the art of boring™

EP26 | Quarterly update: 4Q 2018

00:42 **Cameron Webster** Today with us is Greg Peterson. He's head of some of our balanced strategies and chair of our asset mix committee. Every quarter, we've been having Greg on to give us an overview of what markets have done, a little bit about what we've done about it, and a little look forward.

00:59 **Cameron Webster** So, that's the setup Greg. Welcome back!

01:02 **Greg Peterson** Hi Cam, good to be back. Nice to have 2018 behind us.

01:05 **Cameron Webster** Yeah! Well, let's start on that note [laughs]. ... What was behind that comment? Why are we glad to see 2018 behind us as investors?

01:06 **Greg Peterson** I was kidding a little bit. 2018 naturally ended with a much more volatile environment than what we've been used to for some time. Markets have behaved for many years. Really, since 2009, we haven't had very many disruptions; high in equity markets globally. There've been a few hiccups here and there. I think this is the first time we've experienced declines as quickly as we have for a while.

01:36 **Greg Peterson** So, this might be relatively new to some investors and it could be just a bad memory for others as it's been carried forward. It was a more difficult time at the end of the quarter. We've talked about volatility increasing for some time. A few people have commented to me, “Well, you're just telling me that. It's not really going to happen anymore.” But no, we are seeing that now. That was expected and now it's come to fruition as well.

01:56 **Cameron Webster** Give us some perspective on what were some of the catalysts in the quarter. The fourth quarter was a big, negative quarter for equities and a not-so negative quarter—depending on where you were positioned—in bonds. What were the catalysts out there?

02:10 **Greg Peterson** I think there are a few things that have led to this. One, is you've had really good markets for some time, so stock valuations may have been a little bit on the expensive side. Or certainly higher, anyway. So that already leads them to be a bit more subjective to change or to disruptions such as we've seen in the last few months.

02:27 **Greg Peterson** The real catalysts or likely expectations—or concerns, rather—are around growth going forward: where is economic growth coming from? It is slowing, so the growth cycle has likely peaked. And so there are some concerns about, "where do we go from here?" How quickly did the global economy slow down?

02:43 **Greg Peterson** The other [concern], sort of combined with that, was rising interest rates. The U.S. has been raising rates for some time. Canada has raised rates five times in the last year and a half. Higher interest rates are not necessarily good for equity markets either. Those are probably two of the main concerns.

02:58 **Greg Peterson** And then, of course, the other [one] just to top things off, is concerns around global trade—tariff wars in particular—the dispute between China and the U.S., and what that means for global trade, and how that relates to economic growth as well.

03:09 **Cameron Webster** Okay. Capital markets are voting machines—we've heard that out there quite a bit. The past quarter, the votes were that broadly speaking, equities are overvalued. Because there's the bond market saying something else about future economic growth and the speed with which interest rates were being raised. Leading [us here] into something called the "flat yield curve." Let's talk about that for a brief moment and give listeners some perspective on whether that's a signal or not that times are changing.

03:39 **Greg Peterson** A flattening yield curve typically does lead to slower growth. If you think of it from a bank's perspective and credit creation, banks tend to borrow short and land long. And if you have a flat yield curve, that means that short rates are about the same as long rates. So there's really no incentive for the financial community to be lending money because they don't earn the same spread on that—they don't have a financial incentive.
That does oversimplify things a little bit, but that's sort of the premise. From an investor's perspective, if you're not being paid to take risk by going

longer on a yield curve, or for other long-term assets such as stocks, then you're probably incented just to park money in short-term because short-term rates are higher—at least relative to the longer-term rates.

04:21 **Greg Peterson** So, there's a natural effect from flattening yield curve. I think from a psychological perspective, too, a flattening yield curve could lead to an inverted yield curve. An inverted yield curve is where short rates are higher than long rates. And historically, an inverted yield curve has led—most times—to a recession.

04:37 **Greg Peterson** It's been a bit of a forecast, if you will, of pending recessions. I'm not sure that it works the same way this time around. We have had a great deal of central bank intervention in markets for the last 10 years. And they have, perhaps, disrupted that message that the yield curve is sending us by manipulating that yield curve through quantitative easing or just through manipulation of interest rates. So, I'm not entirely convinced that the message is as sound as it's been in the past. We may have a flatter yield curve; it may or not lead to a recession at some point.
Although, as the world has to go through cycles, you know a recession comes at some point. We just don't know whether that's a year from now or three years from now.

10:52 **Cameron Webster** Let's talk a little bit from an asset class point of view of how returns shook out in the quarter. Maybe dive a little bit more into bonds and building a balanced portfolio. ... If you're a balanced investor in the fourth quarter, how did that actually shake out?

05:39 **Greg Peterson** For a balanced and well-diversified investor—just for instance, our Balanced Fund was down 3.6% in the quarter. Depending on how you look at that, that may have been good, or not so good. Definitely from an absolute perspective we're never really happy having a decline in asset values. Relative to the decline in stock markets, it's been much more attractive that way.

05:59 **Greg Peterson** The diversified investor has benefitted from that diversification. As the expectations were changing and the equity markets perhaps towards slower growth, the same thing was happening in bond markets. We saw bond yields ease. Bond yields have moved lower and that's caused bond prices to move up, which is exactly what we like to see in the environment where equities are dropped—we'd like to see bonds moving higher and providing a bit of offset and helping to reduce that volatility for balanced investors.

06:25 **Greg Peterson** So that worked in the past quarter and through the course of last year as well. And then the other thing that's worked for us in addition to bonds and cash preserving value in the fourth quarter was the Canadian dollar. The Canadian dollar tends to be a fairly volatile currency globally. We're not one of the reserve currencies of the world, which would typically be the U.S. dollar, Japanese yen, Swiss franc. That's sort of the top three—or first three that come to mind, anyway.

06:48 **Greg Peterson** And so because of that, when we have this fear in the market, or markets selling off, the Canadian dollar tends to do that as well. And given that we have a fairly high concentration of assets outside of Canada, that drop in the Canadian dollar increases the value of those assets for a Canadian investor and helps to offset some of the decline in equity markets globally.

07:07 **Greg Peterson** So, a few things worked in the quarter. Bonds improved in value, cash naturally held its value, and then the drop in the Canadian dollar was good for Canadian investors as well. Maybe not so good for their holiday plans if they're going outside of Canada.

07:20 **Cameron Webster** True, true.

07:21 **Greg Peterson** But it certainly worked better for portfolios.

07:23 **Cameron Webster** So—just on the Canadian dollar—let's dive into a little bit of the reasoning behind the weakness in the dollar. The Bank of Canada certainly said a few things in the quarter, oil prices have something to do with that... [what’s] your perspective on where the Canadian dollar's at, and why?

07:39 **Greg Peterson** There are many things that contribute to a currency’s fluctuations. A few of the main items are expectations for economic growth in that country. I think the Canadian dollar has declined partly because of concerns over economic performance in Canada. Canadian growth has been slowing much like other developed countries. So, that's not something that's unique and would necessarily cause the dollar to drop on its own.

08:01	**Greg Peterson**	I think some of this fear from a psychological perspective also contributes to that. As I was saying, when markets are selling off, the Canadian dollar tends to decline in value as well—so that may have contributed a little bit.
08:11	**Greg Peterson**	But more [on] what you were mentioning with the Bank of Canada—the Bank of Canada had been pretty set on raising interest rates ... having done that five times since mid-2017. I think expectations are that the Bank of Canada is not raising rates as quickly going forward. And because there's a shift in that expectation (that interest rates in Canada don't rise or rise much from here), then the appeal of Canadian bonds and the dollar isn't the same as it would be otherwise.
08:36	**Greg Peterson**	And this is usually looked at in relation to other central banks. The easy example is Canada and the U.S.—that's what most of us tend to see and follow all the time. So, as expectations were that the Bank of Canada's not raising rates as quickly, the Federal Reserve has still been raising interest rates. It's still expected to continue raising interest rates. And that helps to sort of to bid the U.S. dollar versus the Canadian dollar, if you will, and causes our dollar to decline in value relative to the U.S.
09:02	**Cameron Webster**	Just to [key] in on central banks for a minute. I'm curious what your perspective is on: we've had rate rises...how much dry powder would a central bank have now on a go forward basis? What's your opinion there?
09:17	**Greg Peterson**	Yeah, there's lots of debate about the level of where central banks have gotten to with interest rates and whether they've gone too far or not. Regardless of that, they have sort of re-established interest rates—they're no longer at zero, they're significantly above that. So they've given themselves enough dry powder, if you will, to work with, so that if things did slow significantly, the Federal Reserve in the U.S. or the Bank of Canada can start to reduce interest rates from where they are now.
09:40	**Greg Peterson**	Whether they have very far to move or not...it's just that signal, that message, is generally received by markets. And whether it's just effecting stock markets, or perhaps it's helping companies that are making investment decisions have a bit more confidence—perhaps interest rates are not moving significantly higher and [investors] may be more inclined to start to invest[ing] a bit more now as well.

09:58	Greg Peterson	So the message is not just "the markets," it also tends to [have a real effect on businesses as well]. And I think they have enough room now to be able to do that if they need to.
10:06	Cameron Webster	To me, that's a positive potential that maybe the market's missing. Let's shift gears to asset mix. As a balanced manager, how did you start the year in terms of view and asset mix? How did you end the year? And maybe a little bit about where we're going.
10:25	Greg Peterson	The start of the year was significantly different than the end of the year [laughs].
10:28	Cameron Webster	Sure was! [laughter]
10:29	Greg Peterson	At the beginning of the year, we still had asset equity markets doing quite well. And so, our position, whether it's the beginning of this year—or the middle point of this year, for that matter—and the years all prior to that, was really trying to keep equity from drifting much higher in the balanced portfolio. What I mean by that, is as equity markets are doing very well, they're performing stronger than bonds and cash. They tend to become a higher percentage within your portfolio as a balanced portfolio. So we've been trimming equities regularly just to keep them from moving too much higher. We already had some—not necessarily concerns—but we knew we were later in the cycle. Valuations weren't as appealing, earnings growth was starting to peak, perhaps, with the beginning of the year…we didn't want equity to get away from us. And so part of that risk management was just to keep that in check by trimming from time to time and reallocating.
11:17	Greg Peterson	It's interesting, as we went through 2018 earlier this year, we were often asked, "Well, why are you trimming equities in favour of bonds?" Bond yields were very low.
11:26	Cameron Webster	Yeah, like "why own bonds?"
11:28	Greg Peterson	We got that question frequently.

11:28	**Cameron Webster**	"They're not doing anything," yeah.
11:29	**Greg Peterson**	Yeah, why own bonds? Well, we now remember why we own bonds in the portfolio.
11:33	**Cameron Webster**	[laughs] Yes, a little bit of a, punch-to-the-gut of a reminder there—but yes.
11:37	**Greg Peterson**	Well, those reminders are helpful from time to time.
11:38	**Cameron Webster**	Absolutely!
11:39	**Greg Peterson**	As much as we don't like it and things are uncomfortable for a period of time, I think they do help investors to come back to some reality and remember why they're there. And bonds are there, quite frankly, to provide that stability within the portfolio and to provide some level of income as well.
11:52	**Greg Peterson**	So, we were adding the bonds at a time where bond yields were becoming more appealing at one point. The 10-year Government of Canada bond peaked out at just over 2.5%, roughly. Relative to where we've been in the last several years, that was fairly high. It turns out in hindsight, that was a good value, at least short-term.
12:10	**Greg Peterson**	And bond yields more recently had bottomed out around 1.8%. We're back up to just over 1.9 as we talk today. So that's why we were reinvesting in bonds at the time, selling assets that are relatively expensive and buying assets that are relatively inexpensive.
12:24	**Cameron Webster**	And where did asset mix end the year at? ... Are you planning to change it based on conditions and risks out there? Maybe you can give us a quick ... top three or five risks looking forward, and what that means for asset mix.
12:40	**Greg Peterson**	Sure. We ended the year just below neutral for equity. Equity in the balanced fund is 60%—that would be our neutral position. We were just below that at the end of the year from trimming. Then the market did help to take that a little bit lower at the end of the year as well.

12:55 **Greg Peterson** We were slightly higher, naturally, in bonds. So then cash was a bit overweight in the portfolio too—wanting to be somewhat defensive there. That's where we ended the year: slightly different from where we started the year. When we started the year, we were slightly overweight equity, underweight bonds. That position reversed to some extent.

13:10 **Greg Peterson** Within the equity mix, things haven't changed that much. ... We continue to be slightly underweight Canada. We still have some concerns about headwinds here, despite the fact that valuations in Canada are probably more appealing than they've been for some time. We continue to be slightly overweight within the U.S.—and for a couple of reasons. Valuations there are not as compelling, naturally. The U.S market is still relatively expensive, but the U.S. economy is also on better footing. Companies are performing relatively well despite the trade talk and disruptions that are taking place. And then we have the benefit of the reserve currency as well.

13:46 **Greg Peterson** So we don't lose sight of the fact that we're investing in foreign currencies as we're adding to stocks globally. If things do turn as they did in the fourth quarter, the U.S. dollar tends to hold value quite well. So we still have a higher position there.

And then—we still like the diversity of international markets. There are many different types of very good companies despite some of the geopolitical concerns that are out there at the moment. There are good companies with good management teams that know how to work through that and manage through whatever situation may be coming up. So we continue with that diversity in the portfolio.

14:17 **Greg Peterson** In terms of where we're making changes...most recently we have just repositioned to add a little bit backed equity. And it's not that we've been buying and finding that things are terribly compelling—we just didn't want equity to drift significantly lower in the portfolio. I did feel that the sell-off at the end of the year was fairly sharp. It may have been slightly overdone given the conditions.

14:37 **Greg Peterson** So, even though economic growth is slowing, it's still positive. Earnings growth has slowed...earnings are still positive. And despite that, interest rates haven't increased—they're still relatively low. So the environment for equities is not that bad. The sell-off in the short-term may be a little bit overdone. Time will tell. Perhaps as we're talking next quarter, we'll find out where that's at.

14:56 **Cameron Webster** Good! [laughs] You're coming back next quarter, all right!

14:58 **Greg Peterson** But that's all very short-term thinking. What we're really trying to do is position the portfolio appropriately for the next two to five years or longer, and not try to react or position for the short-term.

15:07 **Cameron Webster** Well, I think in this podcast we've actually managed to cover "the drift" subject. So, we've gone above 60 and we trimmed—and the market takes us below...so now we're trying to get back to that.

It seems that, as a balanced manager that—it's tough to predict markets, admittedly—but if you have that 60% marker in front of you, it's a good ballast that is a reminder that, well, actually maybe we're overdone. Maybe valuations are high. Is that something you look at on a regular basis?

15:39 **Greg Peterson** Yeah [laughs], we look at it very regularly—daily in fact. We haven't moved quite back to 60 but we've just kept a floor under equities for the time-being.

15:46 **Cameron Webster** And then on asset mix...maybe we can close out the conversation here, Greg. Our firm is fundamentally driven by our research team and the portfolios we build stock by stock. Was there anything in the fourth quarter that stood out that the portfolio teams have done to position portfolios in the current environment?

16:04 **Greg Peterson** Yes, the portfolio teams have been working for the last few years knowing that perhaps valuations are a little bit high, or eventually you come to an end of the cycle, and so forth. And so they've been working to make sure that the portfolios are quite resilient. It's a word you hear often from us. And that's really making sure that valuations within the companies that we own haven't become too stretched. Typically in the last few years we've been trimming or selling those businesses where we think they become too expensive—either given the current environment, or [given] the pathway for growth for that business, and what have you.

16:34 **Greg Peterson** The team has done a good job, I think, of managing that, and trying to move capital to the businesses that they feel are better positioned to withstand perhaps a recession—or at least some downturn—and take away a little bit of that volatility.

16:46 **Greg Peterson** So despite the fact that the fourth quarter was negative, we were pleased to see most of the asset classes on the equity side outperform their benchmarks. I think that's because of that resiliency. That, also, from a balanced perspective, then helps us to provide value for the Balanced Fund that features the underlying asset classes that are also performing better than their benchmarks.

17:06 **Greg Peterson** So I think some of that resiliency has definitely paid off. You never really know about that until you go through a downturn. We've been pleased to see that hold up the way we expect it would.

17:16 **Cameron Webster** You were mentioning resiliency and how each asset class is trying to build that; some worries about valuation, so we're trimming some highly valued names and adding something that's maybe not as recognized in the marketplace. Can you give us an example or two of a company that's been out of the portfolio that fits that criteria?

17:35 **Greg Peterson** Yeah, there's quite a few companies that have been added with the expectation that they provide that resiliency and defensiveness in the portfolios, if you will.
One that was added over a year ago was Société Bic in France—the maker of Bic razors, Bic lighters, pens, and so forth. It's a fairly common name, not a very exciting company. It wasn't added with the expectations for tremendous growth rates. It was added because it has a fairly consistent and reliable revenue stream, and that generally translates into something that's also fairly resilient in down markets. And, combined with that, the stock price—it's not a very flashy company.

18:10 **Greg Peterson** So while tech stocks, perhaps, were getting a lot of capital moving towards them and pushing prices higher, Bic was at a more reasonable valuation.

18:17 **Cameron Webster** I think the flashiest part of Bic I've seen is if you go into Staples and you buy the five colour pen. Anybody remember those five colour pens? I'm dating myself. I actually bought one recently but, anyway.

18:28	Greg Peterson	It would appear that there are lots of people still buying those.
18:30	Cameron Webster	There are!
18:31	Greg Peterson	And just to give an idea of how that worked in that quarter, Bic was up 13% in Q4. We weren't really expecting it to move higher, but that helped in the defensiveness as well. And if you continue with “flashy” in the United States, we added Ecolab. Ecolab is a maker of cleaning materials and consumables for industrial application. Again, very steady, reliable business. Cleaning materials is not particularly flashy either.
18:52	Greg Peterson	So you have a pretty good, reliable company. You had a relatively reasonable valuation to the market.
18:57	Cameron Webster	And a recurring business kind of revenue model.
19:00	Greg Peterson	Absolutely.
19:01	Cameron Webster	Thanks for those examples there, it makes it clear in terms of how we're building resiliency. We can close on this question: what are you losing sleep over these days in markets?
19:11	Greg Peterson	There's always lots to lose sleep over. What we're really good at doing is losing sleep and being concerned about the risks and not always focusing on opportunities [laughs]. I think there are a few things. The leadership in the United States causes lots of concerns. And as much as there's plenty of noise in the media, I think you still worry a little bit that that may turn into real concerns. It's in nobody's best interest, whether it's United States or China, to have this trade battle carry on for much longer. But that's a concern that that actually translates into something real. Something real means tariffs that are in place for a very long time. That's a big cost to consumers and business and does tend to drag down trade. So that would be one way that the cycle ends.

19:53	**Greg Peterson**	I think the other thing that I think about a bit is just central bank mistakes. I don't think that's as likely, but central banks can move too quickly and too far, raise interest rates too much, and cause some problems that way. So that's another one that you tend to be concerned about. Although, signals in the last while have been—especially from the Federal Reserve—that they're well-aware of changing conditions and they'll watch that. They're not necessarily on autopilot going forward. Expectations for higher interest rates in the U.S. have eased in the last while as they have in, I think, a lot of developed countries.
20:24	**Cameron Webster**	All right. So lots to worry about.
20:25	**Greg Peterson**	Always lots to worry about.
20:27	**Cameron Webster**	So much responsibility as a balanced manager! Thanks for being here to give us some perspective on the fourth quarter. And as you mentioned, you'll be here next quarter. Thanks again, Greg.
20:36	**Greg Peterson**	Thanks Cam.