Okanagan Wealth Advisors Q2 2020 Update

THE WEALTH CONNECTION (VOL.14)

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The question everyone investment-minded is asking themselves right now is: is this stock market recovery real, or has it possibly recovered way faster than it should have and is expensive and risky?

A very tricky question to be sure with so many variables at play.

We can say that after digesting and reflecting on an enormous amount of analyst updates, portfolio manager calls, data and charts – we are generally more positive on the overall outlook.

This newsletter will review the potential positive and negative factors. We will review some important topics in our Recession Watch.

We have two Coach's Corner articles. One we were going to save till next quarter but felt it was too important to have sitting on the bench.

Inflation, because of Trillions in new money printing and the effects of low and negative interest rates are our focuses.

While these topics can be difficult to understand, they are very important, and this newsletter will provide the basics. We will explain in better detail during our next review.

Stay safe everyone. It has been a difficult few months and we are likely not out of the weeds yet. Keep your immune systems strong and your outlook positive!

IN THIS ISSUE

"Compound interest is the eighth wonder of the world. He who understands it, earns it. He who doesn't, pays it."

- **Albert Einstein**

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Market Reflection

Has the market rebounded back up too far too fast? This is the question we are all asking ourselves.

We must keep in mind that the stock market looks forward and is not concerned with what is in the rearview mirror. As investors, we tend to have recency bias, which is to say that our emotions focus our attention more on what has happened as compared to what will happen.

The commentary in this article from David Fingold, manager of the Dynamic Global Dividend fund, is almost shocking in its message of both positivity and normalcy to what is happening in markets. “Don’t let the past few months affect your ability to be optimistic about the future” he says. The article is quick and easy to read, we highly recommend it.

Our Coach’s Corner talks about the effects of the super low interest rate environment we are in. With all the detail we provide there, it doesn’t make sense to rehash here. Suffice to say, low interest rates mean a smaller set of investment options, meaning more money goes into the stock market…providing price support.

Also interesting to note is the performance of certain stocks relative to the rest of the market. The S&P500 for example has 6 stocks that make up about 25% of the index, because those stocks are so big. Those stocks are: Facebook, Amazon, Apple, Netflix, Microsoft and Google. But the other 494 stocks may not be doing as well.

This difference in performance appears quite start on this chart.

The above tells us that certain stocks have bounced back quite a bit but overall, the market is still well off their highs. Helps to provide a more positive view that things aren’t as expensive as they feel.

Potential Negatives

1. Will there be a second economic lockdown due to a second wave of COVID-19?
2. Will schools re-open? This is a bigger one that it may seem as its hard for parents to work normally when their kids aren’t at school.
3. What effect with the U.S. Presidential election have on markets?
4. Banks haven’t recovered a whole bunch yet, is that telling us something? Royal Bank, as of June 30, was still down 15.6% from its February highs.

Potential Positives

1. Governments around the world continuing to print new money to support markets.
2. Investors generally have a large amount of cash on the sidelines waiting to be invested after selling major amounts of equities to buy major amounts of bonds in recent years.
3. Interest rates are likely in for a ‘lower for longer’ rate environment which is supportive for equity markets.

4. Real estate, home building and mortgage activity has bounced back faster and stronger than one might have guessed

Conclusions

1. We feel there is a risk that markets are a bit ‘toppy’ and that Summer brings its normal added volatility that could lead to a 10% to 15% correction
    a. We would view this as a normal good thing and importantly – a buying opportunity
2. We feel that that the risk of a major second market flush to March lows is unlikely
3. We feel that, generally, COVID-19 news is going to get more positive than negative as
    a. We learn more about how it works, who it affects most and what we can do to control the spread and heal the sick. COVID-19 is no longer a ‘shocking unknown’, there are uber smart doctors and scientists learnings more everyday about it
4. We feel that the U.S. election is not as important to markets as it seems and feels it is
5. We feel the largest risk in markets has to do with China, specifically the controversy revolving around COVID-19 as well as various trade, technology and military concerns.

As of the end of June indexes aren’t down as much as we feel they are. The average investor in Canada was down about 3.75% in the first half of 2020 which, given all the fear and volatility, isn’t all that bad.

Looking forward, it’s obvious that certain sectors and certain companies are going to do better than others. We feel that investing with a rifle as compared to a shotgun is going to work out much better going forward.

We invest with a rifle by owning actively managed mutual funds that commonly own less than 50 stocks. This is in comparison to ‘owning the entire market’, which is generally done by owning ETF’s.

Benchmark Returns:

	Allocation	Return	Contribution	
Canadian Equity	50%	-7.42%	-3.71%	
United States Equity	15%	-4.90%	-0.74%	
International Equity	10%	-11.6%	-1.16%	
Bonds/Safety	25%	+7.42%	+1.86%	
		Benchmark Return:	**-3.75%***	**June 30, 2020**

***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**

Recession Watch

COVID-19 brought on an immediate recession. The key questions will be how deep the recession is and how long it lasts. The key to that question is how quickly businesses are able to fully re-open and then how quickly the public is willing to get back to fairly normal life.

Indicator	Current	Previous	Trend
1. Yield Curve	Green	Green	Stable
2. Manufacturing	Red	Yellow	Negative
3. Inflation	Green	Green	Stable
4. Capacity Utilization	Red	Yellow	Negative
5. Housing Starts	Green	Green	Stable
6. Labour Market	Red	Green	Negative
7. Leading Economic Indicators	Yellow	Green	Negative
8. Gasoline Prices Up or Down	Green	Green	Stable
9. Credit Conditions	Yellow	Green	Negative

Positives include the yield curve, where short-term rates are well below long-term rates; although we note this is a result of a very managed and coordinated effort. Inflation is under control, for now. Housing starts are the shining star of good news, even though lower interest rates buoy this stat, the economy and jobs market along with general outlook should have an effect on housing starts – which are positive.

Negatives include the obvious in manufacturing which grinded to a half in Q2 along with capacity utilization – think retail shopping malls. The labour market obviously under extreme pressure as well; jobs have come back online faster than expected however current unemployed numbers resemble the worst times during the 2008 great financial crisis. Much work here remains.

These normal recession indicators are not as clear in such a short and volatile time, to use as accurately as they normally are. We looked at a company called Rio Tinto for guidance, as it's one of the worlds largest commodity producers – especially iron ore. Their rebound from the March bottom and current price in relation to pre-Covid prices can give us an indication of global economic health.

In January of this year Rio was trading at about \$60 on the New York Stock Exchange and is trading at \$61 on July 28th. Only one signal in amongst many, but positive none the less. Interestingly, Rio has an approximate 5% dividend and did a special 2% extra distribution last year for a 7% yield. PE ratio of 12.6x screams value against the technology heavy market.

Hard to not comment on inflation. As of now, inflation isn't a huge concern. But with all the Trillions in new money printing, it likely will be an issue in the future. See Coach's Corner for more, very important, info on inflation.

Added/Deleted Investments

Adding
What can we do to keep upside returns in good markets, while also limiting downside in bad markets?

We have so far focused on investment managers with a focus on dividend growth stocks, which have historically had the best risk/return ratio. But the reality is that these funds are 'long-only', which means that markets need to go up for them to make money.

There are other tools out there such as hedging, short-selling and options that can help to protect downside exposure. However, these actions are not allowed in traditional mutual funds, making them long-only.

Hedge funds are allowed to do all those fancy things. Yes, we have all heard about hedge funds on TV that did not go well – those tend to be 'leveraged' hedge funds, whereby they invest more money than they have – which can work well, until it doesn't.

Dynamic Global Growth Opportunities
Manager Noah Blackstein already manages two of the funds on our recommended list: Dynamic Power American and Dynamic Alpha Performance. For some clients, his Global Growth Opportunities could be a better solution.

Noah's long-only Power Global fund, which has a 5-year average return per year of 16.6% (as of June 30, 2020. F-class), returned -11% in 2016 and -15.2% in 2018. Great long-term returns, but perhaps too much downside volatility for some.

The hedge fund version returned 18.7% over the same 5-year timeframe….so better upside. In 2016 it was down a mere -0.6% and in 2018 was up 14.8%....beating his own great long-only by a whopping 30% that year! #MoreToolsCanHelp

Ninepoint Silver Equities
Going back a few years many investors were very excited about pot stocks and the profits they could make; We were skeptical. We see an opportunity in silver equities that could not only provide similar share price increases to the pot craze, but also the profits and positive cash flow to back up the actual value.

Mainly because the overall silver market globally is so small and that there are so few silver producing equities, we feel it's not necessary to take company specific risk in this area. We therefore prefer a professionally managed diversified basket of silver equities.

The fund has a five-year track record, averaging +15.73%. As of June 30, 2020 the year-to-date return was 31.14% and over just the 2nd quarter of 2020 was up 85.96%.

This investment should be relatively small; It is high-risk and will be volatile. We also feel that the potential returns could be huge, such that a small allocation is enough, say 2%. So if you have $400,000 account value, you could buy $8,000 worth.

Dynamic Precious Metals
In the last two newsletters we started recommending initial gold/precious metals allocation. The physical price has performed well this year, moving from about $1500/ounce usd to $1900/ounce usd in late July. That's more than a 25% increase so far this year!

This fund, which invests in gold mining companies, is certainly higher risk than buying simply physical precious metals. The mining companies do however provide leveraged returns, evidenced by their first half of 2020 return of +50.4%....twice the return of physical = leverage. The 5-year ***average*** return has been 28.4%.

The manager, Robert Cohen, has been on this fund for 19 years and is highly respected in the industry. That's a lot of experience managing stocks in a sector that could have a great next couple years.

Deleting

1) BMO U.S. Dividend ETF. We have long-held that the American markets where the place to own passively-managed ETF's, as they so often beat active managers. Further, focusing on dividend-growth companies has historically outperformed. This seems to be changing.
    a. COVID has turned some sectors and companies into winners, and others into losers. Simply 'owning the market' isn't working well this year and, in our opinion, is going to be a challenged approach going forward.
    b. Over the past many years, the 'quality under the hood' hasn't mattered much. But since COVID, quality under the hood matters a lot.
    c. Going forward, we feel that we should invest using a rifle, not a shot gun.
2) Edgepoint Global. While we may not sell this investment right away, as we feel it's likely good value here – noting the managers have provided lots of updates regarding the health of their companies held, which they feel is very strong.
    a. However, we feel the downside capture is no longer worth the upside capture.
    b. Returns are based on two key things:
        i. Getting as much upside as possible during good times, while
        ii. Getting as little downside as possible during bad times.
    c. Their calendar year returns have been nothing short of fantastic
    d. If we are going to replace those awesome returns, we better have something that is not just good – it will need to be very good. We feel that Dynamic Global Growth Opportunities is a better holding going forward.

SPECIAL COACH'S CORNER DOUBLE EDITION-

1) EFFECTS OF LOW AND NEGATIVE INTEREST RATES

Almost hard to believe that rates have gone even lower than they have been in recent years, and it doesn't seem like they will go up anytime soon.

As of July 1, 2020 rates for various US Treasury Bonds were as follows

1-Year	5-year	10-year	20-year
0.16%	0.31%	0.69%	1.20%

Source: [US Treasury Yields]

The effect these low interests have on every-financial is enormous. For retirees and seniors wanting guaranteed yield on their savings, 0.31% for 5 years requires a LOT of capital to meet income needs.

Low interest rates have an enormous effect on stocks as well.

1. **Hard on Retirees and Savers** - One obvious one being that when you can buy a bank or electricity company with a 4% dividend that has a chance of growing, even if you don't like the volatility, the yield is a lot higher. So investors are generally willing to take a bit more risk, supporting share prices.
2. **Stock Risk-premiums** - Stocks tend to be volatile, bonds not so much. If you're buying stocks, you should expect to get a return higher than what the safe bond option offers. Let's say that an investor at least 3% more in return for buying a stock over a bond. When US Treasuries paid 4%, this investor would need to feel he could get at least 7% on the stock to make up for the added risk. With the 5-year treasury at 0.31% and the same risk-premium of 3% - this investor only needs stocks to earn 3.31% to make them 'worth the risk'. Again more support for stock prices.
3. **PE Ratios** - PE ratio's need to be viewed in the context of interest rates. By way of quick background, while PE's can be quite different industry to industry, generally:
   10x PE is considered good value to buy
   15x PE has been the approximate long-term average
   20x PE has historically been expensive
   A 'normal' interest rate environment would yield 5% to 7%. We are currently in a very low interest rate environment where, due in part to the issues raised above, 20x PE ratio is not to be viewed as expensive as it previously was.

4. **Negative Yields** – Over $10 Trillion of the worlds bonds now trade at negative yields. To make sense of that, let's say you had $100,000 in the bank and the interest rate was -1%. That would mean that instead of the bank paying you interest on your banked savings, you would have to pay them $1,000 per year to keep it there. This is real, hard as it may be to believe. Incentive to spend your money and boost the economy and stock purchasing? Pretty much.

2) INFLATION = COMPOUNDING WORKING AGAINST YOU

Compounding, the eighth wonder of world says Albert Einstein. Great if its working for you, bad if its working against you.

Negative compounding is something that affects us all. It happens when the price of stuff we need rises faster than our incomes. Think about food prices rising faster than Canada Pension Plan. Also, when safe investments like GIC's return less than the rate of inflation.

In 2019 Canadian core inflation (CPI) was 1.95%. The word core is key here, as it excludes things like food and energy. Let's say that true inflation (the increase in the price of all goods we need) was 3%. The yield on the 5-year bond the world views as the most ultra-safe investment, the US treasury, yields 0.31% as of early July. That means that each year this investor is losing 2.69% of purchasing power.

Year, after year, after year. This is negative compounding and can be very harmful over time.

Negative inflation of 2.69% a year turns $100,000 into $87,254 of purchasing power over 5 years. With a GIC, you still get your $100,000 investment back at maturity – which can make us feel our capital is safe and has been preserved. But you cannot buy as much stuff with that $100,000 – so your purchasing power has not been preserved.

With M2 money supply up 20% so far in 2020, the price of milk and break is likely to go up in the coming months and years. Going back 10 years, M2 money supply in the US was measured at about 8500. Today that number is 18,400. That's money supply growth of 116% or about 7.5% a year. Compare that to 'CPI', which over the last 10 years is said to be a max of 2.5%.

The key difference here is to focus our attention on slightly different semantics: change 'capital preservation' with 'store of value'. Capital preservation is the GIC example above, sure you got your principle back, but it won't buy you as much stuff as it previously did.

Store of value, specifically 'value' refers to maintaining purchasing power. This will help us to make better investment choices going forward. Argentina is an excellent example, having been very much like Canada in the past, ie: one of the worlds largest oil reserves and production numbers and a very good living standard. Today their country is in shamble and their store of value was not GICs.

PERFORMANCE DATA

AS OF JUNE 30, 2020

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	YTD	3-mos	1-yr	3-yr	5-yr	MER	Description
Manulife Dividend Income Fund	Active	**0.4%**	18.1%	3.7%	8.3%	9.6%	1.18%	Income
iShares Capped Cdn. ETF - XIC	Benchmark	**-7.4%**	16.9%	-2.1%	3.9%	4.5%	0.06%	TSX

United States	Style	YTD	3-mos	1-yr	3-yr	5-yr	MER	Description
Dynamic Power American Growth	Active	**41.2%**	42.5%	47.7%	39.6%	23.5%	2.31%	Value
iShares S&P500 ETF - XSP	Benchmark	**-4.9%**	19.8%	4.9%	8.6%	9%	0.11%	S&P 500, in Cdn $

International	Style	YTD	3-mos	1-yr	3-yr	5-yr	MER	Description
Manulife World Investment Class	Active	**-0.5%**	10.2%	3.7%	5.5%	7.1%	1.22%	Income
Invesco Int'l Companies Fund	Active	**0.3%**	17.8%	12.2%	5.5%	6.8%	1.37%	Growth
iShares MSCI ETF - XIN	Benchmark	**-10.9%**	13.9%	-4.5%	1.3%	2.7%	0.48%	International Index

Global	Style	YTD	3-mos	1-yr	3-yr	5-yr	MER	Description
Edgepoint Global Equity Fund	Active	**-13.5%**	14%	-11.5%	1.5%	5.3%	0.98%	Growth
Manulife Global Equity Class	Active	**1.2%**	12.1%	8.6%	10.9%	10.6%	1.23%	Income
Dynamic Global Dividend Fund	Active	**1.7%**	9.9%	8.2%	13.4%	13.7%	1.11%	Growth and Income
iShares Global ETF - XWD	Benchmark	**-2.1%**	14.5%	5.9%	7.8%	8.3%	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	**2.3%**	5.2%	4.8%	3.4%	3.8%	0.99%	Global tactical
PIMCO Monthly Income Fund	Active	**-2.4%**	5.8%	-0.9%	2.3%	3.8%	0.85%	Global tactical
Dynamic Alpha Performance ||	Alternative	**6.8%**	0.5%	6.0%	-	-	1.25%****	Absolute return hedge
Dynamic Premium Yield	Alternative	**-6.1%**	6%	-3.6%	2.7%	2.8%	1.13%	
iShares Core Cdn Bond Universe	Alternative	**7.3%**	7.5%	7.8%	5.2%	4.1%	1.13%	Options strategy

Specialty Higher Risk Growth	Style	YTD	3-mos	1-yr	3-yr	5-yr	MER	Description
Fidelity Global Innovators Class	Active	**35.6%**	38.3%	48.3%	**New**	**Fund**	1.17%	New Age Tech
iShares US Small Cap ETF - XSU	Benchmark	**-15.3%**	24.6%	-9.2%	-0.2%	2.5%	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 June 30, 2020
****Fund has performance fee's that are different from typical fund structures