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Risk Conscious

Volatility is back. Geopolitical risks have evidently risen this week with the announcement of Russia's foreign import ban, intensification of the Russian-Ukrainian conflict, and continued violence in the Middle East. After reaching a 7 year low, the VIX (Chicago Board Options Exchange Market Volatility Index, an indicator of implied market volatility) has recently ticked up alongside notable market price movements across risk assets.

We do not discount the toll these events extract on human life. To long term investors however, volatility is not a material risk to successful investing. In fact, volatility can create opportunities during swings in market sentiment. Rather we think of risk as the probability of permanent capital loss. Within this framework, we place an emphasis on valuation and business risk, rather than on volatility itself.

The breadth and scale of asset purchase programs by major global central banks have lowered government bond yields and pushed investment capital out the risk spectrum. Canadian and U.S. 10 year government bonds have rallied year-to-date and currently yield nominal rates of 2.0% and 2.4%, respectively. Low considering inflation has been running between 2.0-2.5% in both economies. In Europe, Italian and Spanish government bonds yield 2.8% and 2.6%. This is much lower than the 7.0% levels reached two short years ago when the European crisis was the topic du jour. In the corporate bond market, the spread between non-investment grade bonds and their underlying governments have tightened to near historic lows. Yield hungry capital must now climb the next rung of risk for potentially higher returns.

As a result, equity valuations have quickly risen to levels that require earnings and cash flow growth to justify the sustainability of these higher prices. Following five years of an equity bull market the risk pendulum has swung from risk aversion to tolerance and from fear to greed.

Clearly the broad market now exhibits symptoms of greater risk than reward. Market complacency has led to higher valuations in fixed income and equity markets and this warrants caution. We believe that risk control is just as important as return maximization, if not more so. Identifying and governing risk where we can is instrumental to building client wealth over time.

We have been controlling risk in our bond portfolios by selling some corporate bonds that have benefitted from credit spread tightening and reinvesting in more liquid provincial and government bonds with minimal yield sacrifice. Our corporate credit exposure has been lowered as a result. An emphasis on liquidity, higher coupon rate and lower interest rate sensitivity should limit capital loss if government interest rates move higher or if corporate credit spreads widen.

In our equity strategies, companies showing higher valuation risk have been scrutinized, exited or trimmed back in weight. Attention to businesses at reasonable valuations, with durable franchises, and an above average ability to grow earnings and book value will help limit capital loss. This way we can rely on the power of compounding to help us sleep at night and grow into valuations that have risen over time.

An example is Wells Fargo & Company (NYSE:WFC), a holding in our global equity strategy. The U.S. bank still offers good value at 1.6x price-to-book and 12.3x trailing price-to-earnings, versus the MSCI benchmark at 2.2x and 18.3x, respectively. Wells Fargo earns a return on equity of 13.5% and has consistently grown book value per share at a 10 year compound annualized rate of 11.3%. Recently, its net interest margin has been steadily shrinking as interest rates have fallen. Regardless, WFC's ability to grow core deposits at a below average cost will be a key advantage should interest rates normalize and loan demand improve. In the meantime, strong capital ratios will allow management to increase returns to shareholders.

As investment managers we are stewards of our client's capital. Our role is to build client wealth over a long time horizon and to do so at lower risk than the market. Successful long term investing is not asymmetric. We are always considering returns in the context of risk and aim to deliver on both fronts.