BMO Nesbitt Burns

High Level Investment Report

Trusted Advice & Peace of Mind

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"Loonie" Tunes

In this edition of the High Level Report, I want to focus on a **couple items that can easily confuse investors when reviewing their statements each month.** Specifically, **currency influence on your returns** and also the factors that determine your **cost value of an investment** as compared to the market value and your actual performance.

I will be upfront and tell you that this won't be the most exciting topic, but it is an important one to make sure you are understanding what contributes to performance of your money, as well as what influences the reported values for your investments on your statement (other than pure market investment direction being up or down). I will try to have some fun with this to make it more interesting. Let's see if you notice my attempt to play on words.

The Investment Summary:

Market direction and performance in 2015 were mainly dominated by currency movement and interest rate expectations in my opinion. We can blame the decline in Canadian stock markets on oil prices, which then caused a decline in the Canadian Dollar (the Loonie), but in reality a lot of the downward direction in Canadian Dollar and Commodities in 2015 came from **the tail-end of an 2 year rally in the U.S. Dollar against the global basket of currencies.**

Source: Thompson One – US Dollar Index 2 Year Price Chart

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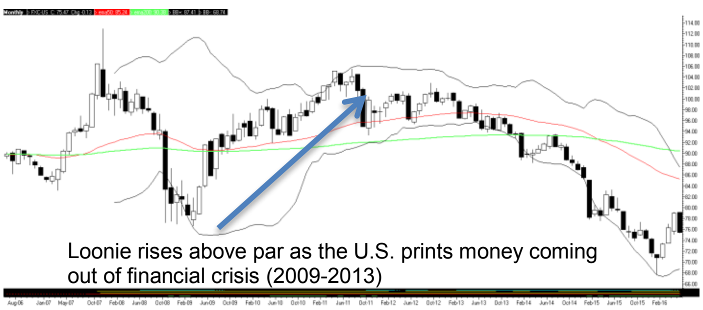
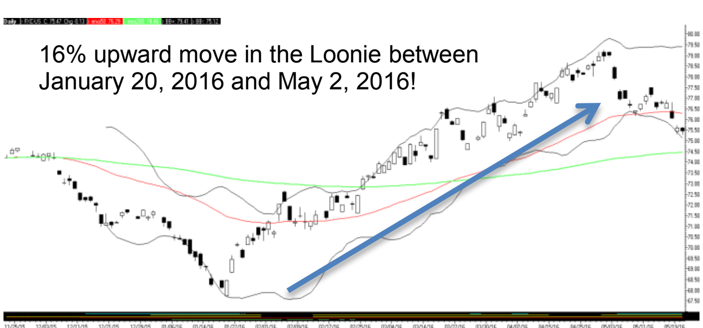
It was **October 2014 when the Federal Reserve officially stopped printing money**, which as seen on the chart before as the beginning of the U.S. Dollar recovery for the next 2 year period. Prior to this date, the **Japanese Central Bank had already started printing money at a massive rate**, and **Europe was discussing printing Euros** themselves. The European Central Bank eventually started their money printing in March 2015. With these events taking place, the U.S. dollar exploded upwards, while the Euro and Yen were depreciating rapidly. This was the opposite of the U.S. dollar direction from 2009-2013 when the U.S. was printing money and the US dollar was falling off of a cliff (do you recall the Canadian Dollar at $1.09?).



Source: Thompson One – CAD to USD Exchange Rate 10yr

If we were to look back to December 2015, many media outlets, TV news broadcasts and online financial websites were confident that the Canadian Dollar was headed below 70 cents — there wasn't any other direction in their minds. In mid-January when the Canadian Dollar broke below 70 cents, the media was then calling for 65 cents as a certainty and even 60 cents was thrown around. I recall hearing many peoples topic of conversations about the Canadian dollar going to 60 cents! Then, in a blink of an eye in January, the Canadian Central Bank didn't cut interest rates (as many thought they would) and the U.S. Dollar was also weakening against most global currencies.

This would lead to a massive bounce in the Loonie, and more broadly into all commodities and commodity driven markets.



Source: Thompson One – Chart of Canadian to USD Dollar 6 Months

So far in 2016, as of this writing in May 20th, Canada's stock market is outperforming in the "Westernized Economies", while Brazil and Russia are having 20%+ returns this year in their markets.

This volatile direction of markets and currencies has many peoples' heads spinning as investors saw better returns in 2015 than they might have thought possible when looking at the -11.09% return on the Toronto market. Much of the reason for this slightly better performance is because they had investments in U.S. stocks or mutual funds with U.S. exposure. **Returns in many mutual funds in 2015 were driven by currency, benefiting from the rise of the U.S. Dollar**. Some Canadian funds didn't lose much in 2015 (even though the market was down 11%) because they are able to hold US investments up to 49% of the fund. Therefore, with an average allocation to U.S. Stocks in a "Canadian Mutual Fund", the currency was able to create positive returns when the US dollar went up. **The Canadian Dollar dropping rapidly was able to stabilize returns last year for the average investor without them realizing it was not a good year for the markets in Canada.**

In 2016 however, **we have seen the exact opposite**. The Canadian Dollar reversed sharply and gained approximately 7% on the year against the U.S. dollar as of mid-May. We are seeing a U.S. market that is slightly positive on the year (as of May 20th), and a Canadian Market that is also up over 6%, **yet many investments are not keeping up** with what investors are hearing and seeing reported in the markets in North America. The media mentions that the DOW & S&P 500 are trying to go back to previous highs, **but Canadian investors are not experiencing the double digit gain off of the February lows, being reported in the past two months**.

So, as Bugs would say……**ehhh, What's up Doc?**

Source: Thompson One – Comparison of S&P 500 in U.S. Dollars and in Canadian Dollars – (Blue is U.S. Return, Black and White is the muted U.S. Market returns to a Canadian because of the Loonie's rise this year)

It's Loonie Tunes really, and currency has been messing with total returns now for a second year, and it becomes confusing for investors to make sense of their returns and how they are being made.

The currency has appreciated in Canada this year, and it actually **translates into a negative 4% return Year-to-Date for the S&P 500 in Canadian Dollars**. Explained differently, it means that a Canadian investors' statement will always convert the value back to Canadian Dollars for the total account statement value. If a U.S. investment was flat so far this year, the stocks' value would show being down almost 5% because of the gain in the Canadian Dollar against your U.S. dollar investment. **I say it's "Loonie",** because Currency has become a massively dominant (and volatile) part of an investors' portfolio return, and **an added layer of complication for investors to understand**.

So what's the good news? **Increased currency volatility and the general public paying attention to mounting levels of debt has had a positive effect on the gold market in 2016.** After several years of suppression in price, the race to devalue most currencies through money printing, has **major money moving to gold to avoid depreciating levels of currency** around the world. At the same time, China also began trading physical gold in mid-April, an exchange that will provide another platform for gold accumulation by investors. The Gold market gaining momentum has had a positive benefit to the Canadian Stock market in general as well, **reversing the negative sentiment our markets have suffered for a couple** of years**.** While gold and gold companies have had a strong run this year, **most investors and funds don't hold a gold position.**

For a majority of my clients, **gold is a core ingredient of the overall strategy and it has been a major benefit to hold so far this year**, even if just owning a small percentage.

To summarize the currency aspects of investing, the main take away is to acknowledge that the past 2 years has seen a dramatic swing in currency values, where owning U.S. investments in the past two years would have added to the return of a portfolio. When money is being made, investors don't spend much time analyzing how their returns were achieved. However, when you get into a period where the market flattens out, or even worse, the media talks about a U.S. market heading back to old highs and yet Canadian investors aren't feeling that same return, it can be frustrating and misleading as to how an investor is truly performing. The rally in the Loonie since February 2016 has eroded most of the strong U.S. stock market returns in the same timeframe. From the lows of the market in February, a 10%+ return in the U.S. market would have earned nothing for a Canadian.

Currency valuation and direction is on my radar 100% of the time for all of my investment decisions. I want all clients to know this. I definitely don't have a crystal ball, but I can say that I am open minded to any outcome with regards to currency and actually **reside more in the pro-Canadian Dollar camp than I am a supporter of longer-term U.S. dollar strength**.

Other Statement and Performance Confusion:

If currency movement on underlying investment performance isn't enough to have you seeing stars, I want to discuss **a topic that I am coming across with clients more often**. This is the true performance of mutual fund investments versus the visible market value and posted gain or loss on the statement, which **can be misleading**.

The best way to illustrate the issue is with an example:

You open your statement one year after meeting with me and your investment in the **Wile. E. Coyote Global Balanced Fund** looks like it **is headed for a cliff.** You don't recall exactly how much you invested but your statement **shows a market value of $21,000**. Beside this it shows that you are down $1,000 from your **average cost or adjusted cost (**important word) which is reported as $22,000. The statement that you are looking at is February 2016 and you are wondering if you should still hold this investment as it seems to be performing poorly. So are you performing badly?

One of the potentially deceiving characteristics of Mutual Funds is that they are structured to easily reinvest dividends and interest. Overtime this can distort how you are doing on each individual mutual fund and make it harder to understand how your investments are performing. The choice to reinvest dividends in Mutual Funds is most efficient for continued compounding growth, but there has to be an adjustment to your cost because at the end of each year the fund will potentially send you tax slips for your earnings from the fund as income or dividends. The mutual fund company doesn't distribute tax slips in non-taxable accounts but the calculation for Average Cost (or Adjusted cost) is calculated for every account the same way.

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Let's continue with the example:

Let's go back to February 2015 and look at your statement to find that you invested $20,000 into the **Wile E. Coyote Global Balanced Fund**. The markets had been doing well, and everyone was chasing the market (The Road Runner). You expected to make a positive return. Since then, no other investment was made into the fund. This would then mean that your February 2016 statement should actually show you to be in a position of $1000 growth not a $1,000 Loss. So why is this?

Throughout the year that you owned the fund, the investment would have produced total returns driven by interest, dividends and gains (or losses) on the mutual fund investment. Let's say that the interest rate and dividends earned were higher on this fund and the fund paid out $2,000 in dividends and interest throughout the year (this is much higher than current reality but easier to illustrate), which was reinvested into the fund and resulted in the growth of your investment fund value over the year.

This money being reinvested back into your mutual fund buys you more units of the fund. It has been building up $2,000 more cash into the original $20,000 fund, but it is not from you adding additional money to the fund from your bank account. This $2,000 of dividends and interest will generate a T-slip for tax reporting, where if this was a taxable account you would be paying tax on $2,000 of income. Therefore, to make sure you don't pay tax on this income now, and then again in the future when you sell the mutual fund, the **Adjusted Cost** (there is that word again) of the fund increases by $2,000. **Your current cost for your Fund is now $22,000** ($20,000 original plus $2,000 reinvented income).

Then in January and February of 2016 the equity market fell 10% in many countries, but since this is a Balanced Fund, your fund only went down approximately half this amount. The fund lost $1,000 in two months and the drop on $22,000 value would lower the funds value in a short period of time down to $21,000 for the month-end February 2016 statement. On this statement you see a market value of $21,000 and an Adjusted Cost of $22,000, which resembles a $1,000 loss, but **you now understand that you are in fact $1,000 ahead in the past year, which is a return of 5%.**

Suffering Succotash!

As you can see, when opening the statement and seeing what appears to be a rapid loss in the investment over the past year, in reality the investment had made a decent 5% return. Clear as mud, right?

The reason I use this illustration is because I am seeing more and more bond and income funds fall into this situation and clients are mentioning it to me. It is because a majority of a bond or income equity return is coming from the income paid out MINUS potential capital decline, specifically in most bonds today. The Total Return is a mixture of both, and **the flow of how you earn your money** (as in the example above) **can mislead you if only looking at your statement cost value for the investment return.**

If you are ever unclear about your statements, or come across what appears to be a situation like this example, please let me know. DO NOT stew or fuss over something that looks to be losing value each month and ask me to look into the investment if you are not comfortable. In reality there will be situations where funds will actually be losing value, but we will be addressing this if it was to become a prolonged situation.

Lastly, as we head into the end of 2016, there is an industry regulation that requires investment firms to disclose account returns over a longer term period (versus month to month values on statements) and also illustrate advisor fees and compensation. In the Fall 2016 newsletter, I intend on addressing some of these statement changes so that you have a good understanding of the differences you will see on portfolio statements coming at the end of the year as well.

I hope that this High Level Report was informative on two of the more opaque pricing and performance influences on your statements. I stress that you get in touch with me should you ever have questions about your statements or performance.

Until the Summer High Level Report,

That's All Folks!

Take care,

Ryan Cockburn