LIBERTY
International Investment Management

MARKET UPDATE

Q2 | June 30, 2019

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YEAR-TO-DATE PERFORMANCE

The Markets – January 1 to June 30, 2019

Equity Markets

2019 Returns at June 30			
COUNTRY	**STOCK INDEXES**	**TOTAL RETURN** (with dividends re-invested in native currency)	**TOTAL RETURN** (with dividends re-invested in Canadian Dollars)
China	Shanghai Composite	+28.47%	+23.55%
Australia	S&P / ASX 200	+19.69%	+14.51%
United States	S&P 500	+18.54%	+13.92%
MSCI Global Index	MSCI Global Index	+17.35%	+12.78%
Europe	Stoxx 600	+17.14%	+11.66%
Canada	S&P/TSX	+16.19%	+16.19%
Brazil	Ibovespa	+14.88%	+11.41%
India	S&P BSE Sensex 30	+9.29%	+6.36%
Japan	Nikkei	+7.53%	+5.66%
Mexico	Mexican Bolsa	+5.62%	+4.08%

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In the table above, the leading stock market through 2019's first half was China, although seven indexes posted double-digit returns.

China's rise, however, is a bit suspect. The market rally in this index came from the addition of Chinese stocks to the MSCI Global Index, coupled with the government's attempts to fund its way out of an economic quagmire. The biggest problem, however, that China faces is a slowdown in its population growth.

China isn't growing – it's in decline

A June 11, 2019 *Globe & Mail* article by John Ibbotson stated that, "China's birth rate is collapsing. A May report co-published by *Global Demographics* and *Complete Intelligence*, two private-sector forecasting firms, states that China has fallen off a "maternity cliff," with 2 million fewer births last year than the year before."

"As a result, the report concludes, the population of China will start to decline in 2024, five years earlier than previous estimates. At around the same time, the world's most populous country, at 1.4 billion souls, will fall to second place, behind India."

"In any case, the Low Fertility Trap, as it's called, dictates that at a certain point, people simply become accustomed to the idea of having one or two – or no – children. Rising living costs in crowded cities and increasing economic insecurity can also act as a drag."

"The only solution to population decline brought on by low fertility is immigration. This is what keeps Canada's and America's population growing despite a fertility rate of only 1.7, well below replacement rate."

Here are the other concerns that could negatively affect future stock market returns.

Trade Wars

According to *Bloomberg*, "It may feel as if the U.S. and China have been at odds forever, but Japan and South Korea have been feuding for much, much longer. They rekindled their animosity this week, as Japan restricted imports of some South Korean materials used to make chips and smartphone components."

"Japan's export restrictions follow similar volleys between China and the U.S., and lately Europe has become restriction-curious too. All of this comes as trade is already slowing down, threatening the health of the global economy. To the extent they muck with or eradicate supply chains, export restrictions could also send consumer prices higher."

Fastenal, the largest fastener distributor in North America, reported worse-than-expected second-quarter earnings and revenue on Thursday, July 10th. The company also particularly noted the damage the trade war has done to its business and the difficulty of countering the losses.

"While we successfully raised prices as one element of our strategy to offset tariffs placed to date on products sourced from China, those increases were not sufficient to also counter general inflation in the marketplace," Fastenal said in a press release.

The Herd Mentality

From a *CNBC* article by Yun Li on June 26, 2019, "Passive investments control about 60% of the equity assets, while quantitative funds -- those relying on trend-following models instead of fundamental research -- now account for 20% of the market share, according to estimates from J.P. Morgan."

"Passive funds have attracted $39 billion of inflows so far this year, whereas active funds lost a whopping $90 billion in 2019, the bank said."

Omega Advisors founder Leon Cooperman previously said, "Computer trading is creating a '*Wild West*' with the markets, calling for an investigation by the Securities and Exchange Commission."

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The market rallies have come with a tremendous amount of volatility. Usually, stock markets move about plus or minus 1% in a month. However, in the past year, the S&P 500 Index has posted monthly returns well above or below the norm.

The table below illustrates the month-over-month change in the S&P 500 Index in the past year. It appears the moves are caused by quantitative investors and artificial intelligence programs.

S&P 500 Index – % Month-over-Month Change

S&P 500 Index	
MONTH	**PERFORMANCE**
July 2018	+2.30%
August 2018	+1.53%
September 2018	-4.00%
October 2018	-2.23%
November 2018	-5.73%
December 2018	+1.56%
January 2019	+5.66%
February 2019	+1.78%
March 2019	+3.56%
April 2019	+0.99%
May 2019	-6.41%
June 2019	+7.19%

Data Courtesy of *Bloomberg* LLP

DoubleLine Capital CEO Jeffrey Gundlach has taken a shot at passive investing, saying it is causing widespread problems in global stock markets. He called it a *'herding behavior.'* "I'm not at all a fan of passive investing. In fact, I think passive investing has reached mania status as we went into the peak of the global stock market," Gundlach said in December.

We agree. We believe that investors are falling victim to a huge marketing machine, getting those investors to focus on low costs instead of total returns.

Passive funds will never create positive Alpha

In an Index fund or an ETF (Exchange-Traded Fund), investors make the market return for a particular index or fund ***LESS*** the management fee and the tracking error.

They will never create positive Alpha (the difference between the investor's return and the index return) as long as they are in these investments.

For example, if the management fee is 0.25% and the tracking error (the difference between the actual index percent holdings and the ETF percent holdings on a daily basis) is 0.15%, the investor would make 0.40% less than the index each year. Also, those fees are not tax deductible.

The other thing investors must pay attention to are the percent weightings of each stock in those index funds and ETFs. Never consider an ETF where the top 10 holdings make up, say, 50% of the entire ETF. All you're doing is subjecting yourself to concentration risk.

Instead, it's better to find an index fund or ETF (if you must), where the percent weightings are equal. Unfortunately, many of these types of products carry a lot of correlation risk – a high concentration of the same types of stocks – something we find unfavourable.

Markets are still expensive

If the historical norm for Price / Earnings ratios is 15 or 16 times, the table below suggests that markets remain expensive.

STOCK EXCHANGE	CURRENT P/E RATIO	P/E RATIO BEFORE ADJUSTED EPS	PROFIT MARGIN (2018)	PROFIT MARGIN (2019)
Canada	17.56	18.86	8.10%	9.39%
United States (S&P 500)	19.32	21.81	10.19%	10.17%
Europe	17.84	17.71	7.64%	7.64%
MSCI Global Index	18.27	19.71	8.92%	8.81%
Russell 2000 Index	39.87	164.03	2.01%	1.27%

Data Courtesy of *Bloomberg* LLP

In a *Bloomberg* article by Sarah Ponczek on July 2, 2019, "More than 80% of S&P 500 companies that have revised their profit estimates one way or the other in the lead-up to reporting have slashed them. Analysts are in

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on the action too, reducing company projections at the fastest pace in nearly three years."

"One of the things that investors seem to be overlooking is how poor the earnings environment is," said David Spika, president of GuideStone Capital Management. "We're so focused on monetary policy and this mythical China deal that we just don't seem to be paying attention to earnings, which are really what should be driving stock prices."

"Last fall, cuts to company earnings sent the S&P 500 Index down 20%. Will it happen again? Stay tuned."

Finally, the Russell 2000, which tracks small-cap companies, is trading at its lowest relative performance to the S&P 500 since the financial crisis, according to data from *Bespoke*.

Miller Tabak's Matt Maley argues that investors should take note of the Russell's slowdown. In multiple instances over the past four decades, it's been a precursor for problems in the broader market.

"I'm very concerned about those who say that the small caps don't matter too much... There's been so many other times where it's been a very big warning signal," he said Wednesday, July 10th on *CNBC*.

Company earnings are out of whack

We looked at the Dow Jones Industrial Index of 30 large U.S. companies to see the difference between Generally Accepted Accounting Principles (GAAP) earnings and "Adjusted" Earnings and found a wide discrepancy, meaning companies continue to "cook" their earnings to justify their stock prices.

Remember, bonuses are performance-based, so there's a reason why company executives favour adjusted earnings and why they continue to buy back shares in increasing amounts, despite lofty stock market valuations.

Below is a table of the companies in the Dow Jones Industrial Index that have the biggest differential between GAAP earnings and Adjusted earnings.

Overstated Earnings

COMPANY	STOCK PRICE	2019 EPS GAAP	2019 EPS ADJUSTED	DIFFERENCE	GAAP P/E RATIO	ADJUSTED P/E RATIO
Johnson & Johnson	$140.57	$6.78	$8.60	27%	20.75	16.34
Pfizer Inc.	$43.92	$2.40	$2.91	21%	18.33	15.09
Walgreens Boots Alliance	$55.19	$4.94	$5.97	21%	11.18	9.25
Dow Inc.	$49.31	$3.83	$4.36	14%	12.89	11.30
Merck & Co.	$85.60	$4.16	$4.74	14%	20.60	18.08
United Technologies	$132.54	$7.04	$7.97	13%	18.82	16.63
IBM Corp.	$141.38	$12.33	$13.91	13%	11.47	10.17
3M Co.	$172.00	$8.54	$9.43	10%	20.14	18.25

Data Courtesy of *Bloomberg* LLP

It's one thing for a company to take a one-time write-down; it's quite another to do it every year, something that has been going on for the better part of the past decade.

The table above is not meant for investors to avoid owning these stocks, just that they should be aware of the accounting games such companies may be playing. Eventually, the write-downs for intangible assets like goodwill and amortization of bad assets will have meaning when firms must reduce the value of their balance sheets. General Electric's demise is one such example. It was discussed in detail in the December 2018 Liberty newsletter.

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More Short-term Thinking: The analysts

Let's not forget the bank and brokerage analysts who are also into short-term thinking. Imagine our surprise when a Raymond James analyst suggested that one of the companies we own, Cantel Medical, should sell its medical water business. What disappointed us was the rationale for selling a business that employs people and earns good profits:

"Market-perform Cantel could sell the business for $75m-$194m in net proceeds which, if used for an accelerated share buyback, could drive a possible 15c EPS accretion in calendar 2020."

Share buybacks are another form of short-term thinking; the current price today seems to be more important than the long-term value of the business.

What to do in this crazy environment?

For current clients who have been with us for more than a year, we're still staunchly holding 20% in cash times the equity weightings of their portfolios.

For new clients, we have bought only half stock positions and will gradually buy more when it's deemed appropriate. Our last entry into the market was in early June after the May selloff when markets were oversold on a technical basis.

It's also a good time to review your portfolio to ensure that the correct plan is in place and that the focus is on the foundation and structure of that portfolio. That means:

- No more than 30 stocks – adding more doesn't reduce portfolio risk. Unfortunately, many do-it-yourself investors tend to have 50 stocks or more in their portfolios. It reduces potential performance because the bet sizes are too small, and the odds rise there may be more losers than winners.
- Diversify by industry, country and size of companies. This ensures you have a good blend of both growth and income. Remember, total return and achieving Alpha is more important than just dividend yield.
- Stop trading. The more you trade, the more you save for your broker's retirement than your own. When you add up the costs of commissions, bid-offer spreads and capital gains tax, this *slippage* retards your total long-term returns.

We have not sold a single stock outright for each of the past two years. As a result, we're not incurring needless costs and we're capturing all the return that the dividends and price increases offer.

Bond Markets

10-Year Bond Yields

COUNTRY	COUPON	PRICE	CURRENT YIELD	YEAR-TO-DATE PRICE CHANGE
Emerging Markets				
Greece	3.88%	$112.32	2.45%	+13.43%
Russia	4.38%	$103.96	3.90%	+9.55%
Indonesia	4.75%	$111.13	3.40%	+9.42%
Chile	3.24%	$104.97	2.59%	+9.09%
Mexico	4.50%	$107.31	3.64%	+7.85%
Brazil	12.25%	$162.74	4.77%	+5.91%
Turkey	7.63%	$102.68	7.27%	+2.92%
China	3.29%	$100.49	3.27%	+0.68%
Developed Markets				
Australia	3.25%	$117.65	1.32%	+8.50%
New Zealand	3.00%	$112.85	1.58%	+6.88%
Germany	0.25%	$105.67	-0.33%	+6.03%
Canada	2.25%	$107.23	1.47%	+4.59%
United States	2.38%	$103.09	2.01%	+4.12%
United Kingdom	1.63%	$107.10	0.83%	+3.76%
Japan	0.10%	$102.55	-0.16%	+1.06%

Data Courtesy of *Bloomberg* LLP

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Since the beginning of the year, interest rates / bond yields have dropped while bond prices have risen. In the chart above, Greek bonds have been the big winners this year, a perfect example of the "risk-on" mentality of investors to capture as much yield as possible.

As a result, the yield curve is now inverted, with short-term rates higher than their long-term counterparts. As you can see in the table below, rates are already negative in Japan and most of Europe (we used Germany in our example).

Government Bond Rates

	CANADA	UNITED STATES	GERMANY	JAPAN
		Short Term		
3 months	1.66%	2.22%	-0.38%	-0.09%
6 months	1.70%	2.12%	-0.34%	-0.11%
1 year	1.73%	1.97%	-0.28%	-0.15%
		Long Term		
2 years	1.62%	1.86%	-0.75%	-0.21%
5 years	1.53%	1.83%	-0.63%	-0.25%
7 years	1.55%	1.92%	-0.59%	-0.25%
10 years	1.57%	2.03%	-0.36%	-0.16%
30 years	1.74%	2.54%	0.24%	0.34%

Data Courtesy of *Bloomberg* LLP

In a negative interest rate environment, investors must pay the banks to deposit their money as their concerns are a return ***of*** capital instead of a return ***on*** their capital.

In a *Financial Times* article by Robin Wigglesworth on June 19, 2019, "The universe of negative-yielding bonds has jumped to a new record of $12.5 trillion after the European Central Bank poured more fuel on the global fixed income rally by hinting that it could restart its "quantitative easing" programme."

"The global bond market has been buoyed by rising concerns that economic growth is petering out, and bets that central banks in the US, Europe and Asia will all have to ease monetary policy to prevent another downturn. The resumption of trade hostilities between the US and China have stirred investor fears and sent bond yields tumbling."

Think about the funding issues that pension funds and insurance companies currently face. If they're paying out roughly 4% to retirees or annuitants but can only make 1% or 2% in income, they'll have to take on more risk to get a reward that matches income and payouts.

Another concern in this same vein is that the last of the Baby Boomers (born in 1964) turns 60 in 2024. With such a large cohort nearing or in retirement, economies will be challenged to grow because retirees don't spend and there are expected to be less employed people who need to spend. *(See China and declining birth rates above).*

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The Trillion Dollar Problem

Accumulating a trillion was challenging, transferring a trillion could prove to be even harder.

According to the Canadian Wealth Advisors Network, Canadians born between the end of World War II and the 1960s — about 42% of our population — stand to inherit $1 trillion over the next 20 years. This is expected to be the largest intergenerational transfer of wealth in Canadian history.

While not every Canadian will pass on an inheritance, those that do, especially High Net Worth individuals and their families, should plan carefully to ensure wishes are met and transfers are tax efficient.

> "Planning for death isn't fun but it's essential"

Estate transfers – The basics

Assets held by an individual when they pass away form their estate. Generally, a Will stipulates how the assets will be passed on. However, an estate of $1,000,000 will not necessarily result in an inheritance of $1,000,000 as many assets within an estate are subject to tax.

Two of the most significant types of taxes incurred are capital gains tax and probate fees. When a person passes away, tax rules state that any asset held is deemed to be disposed at Fair Market Value, whether a sale occurs or not. If an asset's cost base is less than Fair Market Value, then capital gains tax will result.

For example, upon death, Frank had a cottage worth $850,000 but purchased it for only $50,000. This would result in $800,000 of capital gains on Frank's final tax return.

Probate fees, unlike capital gains tax, is levied on the total value of an estate, not just the gain. Across Canada, each province has a different level of probate fees with a wide variance from lowest (Quebec at 0%) to highest (Ontario at 1.5%). While 1.5% tax might seem insignificant, an estate of $5,000,000 would be subject to almost $75,000 in probate fees.

While the outlays discussed above are large, there are some built-in protections to reduce capital gains tax and probate fees. These include the Principal Residence Exemption, whereby the deemed principal residence can be sold on a tax-free basis, as well as the ability to 'roll over' certain assets to a surviving spouse (including RRSPs, LIRAs, RRIFs, LIFs, TFSAs and jointly held non-registered accounts).

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In the event you do not have a current Will, we recommend that you speak with an Estate lawyer. Depending on the size of your estate, reducing some of the potential tax exposures on your estate could pay for the associated legal fees many times over.

Gifting

For those interested in a simple way to avoid probate fees, gifting the asset before death is often the best option. Since the asset is no longer owned by the person, it will not be included in the estate and therefore will not be subject to probate fees.

However, depending on the type of asset being gifted, there can be capital gains tax implications. Gifting cash, as its value does not fluctuate, is the most straightforward asset to gift. Other assets that have appreciated in value, (i.e. Frank's cottage from the example above) would be subject to a "deemed disposition" at the time of the gifting and Frank would have a capital gain amounting to the difference between purchase price ($50,000) and the Fair Market Value ($850,000) at time of the gift.

Depending on the circumstances, one major drawback to gifting is that once the asset changes hands, the person providing the gift no longer has control over the money. Issues can arise when parents or grandparents gift assets to minors or young adults who are then able to save/spend/invest the gifted funds at their own discretion.

Another drawback of gifting is that it is not reversible. For example, a person gifts an amount they believe they would never spend. But due to unforeseen circumstances, they require the funds in the future. Unfortunately, there is no recourse that would allow the funds to be recovered.

Trusts

While trusts are operationally more complex than gifting, their advantage is that they provide ultimate flexibility. For estate planning purposes, trusts come in two main varieties: Inter Vivos and Testamentary.

Inter Vivos is Latin for "in life", and as the name indicates, are created while the person funding the trust is still alive.

On the other hand, Testamentary trusts are formed upon a person's death. This article will discuss Inter Vivos trusts.

Inter Vivos trusts are funded by a "Settlor" who assigns assets to the trust. The assets are controlled by a "Trustee(s)", who may or may not be the Settlor.

The beneficiaries receive the benefit of the assets, whether it be dividends, interest income or capital gains.

The Settlor will work with a lawyer to draft the Trust Agreement, a legal document that sets the rules for how the trust will operate, mechanisms for distribution and any other stipulations that they would like to put in place.

As previously mentioned, from a tax perspective, there are two major considerations with an estate: Capital gains tax and probate fees. Depending on the type of asset being transferred (namely closely held private company shares), there are options for deferring the capital gain by avoiding the deemed disposition.

With respect to probate fees, because the beneficial ownership of the asset changed hands from the Settlor to the beneficiaries, the Settlor will no longer owe probate fees on the asset upon death.

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In addition to saving taxes, trusts also have many other advantages, including:

- Managing the transfer of wealth – Instead of waiting until death and hoping a Will had accounted for all scenarios, a Trust Agreement can give power to the Trustee to make decisions how and when assets are distributed to beneficiaries both before and after death. This allows for more guidance as the funds are transferred rather than just one lump sum upon death.
- Protecting assets – Assets held for beneficiaries of the trust are excluded from creditors and potentially spouses in marriage breakdowns. Using a trust is one way to ensure that the sole beneficiary of an inheritance is the named party in the trust agreement.
- Providing privacy – Upon death, a Will is probated, meaning the documents, including the values of assets, become subject to public record. A trust is a private document that remains confidential.

Although there are many benefits, trusts can be complex: To some, this can be a disadvantage. Trusts require annual reporting requirements, certain expenses for accounting and legal fees as well as certain tax rules around how long a trust can exist before the assets are distributed out to the beneficiaries.

It goes without saying that estate transfers are very involved and have plusses and minuses, but there is no debate on the benefit of planning ahead. Be sure to contact a qualified lawyer and/or accountant to discuss your specific situation further.

CLIENT QUESTIONS

Who votes our shares?

We vote the proxies on behalf of our clients annually.

Our considerations include:

- We do not vote corporate executives such as the CEO, CFO, etc., on to the Board of Directors. We believe they are employees of the firm and should not have influence over the Board's decisions.
- We do not vote the children or in-laws of board members or corporate executives on to the Board of Directors. We believe this to be a direct conflict of interest and voting may be done for individual gains that are not in the best interests of the firm. After all, it's the shareholders' money, not the executives' money.
- We do not vote for Directors who also sit on other public company's Boards. We believe this to not only be a conflict of interest but also an opportunity to spread non-public information to a competitor.
- We do not vote for the Executive Compensation as we believe that compensation is already too egregious.
- If the stock compensation is greater than 5% of the public float, we will not vote for the passage of such compensation.
- We will vote for shareholder propositions that the company does not encourage if it helps to improve company ethics and the firm's long-term growth.

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How do you manage tax efficiency in your portfolios?

To begin, we never want the tax-tail to wag the investment dog. To us, the bigger picture is more important in terms of total returns. We believe that tax efficiency is important but secondary to performance.

Tax efficiency for Stocks

We don't hold a lot of Canadian stocks (about 13% versus 87% for US and international holdings) because long-term returns outside of North America have been 1% to 2% higher compounded annually over a 10 to 20-year time horizon.

The North American population is about 550 million (including Mexico) while the rest of the world has about 7.5 billion people, or 15 times our continent. There are better opportunities overseas for better long-term gains than just investing domestically.

Also, there tends to be higher dividend growth among the foreign companies than the Canadian ones, so there's greater income coming into the portfolios to help ease the tax burden.

The TFSAs fit the bill for our Canadian content as they're usually smaller accounts than the RRSPs that we manage, so we can easily account for the 13% exposure. We can then diversify using 20 companies.

In the TFSA, you'll capture the entire Canadian dividend. However, dividends from U.S. and international stocks are subject to withholding tax that cannot be claimed back on tax returns.

Other accounts, both registered and non-registered, hold mostly the U.S. and international names. For the non-registered accounts, the withholding tax may be claimed back.

Fixed Income

Pundits often suggest that bonds should only be held in accounts such as TFSAs and RRSPs because they are taxed at a higher rate than dividends. However, those accounts should be used to maximize returns as they are tax-sheltered and have been created to provide better long-term growth. They should never be "bond-only" accounts.

Preferred shares pay dividends which carry a tax advantage. However, they shouldn't be the only form of fixed income in taxable accounts because they are known as "quasi-equity" instruments, meaning that when the stock market falls, their share prices often drop by amounts like stock prices.

As far as the foreign holdings report (T-1135) required on tax returns (ownership of $100,000 or more), our tax package provides it for our clients so they, or their accountants, can easily file the report.

I'm 75 years old and you just bought me a Nutrien bond that matures in 30 years. I'll be dead before then. So, why do it?

The answer is two-fold:

- The Nutrien bond pays a 5% coupon. We paid $99.75 for it. It's an investment grade bond at BBB. If interest rates stay low for an extended period, the income will be superior than current rates yield.
- We don't match maturities to life expectancies. We're trying to earn a 5% to 7% yield for clients (less for registered accounts because there's no tax payable) before inflation, taxes and fees so their spending power continues to grow each year.

If you have any questions, let me know.

David Driscoll

President & CEO | Liberty International Investment Management Inc.

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