

# MARKET UPDATE

Q2 | January 1 to June 30, 2021

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During 2021's second quarter, the macroeconomic trends were:

- A flattening of the yield curve as the market pooh-poohed concerns over long-term inflation
- A rotation from growth stocks to value stocks to cyclical stocks
- A demand for higher income in the form of preferred shares and junk bonds, sending prices higher and yields lower

### Equities

In 2021's second quarter, the TSX Composite Index had the best returns among the global indexes noted above. Three of the TSX's sub-indexes that make up 55% of

### Benchmark Total Returns (dividends re-invested) in Canadian Dollars (January 1, 2021 to June 30, 2021)

	Q1 RETURN	Q2 RETURN	YEAR-TO-DATE RETURN
<i>Equities</i>			
Canada (TSX Composite Index)	8.06%	9.55%	17.61%
Small-Cap (Russell 2000 Index)	10.97%	2.92%	13.89%
U.S. (S&P 500 Index)	4.54%	7.12%	11.66%
World (MSCI Global Index)	3.45%	6.46%	9.91%
NASDAQ Technology Index (CCMP)	1.38%	8.24%	9.62%
Europe (Euro600 Index)	2.64%	6.25%	8.89%
Emerging Markets (MXEF)	0.68%	3.70%	4.38%
<i>Fixed Income</i>			
Canada Mid-Term Corporate Bond Index	-3.76%	1.47%	-2.29%
Canada Long-Term Corporate Bond Index	-8.59%	2.92%	-5.67%
Canadian Real Return Bond Index	-7.62%	3.09%	-4.53%
Canadian Preferred Share Index	12.12%	5.68%	17.80%
US Long-Term Corporate Bond Index	-9.79%	5.07%	-4.72%
US Preferred Share Index	0.42%	1.23%	1.65%

Data Courtesy of Bloomberg L.P.

the entire index (financials, energy and technology) accounted for 83% of the overall performance (14.54% of the overall 17.61%). If you weren't invested in those 3 sectors, the rest of the TSX grew only 3.84%.

The U.S. S&P 500 Index shared similar characteristics. The 10 best performing sectors, mostly technology stocks but including financials and healthcare names, made up 45% of the index and accounted for a 16% return, greater than the S&P 500 Index return of 15% in U.S. dollars. The other 55% of the index fell 1%.

Based on those numbers, it's truly been a stock pickers market and why we're not a big fan of Exchange-Traded Funds (ETFs). This is a perfect example why it's always better to focus on quality companies instead of a dog's breakfast of good, mediocre and bad companies that the ETFs offer. More on that in Brett Girard's article below.

That said, investors shouldn't just chase after the hottest market returns. When extrapolated over 10 and 15 years, those performance numbers often fade. There are no guarantees that what works today will continue in the future.

For example, the TSX Energy sub-index had a terrific performance in the first half of 2021, up 37%, while the Utilities sub-index was up only 5%. Over 15 years, however, utility stocks have been a better investment. Compared to energy stocks, the utilities have outperformed energy by a wide margin of 9.7% versus 6.5%.

If you invested \$100,000 in 2006 in each sector, energy stocks would be worth \$258,272 today, while utilities would be worth \$404,813. Given that utility stocks are about half as risky as energy names, that's a huge risk-adjusted outperformance.

The moral of the story is this: Don't chase the hot sectors. Chances are those names will return to more reasonable performances in the future. This is known as the "Reversion to the mean".

## **Bonds**

*By Merab Nathaniel-Alam MFin, FRM, CFA, CIPM*

As Q2 ended, the global bond market, in Canadian dollar terms, stood at a market cap of \$143 trillion. This dwarfs global GDP of about \$107.78 trillion (on December 31, 2020) and highlights the important status that debt markets hold in the grand investment landscape.

To put this into perspective, the global equity market capitalization is about \$144 trillion. This translates into a global asset mix across the world equal to 50 percent equity and 50 percent fixed income.

At Liberty, we're aware of this and manage our bond strategy with meticulous attention to detail just like our equity holdings. This enables our clients to reap adequate risk-adjusted returns after fees to support and maintain their standard of living over time.

If inflation worries become more engrained in the market psyche, the bond market should reverberate with greater downside risk. To alleviate this pressure, Liberty has a laddered bond strategy in place with a good mix of corporate bonds among various credit ratings.

Over time, higher coupon bonds are more stable in a rising interest rate environment than lower coupon bonds, so we look for deals in that space. Additionally, our inflation-protected bond allocation was raised in May from 5% to 10% as a tactical measure.

A silver lining to rising rates is that investors can re-invest their income and maturities at a higher rate (*ceteris paribus*). This is because companies must contend with a rising cost of debt; as their liabilities mature, those must be rolled forward at a higher interest rate.

In Q2, there was a positive return on longer-dated sovereign bonds but overall, bond returns in 2021 remain negative. As the bond gets closer to maturity,

however, this short-term price fluctuation becomes irrelevant.

For example, the 30-year issue that was bought five years ago is now a 25-year issue today, the 10-year bond has only five years left to maturity and so on. This means that if you paid below par \$100 and plan to hold the issuer to maturity, the market effects over the term become benign. That said, the company-specific events must still be monitored closely to manage idiosyncratic risk and therefore, default probability.

Canadian Sovereign Bond Total Returns 2001-2020											
Term	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
2-year	7.70%	3.60%	3.40%	3.20%	2.20%	3.60%	4.10%	6.30%	1.50%	1.50%	2.40%
5-year	8.80%	7.50%	5.00%	5.40%	3.00%	3.70%	4.40%	11.40%	-0.10%	4.90%	7.00%
7-year	7.80%	9.10%	5.60%	6.50%	4.40%	3.60%	4.50%	13.30%	-1.40%	5.80%	9.10%
10-year	5.80%	9.50%	6.20%	7.50%	6.60%	3.30%	4.70%	14.60%	-2.80%	7.80%	12.60%
20-year	4.30%	10.50%	7.70%	9.60%	11.70%	3.20%	4.80%	10.50%	-2.40%	12.50%	17.50%
30-year	4.60%	9.50%	7.40%	10.00%	15.40%	2.70%	4.40%	12.90%	-6.10%	12.80%	23.10%

  

Term	2012	2013	2014	2015	2016	2017	2018	2019	2020	Total Period	Per Annum
2-year	0.90%	1.30%	1.30%	1.60%	0.30%	0.20%	1.60%	2.00%	3.00%	166.08%	2.57%
5-year	1.20%	0.50%	4.70%	3.90%	-0.20%	-1.30%	1.80%	2.60%	6.60%	218.78%	3.99%
7-year	2.00%	-0.80%	6.20%	4.50%	0.00%	-1.20%	2.20%	3.10%	8.40%	244.29%	4.57%
10-year	3.90%	-4.30%	11.20%	5.60%	-0.40%	-0.70%	2.80%	3.90%	10.40%	280.76%	5.30%
20-year	5.10%	-7.90%	16.00%	4.90%	-0.20%	3.30%	3.30%	6.90%	12.40%	353.13%	6.51%
30-year	5.40%	-12.10%	19.30%	6.00%	-0.90%	3.30%	4.00%	11.00%	14.30%	390.03%	7.04%

Data Courtesy of Bloomberg L.P.

In the chart above are the 2, 5, 7, 10, 20 and 30-year term Canadian Sovereign bond performances between 2001-2020. The 30-year bond was the best performing group – it had a cumulative return of about 290%. If you invested \$100 in a 30-year issue on December 31, 2000, that investment would have grown to about \$290, nearly 3 times your investment. While there were three single periods of underperformance in this category, that was trumped by the income generated over the time period.

In the second quarter, meantime, all classes of bonds rallied. That's because the yield curve flattened, meaning short-term interest rates rose while long-term rates fell, a sign that the bond market doesn't believe in future economic expansion. Bond performance in coming years will be determined by whether inflation is transitory or not.

If so, rates could remain the same and bonds could hold their value. If the U.S. Federal Reserve is forced to raise interest rates to offset inflation, bond prices would weaken. We would then use the interest payments and matured proceeds to buy more bonds along the ladder at a higher coupon and income.

And if rates rise, that should have negative implications for technology stocks, especially the smaller ones, as they need low rates to offset their huge cash burn rates. It should also hurt private-

equity and real estate investments as higher interest rates would cool demand and punish returns.

### Preferred Shares

Preferred shares had a stellar first half as the

average total return for rate reset preferred shares was 17.80%. One caveat, however, is that the Preferred Share Index (shown on page 1) is made up exclusively of rate-reset preferred shares and doesn't include perpetual preferred shares. The latter returns were only about half as strong as the rate-resets.

As we've written before, rate-reset preferred shares have done well because:

- 5-year interest rates are higher, meaning if the rate is reset, the coupon and the subsequent income will be higher, thus pushing the price higher.
- Bank and insurance company rate-resets are being called at their \$25 par value and being replaced by Limited Recourse Capital Notes (LRCNs). These institutions save money on taxes as the LRCNs are tax-deductible for them while the previous dividend payment was not.

Given that most preferred shares are trading at their \$25 par value, there isn't much value left from a capital gains perspective. At Liberty, we will never pay a premium over \$25 for a preferred share because, while you can earn good income, you may be exposed to potential capital losses.

For those investors still seeking higher-than-average income, many have moved investment dollars into junk-bonds, instruments that carry a lower-than-average credit rating, known as non-investment grade.

In a *Financial Times* article on June 18th by Joe Rennison and Eric Platt, "Some 373 junk-rated companies have borrowed through the nearly \$11 trillion US corporate debt market so far this year, including companies hard hit by the pandemic like American Airlines and cruise operator Carnival."

"While optimism about the US recovery abounds, the continued zeal for lower-quality corporate debt has caused consternation in some quarters. Investors worry that precarious companies are being offered credit at interest rates that don't account for the high levels of risk involved."

## **Market Summary**

Many investors have expectations that far exceed the reality of what stock markets can reasonably deliver over time.

The S&P 500 returned 18.4% last year, counting dividends, and is up 15.9% so far in 2021. Recent past returns always mold future expectations.

Over the long run, however, investors in a recent Natixis survey anticipate earning an average of 17.5% annually, **after inflation**—even higher than for this year. According to *Morningstar*, it's more than twice the return on U.S. stocks since 1926, which has averaged 7.1% annually after inflation, and more than triple the 5.3% return over the same period after both inflation and taxes.

Given that the stock market is being pushed higher by new, inexperienced investors, we expect a correction in the future because expectations far outweigh reality—corporate profits don't rise that fast forever. While we don't know what the spark will be to cause it, we have cash available to take advantage of any opportunities.

# INVESTING FOR MILLENNIALS – ANALYZE MUTUAL FUND PERFORMANCES BEFORE YOU BUY

By Audrey Leung

Since 1991, Canadians' investments in mutual funds have skyrocketed from \$100 billion to \$1.71 trillion. Currently, mutual funds are the most popular non-cash asset held by Canadians in their Tax-Free Savings Accounts (TFSAs).

Millennials often choose mutual funds due to the low minimum investment, convenience, professional management and ample liquidity. Despite that, many do not realize the drawbacks of mutual funds and how they can affect long-term performance. Below, we explain the issues that are a deterrent to invest in such funds.

## **Management Expense Ratio (MER)**

The Management Expense Ratio (MER) represents the total of the management fee, operating expenses and taxes charged by a fund as a percentage of its total assets. The average MER of Canadian equity mutual funds is about 2.5%.

It may not seem like a lot, but over the long term, the MER can eat away at returns. Assuming you start with \$50K and earn a 6% return before fees, a 2.5% MER gives you a \$49,000 gain over 20 years, while a 1% MER leads to almost \$83,000 of profit. That \$34,000 difference means that fees wipe out almost half the growth.

## **Transaction Costs and the Turnover Rate**

Investors must be wary that transaction costs, such as commissions, are not included in the MER of mutual funds. The size of transaction costs largely depends on the turnover rate. This rate shows the percentage of the mutual fund's holdings that changed over the past year.

The higher the turnover rate, the higher will be the transaction costs. A study by *Dalbar Research* in 2010 showed that the average turnover rate of Canadian equity fund managers was 120%, meaning that by October of every year, they had bought and sold the equivalent of every stock position in their portfolio at least once.

This leads to high transaction costs and greater taxes payable that significantly harm returns. In comparison, Liberty's turnover rate has averaged about 10%. Lower trading leads to lower costs and, ultimately, better returns.

## **Over-diversification**

Most investors understand the concept of diversification – don't put all your eggs in one basket. In fact, the opposite – over-diversification - causes problems.

Some mutual funds own over 100 different securities. Even if one stock doubles in value, the portfolio performance isn't impacted much by that one stock because the bet size isn't big enough.

On the other hand, many statistical studies suggest that a 30-stock portfolio and its 3.3% average bet size is the best way to maximize diversification and ensure that each stock has an impact on performance.

## **Size of the Fund**

The largest mutual fund in Canada has over \$100 billion in assets under management (AUM), while many others have total assets above \$10 billion. The process of buying and selling stocks may be easy for individuals like us, but for a manager of a large mutual fund, it might not be the case.

When a fund is over \$1 billion in size, especially in Canada, it essentially becomes the market. It is often difficult for the fund manager to maneuver in the market without everyone knowing what they're up to. Their size also restricts what they can buy because a lack of stock liquidity enters the fray.

For example, if a fund owns 100,000 shares of a small-cap stock that only trades 5,000 shares a day, it could take the fund 20 days to exit the entire position. Meantime, the price would fall with each successive trade as the bids disappear.

Below is a table showing relevant information of two international mutual funds, Brandeis International (Fund A) and AGF Global (Fund B) at June 30, 2021:

	Brandeis Int'l Equity (Fund A) (BIP161.CF)		AGF Global Equity (Fund B) (AGF233.CF)	
<b>Size (\$millions)</b>	\$129.38		\$543.72	
<b>MER</b>	2.33%		2.54%	
<b>10-year Beta</b>	1.02		0.98	
<b>10-year Sharpe</b>	0.40		0.76	
<i>(Annualized)</i>	<b>RETURN</b>	<b>ALPHA</b>	<b>RETURN</b>	<b>ALPHA</b>
<b>1-year</b>	31.4%	8.2%	22.1%	-3.1%
<b>3-year</b>	1.6%	-4.4%	5.5%	-5.7%
<b>5-year</b>	4.5%	-4.0%	6.7%	-5.8%
<b>10-year</b>	5.5%	-3.3%	9.0%	-3.2%

Data Courtesy of Bloomberg L.P.

When evaluating mutual funds, it is critical to understand the concepts of Beta, Sharpe Ratio, and Alpha.

Beta is a portfolio's volatility in relation to the market. Therefore, the higher the Beta, the riskier is the fund.

The Sharpe ratio is a measure of risk-to-return, or, for every \$1 of risk taken, how much have you earned? A higher Sharpe ratio indicates better performance relative to the risk of the portfolio.

Alpha is the difference between the fund's return and the benchmark return. A positive Alpha means that the fund is doing better than the benchmark, while a negative Alpha represents underperformance. Generally, a 2% Alpha after fees is considered a good performance.

Comparing these two global equity mutual funds, here's what we found:

- Fund A has a 0.40 Sharpe ratio, while Fund B's is 0.76. This means that Fund A has had significantly lower returns relative to its level of risk compared to Fund B.
- Looking at the Beta, Fund B is less risky than Fund A. With a Beta of 1.02 and a 10-year Alpha of minus 3.3%, Fund A was more volatile and earned lower returns than the overall market.
- Despite Fund A's good performance during the past year, both funds have underperformed in the long term. The negative Alpha indicates they have done worse than the overall market within the 3, 5 and 10-year periods.

Despite any advertised benefits, the numbers above explain why almost 90% of mutual funds can't beat their benchmarks. High fees and transaction costs, high turnover rate, over-diversification, and large AUMs all contribute to underperformance.

When evaluating mutual funds, you should thoroughly analyze:

- the ratios
- the sector distribution
- the geographical allocation
- the fees
- the historical performance

If you don't do the analysis, you could be left earning much less than you should.

# FUN WITH MATH: HOW TO MANIPULATE EARNINGS AND PROMOTE A HIGHER STOCK MARKET

*By David Driscoll*

Whenever a brokerage analyst talks about earnings, my inner skeptic goes on high alert. That's because they never tell the true story, leaving the listener to accept what's been said as fact.

An analyst's job is to talk up a stock in glowing terms because the brokerage firm the analyst works for may be doing investment banking for that company. If the firm is raising capital through an equity or bond issuance, the brokerage firm receives a percentage of the deal.

For example, if a company raises \$100 million by issuing equity, the brokerage may receive a 1% or 2% underwriting fee and issue a positive report on the company. This means investors have to take analyst recommendations with a grain of salt. It is not unbiased.

This past quarter, companies reported 2021 first quarter results compared to Q1 of 2020, a period when the world was in lockdown with Covid19. As a result, the comparable numbers weren't hard to beat.

Meantime, many companies failed to report a comparison between the 2020 fourth quarter and the 2021 first quarter. That's because, in many cases, the results were worse and exhibited a trend that the economy wasn't recovering.

Companies and the brokerage analysts made corporate earnings look spectacular and, as a result, investors bought into the story and the market rose to new highs.

In the investment industry, there are three types of earnings: Adjusted earnings, GAAP earnings (Generally Accepted Accounting Principles) and cash earnings. The last one is the only important number because cash is real, while the other two can be manipulated by accountants and Chief Financial Officers (CFOs) and are deemed to be artificial.

A company's goal is to get the earnings as high as possible to push the stock price to higher levels, thus providing the executives with multi-million-dollar payouts.

“

Companies and the brokerage analysts made corporate earnings look spectacular and, as a result, investors bought into the story and the market rose to new highs.

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These actions can be manipulated by a number of accounting methods and rules. Here are three such accounting shenanigans:

- In last quarter's Liberty newsletter, we explained how using LIFO, FIFO or Average Cost could pad net profits.
- A second example would be ignoring takeover costs after an acquisition if a company can argue that it's only a one-time expense. This leads to higher realized revenues, lower costs and higher profits.
- A final example would be moving inventory from the factory onto trucks and calling it sales (a timing issue), even though nothing's been sold.

In this article, we'll deal only with the first two accounting methods, adjusted earnings and GAAP earnings, to show how the numbers are used to argue the case for the market to move higher. The anticipated profits for 2021 are compiled from the 30 companies that make up the Dow Jones Industrial Average (DJIA).

Here's what we found:

- For 2021, GAAP earnings for the DJIA are forecast to be \$252.20.
- Adjusted earnings are forecast to be \$267.34, 6% higher than GAAP earnings.
- Technology and pharmaceutical firms show the greatest discrepancy of earnings, with adjusted

earnings of both sectors 20% higher than GAAP earnings.

For example, brokerage analysts expect Amgen's adjusted expected earnings to be \$16.29 per share versus GAAP expected earnings of \$11.72 a share, an almost 40% difference. Based on adjusted earnings and a closing price of \$244.37, the Price-Earnings multiple equals 15 times, making it appear relatively cheap.

However, if you use the GAAP earnings of \$11.72, the P/E multiple becomes 21 times, making the stock appear more expensive.

Naturally, the brokerage analysts will promote the former multiple of 15 times to get investors interested in buying Amgen stock and move the share price higher, thus helping the brokerage firm get business from the company and the firm's executives to reach their 2021 financial goals.

On the technology side, both Cisco Systems and IBM Corp. showed a 30% difference between adjusted earnings and GAAP earnings, so it isn't just limited to one company or one sector. It's rampant throughout the market.

That's financial engineering at its finest – and a warning for investors to ignore analyst opinions and do their own work.



# WHAT MAKES A QUALITY STOCK?

By Brett Girard CPA, CA, CFA

For decades, the investment world has fiercely debated the merits of growth stocks versus value stocks. Growth stocks tend to have high Price-to-Earnings ratios, faster earnings growth and little to no dividend yield. The valuations of these stocks hinge on continued (most often rapid) growth of users and customers, revenues and eventually earnings.

As a result, during expansionary economic times, growth stocks tend to outperform but then crash back to reality when the economy stalls.

On the other hand, value stocks have lower Price-to-Earnings ratios, lower Price-to-Book ratios, slower earnings growth, and higher dividend yields. These stable names are favoured through economic contractions as equity investors seek safety in lower price volatility and rising dividends.

Proponents from each camp selectively choose a starting point where their strategy outperformed and then proudly display charts to support their views.

In the recessions of 1981, 1991, 2000 and the early part of 2007, value stocks did well. Growth stocks outperformed during the mid-1980s (due to service sector job growth and productivity gains from offshoring), the late-1990s (widespread internet adoption) and after 2008 (zero-interest rate policies).

This year, threats of inflation and job gains in the labour markets should dictate the future strength of growth or value stocks. At Liberty, we do not view equities through a growth or value lens. Instead, our preference is looking for the presence or absence of quality, a divergent and much more important lens.

On the surface, quality is amorphous; there are no rules-of-thumb around fundamental metrics like Price-to-Earnings, Price-to-Book or even dividend payments.

Instead, quality requires an examination of the business model. This examination dives into Harvard Professor Michael Porter's eponymous "*Porter's Five Forces of Strategy*" and requires looking into a company's suppliers, customers, competitors, substitute products and the threat of new entrants.

It's important, therefore, to understand the main drivers of what a company does, how well it does it and how future changes may affect these forces.

Companies operating in monopoly or oligopoly markets, offering mission critical components, or whose costs are but a small percentage of the good they contribute, have been fertile ground for finding quality companies.

Finally, we must understand how management considers capital allocation and how the company treats its employees, customers, vendors, broader stakeholders and even competitors.

This might all sound subjective. In the short term, we would agree. However, in the long term, companies that exhibit quality consistently earn returns on invested capital ("ROIC") in excess of their cost of capital or funding.

For example, these companies can invest a dollar in themselves and regularly generate more than a dollar in profits. The positive differential of ROIC versus the cost of capital translates into generating above-average free cash flow, earnings and ultimately, returns. This is how to select a stock to hold for the long term.

Since our desired holding period is 10-30 years, evidenced by the 1-3 annual stock turnover in a 30-stock portfolio, quality becomes a critical anchor for holding a company through economic cycles. It allows us to avoid getting hung up on the

specific Price-to-Earnings ratio or other metrics of a company, or whether in the short term it is “cheap” or “expensive”.

And while we pay attention to macroeconomic issues like inflation levels and employment trends, quality companies that are equipped with sound management and an ability to grow returns are at a huge advantage to navigate both their industry and the broader economic headwinds and tailwinds.

These companies can be flexible and nimble in picking their spots in terms of when to spend more on research & development (R&D), make “bolt-on” acquisitions, leverage the balance sheet but pay down debt quickly, buy back shares and grow their dividend.

This is why quality is so valued when we find it. We screen over 7,000 companies from around the globe and only find such quality in about 80 firms, or a little

more than 1% of our investable universe. While a lot of monitoring goes into maintaining a position, our strategy from the outside may look like, “Do nothing”.

Instead, our omission of action is an illusion. Holding these types of companies allows for active compounding of price in a tax efficient manner and the compounding of dividends to create increased income over time. Both factors are critical inputs to create wealth.

It should, therefore, not come as a surprise that, at Liberty, we avoid the growth versus value debate. As the economic cycle changes, active trading exposes one to higher taxes, higher trading costs and the risk of timing the market wrong. These actions are characteristics of wealth destruction, not wealth creation.

### *Is there any time of year when you prefer to buy stocks?*

If the worst equity markets have occurred historically in September or October, common sense would suggest that markets should be cheapest after the storm.

Combined with the fact that the fourth quarter offers the strongest earnings in any year, along with dividend increase announcements, investors may find the best opportunity to buy in October.

We compared annual calendar returns starting in Year 2000 (January-to-December) to performance from October 24th to October 24th and discovered a significant difference.

For example, the average October 24th to October 24th returns for the TSX 300 Composite Index (6%), S&P 500 Index (6%) and MSCI Global Index (5%) paled

### *Why don't we just own the best 10 stocks each year?*

The difficulty with this question is identifying which stocks will be the best 10 performers each year. Unfortunately, no investment guru is God, nor do these experts have access to the newspaper headlines one year from now.

Instead, the discussion point to this question revolves more around how to manage risk. Unfortunately, many new investors only think about how much they can make (the upside) if the “hot stocks” rise at the same pace every year. They never think about risk (the downside) until they've lost money on that investment.

When I began investing in the late 1970s, the best thing that happened to me was watching my first stock purchase through a broker friend go to zero. After that experience, I fired them because I figured I could do just as badly myself.

in comparison to the Liberty stocks, whose October 24th to October 24th returns averaged 19%. It drops to 17% if you remove Shopify Inc. and its 116% return. Not all of the Liberty names provided those types of returns but 67 of 75 did (almost 90%).

Is this 17% average figure a guaranteed return each year? No, but the strategy has provided above-average returns about 75% of the time. That compares to calendar returns where markets have been higher historically about 67% of the time. That 8% of alpha (the amount the returns are greater than the benchmark) is significant and creates an edge for investors.

So, if you have money to invest, we believe the best time to do so is on October 24th.

I never forgot that lesson. In the succeeding years, I took many investment courses et voila! Here I am today running an investment firm with a clear mandate of managing risk to protect clients' capital.

Risk comes in all shapes and sizes:

- **Systematic risk** – the risk of being invested in a market such as real estate, stocks or bonds.
- **Non-systematic risk** - the risk of losing an investment due to company or industry-specific hazards. This risk is reduced through diversification.
- **Business risk** – the risk that a specific company will consistently turn a profit.
- **Country risk** - the risk that a country like Argentina won't be able to honor its financial commitments.

- **Credit or default risk** - the risk that a borrower will be unable to pay the contractual interest or principal on its debt obligations.
- **Currency risk** – the risk that exchange rates can create unrealized losses on the underlying investment instrument.
- **Interest rate risk** - the risk that an investment’s value will change due to a change in the absolute level of interest rates.
- **Political risk** - the risk an investment’s returns could suffer because of political instability or changes in a country’s laws.
- **Counterparty risk** - the likelihood or probability that one of those involved in a transaction might default on its contractual obligation. Financial investment products such as stocks, options, bonds and derivatives carry counterparty risk.

- **Liquidity risk** – the risk that some investments cannot be easily liquidated. Private equity investments are examples where you may not get your money out of the investment when you want to.

If new investors who wish to do it themselves put \$20,000 into a currently “hot” cryptocurrency investment and lose it all, how long will it take them to save another \$20,000 to invest?

Instead, it’s better that they focus on investing in relatively safer blue-chip stocks first to earn a positive return. Only after they’ve made money should they consider investing in riskier instruments.

And as for the best 10 investments, they change each year, often based on macroeconomic factors. Therefore, the odds are that investors should avoid last year’s best investments and focus on something else.

### How come the stock names stay the same with little turnover?

Some clients have asked if the companies we own today are still worth owning. The answer is a resounding “Yes”. That’s because, compared to their competition, they have the following characteristics:

- Free cash flow generation
- Strong financials
- Above-average market share
- Pricing power

These stocks may not earn similar returns each and every year, but over time, the free cash flow they generate gives them the financial flexibility to do what they want when they want to. Their competitors may be restricted in

their ability to make money, either because of a lack of any or all of the four characteristics noted above.

Here are three Liberty stocks (Toromont Industries, Danaher Corp. and Dassault Systemes) that most clients have held for a long time. Some years, they may not earn a great return and may even perform worse

Total Return Performance of 3 Liberty stocks vs. their comparative benchmarks (dividends re-invested)					
	STOCK SYMBOL	1-YEAR RETURN	5-YEAR RETURN	10-YEAR RETURN	15-YEAR RETURN
<b>Toromont Industries</b>	<b>TIH CN</b>	<b>21.88%</b>	<b>25.44%</b>	<b>21.24%</b>	<b>16.30%</b>
vs. TSX Composite Index	SPTSX	17.30%	10.76%	7.43%	6.83%
<b>Danaher Corp.</b>	<b>DHR US</b>	<b>21.02%</b>	<b>29.18%</b>	<b>21.45%</b>	<b>17.75%</b>
vs. S&P 500 Index	SPX	15.24%	17.62%	14.82%	10.72%
<b>Dassault Systemes</b>	<b>DSY FP</b>	<b>13.90%</b>	<b>25.12%</b>	<b>22.17%</b>	<b>17.38%</b>
vs. EuroStoxx 600 Index	SXXP	15.78%	10.06%	8.82%	5.93%

Data Courtesy of Bloomberg L.P.

than the underlying indexes but, over time, they have provided above-average performance returns for investors.

For example, Toromont Industries underperformed the TSX Composite Index in five of the last 15 years (2006, 2009, 2010, 2012 and 2014). Its long-term performances, however, are vastly superior, shown in the table above.

That's why it's so important to drown out the noise of short-term price movements and stay focused on

longer term returns. The easy way to think about investing is:

You're investing in a company that employs, say 30,000 people. If you have 30 stocks in your portfolio, you have essentially 1 million people working every day for you to create a profit, a percentage of which you receive each year in the form of a dividend – all without having to lift a finger. Ultimately, as the dividends rise, the share price has to follow.

## IN OTHER NEWS:

Patricia Matheson, our original client service manager, has taken full retirement to spend her time doting on her grandchildren.

We currently have five staff members (Farai Murove is on maternity leave) at Liberty to deal with client service. Virginia Randall leads the team that includes Alice Park, Farai, Sharang Arora and Victor Hulea.

Because we are a teaching institution, we are pleased to announce that Farai, James Coman and Alice Park recently passed their Canadian Securities Course exams.

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If you have any questions, let us know.

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Portfolio Manager & CFO

**Annie Bertrand CIM**  
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