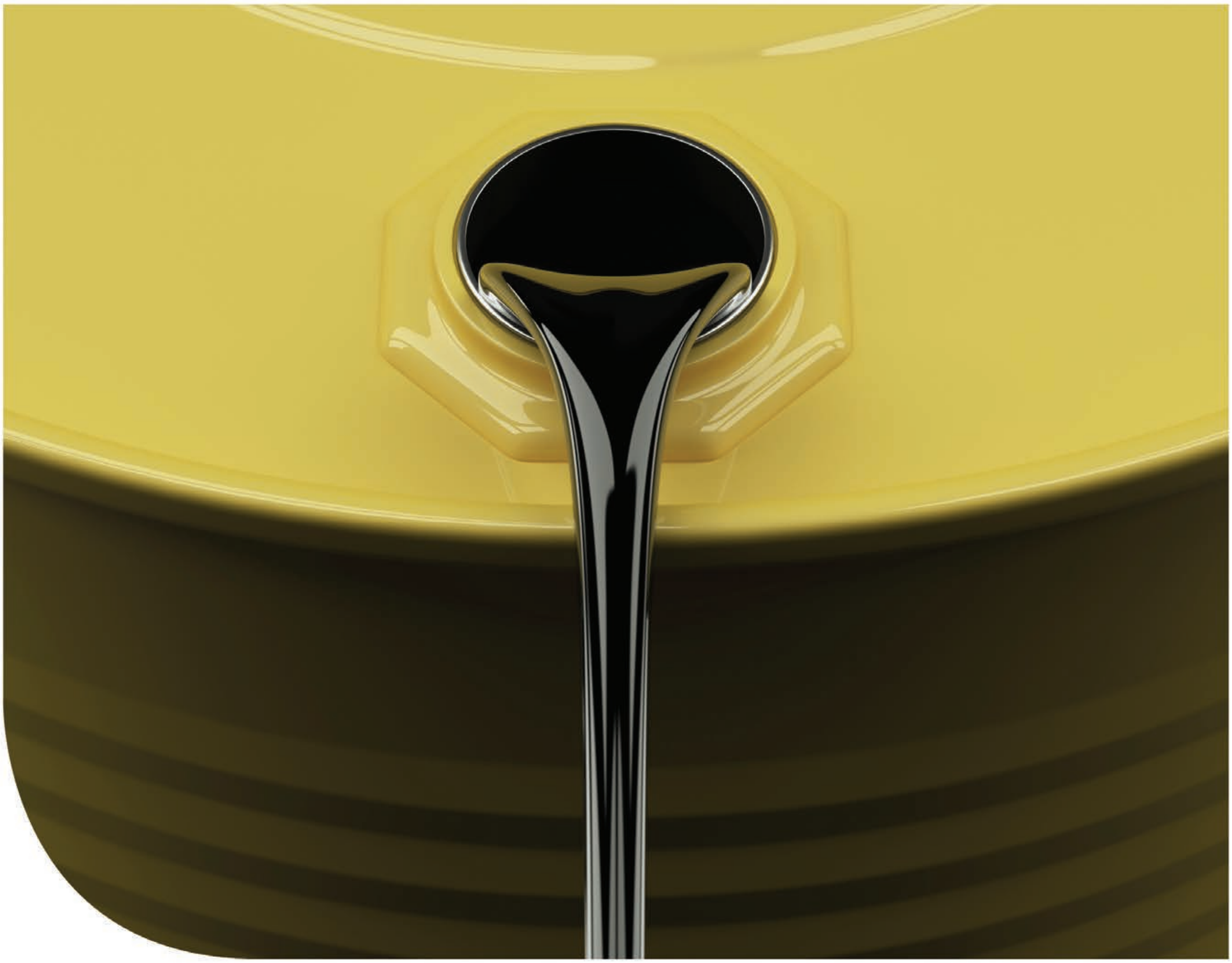
The Cosgrove-Brock Group

Newsletter #4 **Winter 2015**

A Crudely Built Economy



The COSGROVE-BROCK Group

BMO Nesbitt Burns®

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Philip's Comments

> "I know enough of the world now to have almost lost the capacity of being much surprised by anything"
>
> — ***Charles Dickens***, *David Copperfield*

Since publishing our last newsletter *"Are we there yet?"* markets have delivered more than a few surprises. In North America we have seen two very different pictures, depending on which side of the border we look at.

Canadian markets as represented by the S&P/TSX Composite Index have seen a decline of 3.6% in the last six months. Meanwhile, the S&P 500 Index has produced an equal and opposite increase of 3.6% over the same time period.[1]

Few of us can claim as strong an immunity to the unexpected as Dickens did. We have witnessed events since the writing of our summer newsletter that have surprised financial markets and that have challenged our thinking:

- At its January meeting, the Bank of Canada surprised just about everyone and lowered its key lending rate by 0.25% - the first interest rate move by the central bank in over four years. Economists expect another decrease later this year.[2]

- The Canadian dollar fell by 14.3% since August 1st as compared to the US dollar. As of right now, our loonie is worth just under 79 cents US.[3]

- The biggest change in financial markets in the last six months has been the 51% drop in the price of oil: from $97.88 / barrel to $48.24 / barrel.[4]

These events have forced us to examine the construction of our model portfolio and have reinforced our belief that holding a well-balanced, properly diversified, high quality portfolio such as our model is the best way to navigate even the most unpredictable financial markets.

As this is being written corporate earnings for the fourth quarter of 2014 are being released. So far, approximately 80% of companies have reported earnings above analysts' expectations. Understandably, energy companies have tended to report disappointing earnings. Also, a rising US dollar has put pressure on earnings for US companies with strong foreign-currency revenues.[5]

We made a significant security selection change in the model portfolio since the last newsletter was issued, removing Target Corp (TGT) from the model and adding Home Depot (HD). We feel that Home Depot provides us with better exposure to one of the main themes we discussed in the last newsletter – the continuing US housing recovery.

Challenging our thinking

Let's review how the above-mentioned changes in interest rates, exchange rates, and commodity prices tie in to our strategy and some of the themes from our previous newsletters.

Interest rates

We have been very cautious about the potential for *rising* interest rates since the first edition of our newsletter in August of 2013. We feel that this caution is still justified, if a little less urgent than initially thought. With rates as low as they are, a transition to a period of rising interest rates will have real consequences for investors and we have felt that the most prudent approach has been to prepare portfolios for that eventuality. We have taken actions to limit the impact of an eventual rise in interest rates such as:

- using laddered fixed income maturities comprised primarily of short-term issues
- adding floating-rate preferred shares in certain non-registered portfolios
- reducing exposure to utilities and real estate investment trusts (REITs) in favour of life insurers

So far, rates worldwide have remained historically low, a fact punctuated for Canadians by the 0.25% interest rate decrease announced on January 21st of this year. We have yet to be proven right by the markets. The bigger risk to our clients' invested capital is tied to a rising rate scenario, which is why we advise our readers to hold the course with a defensive posture in regards to the interest-rate sensitivity of their investment portfolios. While the current context does allow us to consider maturities beyond 1-5 years, we prefer to keep most maturities short-term and we are hesitant to take on any maturities beyond 10 years.

Currency moves

The most substantial change in the foreign exchange landscape from the standpoint of the Canadian investor has been the downward trajectory of the Canadian dollar compared to its US counterpart. The 14.3% drop we have seen in the last six months has been partly due to the fundamental strength of the US dollar and general US economic strength and partly due to the falling price of oil (which itself has helped further strengthen the US economy). More recently, falling Canadian interest rates have also pushed our loonie lower. Generally, a lower Canadian dollar will have a positive effect on Canadian companies that sell into foreign markets and are paid in more valuable US dollars. Conversely, some of the American companies in our model portfolio will face headwinds as their strong domestic currency hurts the profitability of their international operations.

One of the main underpinnings of our model portfolio is its inclusion of US equities in industrial sectors where Canadian options are fewer and of generally lower quality. This has resulted in exchange rate gains on the roughly 1/3 of the equity portfolio represented by US stocks. It is important to remember that when we purchase a foreign asset, like a US stock, we own both the asset and the currency in which it is valued. As the Canadian dollar has fallen, the US dollar and the stocks in our model that trade in USD terms has gained in value.

Commodities

Who has not been pleasantly surprised by a lower-than-expected number showing up on the gas pump in the last few months? The news has been good for drivers but not for investors: the falling price of oil has been the primary cause of the recent disappointing Canadian equity returns. How could it not? In August of last year, when we issued our latest newsletter, the energy industry represented 25.9% of the S&P/TSX Composite Index.[6] The risks of overconcentration are very clear.

The same principle that drove us to include US equities as part of the portfolio – diversification – has also kept a tight lid on the presence of the energy sector in our model portfolio. In our view, dedicating a very large component of the portfolio to energy stocks would have represented too great a risk due to overconcentration. We therefore set a 10% target for the energy sector in the model. This lower exposure to energy companies, combined with the positive currency effects of the US stocks in the portfolio (as described above), has helped us navigate this difficult market with greater ease and much greater stability.

A tale of two countries

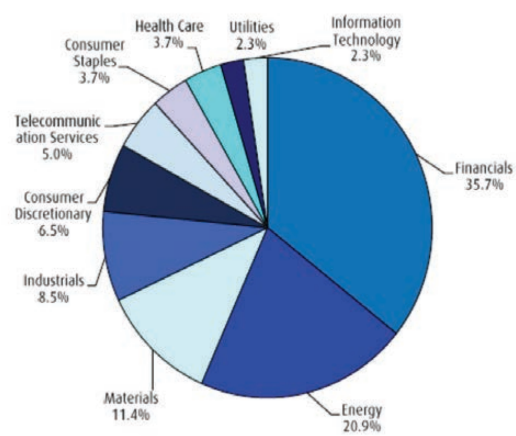
The last six months have demonstrated very clearly why it is so important to diversify portfolios beyond our borders. At the risk of sounding unpatriotic we must recognise that our economy is not balanced. As we see when we look at the sector allocation of the S&P/TSX Composite Index (Figure 1), the energy sector represents almost one fifth on the index, and this is after a 51% correction in the price of oil.

Figure 1: S&P/TSX Composite Sector Weightings

S&P/TSX Composite Index Sector Weights

GICs Sector	Market Weight (%)
Financials	35.7
Energy	20.9
Materials	11.4
Industrials	8.5
Consumer Discretionary	6.5
Telecommunication Services	5.0
Consumer Staples	3.7
Health Care	3.7
Utilities	2.3
Information Technology	2.3

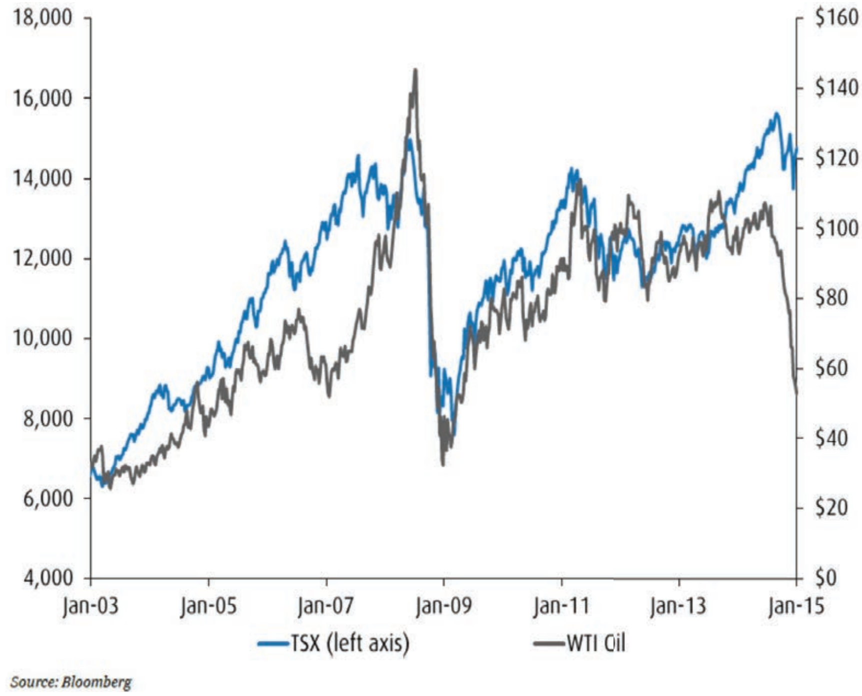
As of December 31, 2014
May not add up to 100% due to rounding



Source: Private Client Research, Asset Manager (January 2015)

It should not be surprising that such a crudely built stock market will follow energy prices in lock-step. Further evidence of this is seen in figure 2 which shows the high correlation between the S&P/TSX Composite and the price of oil.

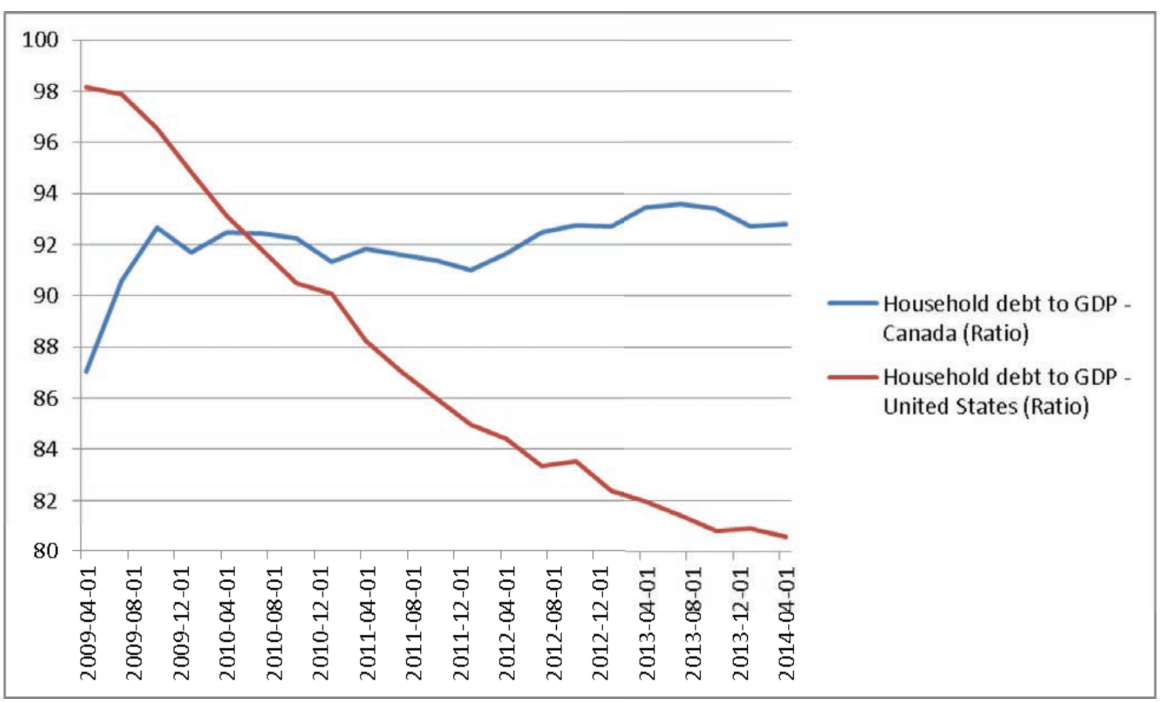
Figure 2: S&P/TSX Composite Index vs WTI Oil Shows an 87% Correlation



Source: Private Client Research, Bloomberg

Beyond the structure of our market, we must examine the actual drivers of economic growth. We have a US consumer who has now largely surpassed her Canadian counterpart in terms of the health of their respective balance sheets. In short: Canadians have more debt and therefore less capacity to spend than Americans (see figure 3).

Figure 3: Household Debt to GPD (US and Canada)



Source: St. Louis Federal Reserve

North America is truly the tale of two countries.

On one side of the border we see the US economy, stimulated by the low price of oil, showing strong employment figures, with a consumer able to spend.

On the other side of the border we find Canada with its limited menu of potential investments due to an overconcentrated stock market, a high correlation to the whims of a very volatile commodity, and a population taking on a greater amount of debt which may eventually constrain domestic consumption.

As the US dollar has gained in value as compared to the loonie, so has the Canadian dollar value of the US holdings in the model portfolio due partly to the currency gain. It may be tempting to lock-in the currency gains by selling the stocks and converting the proceeds back into CAD. Given the factors that we have identified above, our advice is to to continue to hold these positions and even to add to them, albeit in a more measured way than in previous months, despite the recent currency shifts.

From a portfolio management standpoint we will continue to place emphasis on US holdings in sectors where Canadian alternatives are limited. In Canada, dividend-rich sectors such as financial services, telecommunications, and utilities still provide interesting investment opportunities – despite the limitations of our crudely built economy.

Conclusion

The last six months have been some of the most eventful in recent memory for the Canadian economy. We feel that the structure of our model portfolio continues to be well-suited for the current environment; in particular our exposure to US equities and our conservative sector allocation have helped stabilise the portfolio.

- Falling energy prices and a decrease in interest rates both contributed to push the Canadian dollar down below 80 cents US, which has resulted in currency gains on the components of our model held in US Dollars. We feel comfortable continuing to add to US positions, though likely at a slower pace than before given the current exchange rate.

- We have benefitted greatly from the sector allocation of the model portfolio, in particular our 10% exposure to the energy sector as compared to the 20-25% exposure to energy in the S&P/TSX Composite Index.

- While interest rate increases do not look imminent, we continue to prefer a defensive posture by focusing on shorter term maturities in fixed income portfolios. We are open to complementing our short-term core fixed income holdings with terms beyond 5 years, but are hesitant to extend maturities beyond 10 years.

Asset Allocation

Every investor's asset allocation target should be determined through a financial planning process. The portfolio's equity allocation should be in line with this target when our view on the markets is "neutral". At times, financial markets will present us with possibilities for greater growth or greater risks. Modifying the asset allocation of the portfolio to account for these factors is appropriate, so long as the investor's actual asset allocation does not deviate too severely from their plan and remains within their investor profile and risk tolerance boundaries.

At this time our view is that portfolios should be tilted as follows (deviations are a percentage of equity exposure, not a percentage of the total portfolio):

For example, a portfolio with a long term strategic target of 60% equity should currently be targeting a 66% equity weight, which represents 110% of the long term equity target.

Please note that our Model Portfolio is meant to be a guide as to the equity portion of our clients' portfolios – not their entire portfolio. Clients who have *Balanced* or *Income* investor profiles will require significant assets in fixed income securities in addition to the equities they hold.

Model Portfolio Metrics

	Model Portfolio	MSCI World Index
Yield*	3.51%	2.41%
Portfolio Beta*	0.89	1.00
Number of Holdings	28	1636

Sector Allocation (Core Portfolio)

Financial Services	30.0%	20.9%
Telecom. Services	7.5%	3.3%
Utilities	7.5%	3.4%
Consumer Staples	10.0%	9.9%
Consumer Discretionary	10.0%	12.4%
Healthcare	5.0%	12.7%
Information Tech.	5.0%	13.4%
Industrials	10.0%	10.9%
Energy	10.0%	8.0%
Materials	5.0%	5.1%

*As at 2015-01-31; source: Thomson ONE

Meet Our Team

Elizabeth I. Cosgrove, CFP

Vice-President, Senior Investment Advisor and Financial Planner
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Elizabeth became an Investment Advisor in 1983 after spending her first 8 years in the business working as an assistant. She received her securities license in 1980 by successfully completing the Canadian Securities Course and the Canadian Options Course. Elizabeth achieved her Vice President status in 2004. She has been practicing financial planning as a CFP® certificant since 1998 after successfully completing all six courses offered by the Financial Planners Standards Council. Elizabeth is fluently bilingual and offers her services in either French or English.

Elizabeth was born and raised in Ottawa in a family of eight. She currently resides in Manotick with her husband David. They enjoy golfing, gardening, bird watching and playing music.

Philip Brock, CFA, CFP, B.Com

Investment Advisor and Financial Planner
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Since his entry in the financial industry in 2004, Philip has advised many families on retirement planning, personal credit, and investment management. He holds a Bachelor's degree in Commerce from the University of Ottawa and holds the Chartered Financial Analyst (CFA) designation. In addition, he has been practicing financial planning as a CFP® certificant since 2007. Philip is happy to offer his services in French, English or Spanish.

Born in Montreal, Philip has lived in the National Capital Region since 1987. He currently calls Orléans home along with his wife Kathleen and their young sons, David and Jonathan. When he's not providing financial advice to his clients, he can usually be found on the curling rink or off in the woods on a canoe trip.

Patricia Butler, B.A.

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Patricia has been in the financial services industry since 1985. She received a B.A. from Concordia University in 1987 and has completed the Canadian Securities Course and the Professional Financial Planning Course. She joined BMO Nesbitt Burns in March 2004. As Associate Investment Advisor, she engages with our clients around issues of financial planning and portfolio maintenance among others. Patricia is fluently bilingual and is happy to assist you in either French or English.

Patricia enjoys reading, playing soccer and golf and spending time with her husband and two children.

Debbie Kelly

Administrative Assistant
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Debbie joined BMO Nesbitt Burns in 1999 after a career in banking. Debbie takes care of all the administrative needs of the team. She will be happy to assist you with any inquiries you may have regarding your accounts. It is also her role to reach out to our clients to coordinate the scheduling of periodic review meetings.

Debbie grew up in a large family in the Pontiac and currently makes Orléans her home. She enjoys spending time with her three granddaughters.

[1, 3, 4] Thomson One

[2] BMO Capital Markets Economics, Focus, Douglas Porter, CFA, Chief Economist, January 23, 2015

[5] Private Client Research, Afternoon Update, S&P 500 Earnings Update (Factset), Stéphane Rochon, CFA, Equity Strategist, January 27, 2015

[6] Private Client Research, Asset Manager, August 2014

[7] Profiles for BNS, BCE, GE, GIS, ITW, IFC, JCI, MFC, NA, TD, TRP, and VET replicated from the December 2014 Canadian Equities Guided Portfolio and US Equities Guided Portfolio, BMO Nesbitt Burns Portfolio, Action and Research Team, December 2014

MSCI World Index, MSCI Inc, www.msci.com

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