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Risk Management

In writing our recent quarterly reports, we discussed the increase in margin debt and a more optimistic consensus. Low interest rates have pushed people to take on more risk by moving into equity markets and lower quality bonds. This has assisted in raising valuations to higher than average levels. This was not lost on us, since historically this combination has indicated that risk levels were elevated. As a function of our risk management, we identified that valuations were not pricing in a change in sentiment or a potential slowdown in the global economy. It is not easy selling companies when sales are strong and increasing, stock prices are rising and the economic environment shows signs of improvement. However, in doing so, we have higher than normal cash levels, which have provided a marginal buffer in recent weeks. In addition, the focus on quality and value has assisted in mitigating declines. We have also dialed back our allocation to equities in our balanced fund portfolios.

What happened?

Stocks in Canada peaked September 3, 2014 and this week the Canadian stock market posted an official correction, which is defined as a decline of over 10%. The United States, on the other hand, is also down but not in correction territory. The difference is a result of Canada's larger exposure to commodity markets. As an example, the West Texas Intermediate (WTI) benchmark oil price reached bear market territory as it has declined by over 20% since its peak of $107.26 USD in late June of this year. The decline has intensified in October with the price down over $10 USD per barrel, putting significant pressure on the energy sector which encompasses just over 25% of the Canadian stock market, and 10% of Canadian GDP. Oil and other commodities have been declining due to slowing growth in developing markets and Europe. The rapid oil downturn in October was most likely spurred by the belief that Saudi Arabia is willing to allow the oil price to decline rather than cutting its production as it typically has as a member of OPEC. Oil production in the United States has been increasing with the technological developments in shale oil. Producers such as Saudi Arabia may be anticipating a lower price may result in a slowdown in US production, which is considered to be more expensive than conventional sources.

We have to remember that the S&P500 and the MSCI World were up 35% in 2013 and the TSX almost 13% in that same period. In 2014, the TSX was up about 15% before the selloff began. These are strong returns and the TSX had not seen a correction in over 1000 days. A correction is healthy as it shows more skeptical analysis is taking place rather than unbridled optimism. This should allow for more sustainable gains over the long-term.

What now?

Earlier in the year, we asked ourselves the following question: Would we be comfortable buying the current businesses in the portfolio if their prices declined significantly? If we answered no, the companies were removed.

Our focus remains on those companies with well-financed balance sheets that can maintain them in tougher markets. We have been slowly augmenting existing positions in the portfolios experiencing weakness, and where we feel the downside is limited.

In our company screening, we have identified better valuations in the materials sector. Like oil, commodities such as iron ore and coal have been negatively affected by slowing developing market growth and increased supply. This supply increase was set in motion when commodity prices were high in 2007, but it takes this long to get these projects to production. Even with the current decline in stock prices, we have not found businesses at levels that interest us.

We have healthy cash levels, which allow us to put money to work in this environment when we see opportunity. We will be careful as valuations may still go lower. We will not catch the bottom, just like we have trouble calling a top.