April 2016

> ***"Where do we come from? What are we? Where are we going?***
> –Title of a Paul Gaugin painting

The Sheldon Benchmark

Dear Investor,

The inscription of Paul Gaugin's masterpiece was inspired by the eternal questions that have been reflected upon by humanity since the beginning of time.

These questions are relevant to ask from an investment perspective as well. We can look at investment returns going back many years and read about various prognostications for the future. However, in spite of our desire for certainty, with regard to the outlook for investment returns, uncertainty is the only constant.

On Jan. 2, 2008, Goldman Sachs strategist Abby Joseph Cohen forecasted that the S&P 500 would rise to 1,475 by the end of the year for a gain of 10%. The reality? A decline of 38% to 903. In her defence, most Wall Street strategists had forecasted similar numbers.

So why do investors pay so much attention to forecasters? Probably because we all want someone – a doctor, lawyer or investment manager – who will tell us what we want to hear about the future. Of course, Gaugin's questions lead one to conclude that if we do not know what the future holds, we should start by learning from the past.

Q1 2016 – Where are we going?

Market volatility continued into the first quarter of 2016. Canadian investors were also negatively impacted by foreign exchange, as the Canadian dollar rose with the price of oil. Although it is easy to get lost in the day-to-day headlines, there are a number of issues that remain troubling, including:

- **Slowing growth in China**. Growth in the world's second largest economy has been declining steadily for the past several years. Growth in the first quarter of this year fell to an annualized 6.7%, the slowest rate since 2009.

- **The global economy continues to struggle.** It seems that every time the IMF releases a new economic forecast, the projection is lower than the previous one. That was true yet again in April, as their projections were reduced from January's numbers. One year ago the IMF forecasted 2016 global growth of 3.8%. Today the forecast is 3.2%. All of this indicates that despite the ongoing efforts of central banks to stimulate the economy, the job is far from complete.

- **NIRP (Negative Interest Rate Policy).** Central banks in some countries (Germany, Switzerland and Japan) have instituted negative interest rates (yes – if you buy a 5-year German government bond, at maturity you will receive less than your original investment!). This is supposed to encourage people to spend and invest, but so far the results are mixed. Artificially low interest rates hurt savers and help borrowers, potentially leading to dislocations such as asset bubbles.

- **Corporate earnings.** Earnings-per-share for the S&P 500 declined in the first quarter of 2016, marking the first time since 2009 that earnings have declined in four consecutive quarters. Companies have been generating EPS growth over the past number of years through cost cutting and share buybacks, while revenue growth has been hard to come by. The strong U.S. dollar has had a negative impact on corporate America, and companies have responded with job cuts. Even the Canadian banks, the most profitable companies in this country, have been firing employees to boost profits in anticipation of a tougher environment.

All of the above has weighed on equity prices and we took advantage of the volatility by adding to several positions, such as Alcoa, Manulife and Aegon during the quarter.

Benchmarks

The investment industry is full of consultants who make a living by creating benchmarks in order to assess investment returns. While I will not get into the problematic statistical issues with benchmarks, one of the consequences of the use of benchmarks is that too many industry professionals end up focusing on short-term results, to the detriment of their clients. Much has been written about the negative impact of short-term thinking by investors and corporate management.

Many institutional investors are so focused on specific benchmarks that they lose sight of what should be their ultimate goal: to preserve capital and generate returns in excess of inflation. Over the past decade or so, countless institutional investors, including the Harvard endowment, focused on creating complex benchmarks that were designed to "beat the market," only to end up with terrible returns. When many of these strategies fail, the various institutions hire a fresh group of consultants who usually recommend changing the benchmarks as the solution. These new benchmarks are usually based on buying that which has performed well over the recent past – invariably buying high, which is never a good long-term strategy.

The Sheldon benchmark

I learned about benchmarks well before I knew anything about investments. It was one of the many things I learned from my mother, a wonderful woman who taught high school history and geography.

When I brought home a test result, rather than focusing on my grade, my mother would often ask how Sheldon did. Sheldon was one of the smarter kids in my class. He was actually a nice fellow, but he lived on my street and his mother had an annoying habit of letting the neighborhood know when Sheldon received a top grade. So, Mom's focus was not on whether I did well in a particular class, but rather whether I did better than Sheldon. He was my benchmark. And for a long while (all of Grade 7 as I recall) I underperformed my benchmark. Whatever grade I received on an exam, Sheldon always seemed to do better. It was a long year!

Thankfully when I started Grade 8, my first year of high school, I seemed to have developed better study habits and my grades improved. Sheldon, however, seemed to have found other interests (her name was Cheryl), and his grades slipped. I remember coming home with my first semester report card. Generally good results, except for math, where my grade was akin to a B-. Of course, Mom's first question was "how did Sheldon do in math?" Just the question I was waiting for! He got a "D" I answered, waiting for a congratulatory comment. What was mom's retort? "I don't care how Sheldon did, you can do better."

Now let me get this straight, Mom. When Sheldon was doing better than me, even if I did well, all you cared about was whether I did better than Sheldon. Then, when my grade was not great, but I beat Sheldon, suddenly you change my benchmark. Don't get me wrong, I love my mother, but I learned an important lesson about benchmarks the hard way.

There are many in the investment world who are like my mom. They want to beat the benchmark in good years, but if the benchmark has a negative return, beating the benchmark is no longer the goal – instead they want to preserve capital.

The reality: investors need to give serious thought to what the relevant benchmark is for their own risk tolerance and investment goals. The key to generating good long-term investment returns is to avoid large losses and protect capital, regardless of whether one bests a benchmark.

High Yield Bonds

A review of the high yield bond market and our high yield fund is available here: High Yield Quarterly.

Final thoughts

I am involved in several non-profit organizations. Given my background, I usually end up on the investment committee. Most charitable organizations depend upon generous donors to fund their programs. The mandate is to preserve the capital without taking excessive risk, because loss of capital will result in loss of help for those in need.

One need only go back to the financial crisis to see examples of exceedingly poor risk management. Some of the finest U.S. universities suffered large investment losses, resulting in higher tuition and program cuts. Yet, too often, I am forced to listen to recommendations that involve more (rather than less) risk because someone has found another fortune teller (consultant) promising to have formulated the perfect potion (benchmark). Unfortunately, there is no elixir in the investment world that can heal large investment losses. The only rational strategy is to try to avoid them in the first place. Here, we do this by placing an important focus on price, diversification and quality, by exclusively holding securities that meet our strict financial criteria and by holding some cash when we cannot find enough opportunities that fit.

As always, we welcome the opportunity to discuss our outlook and investments with you.

Sincerely,

Lorne Steinberg
President