be.

4. **Stop Trading**

Excessive trading can cause poor returns and / or a bad tax outcome. You don't want a lot of tax-loss carry-forwards because it means you're constantly losing money on your trading. Besides, active trading only saves for your broker's retirement, not yours.

A 2010 survey by *Dalbar* Inc. showed that the average turnover rate by Canadian equity fund managers was 120%, meaning that by October of that year, they had bought and sold every stock in their portfolio at least once. This excessive trading, together with the high fees, caused returns for 85% of the funds to underperform their benchmarks.

Instead, our historical turnover rate is less than 10% a year - on average, 3 out of 30 names may be sold in any one year. In 2018, the turnover rate was 0% because our stocks outperformed the market and there was no reason to sell.

Stop chasing yield

Some investors believe that buying a stock with a hefty dividend can't go wrong. Unfortunately, it can be cause for concern because the quality of the balance sheet may be in peril. For example, investors in AltaGas Ltd. (ALA CN) saw the dividend yield reach as high as 25% in 2018.

When the company's reported earnings growth wasn't as high as expected, the stock price descended rapidly to a low of $8.75 and the company cut its dividend 56% to $0.56, leaving investors with capital losses and lost income.

Another example would be buying a stock with a big yield but with no growth on the horizon. This is also a precarious investment because inflation can wipe out the earnings power of that income.

For example, RioCan REIT currently offers a 5.89% dividend yield. With the TSX Index dividend yield at 3.32%, it sounds like a great opportunity.

What is lost on some investors, however, is the dividend growth. The payment must be able to keep up with inflation or spending power will diminish. Also, the payout isn't a true dividend as the income is made up of portions of interest, return of capital and a taxable dividend.

In RioCan's case, the dividend was raised 2% last year. Using the "Rule of 72", whereby you divide 72 by the 2% yield, it will take 36 years for the income to double.

If the dividend grows 2% each year and, compared against the 250,000 or so publicly-listed stocks worldwide that grow their dividends an average of 7% a year, RioCan's payout policy is well below-average.

Instead, we prefer to own companies that grow their dividend annually in the 10% to 15% range. That means that we're doubling our income every 5 to 7 years, not every 36.

5. **Diversify Globally**

Studies have shown that long-term returns outside North America have been 1% to 2% better when compounded over a 20-year time horizon. That's because there's more going on outside the North American continent, especially given that its population is a mere 400 million, compared to the 8 billion or so that inhabit the planet.

Global diversification also helps keep correlation risk low. This is especially important for Canadians to consider as Canada's TSX stock market index is roughly made up of 35% financials and 35% resource companies.

6. **Diversify by industry**

There are two types of businesses – elastic and inelastic firms.

An elastic business is one that makes all its money in the good years and loses it all in the bad ones, netting out poor long-term returns for investors. These types of industries include steel, airlines, oil and gas and some industrials.

Conversely, inelastic businesses make money whether or not the economy is strong (in an expansion phase) or weak (during recessionary periods).

Inelastic businesses are industries such as consumer stocks, utilities, financials and healthcare companies. Whether or not the economy is strong or weak, people still have to buy their toothpaste, pay the gas bill, do their banking or buy their prescription drugs.

By design, we want 50% of our stocks to come from inelastic industries and we have little to no exposure in the elastic industries. We don't own any oil and gas stocks as our natural resource preference is to own water companies, those involved in waste water management, water purification and water irrigation.

7. **Diversify by size of company**

There are 3 sizes of companies based on their market capitalization: Large-Caps (over $20 billion in market cap), Mid-caps ($10 billion to $20 billion in market cap) and Small-Caps (under $10 billion in market cap).

We invest 50% of our stocks in large-caps. Most of their profits go toward paying the dividend which provides our clients with income.

The rest of the stocks are mid-cap and small-caps that pay a smaller, faster-growing dividend but that put more of their profits back into the business for future growth and capital appreciation and to help stay ahead of inflation. Combined, clients get a good blend of income and growth.

8. **Own companies with the best attributes**

In past newsletters, we've written about the importance of owning companies that generate consistently growing free-cash flow. This provides a company with financial flexibility and it can grow through both good and bad markets.

In our last newsletter, the second metric we discussed was comparing Return on Invested Capital to the Weighted Average Cost of Capital.

The importance of this metric is it can be used to see how much cash flow a company can generate relative to its peers.

If they make an ROIC of 15%, or 15 cents on every $1 dollar of invested capital and the cost of the capital is 6 cents, the excess 9 cents creates free cash flow that can be allocated in the best strategic manner. And if management is any good at allocating this capital, it should be reflected in higher profits, higher dividends and higher stock prices.

How Discipline may Lead to Outperformance

Armed with the disciplined strategy of the 8 points above, we can now illustrate our disciplined approach.

Below is a sample global model portfolio, showing total returns with dividends included less a 1% fee and compared against a global benchmark, the MSCI Global Index. The MSCI is a market-cap-weighted stock market index of 1,649 stocks from companies throughout the world.

We have shown each stock's total return for 2018, plus its 3, 5 and 10-year compounded returns from December 31, 2008 to December 31, 2018.

Compound Annual Returns

COMPANY	SYMBOL	1-YEAR RETURN	3-YEAR RETURN	5-YEAR RETURN	10-YEAR RETURN
A.O. Smith	AOS US	-23%	+4%	+17%	+27%
Balchem Corp.	BCPC US	+6%	+9%	+12%	+18%
Becton Dickinson	BDX US	+16%	+15%	+23%	+16%
Chubb Ltd.	CB US	-2%	+5%	+12%	+13%
CN Rail	CNR CN	-1%	+11%	+13%	+18%
Coloplast A/S	COLOB DC	+30%	+15%	+15%	+25%
Cognex Corp.	CGNX US	-31%	+31%	+21%	+29%
Danaher Corp.	DHR US	+21%	+14%	+18%	+18%
Dassault Systemes	DSY FP	+22%	+14%	+20%	+20%
EssilorLuxottica	EL FP	+1%	+1%	+10%	+13%
Femsa	FMX US	+1%	-1%	+4%	+14%
Halma plc	HLMA LN	+12%	+12%	+19%	+23%
HDFC Bank	HDB US	+2%	+19%	+32%	+24%
Heico Corp.	HEI US	+39%	+40%	+28%	+28%
Intertek Group plc	ITRK LN	-4%	+16%	+10%	+21%
Jardine Matheson	JM SP	+17%	+15%	+8%	+17%
Lindsay Corp.	LNN US	+20%	+11%	+10%	+14%
Littelfuse Inc.	LFUS US	-5%	+17%	+19%	+29%
Lindt & Sprungli	LISP SW	+12%	+1%	+14%	+16%
NextEra Energy	NEE US	+24%	+21%	+25%	+18%
Novo-Nordisk NV	NVO US	-4%	-5%	+12%	+20%

Data Courtesy of *Bloomberg LLP*. All performance numbers are in Canadian dollars and are compound annual rates of return. The portfolio return is net of a hypothetical 1% fee. Also, there are no trading costs or taxes incurred.

Compound Annual Returns					
COMPANY	SYMBOL	1-YEAR RETURN	3-YEAR RETURN	5-YEAR RETURN	10-YEAR RETURN
Novozymes A/S	NZYMB DC	-14%	-2%	+7%	+13%
Paychex Inc.	PAYX US	+8%	+10%	+17%	+15%
Rollins Inc.	ROL US	+28%	+29%	+30%	+24%
Roper Technologies	ROP US	+13%	+12%	+20%	+22%
Stryker Corp.	SYK US	+11%	+20%	+23%	+17%
Thermo Fisher Scientific	TMO US	+28%	+16%	+21%	+23%
Toromont Industries	TIH CN	-1%	+22%	+17%	+17%
TD Bank	TD CN	-5%	+12%	+10%	+16%
Unilever NV	UN US	+7%	+10%	+15%	+13%
Portfolio Total Returns		+7%	+12%	+16%	+18%
MSCI Global Index Benchmark		-0.2%	+6%	+10%	+11%
Alpha (difference)		+7%	+6%	+6%	+7%

Data Courtesy of *Bloomberg LLP.* All performance numbers are in Canadian dollars and are compound annual rates of return. The portfolio return is net of a hypothetical 1% fee. Also, there are no trading costs or taxes incurred.

The Importance of "Alpha"

For example, the 2018 portfolio return was 7% net of a 1% fee in Canadian dollars, compared to the MSCI's return of -0.22%. The difference between the returns is known as "Alpha". In 2018, the Alpha was 7.22%.

An old axiom is that if the portfolio manager can beat their benchmark by 2% a year (after fees), then you've got a good portfolio manager.

In this sample, having a consistent Alpha of 6% or 7% over the years is huge. Using the 10-year return metrics, the sample portfolio grew at 18% a year, meaning it doubled in value every 4 years. This compares to the MSCI at 11% which doubled every 6.5 years.

In the one-year column, you can see that 10 of the 30 stocks were down in 2018. This means that to be successful, not every stock has to be up every year. Some of the winners helped pull along the losers, allowing a potential investor to be patient and stay invested in all the stocks.

As long as the financial metrics are sound, a stock that is down one year usually goes up in the following year.

Dealing with Debt on the Balance Sheet

> "We take seriously the '3 Ds of investing' – Debt Doesn't Disappear."

At Liberty, we take seriously the "3 Ds of investing" - Debt Doesn't Disappear. Debt-loads have often been one of the biggest reasons why companies go bankrupt and why we're never tempted to own companies that carry a large amount of it.

For this article, we'll look at a few metrics we use to help you understand the debt / credit profile of companies. As examples, we'll use industrial conglomerates Danaher Corp. (a company that we own) and General Electric (one that we don't own).

The metrics include:

- Debt Distribution – How is the debt spread out? What is the company paying on that debt? What is the average debt to maturity?
- Debt-to-Cash Flow – How quickly can a company pay down its debt?
- Net Interest Coverage – Can a company make its interest payments?
- Credit Rating - What is the company's credit rating? Is the short-term rating stable or negative?
- What's the debt-to-equity ratio? What's the quality of the balance sheet?

Debt Distribution

A company's debt distribution is important because it doesn't want all its debt coming due during a recession when profits are lower and they can't make good on the principal payments. Also, if all the debt comes due during a time of higher interest rates, the firm may not be able to roll over their debt, forcing them to sell assets at an inopportune time.

In the table below, we've chosen to highlight the debt distribution table of Danaher and General Electric.

In Danaher's case, the debt load is reasonable. Its debt-to-equity ratio is just 40%, below the 60% norm for industrial companies. On the other hand, with a debt-to-equity ratio of over 200%, General Electric's debt-load is excessive.

While the debt is spread out over a longer time-frame than Danaher, a good proportion of it is due in the next 5 years at a time when it is struggling to turn a consistent profit and as the economy shows signs of slowing.

Because its debt rating is lower, (See the table on page 14), General Electric must pay a higher interest rate on its debt. Therefore, more of the profits are being paid to the bondholders, leaving less income to be used for business growth.

Debt Distribution			
COMPANY	TOTAL DEBT (BILLIONS)	WEIGHTED AVERAGE FIXED COUPON	WEIGHTED AVERAGE YEARS
Danaher Inc	$7.253	1.93%	6.66
General Electric	$111.184	3.98%	9.17

Data Courtesy of *Bloomberg LLP.*

Debt to Cash Flow

This ratio can be used to determine how long it would take a company to repay its debt if it devoted all of its cash flow to debt repayment. Cash flow is used rather than earnings because cash flow provides a better estimate of a company's ability to pay its obligations.

We prefer to own companies that have a debt-to-cash flow ratio of 2 times or less. If recessions last 2 years, a company could pay off all its debt. Essentially, it allows them to stay focused on the future and, during a weaker economy, take advantage of any acquisition opportunities.

Those that have a higher debt-to-cash flow ratio (such as greater than 4 times) must spend inordinate amounts of time dealing with their bankers to ensure they aren't breaking any covenants and causing debt to be called.

It's easy to see that General Electric's debt-to-cash flow ratio at almost 11 times is way too high (see the table below). Since that ratio has been greater than 4 times for each of the past 10 years, investors had a red flag staring them in the face for the past decade and they should have sold this stock before its price fell further.

Net Interest Coverage

The interest coverage ratio is a debt and profitability ratio used to determine how easily a company can pay interest on its outstanding debt. The interest coverage ratio may be calculated by dividing a company's earnings before interest and taxes (EBIT) during a given period by the company's interest payments due within the same period

Essentially, the interest coverage ratio measures how many times over a company could pay its current interest payment with its available earnings. It measures the margin of safety a company has for paying interest during a given period, which a company needs in order to survive any financial hardship that may arise. A company's ability to meet its interest obligations is an aspect of a company's solvency, and is thus a very important factor in the return for shareholders.

Generally, an interest coverage ratio below 2.5 is often considered to be a warning sign, indicating that the company should be careful not to add more debt.

In Danaher's case, its net interest coverage ratio is a very safe 20 times. Meantime, General Electric had a coverage ratio of 11 times in 2014 but it has since turned negative – another warning sign after 2015.

Credit Rating

The higher a company's credit rating, the safer the company's perceived fortunes. The highest rating possible is AAA, held by few companies (Johnson & Johnson is one such firm). Both companies below have investment-grade credit ratings, but General Electric's has been cut multiple times from its once AAA rating, with some of its bonds trading like junk (below BBB).

Debt-to-Equity Ratio

The Debt/Equity (D/E) Ratio, also referred to as the "gearing" ratio by international companies, is calculated by dividing a company's total liabilities by its shareholder equity. These numbers are available on the balance sheet of a company's financial statements. The ratio is used to evaluate a company's financial leverage.

A high debt/equity ratio is often associated with high risk; it means that a company has been aggressive in financing its growth with debt.

In Danaher's case, the debt load is reasonable. Its debt-to-equity ratio is just 40%, below the 60% norm for industrial companies. General Electric, on the other hand, has an excessive debt load, with a debt-to-equity ratio of over 200%. This usually is another warning signal that assets may have to be sold to pay down the debt and keep the company solvent.

Metrics

COMPANY	DEBT TO CASH FLOW	NET INTEREST COVERAGE	CREDIT RATING	DEBT TO EQUITY
Danaher Inc	2.00	20.11	A	39.9%
General Electric	10.66	-16.02	BBB (High)	209.5%

Data Courtesy of *Bloomberg LLP.*

People seeking to do their own investing must always consider leverage and debt loads before deciding on whether or not the investment is worthwhile.

From the numbers in the tables above, it's easy to discern the difference between a quality asset (Danaher) and one that is facing considerable economic challenges (General Electric).

We've had a 20% correction. Aren't you interested in spending the remaining cash?

In the past few weeks, we've heard from a number of people (all men, unsurprisingly, as they tend to gamble more) about whether or not to add money to the market. "Is it time to go all in or even just nibble a bit?" Or, "Aren't you tempted to jump in and buy some oil and gas stocks?"

Sadly, that's the voice of a gambler or speculator, not an investor. There isn't much rationale in their judgements because they're listening to the noise and not thinking of the structure of the portfolio or the goals of what it's supposed to accomplish.

When we look at prospective client portfolios, it's not surprising, therefore, that they usually hold between 50 and 100 stocks, not 30 names, a sure sign of habits that aren't disciplined.

They fail to understand that in the past 100 years of stock markets, roughly two-thirds of returns have come from dividend growth and the re-investment of those dividends, not stock prices.

And to answer the question, we're not nibblers. We're investors.

I bought Littelfuse, Cognex, A.O. Smith, et al on your recommendation. Why are they going down?

The first question an investor has to ask themselves is, "Is it the business itself that is the problem or is it the market in general?"

Of the companies listed above, there's nothing wrong with the fundamentals. They're still growing earnings and raising their dividends faster than the average company.

The stocks went down because the market itself, in our opinion, was overvalued and we were due for a correction.

Secondly, the three stocks named above are small-caps. They usually do better than the market when it goes up and worse than the market when it goes down. When investing in such small-caps, investors have to have greater patience as they will always be more volatile than larger companies.

During the 2008 financial crisis and the recovery in 2009, the price performances of some of our small-cap stocks were:

COMPANY	2008 PERFORMANCE	2009 PERFORMANCE
Kingspan Group plc	-70%	+92%
Lindsay Corp.	-55%	+25%
Littelfuse Inc.	-50%	+94%
Raven Industries	-37%	+31%
Graco Inc.	-36%	+20%
Heico Inc.	-29%	+14%
Cognex Corp.	-27%	+20%
A.O. Smith	-16%	+47%

Data Courtesy of *Bloomberg LLP.*

When investing in small-cap stocks, a strong stomach is required but, over time, the rewards should be greater than the risks.

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.