The Cosgrove-Brock Group

Newsletter #2 Winter 2014

Holding the Course

The COSGROVE-BROCK Group

BMO Nesbitt Burns®

Making money make sense®

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Philip's Comments

The cold winds blowing in from the north this winter have chilled our home-base of Ottawa to the bone. Meteorologists have blamed the "polar vortex" – how ominous! And yet, as cold as the weather has been, one has only had to look to markets to find heat.

As this comment is being written markets are facing some head-winds: a well-deserved and necessary break in our view – especially after strong growth in 2013.

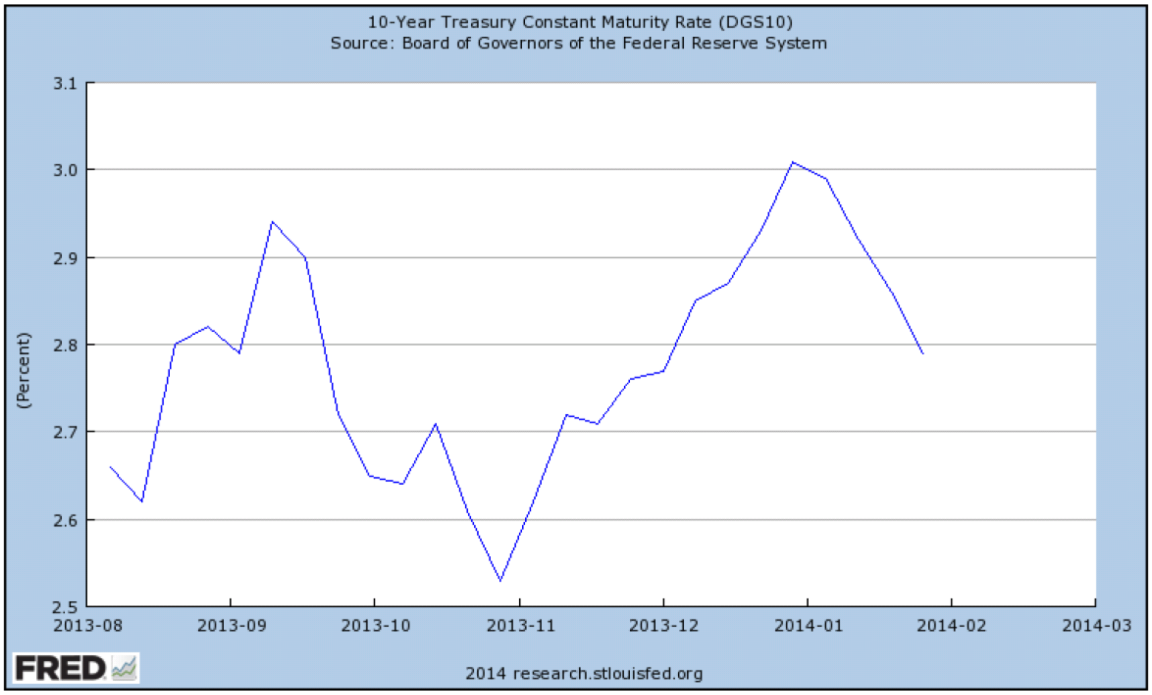
Setting aside the volatility that the end of January has delivered to us, 2013 gave us a brisk increase in equity markets with the S&P/TSX Composite Index generating a total return of 12.99% and the S&P500 delivering a very impressive total return of 32.39%[i].

Newsletter season means earnings season, with fourth quarter earnings in full swing at the time of writing. In a market that is driven by fundamentals it should be earnings (profits) that drive stock prices more than any other factor. We have heard from roughly half of the companies represented in the S&P500 so far and of those almost 70% have reported earnings that have beat analysts' expectations.[ii] The profitability of the businesses you own in your portfolio is of utmost importance and as business owners you will be happy to know that this earnings season has shown us corporate income statements that are quite healthy.

In the summer issue we delved into the role that changing interest rates may play in the management of money in the future. You will find this to be a recurring theme: it is our belief that adapting to the evolving interest rate environment will be the single greatest challenge portfolio managers will face in the foreseeable future. As a very preliminary salvo when discussing the "Risk of Safety" theme we recommended that clients increase their holdings in life insurance companies and begin to trim their exposures to interest-sensitive sectors like REITs and utilities.

Since then, short term rates have remained flat: the U.S. Federal Reserve has held short term rates in place and is not expected to raise them for another two years[iii]. The Bank of Canada, under the still-new leadership of Governor Poloz, has also held the course but do not be misled by their inactivity: interest rates are nothing more than the price of money and in our market-based economic system prices are not set by dictate, they are set by the marketplace. As shown in Chart 1 below, between July 31st and the end of December, 10-Year U.S. Treasuries increased substantially, hitting 3% for the first time since 2011 (though they decreased with January's market volatility, they are expected to continue to rise in the long term). This increase was not based on a boardroom decision at the Federal Reserve but rather the market dropping the value of 10-year U.S. Treasuries and so increasing their yield. This is likely how it will be with interest rates: central banks are still timid about increasing short term rates but as the economies of the world progress and emerge from their crises long-term rates will likely be adjusted higher by the bond market.

Chart 1: 10-Year Treasury Constant Maturity Rate (July 31 2013-January 30 2014)[iv]



As we mentioned last summer, it is time to get ready for a world with consistently higher interest rates. So far our advice to turn more towards life insurers and hold an underweight allocation of utilities and REITs has been beneficial. The S&P/TSX Capped REIT Index has generated a total return of 5.23% (August 1 2013 – January 31 2014) and the S&P/TSX Capped Utilities Index posted a 2.55% total return[v]. Meanwhile, over the same time period, the two life insurance companies in our Model Portfolio, Manulife and Great West Life, generated total returns of 12.79% and 6.66% respectively[vi]. We are holding firm with this approach at this time.

Lower Tide

The story of the new year from the standpoint of the Canadian investor has been the drop in the Canadian dollar. Our Loonie is worth roughly 10% less than it was this time last year with almost half of that decline occurring in January (see Chart 2).

Do not look to the Bank of Canada for support: Governor Poloz is quite content to see our dollar drop (at least to a point). His main concern is that inflation is too low; the increase in prices that you and I will see at the grocery store due to a weaker currency will not be causing him to lose sleep any time soon. Canadian exporters will have the wind at their back. A more favourable exchange rate will give them a competitive edge against their U.S. rivals and a strengthening U.S. economy will also provide significant momentum. Look to our energy sector to derive particular benefit from this phenomenon.

Chart 2: USD/CAD exchange rate 2013-01-01 to 2014-02-01[vii]

Source: Thomson ONE

One of our recommendations in July's issue of the newsletter was to continue to look to the U.S. as an area of relative value and diversification for Canadian investors. A by-product of the recent decline of the Canadian dollar will be higher currency-adjusted values for U.S. holdings in accounts. It will mean, however, that we will need to be more cautious if we continue to ramp up U.S. holdings: the lower Loonie will not have the same buying-power it did through 2013.

In the long run we do not feel that a low Canadian dollar is a benefit to Canadians. We are a developed economy and our currency is the stock of our country. Our business sector can more successfully drive productivity improvements in a high-Loonie environment and we can retain a more highly skilled workforce with a strong currency. In spite of this, the short term benefits to our export sector and to Canadians holding U.S. assets will be welcome to many.

Shifting Winds

Canada's currency is not the only one making headlines these days. A combination of factors, led by weaker-than-expected Chinese economic data, have sent emerging market currencies (and equity markets in emerging economies) falling fast. As of this writing the situation is not at a crisis level but in the past we have seen examples of economic troubles in emerging countries spreading from country to country like a bad cold.

Major instability in emerging markets usually has the effect of sending the U.S. dollar higher relative to world currencies as it acts as a safe haven for global capital. As mentioned earlier, this would yield positive returns for Canadian investors with positions in U.S. equities.

Another possible effect of turmoil in emerging market equities is weakness in Canadian equities. While Canada is certainly not “emerging”, our economy bears some similar characteristics due to the cyclicality of our natural resource industry. As Scott Barlow recently wrote in the Globe and Mail:

> *The correlation between the S&P/TSX Composite and the MSCI Emerging Markets Index is insanely, ridiculously high. Using monthly data from December, 2002, the “coefficient of determination” […] is 0.93. Charting the two indexes makes it obvious they are virtually the same line.*[viii]

For the moment we see this instability as a squall on the horizon. It may blow itself out but we must keep close track of it in the meantime.

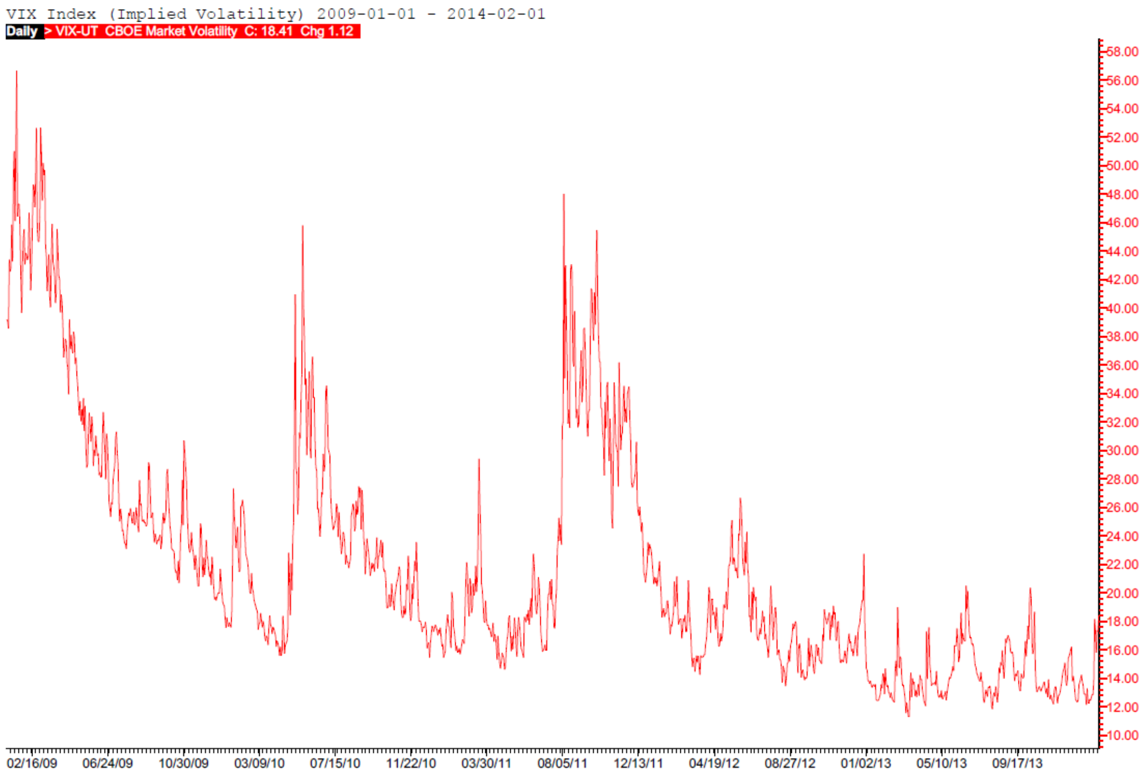
On February 1st, Janet Yellen will take the helm as Chair of the U.S. Federal Reserve, relieving Ben Bernanke after his 8-year tenure. Market observers expect no major course correction as she is said to be philosophically aligned with her predecessor. Bernanke’s two terms were challenging: one need only think of the financial crisis of 2008, the deep recession that resulted from it, the steep decline in interest rates and additional measures like Quantitative Easing (QE) implemented to address the crisis. In the final months of Bernanke’s chairmanship we have witnessed a reversal in regards to QE: two $10 billion decreases caused the monthly asset purchases to fall from $85 billion to $65 billion. It is expected that if the U.S. economy in general, and unemployment in particular, keep improving in the near-term, Chair Yellen will continue the gradual termination of the QE program.

We would see this as a positive development and one with major implications for portfolio managers. The “artificial stimulus” has certainly been positive for equity markets but with a stronger economy in place and less risk of a financial crisis we anticipate that its removal would not necessarily lead to falling markets. In a world without QE we would instead likely see equity pricing depend to a greater extent on company-by-company fundamentals. If the tagline for 2013 was “a rising tide lifts all boats” then 2014 may be the year where our skill as navigators is tested. Since last July we have not seen the need to make any changes to our Model Portfolio. We expect more activity to be required in 2014.

Calmer Seas

On the political front we faced choppy seas since the writing of our last newsletter. Our neighbours to the south played chicken twice: once over the shutdown of the U.S. government and once over the debt ceiling (the artificial limit Congress imposes on its borrowing – even if it must pay for spending it has already incurred). In 2011 the markets took a decidedly poor view of U.S. politicians playing fast and loose with the good faith and credit of the largest economy in the world. Markets were similarly temperamental this fall but not nearly to the same extent as two years prior. Chart 3 shows us the evolution of the VIX Index – a measure of market volatility. While it did spike this fall it was still only half as high as it was in 2011. We have also seen a general decline in market volatility since the financial crisis, with major peaks in 2010 and 2011 primarily due to the European debt crisis.

Chart 3: VIX Volatility Index – 2009-01-01 to 2014-02-01[ix]



Source: Thomson ONE

Markets have benefitted from a generally calmer financial situation in Europe and a budget deal between Democrats and Republicans struck this December which promised two years without another government shutdown. As this newsletter is being written another debt ceiling debate is fast approaching, with the U.S. Treasury suggesting that its borrowing authority could run out by Thursday, February 27th. Risk always exists with such deadlines but at the moment it seems that because 2014 is a mid-term election year Republicans are unlikely to risk the political damage that usually accompanies a drawn-out debate around the debt-ceiling.

Since 2014 is an election year partisanship will certainly be present. Despite this, there is a good chance that we may break the crisis-to-crisis-to-crisis routine we have followed since 2011, at least for a time. This would be a welcome calm after the political storms of years past.

Conclusion

We are not advising a major deviation from our strategy for the moment. While the headlines that will drive 2014 will certainly be different than those that influenced markets last year, we feel that equities still provide good relative value and so we are holding the course.

- Equity markets performed well in 2013 and we expect sustained (though perhaps more modest) growth from them this year. There are, however, many risks that could affect this forecast: continued instability in emerging markets, another contentious political debate around the U.S. debt ceiling, market indigestion regarding the end of Quantitative Easing, etc.

- Corporate income statements and balance sheets continue to be strong. With the gradual removal of the U.S. Federal Reserve's emergency stimulus measures (QE) and the potential for a calmer political environment we should see corporate fundamentals playing a greater role in the valuation of equities. Without losing sight of the long run nature of prudent investing, we may need to be more active in the management of our Model Portfolio in 2014.

- The falling Canadian dollar is in the short-term a positive occurrence for Canadian investors holding U.S. assets. Conversely, rising long-term interest rates is likely to be seen as negative. We remain adamant that investors should continue to underweight interest-sensitive sectors such as REITs and utilities in favour of life-insurers.

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*	3.49%	2.39%
Portfolio Beta*	0.92	1.00
Number of Holdings	28	1610

Sector Allocation (Core Portfolio)

Financial Services	30.0%	20.9%
Telecom. Services	7.5%	3.8%
Utilities	7.5%	3.1%
Consumer Staples	10.0%	9.9%
Consumer Discretionary	10.0%	12.3%
Healthcare	5.0%	11.3%
Information Tech.	5.0%	12.1%
Industrials	10.0%	11.5%
Energy	10.0%	9.4%
Materials	5.0%	5.7%

*As at 2014-01-31; source: Thomson ONE

Meet Our Team

Elizabeth I. Cosgrove, CFP

Vice-President, Senior Investment Advisor
and Financial Planner

Tel: 613-562-6498
elizabeth.cosgrove@nbpcd.com

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

Tel: 613-737-3003
philip.brock@nbpcd.com

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 son, David. 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.

Associate Investment Advisor

Tel: 613-562-6487
patricia.butler@nbpcd.com

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

Tel: 613-562-6486
debbie.kelly2@nbpcd.com

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.

[i] Investing Handbook (2014), Portfolio, Action & Research Team, BMO Nesbitt Burns

[ii] Global Equity Weekly (January 31, 2014), BMO Capital Markets

[iii] Rates Scenario (January 21, 2014), BMO Capital Markets

[iv] Economic Research, Federal Reserve Bank of St. Louis

[v] S&P Dow Jones Indices

[vi] Thomson ONE

[vii] Thomson ONE

[viii] *Why it's time to sell Canadian, buy U.S. stocks*, Scott Barlow, Jan 27 2014, The Globe and Mail

[ix] Thomson ONE

[x] Profiles for GE, JCI, NA, TD, BNS, TRP, VET, BCE, IFC, MFC and MCD replicated from December 2013 Canadian Equities Guided Portfolio and US Equities Guided Portfolio, BMO Nesbitt Burns Portfolio, Action and Research Team.

For more information, please contact us:

The Cosgrove-Brock Group

Investment Advisors

BMO Nesbitt Burns
303 Dalhousie St.
Ottawa, Ontario K1N 7E8

Tel: 613-562-6498
Toll Free: 1-800-230-9775
Fax: 613-562-6401

www.philipbrock.com
www.elizabethcosgrove.ca

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