GROW TOGETHER

CWB Wealth Management Newsletter

Q3 2016

President's Message *by David Schaffner*

Crisis What Crisis?

- Supertramp album, 1975

It would be nice to say that this year is different, with the markets being buffeted by various crises, but the historical "record" tells us otherwise. We know that markets are volatile, and that the higher the expected return for an asset, the higher the risk. But knowing what is "The Logical Song" (OK, different album!) and experiencing the markets in real time are two different things. Crises happen more regularly than we think they should, and the gyrations and dislocation that follow are a familiar tune. And, sure enough, some people will hit the right note and make piles of money when unexpected events like the outcome of the Brexit vote occur. But that isn't the realm of investing; it is the world of the speculator.

Even though Brexit and other events disrupt the risk appetite of markets in the short run, we know that ultimately the markets settle down and valuations reflect the long term prospects for companies. Our role is to steward our clients' hard earned money with a longer term focus based on their financial roadmap. While we want to avoid the potholes in the road, sometimes we just can't see them until they are right in front of us, but as long we hold on tight to the steering wheel and focus on the way ahead we will keep moving forward, hopefully without a tire change!

David Schaffner

The financial media loves to focus on the bad days in the market, and these are frequently linked to the crisis of the moment. However, the long term history of the stock markets show that if you miss the best days in a given year your investment returns are much lower over time. Avoiding the potholes by keeping your car off the road may eliminate the bumps, but it won't get you to your destination. As Maria Holowinsky points out in her article "Investor psychology: lessons from the snack dish", it isn't easy to avoid the temptation to focus on short term, market moving events, but that is what we must do to succeed in investing.

In this issue:

CWB WEALTH MANAGEMENT

Investor psychology: lessons from the snack dish

by Adroit Investment Management

It starts with the cashew dish. Or, a big bowl of chips and cream cheese and onion dip. Or a jumbo bag of tacos and salsa.

With summer season upon us, there is every incentive to act sensibly when confronted with these foods. Logic tells us we should nibble on a few cashews here, a couple of chips there, and move on to the vegetable tray.

Yet, when most of us mere mortals are confronted with these wickedly tasty and fattening foods that practically scream "bet you can't have just one!", we cave. Most of us will hang around the cashews until the bowl is empty. Hey, we're only human!

And therein lies the rub. If we were rational creatures, we would do the logical thing, and not give in to temptation. But how many of us are truly such rational creatures?

This poses a major problem for investors. Everything we're taught about investing assumes that investors behave rationally. Investment theories are based on the assumption that people, in their economic lives, are everywhere and always rational decision makers; those who aren't are either punished by the markets or go broke.

Anyone who has ever faced down a cashew dish and lost knows this just isn't so. As we move into the second half of the year, it's time to do a quick check up on how we make these decisions.

The following are three common mistakes investors make:

Overconfidence

People often see order where it does not exist and interpret accidental success to be the result of skill. This includes seeing patterns in random sequences in financial data. A good example is the ongoing fascination with online trading. Countless online sites promise to make online investors rich by showing them how to interpret the data to "reveal the secret trading patterns that make the pros rich" (wording is from an unsolicited e-mail which I received recently). Unfortunately, the riches turn to rags for most, and the secrets still remain undiscovered.

Selective Memory:

I call this the "Head in the Sand Theory", though many in behavioural finance folks will call it "confirmation bias". People tend to remember only what they want to. According to John Allen Paulos in his book Innumeracy: "There is a strong general tendency to filter out the bad and the failed and to focus on the good and successful."

In other words, investors will only see and hear the information that confirms what they already believe or want to believe.

A recent example of this is investors' watching the price of Valeant stock going higher and higher, "to go where no stock has gone before (apologies to Star Trek)", and congratulate themselves on how well they did in choosing this fine specimen. At the same time, all concerns about how expensive the stock was, questions about sustainability of earnings growth, were ignored… until it was too late.

Prospect Theory:

I call this the "Muddled Response Theory". People respond differently to equivalent situations, depending on whether they are presented in the context of a loss or a gain. Avoiding a loss is more important to people than making a gain.

Richard Thaler, a professor specializing in behavioral economics at the University of Chicago, uses this example: A friend of his admitted he mowed his own lawn to save $10, but he would never mow someone else's lawn for $10. Same $10, same action of mowing the lawn, different responses. Go figure.

I see the investment equivalent of this all of the time. People won't buy shares in OnlineMegaCorp because the price is down, and technology shares are depressed. But they won't sell OnlineMegaCorp if they already hold it, because they want to hold it until it goes up! The rational investor would not see a difference: if you would not buy the stock today, you should sell it.

The lessons in all of this? Investor, know thyself. If you understand your behavior, you can learn to adjust for your weaknesses and still profit.

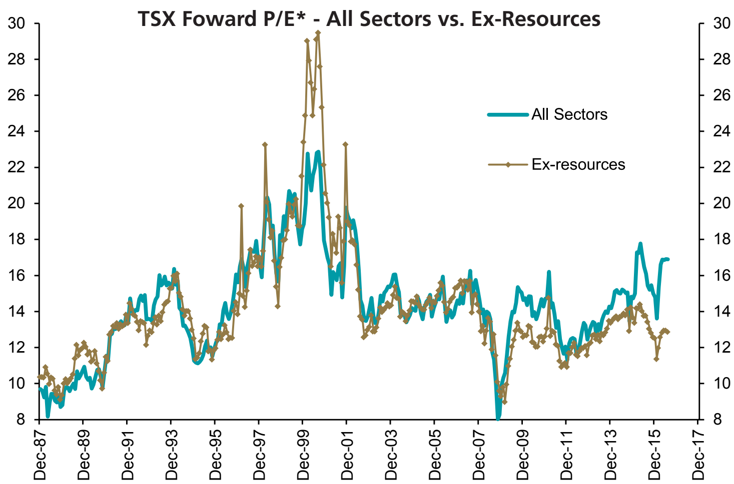
Makes sense to me. Oh, by the way, please move over. You're crowding the dish of Doritos.

Shifting Focus to Unloved Canadian Sectors and Understanding China's Debt Levels *by McLean & Partners Wealth Management*

The Toronto Stock Exchange (TSX) has been the second best performing market this year, up 10%, beaten only by the Brazilian market. Energy (19%) and materials (52%) are the best performing sectors, meanwhile healthcare (-72%) and information technology (-6%) have been the worst. Financials and banks are up modestly, but have been underperforming the TSX.

When the CWB Onyx funds launched in February, we focused on commodity stocks as we felt they were very undervalued and ripe for a recovery. We bought names such as Arc Resources, Pembina, Suncor, TransCanada and Vermilion. Since then, the energy sector has rallied and valuations have expanded materially. As seen in Figure 1, the price-to-earnings (P/E) ratio of the TSX (blue line) went from 14x, at the beginning of the year, to 17x, almost reaching the peak of 18x in 2015. The ex-resources P/E ratio, which represents the TSX excluding commodity stocks, (red line) increased from 11x to 13x , which is below the peak achieved in 2015 of 14x. This indicates that TSX non-commodities are trading cheap right now, and that is where we're shifting our focus to finding high quality companies that are undervalued. As an example of this, we have recently added Magna International to the Onyx funds. Magna International is one of the largest auto parts manufacturers in the world and yet it a trades at a P/E of 6.5x, a huge discount to the market.

Figure 1:



Source: Scotiabank GBM Portfolio Strategy, Thomson Financial

With the market focusing on energy- and metals- related sectors, we are seeing emerging value in other sectors. For example, consumer staples, such as grocers, have underperformed the TSX YTD. Some grocers trade at very compelling valuations and some generate very high levels of return on capital despite relatively slow growth. In addition, despite a sharp rally in materials, agriculture-related stocks lagged the TSX substantially. We continue to research several names in these sectors as possible holdings.

On the international side, China's debt has emerged as one of the biggest question marks in global economics, and many believe this to be the reason why China's economy will implode. We believe that understanding China's debt situation is crucial to why we find China attractive.

As a command economy, China's government is directly responsible for more kinds of debt than other major countries, whose private sectors play a much larger role in GDP. Acknowledging this fact, China has adopted an "only-in-China" measure of all debt and equity that enhances economic growth, issued by the Chinese governments and private companies, called Total Social Financing (TSF).

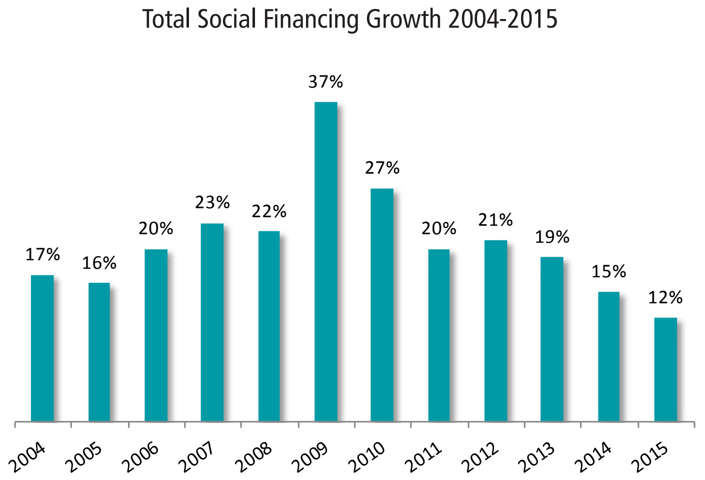
On this basis, China's accumulated public debt is estimated about 217% of GDP which is the same as the U.S., the U.K., and Korea. Germany has less debt at roughly 190%, but China's debt is comfortably below Japan's which is 400% of GDP.

Admittedly, China's total debt reached 217% much faster than other leading nations, as a consequence of underwriting the rapid economic expansion of the past decade. However, analysts that are worried about China's debt levels make the assumption that the government will continue to push debt-fueled, export-dependent industrial expansion, even in the face of significant over-capacity in sectors such as steelmaking. This thesis ignores the determined government commitment to transitioning the economy from export dependency to domestic consumption.

To be continued on page 4.

We are already seeing evidence of this shift through the rapid progress of the retail and services sectors, fueled by the growth of mobile internet and e-commercial. We believe China's transformation to a consumer economy will slow the growth of government debt to manageable levels, and that, in the interim, the Chinese government and People's Bank of China have the fiscal and monetary tools to successfully manage this transition. Figure 3 below shows the rate of growth of TSF in China is 12%, the lowest level since 2004, which is a clear indication that China's debt growth is moderating.

Figure 3:



Source: PBOC, Haver, Bernstein Analysis, China banks team

The fear around the Chinese economy has led investors to heavily discount the Chinese market, while our process — based on identification of high-quality, undervalued companies — strongly suggests that the risk/reward remains skewed to the upside. Examples of Chinese companies that we hold in the Onyx funds are Alibaba, Galaxy Entertainment, China Life Insurance, and Industrial and Commercial Bank of China (ICBC).

To wrap up, we want to emphasize that as an investment firm, we don't manage volatility in the markets – what we can and do manage is how we react (or more importantly, don't react) to it. Just because a stock is down, it doesn't necessarily mean the thesis is broken, or that it is a permanent impairment to the value of the stock. When the markets are volatile, or stocks move in a manner we don't expect, we remove emotional bias and reaction by reviewing our investment process which dictates whether the thesis is still intact or broken, and act accordingly.

CWB Wealth Management provides discretionary portfolio management and investment advisory services, as well as a range of financial planning, products and services. Along with our affiliates, Adroit Investment Management, McLean & Partners Wealth Management and Canadian Western Financial, we deliver a unified approach of providing solutions and support to help you achieve your vision for the future.

Put our expertise to work for you and reach out to one of our Wealth Management Specialists.
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