TD Wealth

The Charter Group Monthly Letter

February 2018

Mark Jasayko, MBA, CFA
Portfolio Manager & Investment Advisor
TD Wealth Private Investment Advice
The Charter Group, Langley, BC

Economic & Market Update

Cars, Cryptos, Cannabis & The On-going Need for Capital

Throughout investment market history, investors have been seduced by the allure of an enticing story. Perhaps it's a small mining company on the verge of a discovery. Or a biotech start-up that is only a step away from government approval for a treatment that might change lives. Understandably, it is easy to overlook a company's financial condition when the story is so exciting and the implied payoff is considerable. However, unless a company is able to internally generate the cash flow needed to finance operations and growth, it will run out of capital.

The main priority of young companies is to get access to capital.

The ability to get capital is their most important "asset."

Young companies that are able to internally generate enough cash flow to be mostly self-sufficient are a very rare breed. And, they tend to stay private for an extended period as the original principals consolidate their ownership and place an effective moat around it before ever issuing shares to the public (Microsoft remained private for its first 11 years).

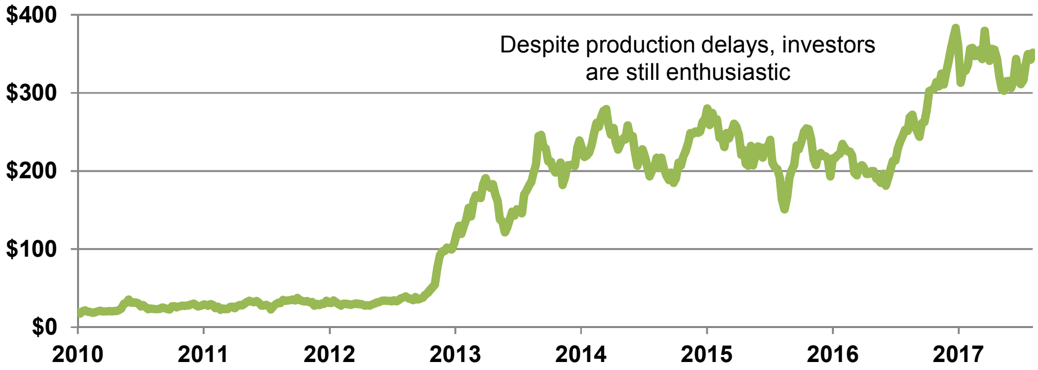
For most other young companies that don't have the luxury of generating substantial cash flow, going public early is usually the easiest path to obtaining capital with relatively few strings attached. However, if the cash flow situation doesn't change much (and it is unlikely that it would without the promised "breakthrough"), they will have to keep going back to the well (back to investors and asking them for more capital in exchange for an additional issue of shares).

As long as investors are willing to put up more capital, a young company can perpetuate despite not achieving profitability. It is incumbent upon management to convince investors that the company's ambitions are in reach within an acceptable length of time.

New companies that are not able to generate enough cash flow to maintain capital will likely have to go back and ask investors for more and to do this repeatedly.

Management needs to be able to maintain the positive story and imply that a breakthrough is not too far off into the future.

Chart 1:
Tesla Inc. (in U.S. dollars)



Source: Bloomberg Finance L.P. as of 2/1/2018

One of the most prominent case studies of a company repeatedly seeking capital at the current time is Tesla (**Chart 1**). Last year, I had the opportunity to drive a Model X (Tesla's version of a crossover SUV) and was able to see what all the excitement was about. However, operating a car company is hard and merely dazzling prospective buyers with advanced automotive technology does not necessarily portend profitability.

Tesla does have a unique asset in the form of its founder, Elon Musk. He's a visionary. He's charismatic. He has skirted financial disaster and survived and has used this story to captivate an audience hungry to hear about the value of perseverance. And, when he goes to investors and asks for another capital infusion, they open up their wallets. This is what Elon Musk is great at doing. And, by extension, this is what Tesla is great at

Tesla is one of the most prominent examples of a company that has mastered the ability to repeatedly get investors to put in more capital … for now.

This might be the most important "asset" that Tesla has.

doing. What Tesla is not great at doing is producing cars on time and on budget. Toyota and General Motors, and others, have fined-tuned automobile production techniques with decades of experience. Relative to the efficient production standards set by the better-run brands among the established automobile companies, Tesla is actually pretty lousy at assembling cars. But, right now, investors don't care.

Producing amazing cars can't be Tesla's top priority. The existential risk is not being able to raise enough capital.

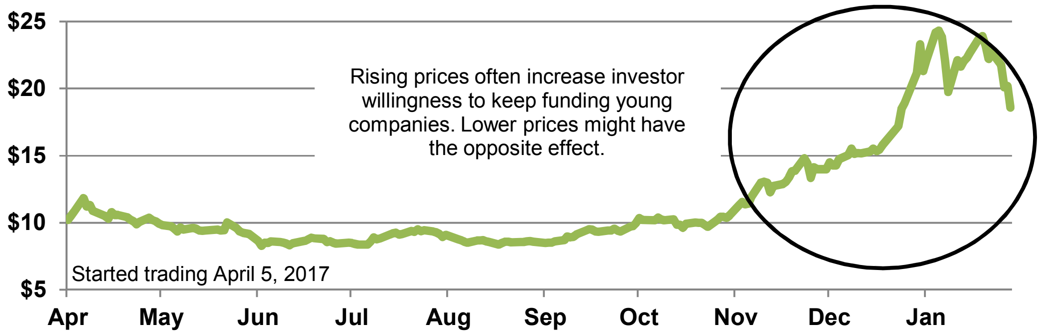
Viewed through this prism, Tesla is really in the business of "successfully raising capital when needed." For now, the production of high tech cars is really only a sub-story used to attract potential investor attention.

This brings us to the trend of new companies focusing on things like cannabis and cryptocurrencies. Generally, companies in these industries lack the capital to survive for long.

Companies that focus on cannabis and cryptocurrencies face the same challenge as Tesla.

Chart 2:

Horizons Marijuana Life Sciences Index ETF (in Canadian dollars)



Source: Bloomberg Finance L.P. as of 2/1/2018

A quick analysis of the larger players in the cannabis industry (**Chart 2**) indicates that they have two years at the most given their current rate of cash-burn before they run out of capital. In order to survive, it is almost a certainty that they will need to go back to the market and ask investors for more capital. At the current time, investors are willing. The enticing prospects offered by legalization are enough get investors to look past all the potential pitfalls associated with the uncertainties regarding each province's approach to regulation and the limiting of potential associated with controlled distribution (for example, liquor is legal but that doesn't mean it's easy produce and to sell despite the hordes of willing drinkers). Until legalization finally arrives and one is able to assess the real potential for profitability, cannabis companies will need to be better at raising capital from investors than any other aspect of their operations.

Heading into the unknown environment of legalization, cannabis companies as a whole are burning through too much cash to last perpetually.

They will likely need a lot more capital (or maybe be bought out by "Big Tobacco").

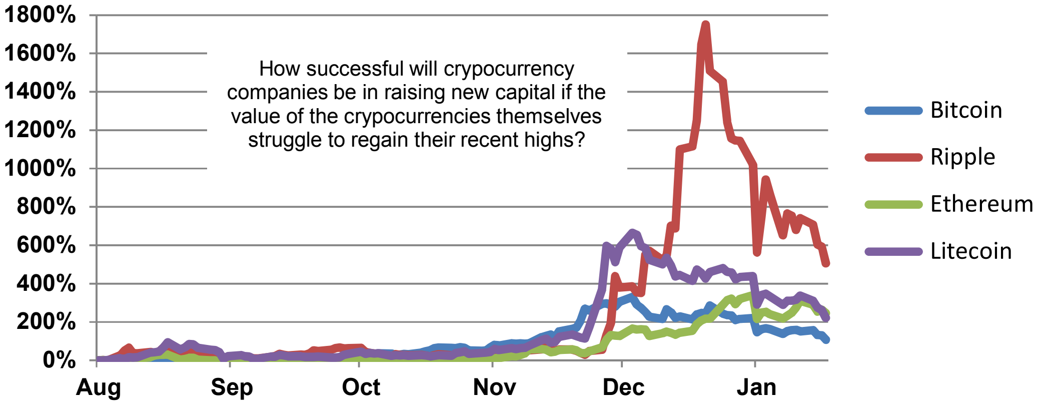
Compared to most cannabis business models, the gulf between promise and eventual viability for cryptocurrency companies (**Chart 3**) appears to be even wider. This might explain their preference for initial coin offerings (ICO's) which preach to and target the "converted" when seeking new capital. The most ardent believers often have the least need for details! The savvy managers of these companies know this and lean on this in their pursuit for more capital.

Companies that are capitalizing on the cryptocurrency craze require a huge leap of faith between promises and eventual profitability.

There are going to have to be especially good at convincing investors to give them capital.

Chart 3:

Recent Cryptocurrency Relative Performance (in U.S. dollars)



Source: Bloomberg Finance L.P. as of 2/1/2018

It should be noted that in addition being able to seduce potential investors, young companies also need to have a little luck. Arguably, we are fairly late into the market advance that began in 2009. Investor enthusiasm for funding companies that require a large leap of faith tends to reach a crescendo during this part of the cycle (especially among individual, as opposed to institutional, investors).[1] If we were to get a cyclical (shorter-term) bear market selloff of 20% or more (which we haven't seen in U.S. stocks in nine years for example), investors may not be as keen to provide more capital. Then, it's not going to matter how well one produces electric cars, grows and produces cannabis, or produces a cryptocurrency that replaces my need to buy a Big Mac Meal with cash. Such companies need to be better at raising capital than doing anything else.

At the current time, investors appear to be generous in providing more capital. Market psychology is positive. But this could change if volatility in stock markets push investors into being more conservative.

No capital. No future.

[1] In late December, the on-line self-directed trading units at RBC and TD suffered outages. One of the reasons given was the massive surge in customers trading cannabis stocks. https://www.theglobeandmail.com/globe-investor/td-cites-unprecedented-trading-volumes-as-online-brokerage-delays-continue/article37499223/

Model Portfolio Update[2]

The Charter Group Balanced Portfolio
(A Pension-Style Portfolio)

	Target Allocation %	Change
Equities:		
Canadian Equities	15.0	None
U.S. Equities	35.7	None
International Equities	9.3	None
Fixed Income:		
Canadian Bonds	25.5	None
U.S. Bonds	2.5	None
Alternative Investments:		
Gold	7.5	None
Commodities & Agriculture	2.5	None
Cash	2	None

No changes were made to either the investment holdings or the asset allocation in The Charter Group Balanced Portfolio during the month of January.

However, there was a change in one of the names in the Balanced Portfolio. Our position in Agrium Inc. was rolled over on a tax-deferred basis into shares of Nutrien Ltd. Nutrien represents the amalgamation of Agrium and PotashCorp. The new company, based in Saskatoon, is the world's largest potash producer and the second largest producer of nitrogen fertilizer. With greater economies of scale needed to compete in a commodity market like fertilizer, and a little more pricing power with more control of the market, we were in agreement with the decision to merge the two companies.

The other significant news impacting the Balanced Portfolio was the performance of the stocks outside Canada during January with the Dow Jones Industrial Average climbing

No changes were made to the Balanced Portfolio during January.

Our position in Agrium rolled into a new company named Nutrien after a merger with PotashCorp.

---

[2] The asset allocation represents the current *target* asset allocation of the Balanced Model Portfolio as of 2/1/2018. The asset allocations of individual clients invested in this Portfolio will differ because of the relative performance of the asset classes since the last rebalancing and because of differences in the timing of deposits and withdrawals. The Balanced Model Portfolio is part of a sequence of five portfolios ranging from conservative to aggressive: Conservative, Balanced Income, Balanced, Balanced Growth, and Growth.

5.80% and the MSCI EAFE Index (developed market international stocks) climbing 4.99%. Even with the strength of the Canadian dollar during the month, it was not enough to cancel out those gains for Canadian-based investors since, on a Canadian-dollar basis, the Dow and the EAFE indices were still up 3.36% and 2.97% respectively.[3]

U.S. and international stocks were the star performers during January.

Even though the Canadian dollar was stronger, it was not enough to cancel out returns from non-Canadian investments.

This is in contrast to the performance of Canadian stocks as the TSX / S&P Composite was down 1.57%. So, it was unlikely that a strategy designed to harness a stronger Canadian dollar by increasing Canadian investments would have paid off.

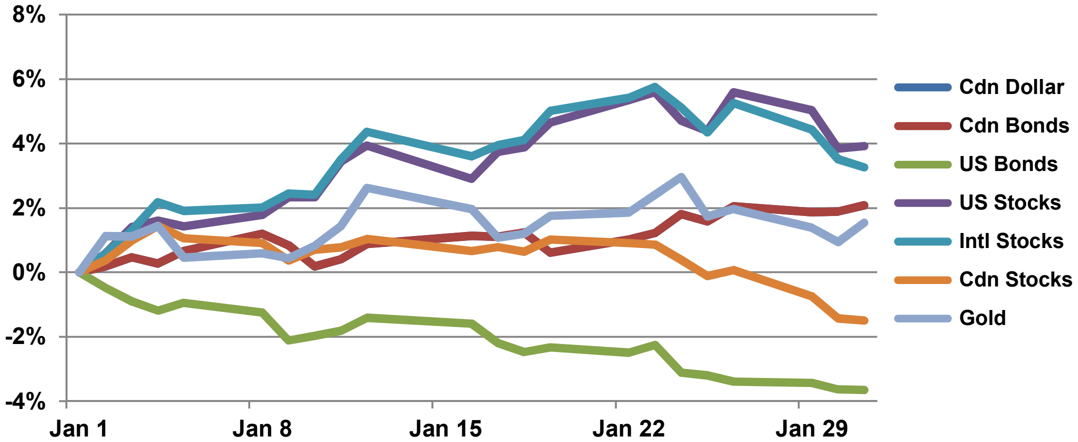
On the subject of the Canadian dollar, our view at The Charter Group is that it will be difficult for the Bank of Canada to match the number of U.S. Federal Reserve Board interest rate increases during 2018. Thus, the Canadian dollar may not look as attractive on a relative yield basis in the eyes of foreign investors.

Going forward, the Canadian dollar may face more challenges in order to rise than many analysts think.

Below is the January 2018 performance of the asset classes that we have used in the construction of The Charter Group Balanced Portfolio (**Chart 4**).[4]

Chart 4:

January 2018 Performance of the Asset Classes (in Canadian



Source: Bloomberg Finance L.P. as of 2/1/2018

[3] Source: Bloomberg Finance L.P. as of 2/1/2018.
[4] Source: Bloomberg Finance L.P. – The Canadian dollar rate is the CAD/USD cross rate which is the amount of Canadian dollars per one U.S. dollar; Canadian bonds are represented by the iShares Canadian Universe Bond Index (XBB); U.S. bonds are represented by the iShares Core U.S. Aggregate Bond Index (AGG); U.S. stocks are represented by the iShares Core S&P 500 Index (IVV); International stocks are represented by the iShares MSCI EAFE Index (EFA); Canadian stocks are represented by the iShares S&P/TSX 60 Index (XIU); Gold is represented by the iShares Gold Trust (IAU).

Top Investment Issues[5]

Issue	Importance	Potential Impact
1. Long-term U.S. Interest Rates	Significant	Negative
2. China's Economic Growth	Significant	Negative
3. Canadian Dollar Decline	Moderate	Positive
4. U.S. Fiscal Spending Stimulus	Moderate	Positive
5. East Asian Geopolitics	Moderate	Negative
6. NAFTA Negotiations	Moderate	Negative
7. Short-term U.S. Interest Rates	Medium	Negative
8. Massive Stimulus in China	Medium	Positive
9. Canada's Economic Growth (Oil)	Medium	Negative
10. Japan's Money Printing	Light	Positive

[5] This is a list of the issues that we currently deem to be the ten most important with respect to the potential impact on our model portfolios over the next 12 months. This is only a ranking of importance and potential impact and *not* an explicit forecast. The list is to illustrate where our attention is focused at the present time. If you would like an in-depth discussion as to the potential magnitude and direction of the issues potentially affecting the model portfolios, I encourage you to email me at mark.jasayko@td.com or call me directly on my mobile at 778-995-8872.

TD Wealth

The Charter Group

Mark Jasayko, MBA, CFA | Portfolio Manager & Investment Advisor
Mike Elliott, BA, CIM, FCSI ® | Portfolio Manager & Investment Advisor
Laura O'Connell, CFP ®, FMA | Associate Investment Advisor

TD Wealth Private Investment Advice

604 513 6218
8621 201 Street, Suite 500
Langley, British Columbia V2Y 0G9

The Charter Group at TD Wealth Private Investment Advice is a wealth management team that specializes in discretionary investment management. For an annual fee, we manage model portfolios for private clients and institutions. All investment and asset allocation decisions for our model portfolios are made in our Langley, B.C. office. We do not outsource any of the decision-making for our model portfolios – there are no outside actively-managed products or funds. We strive to bring the best practices and the calibre of investment management normally seen in global financial centres directly to the Fraser Valley and are accountable for the results.

Accountability is further enhanced by the fact that we commit our own investable wealth to the same model portfolios in which our clients are invested.

The information contained herein is current as of February 1, 2018.

The information contained herein has been provided by Mark Jasayko, Portfolio Manager and Investment Advisor and is for information purposes only. The information has been drawn from sources believed to be reliable. Graphs and charts are used for illustrative purposes only and do not reflect future values or future performance of any investment. The information does not provide financial, legal, tax or investment advice. Particular investment, tax, or trading strategies should be evaluated relative to each individual's objectives and risk tolerance.

Certain statements in this document may contain forward-looking statements (“FLS”) that are predictive in nature and may include words such as “expects”, “anticipates”, “intends”, “believes”, “estimates” and similar forward-looking expressions or negative versions thereof. FLS are based on current expectations and projections about future general economic, political and relevant market factors, such as interest and foreign exchange rates, equity and capital markets, the general business environment, assuming no changes to tax or other laws or government regulation or catastrophic events. Expectations and projections about future events are inherently subject to risks and uncertainties, which may be unforeseeable. Such expectations and projections may be incorrect in the future. FLS are not guarantees of future performance. Actual events could differ materially from those expressed or implied in any FLS. A number of important factors including those factors set out above can contribute to these digressions. You should avoid placing any reliance on FLS.

Index returns are shown for comparative purposes only. Indices are unmanaged and their returns do not include any sales charges or fees as such costs would lower performance. It is not possible to invest directly in an index.

The Charter Group consists of Mark Jasayko, Portfolio Manager, Investment Advisor, Mike Elliott, Portfolio Manager, Investment Advisor, and Laura O'Connell, Associate Investment Advisor. The Charter Group is part of TD Wealth Private Investment Advice, a division of TD Waterhouse Canada Inc. TD Waterhouse Canada Inc. is a subsidiary of The Toronto-Dominion Bank. TD Waterhouse Canada Inc. – Member of the Canadian Investor Protection Fund.