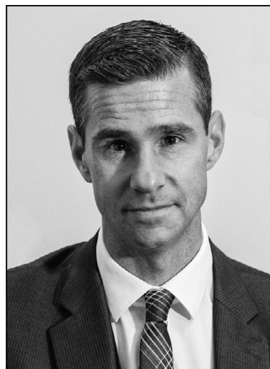
Portfolio Management Commentary

Quarter Ending December 31, 2018



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I think most of us are glad that the final quarter of 2018 has ended. Almost on cue, the annual highs in the S&P 500 were immediately reversed and the selling ensued. To put it in context, the US market had its worst quarter since the financial crisis of 2008-2009. It dropped an astounding 14% in three months time. Canada did slightly better, but with an almost 11% decline in the S&P TSX, we did not escape the market downturn.

Why, is probably the question that will be hotly debated for years to come.

In my opinion, it boils down to a few basic thoughts. First, major market players such as institutional money managers decided to sell. This started in early October just after the highs were in for the year, then again in mid-November, after hedge fund redemption notices were received, and again in December, when the Fed raised short-term interest rates. Keep in mind that the "quant-heads"—algorithmic trading platforms and computer-assisted traders—aren't like you and me. They can hold positions for fractions of seconds (aka high frequency trading), create flash crashes, and disrupt our short-term performance figures. Should we worry? No. Markets do return to normalcy after a period of time. We just need to keep our heads on straight and realize that the time to de-risk a portfolio occurs before or after a cascading sell-off and not during.

Second, the news finally got to investors. Up until September the mantra was buy the dip. After September, it was sell the rally. This was also exacerbated by high frequency trading employed by such participants as the quant-heads. Before the negative news, headlines were shrugged off by the investing public, but no more. The ideas of tariffs, global economic deceleration, impeachment, inverted yield curves, and recessions had more emotional sting and some factual truth. People's fear fueled the sale of risk assets like stocks, commodities, and high yield debt.

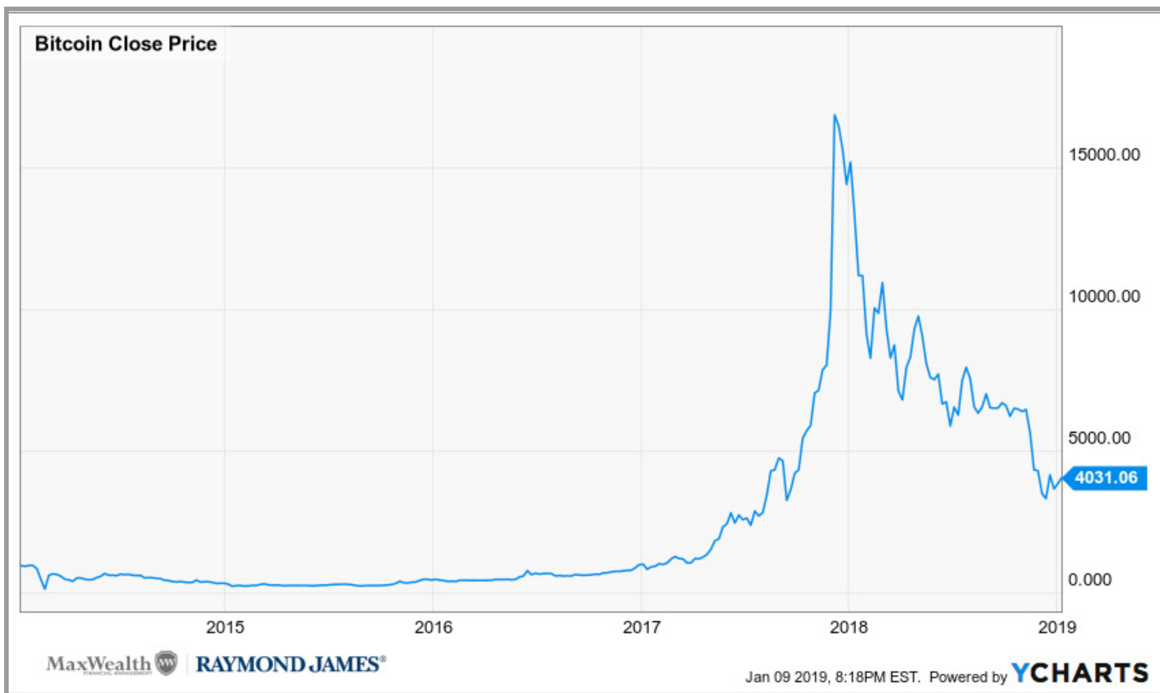
Third, volatility returned to the market. Remember back in February-March of 2018 the S&P 500 sold off roughly 10% and volatility spiked. The market actually shrugged this off for the next six months and volatility crept lower until the beginning of October. The difference this time is that there was a more pronounced sell-off in equities which culminated in the lows seen on Christmas Eve.

Okay, so what now?

I think the first measure is to be realistic and accurate. Markets experience price corrections. This is an inevitability that all investors must come to grips with. Sometimes it is slow and orderly, and sometimes, like the last quarter, it is fast and furious. But just because we had a bad investing quarter does that mean we should abandon our long-term financial goals? Clearly not. It's best to formulate an informed opinion before making a change rather than a knee-jerk liquidation based on emotion. We labour and debate intensely before we make any adjustments to your portfolio. We don't want to be the herd, we want to profit from it!

We need to be adaptive to changes in the marketplace. Many believed, as did we, that a Christmas rally was in play. Unfortunately, it did not materialize to our level of expectation. We can be upset and distracted by this fact or we can strategize for the upcoming year. We chose the latter option. And part of that strategy is to review every holding with an eye towards its fit in your overall portfolio, its risk characteristics, and its capacity to fulfill the objectives of your goals.

Over time, assets regress to the mean. In other words, there is not a straight line to financial gains. There comes a time in any investment lifespan where a belief in its overvaluation leads to selling and a belief in its undervaluation leads to buying. This is why is it extremely important not to place too much trust, hope, or cash in any one idea. The way to counteract this effect is to diversify amongst different investments and to have a realistic time horizon for the realization of return. A great visual of this is the rise and fall of bitcoin. As you can see the parabolic move from 2017-2018 eventually ran out of steam. Those who bought at the top saw a near 80% decline in one year. Ouch!



For the record, I have no idea of its future. I can only say that things that tend to go straight up, tend to come straight down.

Your Portfolio

There were some targeted trades in the portfolio in the past three months. Technology exposure in the balanced and growth strategies was reduced in mid-October as we sold our position in XIT.TO (iShares S&P/TSX Capped Info Tech ETF) and reduced our weighting in TXF.TO (First Asset Tech Giants Covered Call ETF). The rationale was twofold: a) most owners had profits which could be realized, b) technology became the weakest sector and a reduced exposure was reasonable considering the risk. Also, XMH.TO (iShares S&P Mid-Cap ETF) was reduced to half positional weighting to reduce US equity exposure in the growth strategy. Clearly with hindsight, more should have been taken off the table. One position was added to the growth strategy: CGL.TO (iShares Gold Bullion ETF). We added a 5% weighting in gold as an insurance policy against further weakness in risk assets, as a seasonal trade with a positive expectancy, and because we identified a breakout in the chart pattern. Keep in mind that gold is an asset to rent, not own, and we will eventually exit the position. The income strategy, Canadian dividend growth strategy and US capital growth strategy saw fewer transactions due to the lower initial technology exposure, higher cash levels, and fixed income weightings.

Final Thoughts

There was no doubt that Q4 2018 was challenging for investors. The steep daily declines, poor bid-ask spreads, and indiscriminate selling by market participants made it difficult to watch. However, we did not give into our emotions and simply liquidate as some did. We held fast, de-risked as appropriate, sat on our cash, and have been patiently awaiting a more normal market for future considerations. From a technical standpoint damage has been done. The major global stock exchanges are facing downtrends and price momentum was negative into year end. However, the contrarian would mention that the sell-off has been extreme and prone to some form of relief rally. The million-dollar question is: Is this just a correction within a secular bull market or the beginning of new bear market?

There is evidence to support both viewpoints and clearly the financial media is having a field day parading the speakers around the circuit. I would like to revisit an earlier point about adaptability. We need to be flexible on our view about the markets, the economy, and our place within it. Risks constantly need to be assessed and action taken when appropriate. There are times when assets need to be sold to protect capital and times when assets need to be bought to ensure future prosperity. We are constantly moving in this continuum and in the days, weeks, months, and years ahead we will be using both strategies to improve your risk adjusted returns.

A final note for this quarter. Even though many of you have seen some monthly statements that look ugly, the year has not been a rout. Most of you have seen less loss than the overall averages while having the added benefit of diversity and cash available for future investments. As always I am available to discuss your personal financial situation in context of your investment portfolio.

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