VERITAS

Fall 2015

CURRENT SITUATION

This past quarter had the dubious distinction of being the worst for global equities since 2011, and North American markets were not spared. Canada's S&P/TSX Total Return Index, which includes dividends, fell 7.9% in the quarter, leaving it down 7% for the year. Stateside, the broad S&P 500 fared marginally better, declining 6.4% in the quarter, with six percentage points of that decline occurring in August alone, resulting in a year to date decline of 5.3%. Market declines in Canada and the US were officially corrections, as defined by a drop of 10% or greater from cycle highs, and the first real corrections since early 2011. Given the four year duration of the market advance, the corrections arguably were overdue. What struck us though was the volatility associated with the pullback, and the rebound since, which has seen both markets already recover most of what they lost over the summer. Putting the activity in perspective, on the worst performing day last quarter, we experienced a 45% spike in the Volatility Index (VIX), its biggest move ever, accompanied by a 1,000 point drop in the Dow (DJIA). But looking at the levels of both today, one would never know any of it ever happened.

There are a number of possible explanations for the increasingly wild intra-day swings in equity markets, including attributing them to high frequency and algorithmic trading. While these trading practices certainly impact markets, the evolution and increasing popularity of the exchange traded fund (ETF) market is also becoming a significant factor affecting equity market activity. There are hundreds of ETFs listed on North American exchanges, and each one is constructed to mimic a particular index or investment style. In order to accomplish this, the ETF owns the shares of the underlying companies of the index or style it represents. In many respects, the construction of an ETF is very similar to the construction of a mutual fund, but unlike a mutual fund, an ETF trades like a stock. The implication is that every transaction involving a share of an ETF triggers a series of like trades in the companies that the ETF holds. Considering that retail and institutional investors and traders use ETFs as daily trading vehicles, there is a very real potential of distorting market action in the ETF's component companies, particularly when ETF activity is being driven by short term trading strategies as opposed to the fundamentals of the underlying companies. The distortion, and intra-day price swings, can be exacerbated by a number of factors, including an absence of company specific share liquidity, frequency and volume of the ETF trade, and external sentiment and demand associated with a particular component name.

DID YOU KNOW...

- The average North American eats over 28 pounds of French fries per year.
- The average age of all cars on the road in the US is at a record high of 11.5 years.
- 2015 is the first time in 22 years the Toronto Blue Jays have won a playoff spot, the longest playoff drought in North American professional sports.
- The US has over $1 trillion ($1,000,000,000,000) in outstanding auto loans, a new record high.
- Canada's population has risen to almost 36 million, a 1% year over year increase, 60.8% of which has been from immigration.
- There is approximately five kilometres of nylon under the hood of the average car.
- For the first time ever, there are more people in Canada over the age of 65 than under the age of 15.
- American adults check their mobile devices approximately 150 times a day, or every 6.5 minutes.
- Ferrari, set to make its stock market debut, will be listed under the ticker symbol "RACE".
- 35% of the world's 7.2 billion people will own a smartphone by the end of this year.

An unintended consequence of Canadian equity market activity and the dramatic decline in commodity prices in the last year has been to reweight TSX sectors. We have commented in the past that the TSX is very heavily weighted to the natural resource and financial services sectors. While this remains the case, the commodity sectors have declined to just about 28% of the index, as compared to 50% four years ago. Consequently, the relative weights of the other TSX sectors, including financials, have increased. Financial services now account for 37% of the TSX, a level that has not been seen since the start of the commodity boom almost 15 years ago. And with most commodity prices remaining low, and oil hovering around the $50/barrel level, it is unlikely that the sector weights will change much in the near future. What is changing is industry response to the low oil prices, perhaps the most important being a slight decline in North American oil production. This, combined with the increase in demand for refined products, is leading to modest inventory depletion, which in turn should enhance price stability. We are also seeing an increase in consolidation activity in the industry as weaker players are failing or being absorbed by their stronger competitors. Historically, these have been signs that the industry is moving to a new equilibrium, and to a point where fundamentals will play a greater role in share valuations.

OUTLOOK

Despite expectations to the contrary, the US Fed opted not to raise interest rates at their last meeting. The consensus is that summer market volatility influenced the decision not to raise, and uncertainty surrounding interest rate policy will persist. This will continue to impact market activity as it has done since the first anticipated rate increase date came and went. We speculate that absent a definitive move by the Fed, equity markets will rally on news that imply rates will remain low, pull back on news that rates will rise, and generally ignore fundamentals. Our expectations for equity outperformance relative to bonds remain in place, but because of rate policy uncertainty, performance will be more muted. And while the US economy has been performing well, so too has the US dollar, another, more legitimate factor holding the Fed back. Already strong against virtually all global currencies, a rate increase will serve to strengthen the USD even further. This is of concern to policy makers as the strong USD is reducing the competitiveness of US exports and encouraging consumption of imported, versus domestically produced, goods. As a corollary, it is for precisely these reasons that the Bank of Canada is tacitly supporting a weak dollar policy through our historically low interest rates: the low dollar supports exports, and encourages tourism. Given this, and in light of our export-heavy economy, we expect our dollar to remain weak relative to the USD for the foreseeable future, and that our rates will remain lower as well.

STRATEGY

We devote a great deal of time in this space to commenting on the specific attributes a company must have before it is considered for inclusion in our clients' portfolios. What we do not talk about is what leads us to those companies in the first place. The two major considerations that influence our decision to examine a company are whether we can speak to our clients in a comprehensible manner about the company, and the industry in which it operates, and whether the company has a business to which our clients can relate. We want our clients to be able to look at their portfolios and have the comfort of recognising the names and businesses of the companies they own. Ideally, we hope our clients will relate their day to day activities to their portfolios in the context of knowing that by purchasing a particular good or service, they may well be buying from the companies they own. Ultimately, we hope that this comfort and understanding gives our clients the sense of being business owners as opposed to just owning a portfolio full of names.

Please do not hesitate to contact us for further discussion.

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