BMO Nesbitt Burns

High Level Investment Report

Trusted Advice & Peace of Mind

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Was this October a "Trick" or a "Treat"?

It seems like just last week I finished the Summer Issue of the "**High Level Investment Report**", and here we are in November already!

Typically, September to November seems to be a busy time for my clients where most people reorganize their lives after enjoying their Summer. School is back in session, organized sports begin again, most working people have used up their holidays and are back to the daily grind to finish off the year, and some retired clients are planning a winter getaway. It is also a time where investors and clients begin focusing in on their investments again.

If you have been one of my busy clients, then the last few months have certainly been a good time to be busy and not focused on the markets! When I wrote my early **August report, I addressed the volatility in the market and the potential risks that were possible for North American stock markets**. I expected that volatility would likely increase as we entered the Fall. This is exactly what happened, with North American markets dropping nearly 10% during August until their lowest points during September. The Federal Reserve didn't budge on interest rates in mid-September as many thought they would, causing more fluctuations for the month. **At the end of September, the Toronto Stock Exchange was down 9.06% and the S&P 500 was down 6.74% for the year.**

Fast forward one month to the end of October and the **Toronto Market gained a couple percent, but still down 7.54% for the year (**mind you the TSX would have done better had **Valeant Pharmaceuticals not fallen 48% in October,** which kept the market from rising as much as the US markets). The S&P 500 Index on the other hand had **one of the best monthly returns in decades** (up 8.30%) to finish the month back in a positive positon for the year at +0.99%

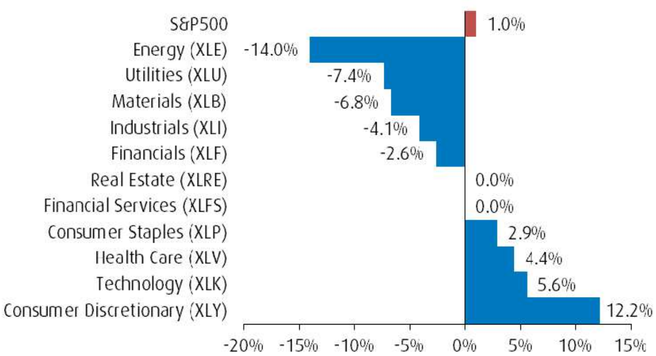
So was October a "trick" or a "treat?". Many market index returns are "market weighted", meaning the largest companies make up a higher percentage of the index return than the smaller companies. This is opposed to an "equal weighted" index, meaning that all companies share an equal percentage of the index and contribute equally to its returns. Over time the returns between the two are similar, **but at times like the present, the <u>returns in our main markets (that are quoted daily on TV) are being skewed by a select group of companies</u>, reflecting a market return that isn't shared by most portfolios' unless they are all Index Based Exchange Traded Funds.**

The following are some examples of what I mean by skewed market returns.

The Toronto market has recently experienced one of its largest company's by market value, Valeant Pharmaceuticals, come under immense selling pressure losing 60% of its value between September 21st and October 30th, 2015. The company has been in the news a lot, so I won't go into details on the company, but being that Valeant was almost 5% of the TSX market weighting, **a drop like Valeants' contributed to a 3% decline during the last 6 weeks all by itself**. Without Valeant declining, the Toronto market likely would have had a better October and more similar to the S&P 500.

In the U.S., the S&P 500 has had the opposite experience, where a certain few sectors of the market are performing well, and driving up the S&P 500 Index values, yet this isn't the experience of all the companies in the market. Below is a chart as of November 1st 2015, illustrating the sector performance within the S&P 500. **Note that the Consumer Discretionary sector has outperformed all other sectors by quite a margin.**

Figure 1: S&P500 Sector Performance (YTD)



Source: http://www.sectorspdr.com/sectorspdr/tools/sector-tracker

However, hidden within this sector data above in Figure 1, are the hidden returns of the **average company, as this sector has seen 12% returns based on the performance of a select few companies. This sector has pulled the S&P 500 index into positive territory again, but without these few companies things wouldn't look the same.**

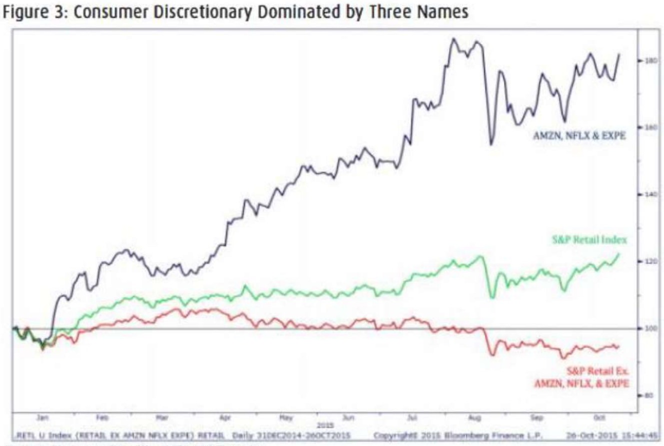
Figure 2 illustrates (in the upper pane of the chart), how the S&P Consumer Discretionary sector has recovered back to July highs, yet the bottom pane chart shows how the equal weighted index is comparing to the standard market weight index. The declining red arrow is showing how the average company is losing ground against the index influenced by a few large companies.

Figure 2: Smaller Caps Discretionary Stocks Doing Poorly Despite Sector Regaining Prior Highs

Source: Strategas Research Partners, Otterwood Capital Partners

In Figure 3 below, the chart illustrates the message another way, **using three specific companies, Amazon, Netflix, and Expedia.**

Figure 3: Consumer Discretionary Dominated by Three Names

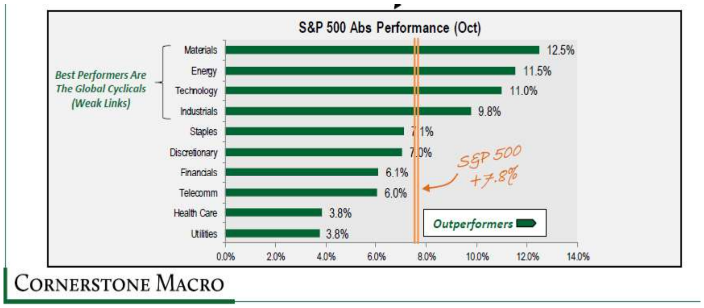


Source: Strategas, OtterWood Capital Partners

The top line is the performance of the three companies only. The green middle line is the S&P sector index, and **the red bottom line is the performance of the sector without the three companies, which you can see is a negative return, almost down 10% year to date.**

In the August report I discussed the overvalued sectors of the market, specifically Consumer companies, which I felt threatened the average investor because they could be caught invested in good companies, that are just simply too expensive. This chart above shows how the sector is influencing the markets' valuations, yet since the summer the **average consumer company is starting to fade and leadership is finding its way to other sectors quietly.**

The illustration on the next page does a good job of showing this rotation, and why I believe patience will be rewarded for those holding resource and materials stocks and **now isn't the time to be selling Canada**.



Oct 26 2015 – Cornerstone Macro Report

The chart above, shows performance of the various sectors in the US market during October 2015. The Consumer sector is still in the middle of the pack for the month, and is a leader year to date, but it was the Materials, Energy, Technology and Industrials that lead the way. On the back of hype over the potential for a December rate hike by the FED, these sectors showed to be most resilient. It is also because these sectors are the least influenced by rate increases within the market. **If rates are to rise, the market will obviously not reward the same companies that went up when rates fell.**

Another chart by Cornerstone Macro on November 5, 2015, illustrates the variance in the target prices set by analysts in the Energy, Materials and Industrial company shares. Energy and Materials have 15%-20% dispersion between share target prices, as compared to 5%-10% for shares in Financials, Utilities, Staples and Telecom companies. This means that analysts can't agree on what a company in these sectors should be worth. <u>There isn't a consensus, and in my view this shows that we are in the midst of a market leadership struggle and a changing of the guard</u>.

November 5, 2015 Cornerstone Macro Report

So what is the point in discussing these facts and statistics? Well, right now **investors are doing what kids do after Halloween**. They are digging through their plastic pumpkin bucket and are picking out the Reese Peanut Butter Cups, Twix, and the Doritos. **What they are really doing is picking their "go to" candies.** No different than what is happening in the stock market right now. **Large consumer companies and well-known brands are skewing investors focus and directing investment attention on the companies that may just give you the biggest toothache in the near future**. They will always be the staple, so there is comfort in this, they just might be costing a lot more than their worth. **It's the other candies, the ones that get picked-over and sit in the cupboard until Christmas, where the value is to be found**. These are the candies that don't cost a lot and nobody wanted to buy, and now they are on sale at real good prices now that October is over. **These are your best value and these "candies" represent the various other sectors of the market.** **<u>A balance of strong U.S. and International investments, tactically allocated, with a strong and increasing foothold in these aformentioned sectors should keep investors returns balanced into 2016.</u>**

For fun, the chart below shows America's top choice of Halloween Candy by State in 2015, by Influenster.

Back to the "Trick or Treat" question. After such a wild swing in the market this Summer and Fall, creating a lot of media attention, **all investors are likely asking themselves if that was all there is going to be for a market decline?**

- Has the October recovery in investors statements (**the October Treat**) confirmed we are headed higher with the markets?
- Or have investors been **Tricked**, and are again ignoring the market signals that are pleading for them to pay attention to their own tolerance for risk?

I want to finish this report by reconfirming that I am looking at the market in an optimistic fashion, but with patience.

Investors are on a bit of a sugar high after the last few years of money printing. When companies disappoint investors' expectations, even companies like Disney and Walmart can drop 10% in a day! Yet these are great investments, and these are the **opportunities one waits for.**

Very few, if any of my clients experienced the wild swings down 10% in the summer and then a recovery of 8% last month. **Overall the declines were in the couple percent range, and recovered modestly in October.** This is because of the rebalancing that has occurred with you this past year or so, and **because of the tactical strategies you are invested in**.

Interestingly, as of the time of writing this article (November 10th, 2015), 15 out of the last 17 days have been down for Gold Bullion (gold still holds above its earlier July low), **but it was actually the Gold Bullion and Gold Shares that were positive in the harsh months of August and September, and helped reduce the otherwise negative stock market performance most investors experienced.** Canadian markets for once weren't underperforming the U.S. Market due to this sectors return to resilience during uncertain times in the market. I expect this to continue in 2016.

Lastly, and to bring this Fall/Halloween report to a close, I wanted to comment on what my wife calls the **"Switch Witch."** Originally on "the Shark Tank", this is where, on the night of Halloween, a Witch comes and switches most of the candy from the kids (to be healthy of course), and replaces it with something better (a toy, or something with less sugar). I think it is a novel idea (not with my candy stash mind you), and **can be correlated to the message of this report**. **Sometimes it makes sense to lighten up on your hoard of favorites' and introduce a balance of other things**. I believe all of my clients are balanced already, and if not they have selected to be more focused with their investments.

The strategy is business as usual for the time being, and I continue to ask for clients to think about risk, their expectations for returns and how the two are related. How much can your statement decline before you take notice? When you do, how long will you give it to recover? Did this occur in the last few months? If so, these are good conversations for us to have right now as I want all of my clients to feel confident and comfortable with their investment strategy.

All the best,

Ryan Cockburn

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