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> *"...optimism is highly valued, socially and in the market; people and firms reward the providers of dangerously misleading information more than they reward truth tellers.* **-Daniel Kahneman**

Fear the Optimist

Dear Investor,

For whatever reason, maybe it is the holidays offering a bit of respite from our day-to-day, this time of year often gives one pause for reflection. For some, it may be a chance to review the year gone by. For most, it is an opportunity to start a new year with a clean copybook, and an opportunity to improve going forward.

Of course, there are the usual New Year's resolutions. Dietary restraint is at the top of my list - again! My family politely reminded me that this resolution is not exactly new, but this year I am optimistic that I will achieve my goal.

If I were to ask Daniel Kahneman for his opinion on the likelihood that I will be successful at finally slimming down, I would not like his answer. Kahneman is a psychologist who won the Nobel Prize in Economics for his ground-breaking research in behavioural economics and finance. His studies show that just because I know it is "rational" to control my food intake (so as to capture the long-term health benefits) does not imply that I will adopt such behaviour. In fact, based on the data (my previous attempts), he would conclude that I will fail.

Kahneman has shown that, in many circumstances, we choose short-term pleasure over long-term reward, even though the rational part of our mind understands that such behaviour is not in our best interest. Yet despite a history of such irrational decisions, we continue to remain optimistic that we will succeed the next time. Fitness clubs and Weight Watchers understand this well and exploit it in their marketing.

This unjustified positivity is ever-present. We get it from prognosticators "forecasting" stock market returns for the next year, CEOs justifying acquisitions based on often overly optimistic assumptions, and those of us who are convinced that this is the year we will shed those few extra pounds. The research clearly shows that we are far more optimistic about our innate abilities than warranted by objective evidence.

Kahneman's study concludes that we should spend less time listening to upbeat forecasts and more time studying data and past behaviour. However, that runs contrary to our human instinct.

Recent events

The polling industry lost some credibility in 2016, as both Brexit and the U.S. election took almost everyone by surprise. The UK referendum was expected to be a close vote, but the Trump victory was a shock. The brightest minds in the polling business had confidently predicted a Clinton victory, but got it wrong.

This is yet another reminder that paying too much attention to forecasting - be it election results, oil prices or stock market returns, for that matter - is foolhardy. In fact, herd mentality often leads to disaster. The dot-com collapse and the financial crisis are but two recent examples where all of the so-called experts got it wrong, and investors paid the price for believing that these market gurus were infallible.

As noted in Kahneman's quote at the beginning of this letter, investors would rather listen to someone who will confidently give a definitive answer, rather than an honest professional reminding them that such forecasting is nothing more than speculation.

Most financial markets performed well in 2016, with the notable exception being government and investment-grade bonds. The "Trump Bump" following the U.S. election, boosted performance for global equity markets, based in part on promises of lower taxes, fiscal stimulus and a more laissez-faire approach to regulation. High yield bonds were the best performing fixed-income asset class and one of the best performing asset classes among global markets.

The market yawned at the Fed rate hike in December, but the interest rate projections revealed by the Fed have important implications for investors.

High Yield Bonds

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

Interest rates and valuations

As most are aware, interest rates have been in decline for thirty-five years, since the double-digit rates of the early 1980s. While there have been several rising rate cycles in the interim, the end result has been an enormous drop in interest rates to their recent lows. This is important to highlight, as many investors today have never experienced a significant rise in interest rates.

Since the financial crisis, near-zero interest rates have supported global markets, driving up the valuation of stocks, bonds, real estate and other income producing assets. Many asset prices are elevated, as evidenced by the housing boom and the current valuation of the S&P 500, which is now trading at a price-to-earnings ratio of 24x (versus a long-term average of approximately 16x).

At every Fed meeting, the Fed governors are asked where they believe short-term rates will be three years hence. In September, the answer was 2.6%. By December the response was 2.9%. The Fed Funds Rate is presently 0.75%, implying that there may be eight or nine quarter-point rate hikes over the next thirty-six months. If short-term rates rise to the 3% level, one would expect the 10-year U.S. Treasury bond yield to rise from the current 2.4% level to somewhere in the 4%-5% range.

Implications of rising rates

From 1963-2007, the U.S. 10-year Treasury yield never fell below 4%. For most of that time, the rate was significantly higher. Mortgage rates during this period were well above 5%.

While we will not speculate as to where rates are headed over the next few years, the Fed's projections should give investors cause for concern. If low interest rates supported rising values for stocks, bonds and real estate, what happens when rates rise?

Over the past few years, government bond yields and bank term deposits have yielded less than the dividend yield attached to common shares. This caused many bond investors to sell their low-yielding bonds and replace them with higher yielding stocks, as they have been more concerned about the dividend than whether the shares offered any real intrinsic value.

However, historically, dividend yields have been significantly lower than bond yields. If investors can once again buy bonds yielding 4%-5% with low risk, while dividend yields are 2%, then share prices need to be cheap enough to justify their purchase. Therefore, as interest rates rise, investors tend to increase their exposure to risk-free assets, such as government bonds. When 5-year government bonds yield 4%, investors in equities and other assets require a higher expected return to justify taking on added risk.

What is the impact on investors?

A rising interest rate cycle poses significant risk for investors.

Over the past few years, certain sectors of the market have become rather fully priced, including: pipelines, utilities, some telcos and a number of consumer stocks. Many low growth companies within these sectors have seen their share prices rise substantially, not due to earnings growth, but because of their secure dividend yield. However, in a rising rate environment, these companies are susceptible to being revalued downward, as their dividends become less attractive versus bond yields.

The same holds true for REITs and other real estate investments. Low rates have driven up the price of commercial properties and if borrowing costs rise, either rents will have to go up, or the property values will decline. The housing boom has been fuelled, in large part, by low mortgage rates. In Canada and elsewhere, homeowners have been increasing their debt to keep up with rising home prices. Higher interest rates make housing less affordable, and would presumably have a negative impact on home prices.

Regarding equities, many public companies would have to adjust their capital allocation strategies if rates rise. Share buybacks and debt-funded acquisitions would be more expensive, hampering earnings growth from such activities.

Government finances will also be impacted. Government debt has remained stubbornly high since the financial crisis, but low rates have reduced the pain. Higher rates will have a significant effect on deficits, taxation, government spending and services. So far the U.S. is the only country to begin raising rates, which is one of the reasons behind the strengthening U.S. dollar. It is also worth noting the rationale behind this shift in monetary policy. With an improving employment picture, an uptick in consumer spending and general economic strength, the Fed has deemed it appropriate to raise rates in order to keep inflation subdued and the economy stable.

Final thoughts

When markets are rising, optimism abounds. The recent stock market rally has been fuelled by expectation of U.S. policy changes. However, markets are not cheap, and the spectre of rising interest rates is a major risk.

In my early days as an analyst, I remember meeting with a client who was a very successful fund manager in Boston. He had no artwork on his walls, only a simple poster that read: "Be early." When I asked him about it, he replied "...young man, when it comes to investing, you are either early or you are late. And if you want to be a successful investor, you had better be early and not follow the crowd..."

At present, with no shortage of rosy forecasts, the crowd has turned euphoric. However, bond yields have risen sharply and the prospect of rate increases in 2017 appears highly probable. The elevated level of investor optimism due to the U.S. election is hard to justify, and the prospect of rising rates suggests that patience will be rewarded.

As for my New Year's resolution to lose weight this year, I remain optimistic.

We welcome the opportunity to discuss our outlook and investments with you.

Sincerely,

Lorne Steinberg
President

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