

THE WEALTH CONNECTION (VOL.8)

Our team takes great pride in preparing this quarterly newsletter for our family of clients. We strive to provide the updates and information that matter to you. Please tell us if there are topics you would like to learn more about!

It's no secret that the 4th quarter of 2018 was volatile. Last month was one of the worst Decembers in stock market history. As much as it makes us uncomfortable, we must realize volatility will always be present and manage accordingly.

Looking ahead to 2019 we see some encouraging signs, despite the generally negative media headlines. In this issue we highlight some solutions we use in portfolios to help reduce volatility.

We place high importance on downside protection and 2018 provided a 'stress-test' of your core holdings – how did they do in a bad year like 2018?

We are adding two funds to our core recommended list. One provides outstanding capital preservation in bad times (+5.7% in 2018) while the other has provided solid growth during markets.

The new year brings with it new contribution room in your TFSA's. Coach's Corner reviews some aspects of TFSA accounts that can help maximize the tax-free benefit of these great accounts.

Our performance data represents transparency at its best, showing returns relative to a benchmark and associated costs. We can review these numbers more thoroughly in person the next time we meet.

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"This too shall pass"

- **A proverb from around 1200AD meaning that all material conditions, whether good or bad, are transient**



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2018 Market Commentary

The first 9 months of 2018 were fairly smooth. October has a reputation for two things:

- 1) Being the most volatile month of the year, and;
- 2) More often than not – marking the bottom of the market for the year.

We got past the highly debated mid-term elections in the US, with what we saw as a Goldilocks conclusion: not too hot, not too cold. The Democrats got some power back to keep President Trump in check, yet the Republicans retained the Senate allowing for some work to still be completed in a timely fashion.

December has been known for bringing a “Santa Claus” rally. Certainly that isn’t a given, but more often than not December is a pretty good month for markets. This December however, this was not even close to being the case.

If we had to lay blame for December we would look to the US Federal Reserve. Fed Chair Powell saying that rates were ‘a long way from neutral’ suggested that many more interest rate increases were in our future. On one side interest rate increases are a good thing: super low-interest borrowing for too long isn’t good and by raising rates they are saying the economy is healthy.

However, history also shows us that raising rates for too long can lead to recession, as economic growth slows more than expected. Noah Blackstein, one of our managers from Dynamic, talked all year about what he saw as the biggest risk to markets: too many interest rate increases.

As 2018 finished with market sentiment somewhat negative, more frequent comments about being closer to the **end** of the rate-increasing cycle began to appear in economic forecasts – a dramatic change in tone from just three months earlier. We hope that an appropriate balance can be found.

While the media seems intent on giving us something to worry about, and sensationalizing negative news, the sun will come up tomorrow and economic activity will continue. People will fill their gas tanks to go to work, drink coffee, pay their hydro and phone bills, etc.

Benchmark Returns:

	<u>Allocation</u>	<u>Return</u>	<u>Contribution</u>	
Canadian Equity	50%	-8.7%	-4.35%	
United States Equity	15%	-6.3%	-0.95%	
International Equity	10%	-10.9%	-1.09%	
Bonds/Safety	25%	+1.0%	+0.25%	
		Benchmark Return:	-6.14%*	Dec. 31/18

*Benchmarks for each asset class above is measured by the iShares ETF relating to that market. Each benchmark can be seen in the performance data at the back of this newsletter

2019 Look Ahead

All the above taken into consideration, we are on balance more positive than negative as we move into the new year. It's rare for the markets to post back-to-back negative years and many of the red herrings that produced negative returns in 2018 are not so much a concern now.

However we do think higher volatility will persist in 2019. None of us like seeing the value of our hard-earned savings bounce around on our statements, but historically it is quite normal to have sizable swings in markets during the course of a year. What is not normal is how low volatility has been in recent years. In 2017 the measure of volatility came close to all-time lows and was also subdued in 2018 until the fourth quarter.

To help combat volatility, we introduced two new investments from Dynamic in 2018 that have a long history of being much less volatile than the market – yet still delivering reasonable returns and monthly income flows. These will be a topic of conversation during our face-to-face meetings.

There are really 3 main factors to consider when we postulate an outlook for markets:

- 1) **Recession indicators:** To start 2019, various common recession indicators and the opinion of the US Federal Reserve suggest low odds of a recession in the next 12 months. We are likely closer to the next one than the last one in 2008, but this factor is currently not flashing red..
- 2) **Economic growth:** US GDP is suggested to be at 2.5% or perhaps a bit higher in 2019, a level that is certainly not indicative of a recession.
- 3) **Valuations:** 2019 earnings for the S&P 500 are estimated at about \$170. Given the ending 2018 index level on the S&P 500 of 2506 – suggests a PE ratio of 14.7x. Recall that about 15x is a historical average, approaching 20x is considered expensive and 10x considered great value. Major markets appear to be trading at fair value, so not much of a concern here.

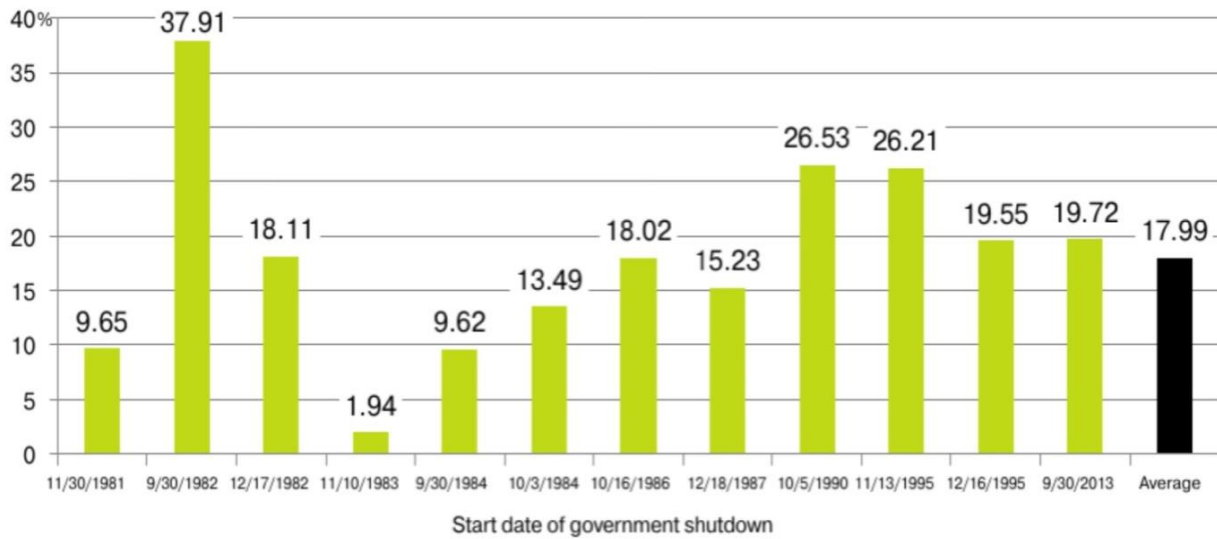
* Source of stat's are Morningstar Canada, as of December 31, 2018

It seems like President Trump is at the heart of many important matters affecting markets – that is likely to be the case moving forward. Two things that moved the markets last year, that need to see some resolution in 2019 if we are to see positive returns are:

- 1) **Interest rates:** Simply put, when interest rates went up last year, the markets went down. To start 2019 Fed Chairman Powell has implied that he is likely to not raise rates as fast as he previously guided. That has relieved a fairly large concern over-hanging markets – allowing them to start moving up.
- 2) **China trade:** The second week of January brings Chinese President Xi and US President Trump together to again try to find common ground. Trump provided some relief in December by saying negotiations were going well and that he wouldn't change the tariff from 10% to 25% as was the proposed plan. After seeing China's stock market drop about 22% from its 2018 high, it seems to us that they will be eager to make a deal and we hope this is nothing more than a bad memory as we move further into 2019.

We start 2019 with the U.S. government in shutdown mode. It sounds quite ominous, and for the federal employees not being able to cash their pay-cheques it most certainly is, but it was interesting to do some research to see how government shutdowns have affected markets in the past.

Exhibit 2: S&P 500 Index Total Return 12 Months After Start of Government Shutdown



Source: Renaissance



Outside recessions, stocks gained on average 4.5 percent three months after a VIX spike, 8 percent six months after a spike and 12.1 percent a year after.

Performance Commentary

We pride ourselves on your core holdings held in many of your accounts preserving capital in down markets and 2018 gave us an opportunity to “stress test” your holdings. In other words, to see how your funds did relative to the market in general during a negative period.

We are pleased that quite a few holdings protected capital in 2018 and beat their benchmarks by quite a wide margin

These funds did well*:

	<u>2018</u>	<u>Bench</u>	<u>+/- (Better or worse than benchmark)</u>
Manulife Global Equity Class	+4%	-1.7%	+5.7%
Mawer Global Small Cap	-2.6%	-12.8%	+10.2%
Manulife Dividend	-3.5%	-8.7%	+5.2%
Dynamic Global Dividend	+6.1%	-1.7%	+7.8%
Manulife World Investment	-4%	-10.9%	+6.9%
Dynamic Premium Yield	-1%	-6.3%	+5.2%

* Source of returns is Morningstar Canada, as of December 31, 2018

Manulife and Dynamic Global funds both produced positive returns, which is impressive in a year when approximately 90%+ of all assets globally had negative returns.

As per usual, your Canadian Manulife dividend fund helped you by ‘only’ going down 3.5% in 2018. This was 5% better than the TSX and more than 8% better than the Canadian banks as a whole.

Recently added to your core holdings was Dynamic Premium Yield, which we recommend as a low volatility diversifier, and we are impressed that it was down just 1.00% in a challenging year, which was more than 5% better than the S&P 500 last year. Also, in the very volatile fourth quarter, it was down only 3.6% compared to the S&P 500 at -14.4%.....75% less downside capture than the market as a whole. *** Source of returns is Morningstar Canada, as of December 31, 2018

These funds struggled:

- 1) **Trimark International Companies.** International markets struggled with trade concerns being a major cause. This fund also has 25% exposure to emerging markets, which really took it on the chin in 2018, mainly due to the US dollar being so strong. We continue to see opportunity internationally and in emerging markets, where a significant amount of the world’s young people reside and future growth potential is above average.
- 2) **Manulife Strategic Income.** A global bond fund with a long history of good performance, but not so much in 2018. To be fair, bad years in bond investments are not that bad and their 2018 return of -1.5% won’t raise many alarm bells. We will be meeting with the management team soon to get a run-down of why this fund posted a rare negative return.

As we've mentioned, a primary reason equity markets were down in 2018 was due to interest rates going up. This is also something that is typically not good for bond funds, so we understand the basics, but we still want to dig deeper into the specifics.

Added/Deleted Investments

We are very excited about our recommendation to add two new Dynamic holdings to your accounts, both managed by Noah Blackstein, who is a 25-year industry veteran with numerous industry awards. Both funds have been managed by Noah since inception - 20 years on American Growth and 16 years on Alpha Performance.

What we look for in a fund, among other things, are:

- How long has the manager been on the fund and in the business?
- Upside capture – how did they perform in good markets?
- Downside capture – how did they perform in bad markets?

New - Dynamic Alpha Performance

A conservatively managed hedge fund designed to protect capital. We realize that 'conservative' and 'hedge fund' in the same sentence may seem like an oxymoron.

It's important to understand that there are many different kinds of hedge funds out there. The ones that have captured headlines (for the wrong reasons) in the past were often 'leveraged' hedge funds, meaning they had \$5 million to invest but they borrowed against this asset base and actually invested \$10 million (half "real" money and half borrowed money). Then when the markets turned against them they were wiped out.

This Alpha Performance fund is different, focused on producing absolute returns and capital preservation. "Absolute returns" mean returns as compared to other investments that carry the same amount of risk. In other words, he is trying to get higher returns from a lower risk (i.e: less volatile) strategy. His consistent performance speaks for itself, especially when you consider

Returns:	2018	3-Yr	5-Yr	10-Yr	Since Inception (Dec. 2005)
	+5.7%	3.8%	4.7%	6.5%	6.1%

*** Source of returns is Morningstar Canada, as of December 31, 2018

New - Dynamic Power American Growth

This fund is all about growth and is meant for investors in their 'accumulation' stage who can tolerate higher volatility. Looking at the 2018 return numbers, we can see the growth potential when markets are rising. Look at the 5, 10 and 15 year return numbers and recall what we have learned about compounding. It is easy to understand why this is a compelling holding.

Returns:	2018	5-Yr	10-Yr	15-Yr
	+24.5%	+15.5%	+18.4%	+12.1%

*** Source of returns is Morningstar Canada, as of December 31, 2018

Old - Various Sentry products

You have invested with Sentry for a long time and are disappointed that what started as a small, family run operation has been sold to a large fund company in Canada, CI Investments. This is a material change that in our view has caused a reduction in “independent thinking”. We have been watching Sentry closely and have recommended that Sentry just doesn’t have a core spot in your investment portfolio’s going forward.

COACH’S CORNER

By Ross Jewell, PFP

The TFSA - the BEST thing to happen to investing since the RRSP

Happy New Year! Hopefully you had a great Holiday Season with family and friends. Now it is back to business as 2019 gets underway and one of the first orders of business for all of us should be to make our TFSA contribution.

This year the annual limit has been increased to \$6,000 - an extra \$500 per year to get working on a tax-free basis. We just never get tired of saying those two words....tax-free....music to our ears!

When the federal government instituted the TFSA account back in 2009, investors were slapping “high-fives” across Canada. The only mistake the government made was in naming this new tax-free account: instead of calling it a TFSA, they should have named it the TFIA → Tax Free **INVESTMENT** Account.

By calling it a savings account they gave the impression that only savings vehicles, like term deposits and GIC’s, could be purchased inside a TFSA. While those types of savings vehicles can be held in a TFSA, it is very important to know that virtually any type of investment can be purchased inside a TFSA.

Our preference, if it makes sense within your overall financial plan and your risk tolerance, is to have more growth-oriented investments in your TFSA, in order to maximize the benefit of tax-free



compounding. Again, keep in mind this is **tax-free** growth, not just the **tax-deferred** growth you get from investing in RRSP accounts. A quick example:

\$50,000 compounded at 3.00% per year for 10 years grows to \$67,195

\$50,000 compounded at 6.00% per year for 10 years grows to \$89,542

How would that extra \$22,347 of **tax-free** cash feel? Obviously higher rates of growth are not guaranteed. If you can tolerate the “downs” of the markets that come along with the “ups” and can have a longer time horizon with part of your portfolio, the benefits of higher growth rates can be significant.

It can also make sense to look at the TFSA as an income-producing account, since any income taken from the TFSA is truly tax-free. For someone with \$60,000 in their TFSA yielding 5%, could take \$250/month of additional income without affecting their tax returns at all. This can also benefit those fortunate enough to have their Old Age Security being clawed back.

If someone had never contributed to a TFSA in the past, as of this year they would be able to contribute \$63,500 to a TFSA. That is a meaningful amount of money to have producing tax-free growth and/or monthly income, so be sure to keep your TFSA contributions “topped up” to the maximum possible.

Be sure not to over-contribute though, because the government penalties can be harsh for doing so. It is best to only have one TFSA account so it is easy to track your contributions and withdrawals and thereby avoid the mistake of unintentionally over-contributing.

You can also name a beneficiary to your TFSAs which means that the proceeds can bypass probate in the event of your passing. If your spouse is named as the beneficiary, then he/she ends up with a TFSA that much larger in size as your TFSA value is added to their TFSA value – creating one fairly large sum of money that is free of taxation.

If you're not already doing so, be sure to ask us about investing inside your TFSA and whether it makes sense as part of your overall financial plan.



PERFORMANCE DATA

AS OF DECEMBER 31, 2018
3 AND 5 YR RETURNS ARE ANNUALIZED

*Individual returns will differ due to deposits and withdrawals and timing of trades throughout the year

Canada	Style	2018	3-mos	1-yr	3-yr	5-yr	MER	Description
Manulife Dividend Income Fund	Active	-3.5%	-9.3%	-3.5%	8.8%	9.2%	1.18%	Income
Manulife Dividend Income Plus	Active	-5.6%	-14.2%	-5.6%	10.2%	9.1%	1.18%	Growth
iShares Capped Cdn. ETF - XIC	Benchmark	-8.7%	-9.9%	-8.7%	6.4%	4.1%	0.06%	Canadian Index

United States	Style	YTD	3-mos	1-yr	3-yr	5-yr	MER	Description
BMO Dividend ETF - ZDY	Passive	3.4%	-3.6%	3.4%	9.9%	14.5%	0.34%	Dividend Quality
Dynamic Premium Yield	Active	-1%	-4.4%	-1%	3.1%	6.7%	1.13%	Defensive Income
Dynamic Power American Growth	Active	24%	-18.4%	24%	12.3%	15.5%	1.32%	Concentrated growth
iShares S&P500 ETF - XSP	Benchmark	-6.3%	-14.4%	-6.3%	7.9%	7.6%	0.11%	The S&P 500, in Cdn \$

International	Style	YTD	3-mos	1-yr	3-yr	5-yr	MER	Description
Manulife World Investment Class	Active	-4%	-5.3%	-4%	4.6%	8.1%	1.22%	Income
Invesco Int'l Companies Fund	Active	-13.1%	-11.2%	-13.1%	3.4%	8.4%	1.37%	Growth
iShares MSCI ETF - XIN	Benchmark	-10.9%	-12.7%	-10.9%	2.9%	3.6%	0.48%	Non-North America

Global	Style	YTD	3-mos	1-yr	3-yr	5-yr	MER	Description
Edgepoint Global Equity Fund	Active	-2.3%	-11.7%	-2.3%	9.8%	12.6%	0.98%	Growth
Manulife Global Equity Class	Active	4%	-4.4%	4%	6.9%	11%	1.23%	Income
Dynamic Global Discovery Fund	Active	6.1%	-7.9%	6.1%	9.8%	12.7%	1.20%	Growth and Income
iShares Global ETF - XWD	Benchmark	-1.7%	-8.4%	-1.7%	5.4%	9.5%	0.47%	World Stock Index

Fixed Income/Alternative	Style	YTD	3-mos	1-yr	3-yr	5-yr	MER	Description
Manulife Strategic Income Fund	Active	-1.5%	-1.3%	-1.5%	2%	4.2%	0.99%	Global tactical
PIMCO Monthly Income Fund	Active	0.6%	0.9%	0.6%	5%	4.9%	0.82%	Global tactical
Sun Life Excel High Income	Active	-0.1%	5.1%	-0.1%	4%	6.6%	1.37%	Emerging Markets
Dynamic Alpha Performance	Hedge	5.7%	-1.1%	5.7%	3.8%	4.7%	1.25%****	Alternative Equity
iShares Cdn Universe ETF - XBB	Benchmark	1%	2.1%	1%	1.6%	3.2%	0.19%	Cdn Bond Index

Specialty Higher Risk Growth	Style	YTD	3-mos	1-yr	3-yr	5-yr	MER	Description
Fidelity Small Cap America Fund	Active	-4.2%	-15.4%	-4.2%	0.9%	9%	1.14%	Income
Mawer Global Small Cap, A series	Active	-2.6%	-8.5%	-2.6%	5.4%	11.1%	1.76%	Small Cap Growth
Dynamic Power Global Growth	Active	-15.2%	-20.1%	-15.2%	4.9%	10%	2.87%	Growth
Fidelity Special Situations	Active	-12.4%	-20%	-12.4%	7.9%	9%	1.13%	Growth Focus
Fidelity Global Innovators Class	Active	-4.6%	-20.1%	-4.6%	Fund			New Age Tech
iShares US Small Cap ETF - XSU	Benchmark	-19.9%	-12.8%	-19.9%	5.9%	3.6%	0.36%	Passive index

* All fund returns are f-series returns

** All values reflect total returns which includes distributions

*** Source of returns is Morningstar Canada

All returns as of September 29, 2018

****Fund has performance fee's that are different from typical fund structures

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