TD Wealth

Murdison Minutes

4th Quarter 2016

Market Statistics

Q4 Returns:
S&P/TSX Comp Index: 3.81%
S&P500 Index: 3.25%
MSCI World Index: 1.48 %
CDN Bond Index: -3.44%

Gov't Bond Yields*:
10-Year Can: 1.64%
10-Year U.S.: 2.33%

Foreign Exchange*:
$1 CAD buys 0.7615 USD
$1 CAD buys 0.7158 EUR

**as of January 12, 2017*

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Our core beliefs:

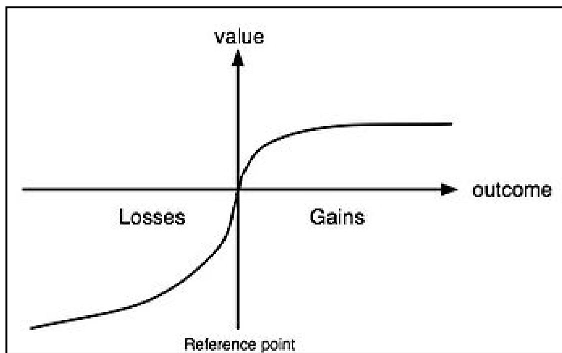
- Transparency
- Accountability
- Client First

We offer a first-class client experience through industry-leading:

- Investment Strategies
- Wealth & Retirement Planning
- Client Service

TM Wealth Management Group

Risk aversion is a fascinating theory where psychology meets finance. More specifically, risk aversion theory states that humans generally experience greater pain from a loss than the pleasure derived from an equivalent gain. The image below provides a visual representation of this relationship. I could go on about the relevance of bahavioural economics, but risk aversion is the foundation of the field of study and critical to understanding how humans *actually* behave rather than *should* behave, as in traditional economic theory. Unfortunately, risk aversion often influences our judgment and subsequently steers us towards decisions that are less than optimal, especially when it relates to finances. I believe that by better understanding the psychology of investing, I improve my ability to deliver strategies that best meet clients' goals and apply that study to a better interpretation of financial markets.



The value function that passes through the reference point is s-shaped and asymmetrical. The value function is steeper for losses than gains indicating that losses outweigh gains.

Following a strong year of returns in equities and a roughly tripling of stock markets over the past eight years, I believe now is a crucial time to remind ourselves of the psychology that drives our decisions when short-term market movements don't meet our long-term expectations. This is not to say I am predicting dire markets are on the horizon (anyone who knows me understands I avoid predictions at all costs). Rather that caution, pragmatism, balance...a gut check is most important when it seems least popular to do so. The euphoria that markets have experienced since Donald Trump's election (who thought anyone would be writing that sentence...ever? Yet another example of why many predictions can be worthless) may or may not be justified.

To quickly address the thousand pound gorilla in the room—the market's reaction to the election of Donald Trump. I would argue that the rise in equities and bond yields has far more to do with the landslide Republican victory (claiming both the Senate and the House of Representatives), rather than the common attribution of Donald Trump being elected President. Republicans will now be emboldened to pursue their long-standing agenda of lower regulation and lower taxes, clearly beneficial to corporate profits. So, the market's reaction should not come as a surprise. I would further argue, Trump's foreign policy, trade policy and erratic Tweets are actually holding markets down from where they could be if Republican Congressional control was paired with a less geopolitically disruptive Republican President.

Despite the rise in equities, I'm not convinced we have hit "peak greed" - investor sentiment has rarely been considered high throughout this bull market as evidenced by the fact that more money has been directed into bonds versus stocks for the past eight years, despite falling bond yields. This is a rather pervasive sign of risk aversion amongst investors that could be the scars from the physiological injuries suffered during the Great Recession. Many metrics indicate valuations on stocks are high, however, not nearly so unnerving once low interest rates are taken into consideration—the dividend yield of the S&P 500 is only slightly below the 10-year US Treasury yield, while the S&P 500 earnings yield is roughly double the 10-year Treasury yield. Both of these factors present a case for additional value in stocks over bonds, in the context of an individual's investment objectives and risk profile. Short ratios (the percentage of a company's stock that is being shorted, or bet against), have been and remain quite high, indicating cautious positioning by hedge funds. Asset allocations amongst the clients of wealth management firms tend to indicate a similar trend, investors are conservatively positioned with high cash, moderate bond and low equity exposures. These collective observations are generally not the conditions observed prior to a market crash.

On the other hand, one trend that has me concerned is the move by many investors, including large institutions, towards index-based investments (i.e. an exchange traded fund that invests in a broad stock index like the S&P 500). By design, these strategies will replicate the performance of the referenced index. Typically investors enjoy this experience as long as the markets are going up, but when markets fall, these

strategies suffer the full impact of market losses. Based on what we know about risk aversion, having no ability to minimize losses does not sit well with investor psychology and may lead to detrimental, emotionally-driven investment decisions. By selecting the highest quality companies with the most dependable returns, my strategies strive to capture the long-term returns of the indices, while minimizing losses relative to the indices. Although index-based investments may serve a purpose in a well diversified portfolio, I'm more worried about the reason cited by those making the investment decisions—underperformance by active managers. By no means is this a scientific statement, but this has bad timing written all over it, in my view. Following an eight year bull market investors are NOW making the decision to gear their portfolios for more upside potential rather than being concerned about downside protection? To further emphasize the point, there have been growing complaints from pension fund managers in the U.S. about the recent underperformance of hedge funds relative to S&P 500 Index funds. It should be intuitive that an investment strategy that "hedges" would underperform during strong market conditions as a necessary compromise for outperformance during weak market conditions. Well-managed hedge funds are designed to produce consistent returns throughout market cycles, including during falling markets. That is (at least should be) the reason to invest in them in the first place, to reduce risk by diversifying the source and timing of returns, not chasing excess returns during bull markets. Selling (well-run) hedge funds now is like cancelling your flood insurance right before hurricane season. Warning signs flash when investors start ignoring their fundamentally sound, long-term investment strategies so they can chase returns in "hot" assets. Signs of this behaviour are starting to appear.

Many market prognosticators like to point out that eight years is a long bull market and although "bull markets don't die of old age", philosophically, the further we are from the start, the closer we are to the end. Hence my cautious tone and renewed focus recently on the question "what if markets don't go our way?" when establishing investment strategy.

A pragmatic tone is nothing new for me, anyone who has been reading Murdison Minutes over the years should be well aware of that. My comments from the previous Murdison Minutes regarding an emerging trend toward fiscal policy to stimulate the economy and the potential negative implications for the bond market, has come to fruition. A cautious approach to potentially higher bond yields, lower bond prices and higher inflation yielded tangible benefits in a short period of time. Never one to make predictions, I merely observed the commentary from central bankers, economists and politicians and weighed the risk/reward profile of the bond market if inflation were to pick up. This was the primary consideration for our reduction in bond allocations in favour of alternative strategies with minimal interest rate sensitivity. The results were resoundingly positive as the broad Canadian bond market fell 3.44% during the final three months of 2016. While our reduced exposure to bonds helped, we also shifted away from bonds that fall when interest rates rise. The result was our bond strategies preserved gains for the year.

Let me be clear, none of this is to say "I saw it coming". I observed a trend—Hillary Clinton and Donald Trump were both discussing fiscal stimulus and Justin Trudeau was beginning to implement his stimulus plan. By no means did I predict Trump would be elected and would create inflationary pressures that central bankers have been trying to stoke since the financial crisis. The point I am trying to make is that the correct decision is only obvious with the benefit of hindsight. We tend to look back on an event and convince ourselves that we or someone else should have seen it coming and invested heavily on that particular thesis (anyone who has seen or read "The Big Short" by Michael Lewis knows this feeling). My response to this is, if we assume the future is impossible to predict and that "we can't win 'em all", how do we minimize the frequency and severity of losses suffered by an individual's overall portfolio. Paying attention to losses is critical because, back to the beginning, humans are all risk averse (to various degrees) - they hate losses more than they love gains. Minimizing losses is not only critical to investor psychology and an investor's ability to maintain discipline to his/her long-term investment strategy, it is also beneficial to total return. The less you lose, the easier it is for your portfolio to recover and resume growing your wealth. Furthermore, there is something to be said for prudent risk-taking. Timing the market is difficult if not impossible, but the odds of having a successful experience if you invest 100% in equities now is likely diminished versus if you did so in 2009. This does not mean we completely divest and move to cash. After all, the odds are almost always stacked against cash—inflation is cash's unrelenting opponent who wins almost all the time.

Since markets are chaotic and unpredictable, I strive to design investment strategies to perform across a wide range of market conditions. This strategy of spreading risk and opportunity across multiple asset classes and ability to profit from falling and rising prices, seems particularly compelling given the current market environment of high valuations for both bonds and stocks. Coupled with what we know about human sensitivity to losses, I am more confident than ever that we have the strategies in place to succeed in this market. I am committed to maintain steadfast discipline to your investment objectives, while constantly searching for better ways to achieve those objectives.

"When the only tool you have is a hammer, everything looks like a nail".

Abraham Maslow, *The Psychology of Science*

If our only choices to invest were bonds or stocks, we would be at a difficult crossroad. Luckily with forward investment thinking that replicates world leading pension funds, we have the tools at our disposal to navigate a prosperous path forward. All the best in 2017!

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