Robust links started to weaken

In a quarter that saw increasingly robust links in the global economic chain start to weaken, we continued to focus on maximizing gains on behalf of our clients without adding undue risk or cost in a number of ways. We adopted a value tilt in the Canadian and U.S. portfolios, while buying into pools to ensure asset diversification of risk. And we also altered our fixed income strategy to maximize yield, which I will expand upon a little later in this commentary. Our ongoing diversification across asset classes and the effective use of Exchange Traded Funds continued to support performance.

Global equity markets delivered mixed results over the third quarter as economic growth continued to diverge and weigh on investor confidence. U.S. equities were a bright light returning 6.1% as the loonie fell and boosted returns from foreign investments. Canadian equities dipped by 0.6% and Canadian bonds rose 1.1%, supplementing gains over the past since months. In the wake of potential equity market volatility, investors began looking to safer assets, such as government bonds.

The portfolios were not exposed to high-yield bonds as unattractive valuations and relative illiquidity exposed the high-yield market to potentially higher volatility. We benefited from active management at PIMCO (Pacific Investment Management Company, LLC) and Manulife Financial. Both managers have done well in a low interest rate environment as we manage risk and increase the upside potential by investing in larger pools.
Last year, Lysander Investments, a subsidiary of Canso Investment Council Ltd., entered into a bond purchase with Blackberry over seven years at 7%. Unavailable to the public, our investment was fortified by ample security from Blackberry and the issue performed well over the quarter.

**Recurring issues made for some sleepless nights**

Investors were kept awake at night throughout the quarter as they pondered several recurring issues. While the U.S. Federal Reserve continued to reduce its monetary stimulus, it made no moves to raise interest rates during the quarter. Nevertheless, Quantitative Easing (QE) is now part of the DNA of many investors and financial advisors and few can imagine what life could be like in a post QE world, given mounting geopolitical turmoil they hear about daily. I am in no way downplaying the horrors of the war against the Islamic State militants in Iraq, the Hong Kong student protest that drew further negative attention to China, or the Ebola outbreak, which has already set many African nations back years, or even decades. We know from experience that markets have come through similar events that seem interminable but eventually abate, albeit at a terrible human price.

**The training wheels will soon come off**

In addition to the U.S. Federal Reserve, the central banks of England and Japan, combined with cheap bank loans from the European Central Bank have helped to prop up the global economic bicycle. Once the training wheels are taken off and the Fed begins to raise interest rates, investors fear they may experience a choppier ride. However, it is important to recall that history shows that higher volatility does not necessarily lead to a long-term market correction.

Ever since the Global Financial Crisis of 2008, the global economy has not returned to full speed. While the five-year bull market buoyed the spirits of many who saw their wealth soar, things were shifting as the quarter closed.
A sudden drop in steel demand in China sent more ripples across global economic waters. Germany’s economy stalled and sinking oil prices began to put a chill on Canada’s energy – fuelled economy. Emerging markets from Brazil to Russia have failed to live up to expectations that they would lead the charge during the next wave of global growth. On a happier note, the U.S. Gross Domestic Product grew at an annualized rate of 4.6% - the most in three years after a 2.1% decline in the first quarter. Combined with the falling loonie, Canadian exporters gained a better foothold in global commerce in the face of moderate softening in the Canadian economy.

Next steps?

“When should I buy back into the market?” Or, “Should I take profits now that the markets are coming back?”

Many investors are asking the questions they posed in 2010, when the Global Financial Crisis (GFC) was slowly becoming memory – and a very tough one at that. According to Geoff MacDonald, portfolio manager at EdgePoint Investments, the fear of recurring losses investors suffered during 2008 and 2009 has made the industry more anxious, making these questions increasingly popular. And I agree. No one can answer those questions with any conviction because “the market” has become diverse and consists of a highly complex array of different businesses. There are the forecasting “pretenders” who offer systems to cope with the range of variables that have yet to stand the test of time – despite several good quarters or perhaps years, at best. First, is “the market” really up?

At the end of the quarter, major market indices were up between 4% and 12% YTD. (If the market is really up, perhaps you should wait until it’s down and then invest.) I noted earlier that the market is a complicated collection of many different businesses. Keeping that in mind, let’s test the popular belief through the quarter that the market was up. A total of 177 (or 35%) of stocks in the S&P 500 Index and 82 (or 33%) of stocks in the S&P/TSX Composite Index are down this year. Looking at smaller companies, 1,314 (or 66%) of Russell 2000 stocks are down this year, while 90 (or 41%) of the stocks in the S&P/TSX Small Cap Index have declined.
Is the market really up when over half the stocks are down? The question is irrelevant as markets ebb and flow. Peace of mind really lies in staying diversified, ensuring you are being compensated for risks taken and that you remain committed to protecting capital before attempting to grow it.

**Making up for lost time**

![Chart showing percentage of outperforming US Equity Fund Managers from 2009 to 2014 YTD.](image)

Fund manager performance has suffered this year, which we believe will add incentive to position portfolios more aggressively between now and year-end to play “catch-up.”

The future is bound to be uncertain and will inevitably be volatile so trying to forecast the timing of macroeconomic trends is pointless. Rather than take on risk in an effort to realize short-term gains, understanding your investments and the sensitivity of each asset class to a wide range of random events is a far more productive use of our time spent on your behalf.
Richard Thaier, professor of behavioral science and economics, University of Chicago Graduate School of Business wrote in 2008, “I have not looked at any of my holdings and don’t intend to. I don’t want to be tempted to jump because I think I’d be more likely to jump in the wrong direction than the right one. My advice has always been to choose a sensible diversified portfolio and stop reading the financial pages. I recommend the sports section.” (Source: Lauren Young: Business Week, October 6, 2008).

**In good company**

I recently had the honour of joining a panel of four at the Canadian Exchange Traded Funds Third Annual ETF roundtable in Toronto for 75 MBA and Finance graduates from Schools of Finance at Queens, University of Toronto and York Universities. My co-panelists included: Barry Gordon, President, First Asset; Greg Jones, Managing Director and co-head of Global Equity Derivatives Sales at National Bank Financial and Susan Christoffersen, Associate Professor of Finance at the Rotman School of Management.

As a guest at the Chartered Financial Analysts’ Forecast dinner sponsored by the Blackrock Group, I was fortunate to hear Charles Brandes, an investment industry icon and long-time value investor. He sees value in Europe and Emerging markets, but fewer opportunities in the U.S. The founder and chairman of Brandes Investment Partners LP, predicts that interest rates will remain low.

Meanwhile, Matt Smith and myself had an informative conversation with Alfred Murata, managing director and portfolio manager of PIMCO’s Newport Beach office. As manager of the PIMCO Monthly Income Fund, Alfred shared several income generating ideas in bumpy global fixed income markets. According to Alfred, it is smooth sailing and business as usual following the sudden departure of PIMCO co-founder Bill Gross to Janus Capital. Conversations with Alfred and others are always useful, as we like to stay in close touch with our colleagues who are responsible for the management of your investments within their firms.
On behalf of The David Bruce Group, I wish you a pleasant autumn. As always, please contact Matt Smith or me with your questions or comments regarding your investments with us. For assistance with any administrative issues, please contact Hayleigh Blaikie.

Sincerely,

David Bruce
Vice-President
Portfolio Manager

P.S. Part of our commitment to you involves reaching out to your family members, friends or colleagues who may have questions about their financial situation and would appreciate an objective, second opinion. Please don’t hesitate to contact us if you feel we could help.