

MARKET UPDATE

Q1 | January 1 to March 31, 2019

IN THIS ISSUE:

- 1 Year-to-date performance for stocks and bonds
- 4 How do I invest when the yield curve is flat?
- 7 **Fun with Math:** Why investing is all about the dividend income, not the stock price
- 10 **Client Q&A:** David Driscoll answers your questions.

YEAR-TO-DATE PERFORMANCE

The Markets – January 1 to March 31, 2019

Equity Markets

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

Q1 2019 Returns

COUNTRY	STOCK INDEXES	TOTAL RETURN (with dividends re-invested in native currency)	TOTAL RETURN (with dividends re-invested in Canadian Dollars)
China	Shanghai Composite	+23.94%	+24.50%
Canada	S&P/TSX	+13.26%	+13.26%
United States	S&P 500	+13.65%	+11.50%
MSCI Global Index	MSCI Global Index	+12.63%	+10.51%
Australia	S&P / ASX 200	+10.86%	+9.60%
Europe	Stoxx 600	+13.26%	+8.88%
Brazil	Ibovespa	+8.56%	+5.65%
India	S&P BSE Sensex 30	+6.88%	+5.57%
Japan	Nikkei	+6.81%	+4.36%
Mexico	Mexican Bolsa	+4.23%	+3.38%

Data Courtesy of Bloomberg LLP

In the table above, the two leading stock markets through 2019's first quarter were China and Canada. Both were market laggards last year so it's just evidence that what goes down in one year may recover in the next as stock valuations may appear more attractive. Last year, Brazil was the leading index but, through the first quarter, it's now just the 7th best market performer.

For China, the recovery was caused by the potential for a resolution to the trade and tariff issues between it and the United States. For Canada, it was the recovery in oil prices.

At Liberty, we were about 2% ahead of all equity benchmarks in the quarter on a price basis, allowing us to continue to hold our cash and not feel pressured to be fully invested.

Equity markets pivot on changes in central bank policies

So, what caused the turnaround in stock market performances after a 20% correction last fall?

From the recent Goldman Sachs quarterly conference call, "We saw central banks pivot to an accommodative policy on rates."

"In the U.S., the Fed shifted from its prior path of incremental tightening to a more neutral stance. In Europe, the ECB signaled a move back to monetary stimulus. Central banks in Asia also shifted to more dovish rhetoric amid a backdrop of low inflation and somewhat disappointing growth."

"The net result was a lower volatility environment as government bonds rallied and yield curves flattened in the U.S. and Europe. With the VIX and other measures of volatility at near-record lows, trading activity remained low."

"Second, we (Goldman) saw a significant slowdown in IPO activity as a direct result of the government shutdown, which weighed on sentiment and kept

issuers and investors on the sidelines. Despite the rebound in equity and credit markets, we saw lower client conviction. Third, ongoing geopolitical risks, including the U.S. China trade and Brexit negotiations added uncertainty."

"Our institutional investing clients appeared less cautious in March. And as we engaged with corporate clients around the world, we continue to hear a strong desire to execute strategic transactions and access the capital markets while the economy is growing, market prices are favorable and financing markets are open."

As interest rates fell, the "risk-on" strategy came back to the fore and stock markets reacted with a quarterly return that usually resembles a full-year's performance.

Other influences on stock markets and stock prices included:

- Share buybacks, or what we call "Smoke and Mirrors"
- Asset sales
- Accounting games

Smoke and mirrors with share buybacks

Many companies have helped boost their earnings by retiring or buying back their own shares in the market. For example, if a firm has 1 million shares outstanding and their profits are \$10 million, the earnings per share is \$10.00.

If that company buys back 10% of its outstanding shares, the earnings per share rises to \$11.11, making it appear that profitability has improved.

For Bank of America (BAC), its diluted shares were down 7% compared to the first quarter of 2018 and down 1.5 billion shares in the past four years.

In its 2019 first quarter report, earnings were \$0.70 and beat the Street estimate of \$0.66 a share by \$0.04. If not for the share buybacks, BAC's earnings per share (EPS) would not have bested expectations.

How asset sales saved the day

Omnicom Group Inc., an advertising and corporate communications company, reported in its latest quarter that organic growth was 2.5% and was in line with its internal targets. Its operating profits and EBITDA margins of 13% for the quarter exceeded its expectations.

However, the improved performance was attributable to a number of factors, including the continuing benefits from Omnicom-wide cost cutting initiatives, the impact of dispositions completed in 2018 and a small gain from a few additional dispositions completed in the first quarter of 2019.

In the near-term, companies can cut costs to help support profits but it can't do it forever. Unfortunately for Omnicom and its competitors in the advertising space, demand and prices have fallen as lower digital advertising revenues replaced higher income from TV ads or magazine / newspaper promotions. There is only so much cost-cutting that can occur before a business loses its ability to compete.

Or, as Warren Buffett says, "If you can raise prices without your customer putting up a fuss, that's a very good business. If you have to have a prayer meeting before raising prices, that's a very bad business." And if you have to consistently cut costs to compete, you won't stay in business for long. We do not own any advertising stocks.

Accounting games: Cash is real, earnings are artificial

For Johnson & Johnson's first quarter, net earnings were \$3.7 billion and diluted earnings per share was \$1.39 versus diluted earnings per share of \$1.60 a year ago. Sounds dismal, doesn't it? But here's where the accountants get to play with the numbers and turn a bad situation into a positive one.

Excluding after-tax intangible asset amortization expense and special items for both periods, adjusted net earnings for the quarter were \$5.7 billion, and

adjusted diluted earnings per share was \$2.10, representing increases of 0.5% and 1.9%, respectively, compared to the first quarter of 2018. On an operational basis, adjusted diluted earnings per share grew 5.8%.

The Securities and Exchange Commission (SEC) in the United States has ruled that adjusted earnings are allowed as long as the company explains how those adjusted earnings were calculated. Naturally, given enough leeway, companies have taken advantage of easier rules than GAAP (Generally Accepted Accounting Principles).

That's why it's important for investors to focus on free cash flow, not earnings. Cash is real while earnings can be manipulated a number of ways to tell a positive story when it clearly isn't.

Markets are still expensive

Depending on who you talk to, if the historical norm for Price / Earnings ratios is 15 or 16 times, the table below suggests that markets are still expensive.

STOCK EXCHANGE	CURRENT P/E RATIO	P/E RATIO BEFORE ADJUSTED EPS
Canada	18.51	22.23
United States (S&P 500)	19.12	21.67
Europe	17.81	17.66
MSCI Global Index	17.76	19.29

Data Courtesy of Bloomberg LLP

As a result, we're still holding 20% cash x the equity weight in each client's portfolio. Currently, the S&P 500 Index is at 2905. If it rises to 3700, or 27% higher, it will be our signal to raise more cash. That higher valuation of 3700 is the equivalent of market peaks in 1929 and 2000.

If the S&P 500 Index drops to 2000, or 31% lower from here, we'll probably start to allocate the cash, as a 31% drop may be considered as investor panic and capitulation.

Bond Markets

10-Year Bond Yields				
COUNTRY	COUPON	PRICE	CURRENT YIELD	YEAR-TO-DATE PRICE CHANGE
Emerging Markets				
Argentina	5.88%	\$75.24	10.22%	+4.14%
Mexico	4.50%	\$103.37	4.09%	+3.77%
Turkey	6.13%	\$91.69	7.35%	-2.51%
Brazil	12.25%	\$157.832	10.22%	-2.22%
Russia	4.38%	\$99.80	4.40%	+4.91%
Indonesia	4.75%	\$106.86	3.90%	+5.08%
Greece	3.88%	\$103.60	3.44%	+4.52%
China	3.25%	\$99.77	3.28%	+1.30%
Developed Markets				
United States	2.63%	\$101.05	2.49%	+1.95%
New Zealand	3.00%	\$109.08	1.99%	+2.99%
Australia	3.25%	\$112.33	1.90%	+8.18%
Canada	2.00%	\$102.43	1.71%	+2.11%
United Kingdom	1.63%	\$104.73	1.10%	+1.44%
Germany	0.25%	\$102.56	0.24%	+2.42%
Japan	0.10%	\$101.59	-0.06%	+0.50%

Data Courtesy of Bloomberg LLP

As interest rates have dropped since the beginning of the year, bond prices have risen. In the chart above, only Turkey's (down 2.5%) and Brazil's (down 2.2%) 10-year bonds have fallen in price, thanks to higher risks associated with their countries' economies.

The implications of a flattening yield curve

To begin, a flat yield curve is one where there is little difference between short-term and long-term rates for bonds of the same credit quality. This type of yield curve is often seen during transitions between normal and inverted curves. The difference between a flat yield curve and a normal yield curve is that a normal yield curve slopes upward.

A flattening yield curve may be a result of long-term interest rates falling more than short-term interest rates or short-term rates increasing more than long-term rates. A flat yield curve is typically an indication that investors and traders are worried about the macroeconomic outlook. One reason the yield curve may flatten is market participants may be expecting inflation to decrease or the US Federal Reserve to raise the federal funds rate in the near term.

From a *Bloomberg* article from June 25, 2018, "There are lots of theories and no shortage of factors. On one hand, the Fed steadily increased short-term rates in response to the economy growing at a moderately strong pace."

"At the same time, America's trade spats and concerns about growth outside the US is helping to keep a lid on long-term yields, which have retreated from multi-year highs."

"Two other possible reasons: Pension funds and insurers have developed an insatiable demand for long-term, high-quality bonds, and the European Central Bank (ECB) and Bank of Japan continue to have loose monetary policies. Both of those developments drive down those yields."

What should investors do with the flattening of the yield curve? Two strategies are prudent:

- Maintain a laddered bond portfolio.
- If the yield curve inverts, prepare for a recession. Have cash available.

Why we prefer to own a laddered bond portfolio

A laddered bond portfolio consists of bond holdings with different maturity dates, usually by calendar year that last for at least 10 years. The table below is a sample of what a laddered bond portfolio would look like.

Note: We own these bonds and are holding them to maturity but they're not worth buying today as the high coupons will reflect a high bond price. We rarely buy bonds at a premium. It's better to buy them at par or a discount to par.

COMPANY	COUPON	MATURITY DATE
TransAlta Corp.	6.40%	November 18, 2019
Wajax Corp.	6.13%	October 23, 2020
Cascades Inc.	5.50%	July 15, 2021
Gibson Energy	5.38%	February 1, 2022
Staples Inc.	4.38%	January 12, 2023
Ingram Micro	4.95%	December 15, 2024
Videotron Ltee.	5.63%	June 15, 2025
Open Text Corp.	5.88%	June 1, 2026
Citigroup Inc.	5.16%	May 24, 2027
Canadian Tire Corp.	6.38%	April 13, 2028
Delamare Finance	5.55%	February 19, 2029

Data Courtesy of Bloomberg LLP

For example, if you have bonds maturing every year from 2019 to 2029, that would be considered to be a laddered bond portfolio (each maturity date would be similar to the rungs on a ladder).

If interest rates rise, the proceeds from the maturing TransAlta 2019 bond can be rolled over to buy a bond that matures in 2030 and pays a higher coupon.

This protection is known as “immunization”. Think of it as a flu shot against rising interest rates.

If interest rates fall, not all of your money will have to be rolled over at a lower interest rate. The laddered bond portfolio protects you against re-investment rate risk if you keep the investment values the same.

For example, if you have \$100,000 to invest, buy \$10,000

each in these 10 bonds, not \$100,000 in one bond. Otherwise, a drop in interest rates at maturity on the latter approach will leave you with a lower rate to re-invest and lower income.

Some pundits may argue that the bond portfolio duration may be too high during a time of rising interest rates. However, the interest earned on each bond provides capital for re-investment which would help ease the risk of a longer duration.

And since our clients have holding periods from 20 to 70 years, the argument about duration risk becomes moot.

Instead of constantly trading bonds and incurring commissions and other brokerage costs, owning a laddered bond portfolio is the most prudent and cheapest way to deal with interest rate risk.

What if we go into recession?

Recessions are often caused when the yield curve inverts: Short-term interest rates move higher than long-term rates. Think of a comparison between the 2-year government bond yield versus the 10-year yield. If the 2-year yield was, say, 4% and the 10-year yield was 3%, the yield curve would be inverted.

Corporations tend to borrow at short-term rates to operate their businesses. If short-term rates are too high, companies will then let go of workers, cut back on research and development and refrain from making acquisitions, leading to a recession, deemed to be two quarters of negative growth. Recessions usually last from 18 to 24 months.

For individuals, the net result is that unemployment rises and income falls. For investors, stock markets can fall anywhere from 20% to 40%. We saw the latter in 2008, the last recession on record. During that time, it was helpful to hold some cash on the sidelines – we held 20% cash in our portfolios in 2008.

Investing is all about the income

Roughly two-thirds of all investment performance in the past 100 years has come from dividends and the re-investment of those dividends. That's why investing is all about the income (dividends).

Many investors have been brainwashed by banks and brokerage companies to believe that trading stocks is the way to fame and fortune. They prey on the investor's emotions by providing them with up-to-the-minute stock prices and bombard them with macro and micro-economic news items that cause investors to get emotional and buy and sell without thinking why they do so. The message is that capital gains through trading stock prices is the only game in town and the only way to get rich.

“
The faster
dividends grow,
the richer you
get and the
faster you get it.
”

The Monte Carlo Simulation and Retirement Planning

Monte Carlo Simulations are named after the gambling hot spot in Monaco, since chance and random outcomes are central to the modeling technique, much as they are to games like roulette, dice, and slot machines. The technique was first developed by Stanislaw Ulam, a mathematician who worked on the Manhattan Project, the team that developed the first hydrogen bomb.

The simulations are a broad class of computation algorithms that rely on repeated random sampling to obtain numerical results. Monte Carlo methods are mainly used in three problem classes: Optimization, numerical integration and generating draws from a probability distribution.

Eventually, Monte Carlo simulations were used in financial analysis for both retirement planning and evaluating the present value of a stock price. For this article, we're only interested in the former, retirement planning.

We start with a number of inputs:

- The investor's age
- The value of their investable assets (not including their home)
- Their asset mix
- Their tax bracket
- Their expenses in retirement
- The inflation rate

The Monte Carlo Simulation, using 100 years of stock and bond market data, provides a probability to age 95 of whether or not an investor may run out of money in their lifetime.

The gist of this discussion is that if an investor drew down 5% of their investable assets in retirement, they shouldn't run out of money in their lifetime.

Or, you could flip the 5% upside down and use the reciprocal (20 times) to determine how much money an investor might need to live on in retirement.

If they plan to spend \$100,000 gross, they'll need \$2 million in investable assets ($\$100,000 \times 20 = \$2,000,000$). Or, the reciprocal ($\$2 \text{ million} \times \text{a } 5\% \text{ drawdown} = \$100,000 \text{ gross income}$).

However, this isn't a tried-and-true exercise - it's not a rule-of-thumb. There are a number of caveats that must be considered if an investor retires at 55 and lives to 95. That's a long time horizon to expect that the Monte Carlo Simulation will always be correct.

The caveats include:

- Using the wrong inputs –if the input data is errant, the output will also be wrong – remember the axiom “Garbage In / Garbage Out”
- Changes in circumstances (health, early death of an individual or their spouse)
- Changes in historical inflation numbers
- Gifting money to heirs or charities before death
- Retirement begins in the year when a stock market collapses, like during the financial crisis in 2008

So, where does that 5% drawdown come from to create the opportunity for retirement bliss? No doubt, most investors may think it would come from the growth in the capital, which is why many fall victim to

the messages pushed by the bankers and brokers.

Instead, that 5% should come from the growth in the dividends. That's why we always say, “It's all about the income.”

It's all about the Income

My first revelation was in high school, when I learned the following formula: $(1 + r)^n$. This is the formula for time and compounding, or the future value of an asset, where R = the rate of return and N = the number of years.

For example, if I have \$1,000 to invest and buy a 6% GIC for 5 years, how much money will I have in 5 years? The answer is $1.00 \times 1.06 \times 1.06 \times 1.06 \times 1.06 \times 1.06$, or \$1,338.23.

This is also how the Rule of 72 came about. If you take 72 and divide by 6%, it will tell you how many years it will take to double your money (12). It all comes from this formula.

My next revelation came early in my investing career when I began to understand the importance of free cash flow and how companies that generate consistently growing free cash flow can raise their dividends at a faster rate.

Remember, dividends are the piece of the profits that shareholders receive each year. Irrespective of stock price movement, the faster dividends grow, the richer you get and the faster you get it.

Of the 250,000 or so publicly-listed stocks worldwide, the average annual growth rate of their dividends is around 7%. In 2018, Liberty portfolios had stocks that raised dividends an average of 16% and in 2019, the dividends are expected to rise about 11%.

The average dividend yield (dividend divided by stock price) is currently about 2% so we'll use that as our starting point.

The table below shows the importance of the higher growth rates.

GROWTH RATE OF DIVIDENDS FROM A CURRENT YIELD OF 2%		
YEAR	GROWING 7% ANNUALLY	GROWING 10% ANNUALLY
0	2.00%	2.00%
1	2.14%	2.20%
2	2.29%	2.42%
3	2.45%	2.66%
4	2.62%	2.93%
5	2.81%	3.22%
6	3.00%	3.54%
7	3.21%	3.90%
8	3.44%	4.29%
9	3.68%	4.72%
10	3.93%	5.19%
11	4.21%	5.71%
12	4.50%	6.28%
13	4.82%	6.90%
14	5.16%	7.59%

Data Courtesy of Bloomberg LLP

If an investor bought a global index fund today with a 2% dividend yield and didn't add more money, it would take 14 years at a 7% annual dividend growth rate to reach the dividend-at-cost yield of 5.16%.

On \$1,000,000 invested in 2019, they would be paid \$51,000 in annual dividend income in 2033, irrespective of stock price movement. As long as the company stays in business, dividend payments are the only guarantees that investors have.

If the dividends grew at a faster rate (10%) as the right column suggests, the investor would reach that 5% yield in just 10 years, not 14 years.

Some may ask if the 10% annual increase is sustainable and the answer is yes. That's because most

companies that generate growing free cash flow tend to pay out only one-third of their free cash flow each year in the form of a dividend so there's a long runway to keep raising the dividends by 10% a year.

Next, we're going to combine the dividend growth with the stock price of a quality free-cash flow company (CN Rail).

For example, CN Rail's dividend has risen four-fold in the past decade from \$0.51 a share to its current \$2.15 a share. If an investor had bought 1,000 shares in 2009, they would have been paid \$510 in income. Today, they'd receive \$2,150.

However, if the stock price was \$20, the dividend yield would be 10.75%. At this rate, investors would pile into the stock, knowing that the dividend was safe and that it was growing by 10% to 20% a year. That's why it now trades at \$125.40 and yields 1.7%.

As the dividends grow over time, so should the stock price.

Growing income leads to better performance but also capital preservation

The chart on the next page shows CN Rail's 15-year performance. The grey bar is the annual growth in the dividend. The stock price movement is shown in blue. The total return (price + dividends) is shown in orange.

On April 12, 2004, CN's shares traded at \$13.49 a share. It paid an annual dividend of \$0.195. The starting dividend yield was 1.4%.

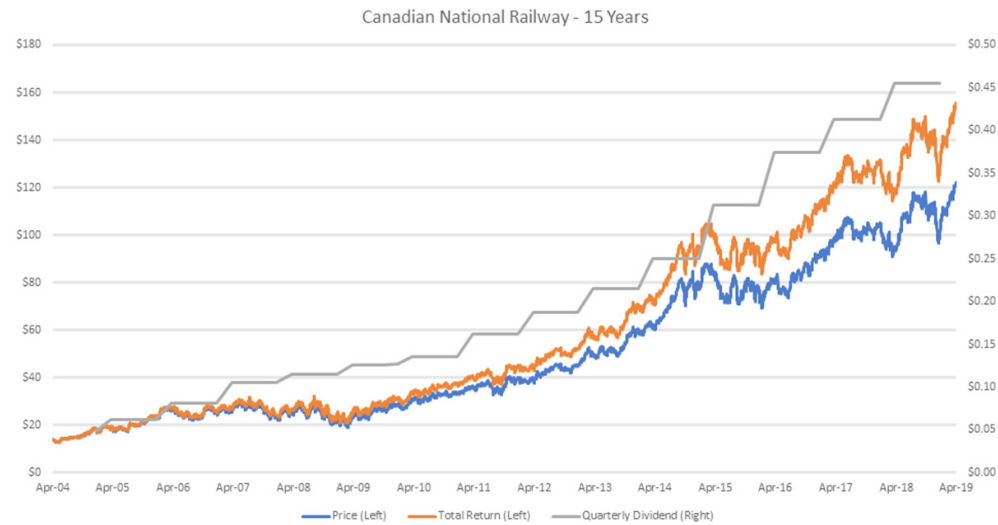
Today, 15 years later, the dividend yield at cost is 15.94%, meaning that investor will make 15.94% on the original investment plus or minus any movement in the share price.

As time passes, the total return versus the stock price widens. That difference is the dividend compounding.

If the stock goes up 10%, the investor makes 26% for the year (10% plus 15.94%) which is great. More

importantly, if the stock goes down 10%, the investor still makes 5.94%. That's how you can have a positive return, even if, like last year, stock market returns were negative.

In other words, dividends help enhance your returns in the good years and provide downside protection and capital preservation in the bad ones.



Think of Warren Buffett's first purchase of Coca-Cola stock in the 1950s. After 60 years of dividend growth, the millions in dividends he receives help

fund Berkshire Hathaway's future acquisitions. The dividend yield is so high the price movement no longer matters - it's a good thing as Coke stock has been a laggard over the past 15 years, up only about 4% annually since 2004.

For Liberty clients, once the dividend yield-at-cost reaches 5% (some are already there), they can draw down the income in retirement without having to touch the capital, the latter which becomes an estate planning issue for future generations or for philanthropy purposes.

It's also why we don't actively trade stocks and why we're investing in businesses. Trading stocks is like constantly hitting the reset button on your dividends and income. Investors never make money by trading because they give up the most important aspect of investing for retirement – dividend growth.

CLIENT QUESTIONS

Why don't you show your past performance on the website?

As I wrote in the December 2018 newsletter, past performance is effectively irrelevant for new clients. You can look at anyone's past performance, and, while it may indicate a few trends during that time, there's no way to predict what their future performance may be. There are three reasons why we're not currently showing our performance:

First, the Law of Diminishing Returns may raise its ugly head. For example, a portfolio manager may start out overseeing, say, \$50 million in assets. By year 10, however, they may be managing \$1 billion and performance numbers will change dramatically.

With the passage of time, the big performance numbers in the early years should get smaller. With more assets under management, especially in Canada, these managers' performances become more like the market. That's why we are global investors. We don't wish to be stuck owning all the Canadian banks, insurance companies, telecoms and utility stocks.

This has even happened with Warren Buffett. You'll see huge returns at Berkshire Hathaway in the 1970s and 1980s while he was still relatively small. This past decade, however, his performance has essentially mirrored that of the S&P 500 Index.

Second, when a portfolio manager moves from one firm to another, they are not allowed to use their past performance figures in the marketing at their new

What keeps you awake at night?

Three things currently keep me awake at night:

- Hyperinflation
- Deflation
- Heightened volatility.

firm. That's a regulatory law.

In our case, the Ontario Securities Commission prohibits marketing ads showing returns at a previous firm. They believe those numbers would be misleading and are not reflective of the new firm which has new clients, new mandates and a new time horizon.

While managing money at a previous firm from 1998 to 2014, my performance numbers related to the clients at that firm, not at Liberty.

Third, our client portfolios aren't part of a pooled fund or a mutual fund, whereby the firm manages just one account, making performance easy to show.

We prefer to customize our portfolios to help the clients reap the benefits of better tax efficiency and lower fees. We have over 250 clients, none of whom owned the same portfolios nor had the same performance numbers.

I can go on until I'm blue in the face but we're doing what's best for the client to maximize their returns - lower fees, low turnover and companies with above-average financial metrics that have proven themselves again and again throughout my 40-year career.

With any manager, it should always come down to your comfort level with the investment philosophy. And like any marriage, a leap of faith is required. The same applies when hiring a doctor, dentist or lawyer.

Hyperinflation

The 1970s was a bad time to be an investor as both stock and bond markets went down and stayed down throughout the entire decade as inflation peaked at 18%. For investors either in retirement or planning to retire in the next 10 years, this could cause a train

wreck that could derail plans in your later years.

We're now at a stage where the US economy is at full employment. What usually sparks inflation is an increase in wages and commodities, coupled with a drop in economic growth. A dearth in skilled workers can inch inflation higher as a sparse crowd increases demand.

A war could get commodity prices moving again as could a drop in the US dollar as commodities are valued in US dollars.

The only investment instruments that can help offset inflation are inflation protected bonds. For clients with fixed income mandates, 5% of their portfolios are US Treasury Inflation Protected bonds (TIPs) and Government of Canada Real Return Bonds (RRBs).

Deflation

The last of the Baby Boomers reaches age 60 in 2024, just five years away. The biggest cohort in Western society will then be in retirement, turning from spenders into savers and potentially reducing economic demand.

If negative interest rates become the new normal – most of Europe and Japan are facing it today - the majority of the Western population (and also China), would see their personal spending power decrease, leading to a decline in living standards. Getting old won't be much fun.

To the right is a chart of interest rates in Germany and Japan.

Long duration bonds (30 years or more) would be the investment holding of choice. Earning a 5% coupon (agriculture stock Nutrien Ltd. just issued one in US dollars) would be preferable to paying the banks to hold your money and incurring a negative return.

Increased Volatility

What happens when companies stop buying back shares and a major stock market sell-off occurs?

From a February 14, 2019 article by David Milstead in The Globe and Mail: "The chief executive of the Canada Pension Plan Investment Board, Mark Machin, says he is often asked what could trigger the next financial crisis or stress point in the markets."

NEGATIVE INTEREST RATES IN EUROPE AND JAPAN		
RATE	GERMANY	JAPAN
Short-Term		
3-month	-0.36%	-0.07%
6-month	-0.27%	-0.08%
1-year	-0.53%	-0.16%
Long-Term		
2 years	-0.57%	-0.15%
5 years	-0.37%	-0.14%
7 years	-0.23%	-0.13%
10 years	+0.07%	-0.02%
30 years	+0.73%	+0.55%

Data Courtesy of Bloomberg LLP

"His answer: He worries about what might unfold if major institutions, having locked up large sums in long-term, illiquid investments, need to raise money quickly, as happened in the 2008-09 crisis."

"They would likely sell things that are quick and easy to dispose of, namely the publicly-traded stocks held by many smaller institutions and individual investors. And that would place rapid downward pressure on their prices."

"If you think about the incredible appetite for private investing around the world, and talk to the investors in private-equity funds, most of them want to increase their exposure to private equity – at a time when there's [US]\$3-trillion invested in private equity right now, by far a record," Mr. Machin said.

"At some point, a lot of funds need to pay their obligations or countries need money from their sovereign funds in moments of economic stress, and everything's locked up ... It's very difficult to get out of

that stuff in a reasonable time frame, so you have to sell the liquid stuff.”

If the above scenario plays out, market volatility could return with a vengeance, similar to October, 1987, when the stock markets lost 20% of their value in one day.

How to deal with volatility

Limit orders are an appropriate strategy to be the buyer of shares during a market panic and extreme volatility. Think of being one of 5,000 people in a gymnasium when the fire alarm goes off and there's only one exit. Pandemonium would ensue as it would be every person for themselves.

In situations like this, we have to hope that it's not the end of the world and use limit orders, also known as “stink bids” to buy shares at ridiculously lower prices. We used them after the terrorist actions of September 11, 2001.

The stock market was closed for 5 days after the attacks. Before the market opened, we put in a limit order on shares of Carnival Cruise Line. The thinking at the time was that nobody would want to own a cruise operator if terrorists could attack ocean-going vessels.

At the previous close, Carnival shares were around \$24. We put in a limit order at \$14 and, when the markets re-opened, panic ensued. By 10:30 a.m., all the bids had disappeared. Our order was then filled.

The stock finished the week at \$19, was at \$24 at the end of September and finished the year at \$28, a tidy 100% gain in just 3 months. That's how one takes advantage of investor capitulation.

Meantime, investors who used stop-loss orders on Carnival shares (say, a price 20% lower at around \$20) didn't get out at their expected price. When the bids disappeared, they were filled at the first available price (ours) at \$14 (a 42% loss, not a 20% loss).

Dealing with the extremes

In the end, we believe the most prudent strategy is to have a number of small bets in place in all investment categories to cover the bases and deal with whatever economic worries come our way.

If an investor or an investment firm makes a big bet and it goes the wrong way, the investor or the firm could be bankrupted. Google “Amaranth Capital” and learn how it became a riches to rags story almost overnight. During its peak, the firm had up to \$9 billion in assets under management before collapsing in September 2006, after losing in excess of \$5 billion on natural gas futures.

For bonds, a laddered bond portfolio. For preferred shares, some perpetual preferreds and some rate reset preferreds. For equities, a 30-stock, globally diversified portfolio of equal weights that pay rising dividends and that are not correlated with each other. And hold some cash just in case.

If you have any questions, let me know.

David Driscoll

President & CEO | Liberty International Investment Management Inc.

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