The Tinnerman Wealth Fall Brief

Fall 2015

Financial markets are many things, but boring is not one of them as we saw firsthand last quarter. The normally quiet month of August was full of excitement this year as investors who were already worried about the U.S. Federal Reserve preparing to raise interest rates were shocked by the unexpected move by the Chinese government to devalue the Yuan. Global equity markets weakened and volatility soared with the Dow Jones Industrial Average setting a new single day record after it dropped by more than one thousand points on August 24th. Things eventually settled down, but not for long, as the Fed decided that it would not "tighten" on September 17th despite having signalled strongly that rates would be increased after years at record low levels.

In the interests of brevity, we will ignore the seemingly innumerable number of other notable events of the quarter and skip to the unusual comments made by James Bullard, President of the St. Louis Fed, during a CNBC interview on September 21st. During the interview, Bullard called out Jim Cramer, the host of CNBC's Mad Money saying,

> "The Fed cannot permanently raise stock prices. ... to have (Cramer) cheerleading for lower rates 24-hours a day is, I think, unsavory".

Bullard's comments are noteworthy because Cramer is far from being alone in his calls for the Fed to support the markets whenever they appear to be weakening. Many other professionals in the investment industry seem to believe that the sole responsibility of the Federal Reserve is to enact policies that support and/or increase asset prices. Such wishful thinking is understandable because rising asset prices are good for investors, clients, and commentators alike. And rising prices are good for the economy under the wealth effect theory which postulates that investment gains make people more financially confident which in turn causes them to spend more money.

Through the support of the money printing policies of the Federal Reserve and other central banks, this "virtuous wealth effect circle" has been in place since the end of 2008. We have now had almost 7 years of zero interest rates and, as the below chart shows, the S&P 500 has risen nearly unabated during this time. The fact that the S&P 500 has not stumbled has been due in large part to the Federal Reserve which has consistently supported markets either through additional policy interventions (e.g. quantitative easing – editions 1, 2, & 3) or through verbal reassurances as happened this past month when the Fed justified its decision to keep holding rates at zero.

Let's connect

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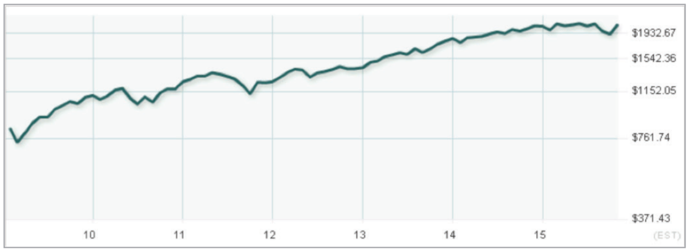
S&P 500 since January 1, 2009 to Present:



Thinking about the current situation in markets, we were reminded of our most recent letter and our discussion of the financial challenges facing the millennial generation. Many of these challenges have arisen because central bankers have been engaged in money printing for so long now that millennials simply do not know anything else. Although it seems inconceivable to us, the hard truth is that many financial market participants possess similarly narrow financial experience. This is due to the fact that, in addition to having kept rates at zero for seven years now, the Fed has not tightened (i.e. raised) rates since June, 2006. Consequently, any portfolio manager who has been managing money for less than 10 years has no firsthand knowledge of, or experience with, markets that have not been artificially supported.

As James Bullard alluded to earlier, central banks will one day stop manipulating asset prices, at which time, we are pretty certain that the financial markets are going to take some hits. If you recall, in our letter from the start of 2014, we quoted the boxer, "Iron" Mike Tyson, who said that, "Everybody has a plan until they get hit. Then, like a rat, they stop and freeze." Market participants would do well to consider that much of the turmoil in August and September came as a result of the Fed signalling that it might raise rates from zero to ¼ of one percent.

Using our boxing analogy for context, what we saw last quarter was the response of markets and investors to the possibility that they would get hit. This begs the question as to what might happen when investors actually do end up getting hit. Given our experience, we are pretty sure the plans currently in place will go out the window – our longstanding clients will recall that equity and fixed income markets around the world reacted very badly after the Federal Reserve began raising rates in January 1994. To put the current situation into context, it is worth noting that the Fed did not stop tightening until 14 months had passed during which time the Funds Rate had risen by 3 full percentage points from 3.0 to 6.0 percent!

Although the markets did settle down last quarter on the reassuring words of the Fed, it was not enough for the S&P500 Index to recover all of its lost ground. The S&P500 ended up turning in its worst quarterly performance in 4 years as it lost 6.44% in U.S. dollar terms to finish down 5.29% year-to-date in 2015. The story was the same for most global markets, including Canada, where the S&P TSX Composite Index fell 7.86% in C$ terms during the quarter to finish down 7.02% year-to-date. Against this tough investment backdrop we are pleased to report that our client portfolios were relatively unscathed last quarter. Note that, because we manage our client portfolios individually (we do not believe in a one-size-fits-all investment management approach), we must again ask you to please look at your statements to see your personal return numbers.

Generally speaking, we have been pleased by the performance of our client portfolios and by the calm response of our clients to the recent market volatility – but we have been less than pleased with the opportunities that the markets have presented to date. In this regard, we have yet to see compelling values in the shares of companies that meet our criteria of being "better businesses". Some share prices have dropped meaningfully, but so far, it has only been for companies which we would not want to own at any valuation. Therefore, despite our keeping a very close eye on the markets for the past several months, we have had little to buy and, for the third year in a row, we have had little to sell for the purposes of realizing tax losses. But we are not complaining as many investors have greater problems than having too few compelling investment opportunities.

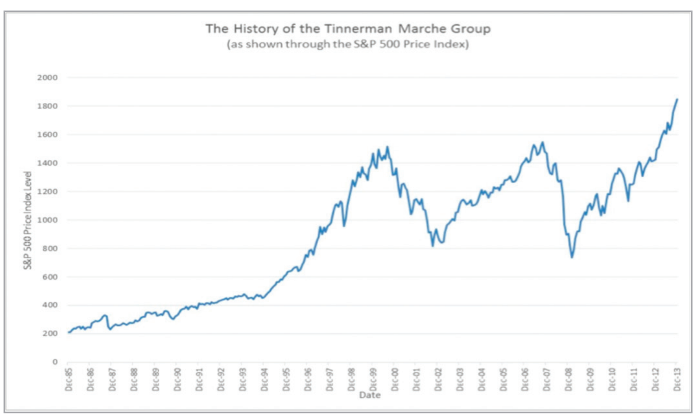
In reading this letter, it might seem that our primary focus as portfolio managers is on macro considerations, foremost among which are the financial markets and the Federal Reserve. Nothing could be further from the truth as we spend the vast majority of our time and efforts on evaluating individual investments for the purposes of constructing client portfolios which have attractive risk and return characteristics. Our interest in the markets and the Fed stem from the reality that the collective thinking, actions, and emotional reactions of investors influences our ability to make investments in better businesses at attractive prices. As we have all heard from our parents or teachers at one time or other, you cannot control other people's actions, but you can control your responses to their actions. In the financial industry, control is what separates those who take advantage of the opportunities that occur when the markets get hit from those who stop and freeze.

Over the years, we have had more than a few clients tell us that they did not want to be a bother by calling us during times of market volatility, such as occurred this past quarter. Such concern is appreciated but unwarranted – we are always available to talk because we hold to our investment discipline regardless of what the markets are doing. To reiterate, we focus on owning companies which have simple and easy to understand business models, can be acquired at prices that offer a margin of safety, have strong balance sheets, have predictable and sustainable revenues, and possess the means for generating above average returns over the long term. On the surface, this may sound simple to do, but it is a complex and time consuming process which can only be properly done before – not during – times of markets volatility. The same typically holds true when it comes to the analysis and selection of fixed income investments, and anyone who says or does otherwise, is a market speculator at best.

Looking back at what happened during the past quarter within the context of the foregoing letter, it struck us that a broader discussion of our investment discipline was warranted. To this end, I do not think that we can do better than the discussion which we presented in our Winter 2014 letter. Now, as then, this letter captures our thoughts on investment success and we therefore provide the following excerpt for your reference. As always, we invite you to give us a call if you (or your family or friends) would like to discuss this letter or any other wealth management concerns which you may have.

Excerpt from Winter 2014 letter

Figure 1 (below) shows that we have experienced many market drops during our 29 year history – including three of the largest market crises in history (i.e. Black Monday, the bursting of the tech bubble, and the 2008-09 financial crisis). And while we always look for opportunities to add to our positions during times of market weakness, it is our experience that no-one can predict the magnitude of a market correction before it happens – or even while it is happening!



The 2008-09 crisis provided some pretty good lessons on the subject of markets and corrections, and in this regard, we would like to revisit an excellent case in point. For this we turn to the following excerpt from a New York Times op-ed which was written during the financial crisis by Warren Buffett – who is arguably the greatest investor and investment philosopher of our time.

> THE financial world is a mess, both in the United States and abroad. Its problems, moreover, have been leaking into the general economy, and the leaks are now turning into a gusher. In the near term, unemployment will rise, business activity will falter and headlines will continue to be scary.
>
> So ... I've been buying American stocks. This is my personal account I'm talking about, in which I previously owned nothing but United States government bonds. (This description leaves aside my Berkshire Hathaway holdings, which are all committed to philanthropy.) If prices keep looking attractive, my non-Berkshire net worth will soon be 100 percent in United States equities.

When this piece from Warren Buffet was published on October 17, 2008, the S&P 500 closed at 940.55. At this point, the price index had fallen some 40% from its pre-crisis peak of 1,565.15, and Warren Buffett was widely reported as having called the market bottom. The sense was that it was an opportune time to buy stocks and so a lot of people went out and invested with the idea that the markets were not likely to fall much further, if at all. Hereafter, whenever you hear someone spout this sort of simplistic planning or reasoning, we would suggest you bring to their attention the words of another less-acknowledged, but well-known philosopher, the heavy-weight champion boxer, "Iron" Mike Tyson, who famously said:

> "Everybody has a plan until they get hit". "Then, like a rat, they stop and freeze".

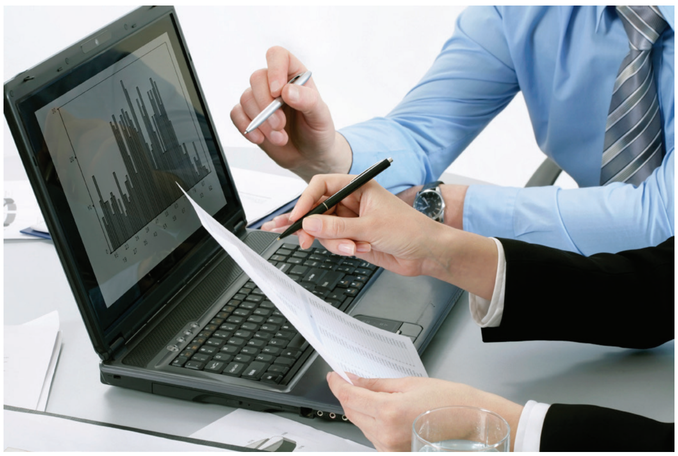
The beauty of this quote is that it is so simple and yet, there is a deep subtlety to it. Boxing is a sport in which fighters expect to get hit many times, so what Tyson is really saying is that what matters most is what people do after they get hit in some unexpected way. This "principle" of surviving "hits" applies to just about everything and everyone, including Warren Buffett.

After Buffett's op-ed, the markets went on to prove that October 17, 2008 was in fact not a very good day to invest as the S&P 500 proceeded to fall for almost five more months until it reached the historic intraday (and very fitting) low of 666 on March 6, 2009. This was an additional drop of 29 percent and those investors who did not have both a proper plan and a proper mindset were not buying more stocks at the lows. At best, they were frozen in fear and at worst, they were leaving the market right at the bottom (while the Buffetts of the world were still buying) because they had long forgotten the other points which Buffett had made in that op-ed.

> A simple rule dictates my buying: Be fearful when others are greedy, and be greedy when others are fearful. And most certainly, fear is now widespread, gripping even seasoned investors. To be sure, investors are right to be wary of highly leveraged entities or businesses in weak competitive positions. But fears regarding the long-term prosperity of the nation's many sound companies make no sense. These businesses will

indeed suffer earnings hiccups, as they always have. But most major companies will be setting new profit records 5, 10 and 20 years from now.

Let me be clear on one point: I can't predict the short-term movements of the stock market. I haven't the faintest idea as to whether stocks will be higher or lower a month — or a year — from now. What is likely, however, is that the market will move higher, perhaps substantially so, well before either sentiment or the economy turns up. So if you wait for the robins, spring will be over.



Looking ahead, we know that at some unknown point in the future, the markets will correct by some meaningful amount. We also know that good companies will trade at attractive valuations before the markets bottom-out. And we know that there will be a lot of panic and hand-wringing as untold numbers of undisciplined and speculative investors will lose everything. And finally, we know that investors who are invested in high quality assets will lose some money, but they will not go bankrupt and, because they are solvent, these investors will have an opportunity to make a lot of money as long as they can keep a cool head and stay focused on the long term.

We know all this because we have seen this happen three times in our careers. We also know that taking advantage of irrational markets may sound simple, but it is far from easy to do. Success in such circumstances requires that an investors portfolio must first survive the type of "hit" which will be delivered by the financial equivalent of Mike Tyson. And second, that investor must overcome the emotional trauma that comes from seeing the scared reactions of everyone else (TV, newspapers, etc.) to such a "hit". Both are needed for an investor to keep moving (i.e. investing), and it is our view that it is our job to ensure that our clients and their portfolios thrive in irrational market situations.

If you re-read our letters and look through our equity and fixed income portfolios, you can see that we have not been chasing returns and taking on undue risk as so many managers have done while the markets have soared these past few years. As we noted at the outset of this letter, we invest in companies and issues which offer a combination of offensive (return) and defensive (risk) attributes so that our client portfolios are positioned to address a market downturn. And as far our emotional state goes, you can be sure that we will not be happy when such a market downturn does eventually come, but we will be ready to keep on investing. Clients who went through the 2008-09 financial crisis with us (and previous crises) know firsthand that we will be calling and working with you to ensure that you are also ready to keep on investing.

Sincerely,

Mark Tinnerman

Mark Tinnerman
Portfolio Manager

BMO Wealth Management
BMO Nesbitt Burns

Tinnerman Wealth Group

**Both Associate Portfolio Managers and Portfolio Managers can offer the BMO Nesbitt Burns Managed Portfolio Account to clients. For simplicity, we have used the term "Portfolio Manager".*
Bank of Montreal or its affiliates may act as a lender or provide other services to certain of the corporations mentioned herein and may receive remuneration for the same.