QV UPDATE

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Q & A

As we end the third quarter of 2017, we thought it would be timely to highlight a few common questions we have been asked over the past few months. Those questions, and our responses, are as follows:

Investment Performance

Q: I have noticed that my investment portfolios have not performed as well this year as in previous years. What are the reasons for these low returns?

A: This has been a more challenging year for returns both in the broad markets and in the QV portfolios. We have been communicating for some time our expectations for lower returns in comparison to recent history. Our low return expectations have been framed by the following:

Low, but rising interest rates. At the start of the year, we expected the US central bank to continue raising its policy rate, albeit slowly. The path of Canadian interest rates was less certain given the continued weakness in exports and business spending. Despite meagre interest income, price gains helped to bolster bond returns in previous years. We did not expect this to continue given the prospect for rising policy rates. The surprise has been the strength in the Canadian economy this year, resulting in two rate hikes since July. Bond yields in Canada adjusted quickly, and consequently bond returns are anemic year to date.

High equity valuations. This extended period of extraordinarily low interest rates continues to make all other risk assets look attractive compared to bonds. At the start of this 9-year bull market in equities, the earnings yield on the S&P 500 was 9.0%. It is now 4.7%. We are not willing to take the same degree of risk as we did in 2009 for much lower prospective returns. Our balanced asset mix at 50% cash and short-term bonds, and 50% stocks reflects this caution, as does our defensive positioning within our equity strategies. While a few more speculative areas of the market (gold, technology) continue to march higher, broadly speaking equity returns have also been lower than recent history. Additionally, certain QV strategies have experienced company specific challenges which have impacted near-term relative performance.

Geopolitical Risk

Q: Given the heightened amount of social and political discord in the world today, what will be the potential effect on the markets?

A: In the past year, a rise in trade protectionism and anti-immigration sentiment resulted in a British vote to leave the European Union, and the election of a new US President espousing these restrictive policies. Further, last week's German election saw a far-right party running on an anti-immigration platform increase their share of the popular vote at the expense of Chancellor Angela Merkel's centre right coalition government. Add rising tensions between North Korea and the United States to the mix and it is not hard to feel like geo-political risk is the highest it's been in recent history.

This level of discontent adds to economic uncertainty. Threats to trade deals and movement of labour may cause capital expansion plans to be delayed. We would expect earnings growth projections to adjust lower in companies affected by these policies. For many investors, further evidence of unrest may become a trigger for risk aversion, and an opportunity for us to buy stocks at more attractive valuations. We should also be prepared for volatility to increase given the changing global dynamics.

Outlook

Q: What is your outlook for returns over the near term?

A: Our outlook has not changed. We continue to expect returns to be lower than normal. High equity valuations and rising bond yields dictate a cautious approach. We are seeing investment opportunities, but expected rewards are more modest and are taking longer to materialise. We note complacency in the market as investors continue to shrug off news or events that in previous cycles would have resulted in an equity market correction. The relative yield advantage of stocks over bonds may partially account for this. We do not know what the trigger will be to change investor sentiment. We will, however, continue to be defensive in our portfolio positioning and wait for a better opportunity to buy equities at valuations that justify the amount of risk we are taking.