GROW TOGETHER

CWB Wealth Management Newsletter Q4 2016

President's Message *by David Schaffner*

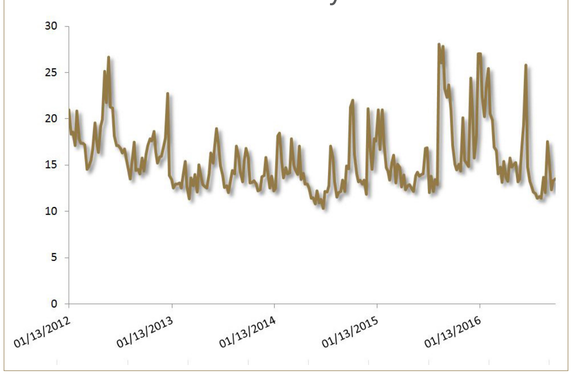
David Schaffner

Calm before the?

Since our last quarterly, equity markets enjoyed a period of relative calm over the warmer months of the summer, with volatility at the "cooler" end of the range as measured by the VIX Index in Chart 1.

Will volatility "heat up" as the weather cools down? It certainly looks that way. Investors are dealing with the potential slowing of the Canadian housing market, an uncertain outcome of the U.S. election, the U.K. moving forward on Brexit, increased speculation on the timing of the Federal Reserve's next interest rate hike, the potential for a "taper tantrum" for the Euro area if the market senses that quantitative easing may not last forever, and…STOP! The list is potentially endless of all the events where we can't reasonably forecast the outcome!

Chart 1 VIX Volatility Index



Let's look at what we can control and how can manage our investments prudently. We can control the risk in clients' portfolios by providing the appropriate needs-based solution, which is determined by our expert financial planners. We can make adjustments to clients' asset mix based on the insights of our asset allocation team. We can be consistent in applying our investment process in warm or cool markets.

Looking at asset mix, we see that overall valuations for equity markets will remain on the higher side of fair value, as measured by their current prices versus projected earnings over the next year. While we still expect to be rewarded for the risk of equities, the fuller value combined with the mix of unknowns over the next few months requires us to be more cautious. For the Onyx Portfolio Series, this has translated into building up our cash levels to take advantage of opportunities that higher volatility can present to reinvest at more attractive levels. We have also reduced credit exposure in our fixed income investments by lowering our holdings of preferred shares.

So, in the shorter run we can look to provide some protection in the event there is a storm after the calm, but still keep the portfolio focused on the longer term reward for holding a diversified portfolio of attractive equity and fixed income securities.

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CWB WEALTH MANAGEMENT

Don't be afraid of the dark

by Adroit Investment Management

"I'm fast as a sailfish, I'm strong as a shark; I'm smart as a dolphin, but I'm afraid of the dark." So say the Pout-Pout fish in a children's story[1] as he continues on his quest that takes him ever deeper in the dark depths of the ocean. It's dark, it's scary, and he wants to give up.

Over the last decade, the global economy has been descending deeper into the dark depths of low growth, modest investment returns, and increased political tension. Just like our intrepid fish, people are becoming scared; people are looking to give up.

When enough people are afraid, an opportunistic (and often well-meaning) politician can step forward to offer a populist solution. As an example, the politician could pick any identifiable group and have them punished under the guise of "If only (fill in the blank) could be punished, then all the problems of you fine people would disappear!" The choice of offending group could be based on ethnicity, or religion, or age, or gender, or wealth, or any number of other characteristics. The broad population is offered an avenue to surrender to their fear, to ignore their innate skill, and to throw up their hands and await a solution from someone else.

Living in Canada, the example that most likely springs to mind is the current U.S. presidential election. In this case both leading candidates are offering a populist, protectionist platform. Both candidates are proposing some measure of ensuring trade is "fair" for Americans. Neither seems to want to offer a clear definition of what "fair" means. Both are proposing plans that will purportedly benefit workers. Jobs will be created in roles where Americans are no longer efficient; wages will be paid that are not commensurate with skill levels. Neither candidate seems to want to discuss how to pay for these benefits. Neither candidate wants to discuss how these interventions will serve to stifle growth going forward.

You can see where this is going. People can be lured in by the promise of a quick fix, particularly a quick fix that doesn't cost them anything. No one wants to listen to the curmudgeonly economist proclaiming that these are not tenable solutions. Or more insidiously, someone might listen to the economist, but choose to believe that while the overall economy will suffer, his personal economic lot will improve.

The facets showing in the current US presidential election are certainly not limited to North America. There are many nationalist parties in Europe that have seen a dramatic increase in support and even parliamentary seats. South America is obviously no stranger to populist sentiments. This isn't even a modern phenomenon. History is littered with examples. Given all that history, we should be able to go back and review the success of the solutions. History suggests that the verdict is on the side of our confounding economist.

Why does practice fall so short of theory? Let's look at a simplified example. If you hire a mercenary to take something from me, surely you should end up better off. Surely the mercenary can capture more value than his cost to you. But the equation ignores the second and third order consequences. I'm not going to sit idly by. I'm going to hire my own mercenary to take something from you. At the end of the day we will each have what we started with, except, tellingly, for the cost of the two mercenaries.

What became of the fish from the beginning of the article? Did he extol the sun to shine brighter? Did he force one of his compatriots to clear the path before him? No. His friend reassured him, and reminded him, that despite his fear, he still had innate strengths. Pout-Pout used his skills, he made it through the darkness, he completed his quest, and everything was for the better in fishyland.

As investors we cannot influence policy. We take the economy as it is given. We take government policy as it is given. But if we have a good understanding of the path ahead, we can identify securities that will make it through the dark times. We can identify securities that will rise above the fear, and capitalize on their innate strengths. Our objective is to appraise the real risks, ignore the imaginary risks, and calmly navigate through shark infested waters.

[1] "The Pout-Pout Fish in the Big-Big Dark", Deborah Diesen

European Banks: Seeing the Opportunity through the Doom & Gloom *by McLean & Partners Wealth Management*

Investors have a myriad of reasons not to own European banks. Below are some of these reasons:

1. *A belief that negative interest rates will continue to pressure revenues and NII (Net Interest Income) in a downward spiraling profitability.*
2. *A belief that a slowing European economy will continue to hamper asset quality, leading to higher NPLs (non-performing loans).*
3. *EU banks have been the worst performing sector/ region out of 285 in the last 10 years.*

Yet where others see doom, despair and volatility, we see value and opportunity. We find that while the negative sentiment based on the current macro environment may be justified, it is more than reflected in our analysis of the company's valuations and stock prices. In addition, market expectations for revenue and profitability for our banks are down significantly, making the risk/reward very attractive as we believe the dire circumstances reflected in consensus downgrades will not materialize.

We believe the Italian banking sector is a poster child for our philosophy that macro uncertainties create micro opportunities. Italian banks are down some 35%-80% year-to-date (YTD) with the re-emergence of asset quality fears and potential additional provisioning needs. Yet within this toxic macro environment we consider Intesa Sanpaolo stock extremely attractive.

Our thesis is quite simple: Intesa has one of the best and most resilient business models, a progressive dividend policy and one of the strongest balance sheets in the sector - but it happens to reside in Italy. Consider that while most investors fret about what negative interest rates will do to the bank's NII, a closer look at Intesa reveals that almost 35% of its core revenue is generated from insurance and wealth management products, the highest in its peer group. To us, this means that its net income and net interest margin are much more resilient yet underappreciated and undervalued by the market.

On the cost side, Intesa has expensive funding on its balance sheet that is set to roll off the books, to be replaced by much cheaper wholesale maturities. This again provides margin upside which the market is paying no attention to. Finally, the beauty of being the best bank among bad banks in Italy is that while many peers are focused on restructuring and/or are capital constrained, Intesa is well positioned to take market share and protect pricing. From a dividend perspective, Intesa has made returning excess capital to shareholders a priority.

A commitment to pay €3 billion in dividends in 2016 and €4 billion in 2017 means a consensus dividend yield of 9% in 2016 and 10% in 2017, and while the high yield suggests that the market doubts payment, we believe management will make good on its commitment. Our belief stems from the fact that Intesa has one of the strongest and underrated balance sheets amongst EU banks. Its capital ratio and buffer – known as SREP or Supervisory Review and Evaluation Process, which the European Central Bank (as the banking regulator) uses to measure how strong the balance sheet is and make certain that institutions have adequate arrangements, strategies, processes and mechanisms as well as capital and liquidity to ensure sound management and coverage of their risks, to which they are or might be exposed – is one of the highest in its group. For Intesa, this means a strong capital ratio (or CET1) of 12.7%, an SREP of 9.5% and a capital buffer of 3.2%, one of the highest in Europe.

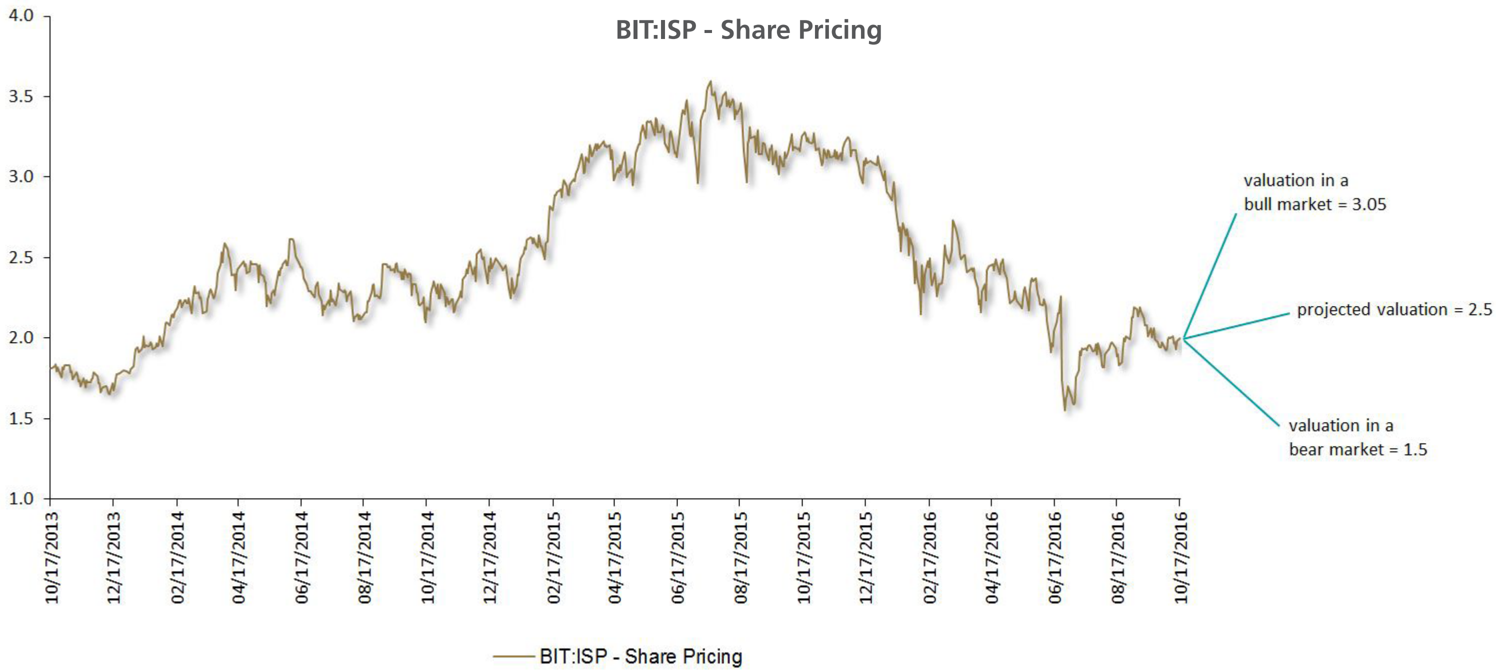
So what does the current stock price of €2.00 reflect?

That question is undoubtedly one of the most important we ask when determining if we buy the stock and how much capital we allocate to the stock. This is extremely important due to the fact that no matter how great we think a company and its stock is and that it ticks every box of our investment process, if all of those expectations are reflected in the stock price then none of it matters because the stock will not perform.

For Intesa, we note that the stock price performance of -35% YTD is an indication that investors are extremely skeptical of the thesis and analysis we put forth. In fact, consensus profit expectations for 2017 have been ratcheted down 20% by analysts. The valuation metrics also reflect very low expectations with Intesa trading at a P/B of 0.75 and a P/E of 8x. Finally, with a Return on Tangible Equity of over 10% and a 9% dividend yield, we believe the risk/reward is definitely skewed to the upside with an intrinsic value of €2.50 (Figure 1).

To be continued on page 4.

Figure 1: Intesa SanPaolo Stock Chart



Source: Bloomberg

Client Relationship Model 2 (CRM2)

CRM2 is the second phase of the Canadian Securities Administrators' (CSA) Client Relationship rule changes that apply to all securities dealers and portfolio managers registered with any Securities Commission. CRM came into effect on July 15, 2013 and had several stages of implementation, with the most recent being expanded annual client account reporting requirements including fee and performance information.

At CWB Wealth Management, we fully support the regulatory reform in the investment industry aimed to create transparency and strengthen the advisor-client relationship. We are committed to providing you with the service and support needed to achieve your investing objectives including:

- **Ongoing needs and risk assessment**
- **Record keeping**
- **Account statements**
- **Mutual fund options including the CWB Onyx Portfolio Solutions**
- **Access to information including online account services**
- **Transaction fulfillment based on individual needs**
- **Guidance on meeting personal goals and objectives**

Should you have any questions about how these reporting changes will affect you, or on the costs and performance of your investments, please do not hesitate to reach out to your Account Manager or one of our Wealth Management Specialists.

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