April 21, 2014

"Uncomfortably Idiosyncratic"

"The greatest mistake you can make in life is to be continually fearing you will make one."
- *Elbert Hubbard*

Bottom Line:

After a strong year for U.S. and International equity markets, the first quarter slowed to mixed results at best. At home, our equity market proved to be one of the best in the developed world. In the last couple years, however, our market has not been able to sustain that first quarter push through the rest of the year (especially in 2011) so we are hesitant to be too optimistic that it will be different this time. The bond market on the other hand had a strong response this first quarter after enduring its first annual decline last year since 1999, with the 10-year Canadian government bond yield declining by approximately 30 basis points (bond prices rise as yields decline).

In our view, one of the primary drivers for equity returns last year was continued unprecedented stimulus and accommodative policies from central banks around the world. If we look specifically at the U.S. market, sentiment rose strongly with some improving economic data and as a result, equities rose at a pace far greater than the rate of corporate profit growth. In other words, a very large portion of equity price appreciation last year was price multiple expansion (i.e. people were willing to pay more for the same profit stream) as opposed to outright profit growth. This multiple expansion is a typical characteristic of a cyclical bull market, which has been intact now since mid-2009.

What may be the defining theme of 2014 is whether or not this trend can continue. Can the U.S. successfully transition and normalize from an extremely accommodative monetary policy? Will the fiscal drag continue to the same extent? Will the economy finally be able sustain 3-4% growth over more than just one quarter? There are pundits who believe that we are now in a secular bull market, but there are also still those who believe this cyclical expansion is nearing an end within a still enduring secular bear market.

With a slowly improving economic backdrop, extremely low short-term interest rates and an overwhelmingly accommodative stance from global Central Banks (who have thus far proven to be effective in aiding rising equity prices) we are inclined to believe the higher probability path is one where the positive trend will continue. That being said, we are also very much on guard for signs of a longer term reversal and remain steadfast in monitoring market internals and sentiment.

__Economic Overview:__

We do not have an abundance of discussion points with regards to the economy since our last commentary, but we would like to spend some time on the U.S. Federal Reserve and their monetary policy decisions as well as provide some insights on Canadian & Provincial debt levels. But first, we would like to take a step back from the economy for a moment at this point to share what we believe to be an important aspect of our investing philosophy. A bit of variety, but nonetheless as important.

"Uncomfortably idiosyncratic"

This is a term coined by David Swensen, Chief Investment Officer of Yale University since 1985. Their endowment assets and investment funds that he is responsible for managing have achieved great success over the years, and we have not been shy in describing our investment philosophy in very similar light to theirs, except from a retail perspective and all the differences that entails in comparison to institutional investing. We are borrowing this term from a quote in his book titled *Pioneering Portfolio Management*:

"Establishing and maintaining an unconventional investment profile requires acceptance of uncomfortably idiosyncratic portfolios, which frequently appear downright imprudent in the eyes of conventional wisdom."[1]

The main investment thesis behind these words is that the road to investing success runs through unconventional, uncomfortable investing.

Recently, great institutional investor Howard Marks of renowned global asset manager Oaktree Capital published an impressive note to his clients that he very much believes in these words. He wrote "Most great investments begin in discomfort. The answer may not be obvious, but it's imperative: you have to assemble a portfolio that's different from those held by most other investors. If your portfolio looks like everyone else's, you may do well, or you may do poorly, but you can't be different. And being different is absolutely essential if you have a chance at being superior."[2]

Our investment philosophy here at Milestone has always been to do our very best to achieve a consistent risk-adjusted return above inflation over a full market cycle. The degree of risk required to achieve a given result depends on each individual client's ability to accept said risk. At the core of this goal though for us, with similarities to institution investing, has always and will continue to be capital preservation.

With that core in mind, there are times when investing decisions can be uncomfortable. Uncomfortable investment decisions usually go hand and hand with being wrong for a period of

Footnotes:

1. David Swenson, *Pioneering Portfolio Management: An Unconventional Approach to Institutional Investing*, May 22 2000.
2. Howard Marks, *Memo to Oaktree Clients: Dare to Be Great II*, April 8 2014.

time. It is often the easiest to simply do as others do, as it by nature does not allow one the chance to fail. We don't preach that we will achieve superior results all the time, but we do stick to our investment philosophy of being different, with capital preservation as a core objective as fiduciaries of our clients' capital. If that results in periods of discomfort, we are willing to make that uncomfortable choice.

Milestone continues to maintain an investment philosophy where we will not always follow the crowd but make investment decisions that are driven to preserve and grow capital, and at times these decisions can be uncomfortable, but at the end of the day we believe they will result in the best chance of long term investing success.

If we look back to 2007 and 2008, there was a period of time where our defensive investment decisions were uncomfortable, but those decisions also improved our success over the 2008 and 2009 market down cycle. More recently, we came into last year in a fairly defensive position with capital preservation in mind, and that decision resulted in a bit of discomfort in the middle part of last year. However, we made quick adjustments to move our way through that period of discomfort and achieve solid results over the last two quarters.

With that in mind, we are constantly pushing the envelope here to argue for or against our positioning and there may be a time in the future when our investment decisions may feel uncomfortable, but it is our hope that our clients can understand that the decisions we make are born from capital preservation as a core philosophy, and that unconventional investment thinking should result in investing success over the long term.

As Howard Marks recently wrote, "The goal in investing is asymmetry: to expose yourself to return in a way that doesn't expose you commensurately to risk, and to participate in gains when the market rises to a greater extent than you participate in the loss when it falls." [2]

The U.S. Fed in a difficult position

We believe that the U.S. Federal Reserve has thus far been successful, directly or indirectly, in steering the economy back in line with its longer-term employment and inflation objectives. It has been a winding road and there is still a ways to go but the trend is positive. However, its path going forward is definitely one of uncertainty.

Although still in a highly accommodative stance (zero bound interest rates and quantitative easing), they are slowly taking the gas pedal off by gradually reducing their monthly asset purchases. They have reduced these purchases from $85 billion to $55 billion a month so far. The big question in our minds is: will they be able to continue their reduction in asset purchases to the point where the economy is self-sustaining?

One can think of this in terms of cruise control on your vehicle. Once you have it up to the speed you want to travel at, you hit the cruise button and let go of the gas pedal as the vehicle continues to travel at that speed until you need to hit the brakes again. Will the economy be strong enough by the end of this year for the Fed to be able to hit that cruise control button?

This is a question that doesn't have an answer as we are in unprecedented times, but we need to be very mindful of the difficulties that may lie ahead and not be complacent when it comes to one's capital and how it is invested. We need to constantly question the consensus and think in an unconventional way.

The best case scenario for the Fed is one where macro data is strong enough to keep the U.S. economy out of recession but weak enough to keep the market positive side of the Central Banks in play in a slow and gradual removal of stimulus. This keeps the current narrative moving along and positive for equities. We view this scenario as the one with the highest probability; however, it will not be an easy task for the Fed to navigate and keep markets confident over this period.

We see the recession scenario unlikely at this point in time, but the potential for stronger growth fueling the flames of inflation could potentially be worrisome and perhaps a more likely worst case scenario. This could force the hand of the Central Bank into a tightening bias, which in turn can be negative for equities and longer term bonds where good economic news becomes bad news for equities. This in turn slows growth but not necessarily inflation causing a vicious cycle known as stagnation.

Canadian Federal & Provincial debt

A very important item that we all need to concern ourselves with is government debt. Our own Bank of Canada has warned us Canadians repeatedly about the risks of carrying too much debt (which we of course agree with); however, perhaps our various levels of government should heed the same advice.

It is very true that Canada is a shining example of how a country can get through a major financial crisis as we all endured in 2008 – 2009. Our central bank has resisted any temptation to print new money, none of our banks needed to be bailed out and our federal government is on the cusp of balancing its budget. These three items alone allow us to stand out from most other developed nations. Another big positive is our federal government debt. Our federal government debt increased from just under $100B in 1981 (only 25% of GDP at that time) to peak out at around $560B in 1997 (64% of GDP at the time). Since then, our federal government debt improved significantly to stand at only $460B before the Great Recession (31% of GDP at the time). Even with running budget deficits in the wake of the recession, our government debt has increased to just over $600B (approximately 33% of GDP).

Unfortunately, there is another layer of government debt that doesn't receive enough attention: provincial government debt. Much has been made in Alberta of our government abandoning its debt-free status in the last few years. Alberta is estimated to be currently approaching $10B in debt, headed for $18B in a few years' time. As Albertans, we aren't thrilled about that; however, it is the rest of the Canadian provinces we should be concerned about. Although our official federal government debt stands at just over $600B today, we can add another ~$600B to that total when we include provincial debt. Specifically, Ontario and Quebec make up the bulk of that – Ontario is estimated at approximately $285B and Quebec at $175B. Quebec's debt is actually the highest in Canada in terms of debt-to-GDP ratio at around 49% with Ontario at 37%.

As a matter of interest, there is also municipal debt. Edmonton is estimated to have $3B of debt, with Calgary at $3.2B and Toronto estimated to be at $3.7B.

When you add it all together, Canada isn't in such a stellar financial position as the federal debt numbers would suggest. We are north of $1.2 trillion in government debt. This is a big number; however, even that amounts to approximately a 66% debt-to-GDP ratio. By way of comparison, the U.S. public debt is over 100% of GDP.

The Markets & Our Strategy:

Below is the 2014 performance summary of global equity and North American bond markets to March 28th, 2014:

Equity Markets

Canada	Level	Wkly Chg (%)	YTD	YTD C$
S&P/TSX Composite	14261	-0.5%	4.7%	4.7%
S&P/TSX 60	817	-0.7%	4.2%	4.2%
S&P/TSX Small Cap	651	-0.9%	6.6%	6.6%
US	**Level**	**Wkly Chg (%)**	**YTD**	**YTD C$**
Dow Jones	16323	0.1%	-1.5%	2.5%
S&P 500	1858	-0.5%	0.5%	4.6%
Nasdaq	4156	-2.8%	-0.5%	3.6%
Russell 2000	1152	-3.5%	-1.0%	3.1%
International	**Level**	**Wkly Chg (%)**	**YTD**	**YTD C$**
DAX	9587	2.6%	0.4%	4.6%
FTSE 100	6616	0.9%	-2.0%	2.6%
Nikkei	14696	3.3%	-9.8%	-4.2%
MSCI EAFE	1904	1.9%	-0.6%	3.5%
MSCI World	1662	0.5%	0.0%	4.2%
MSCI EM	985	4.2%	-1.8%	2.3%

Fixed Income

Indices / Rates	Level	Wkly Chg (%)	YTD
DEX Universe Bond	909	0.2%	2.9%
DEX Real Return Bond	500	0.4%	6.5%
Mer Lynch US High Yield Master II	1052	0.2%	2.9%
LIBOR 3-month	0.2334%	0.2%	-5.2%
Government Bond Yields	**3-mo T-bill**	**10-yr Bond**	**30-yr Bond**
Canada	0.89	2.447	2.945
US	0.03	2.722	3.548
Spread	0.86	-0.275	-0.603

Source: TD Asset Management

Global equities in aggregate were exactly flat on the first quarter this year, with the MSCI World (local currency) posting a 0.0% return. One bright spot was our TSX Composite which had a solid first quarter rising approximately 5%. On the other hand, U.S. equity markets have been in consolidation mode with the S&P500 slightly in the positive and the Down Jones Industrial slightly in the negative. In Europe, we also saw mixed results with the DAX seeing a slightly positive quarter but the UK was down 2%. After a very strong 2013, Japan experienced a correction with the Nikkei down 10%.

The bond markets enjoyed a solid quarter with yields backing off as the DEX Canadian Bond Universe index gained close to 3%. This is a solid start after a very difficult 2013.

One big story was the decline of our loonie which we discussed at length in our last commentary. It fell 4% against the U.S. dollar in the first three months this year. In the commodity space, the price of oil and gold increased approximately 3% and 7% respectively (in

U.S. dollars).

Our repositioning to move closer to full weight again in our equity allocations in the fall proved successful for Q4 and Q1. Our view that we would see a continuation of the positive trend is still intact today; however, we may see some more consolidation or some further corrective moves in the markets here this spring and summer. These times are not usually seasonally strong for equities, but that is not always the case (such as last year). On the longer term horizon, we continue to see many structural issues for developed economies, but we are reluctant to believe these are likely to bubble to the surface to any great extent in the very near future.

Our overall ‘SIRP’ investment strategy (a term coined by economist David Rosenberg which stands for ‘safety and income at a reasonable price’) is still our investment philosophy. As long as we see current monetary conditions in place and gradual improvement in global economic growth, which we have seen from the U.S. and more recently Europe, we believe a balanced and diversified portfolio is the best approach.

We continue to monitor economic data as it arrives, primarily leading indicators, in addition to sentiment and market internals. We have seen some specific worrisome internal signs lately such as very strong insider selling; however, we have seen this occasionally in the past with markets proving to be very resilient.

Our investment decisions are based on a full market cycle and we continue to maintain globally diversified portfolios with a focus on capital preservation and risk-adjusted returns, while maintaining a solid income yield for our clients.

We would like to thank our clients for their continued trust in us.

Respectfully,

- **Your Milestone Team**

“No act of kindness, no matter how small, is ever wasted.”
- *Aesop*

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