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April 2017

> *"It is remarkable how much long-term advantage people like us have gotten by trying to be consistently not stupid, instead of trying to be very intelligent."* **-Charlie Munger**

Common Sense

Dear Investor,

The Trump rally continued through the first quarter of 2017.

Despite the various headlines regarding Obamacare, trade issues and geopolitics, investors were more focused on the possibility of corporate tax cuts and reduced regulatory oversight. If enacted, the former would result in an immediate boost to corporate earnings, while the latter would reduce compliance costs, and allow more risk taking, most notably in the financial services and energy/mining sectors.

We have never spent much time paying attention to geopolitics. Despite the non-stop "white noise" regarding Trump, Brexit, Russia and North Korea, these issues are unlikely to have a long-term impact on corporate profit growth.

We live in an increasingly complex world. There are no shortage of potential crises on the horizon. That being said, Microsoft will continue to develop and sell updated versions of Windows and Office software, consumers will continue to insure their cars and homes with Allstate, and Novartis will continue to improve the lives of patients with cataracts. Each of those businesses is much stronger today than two decades ago, because of forward-looking management teams, strong franchises and financial sustainability - some of the key criteria that we look for in assessing an investment.

Over the past seventeen years, we have lived through the dot-com collapse, 9/11, eight years of George W. Bush, the financial crisis, eight years of Obama and now Brexit and Trump. While stock markets experienced significant volatility at various times during these periods, most of the truly great companies are in better shape today than they were in 2000.

Years ago, a psychologist friend of mine told me that when a patient was feeling stressed, she would often have them perform the exercise of taking a sheet of paper and drawing a vertical line down the middle. On the left-hand side of the page, she asked the patient to write down a list of all the things causing them stress over the past few years. On the right-hand side, they had to write down which of those actually came to pass. Unsurprisingly, the list on the left-hand side of the page was usually quite long, while the right-hand side of the page rarely had more than a few entries.

There is a message here: an investor's time is better spent focusing on the valuations and earnings prospects of individual businesses, rather than trying to assess the impact of economic and geopolitical problems that may arise.

Stock market performance during rising interest rate cycles

When I started in the investment business in 1989, The Zweig Forecast was one of the most respected and successful investment newsletters of its era. Its founder, Marty Zweig, like many successful investors, was both modest and a perpetual worrier, constantly questioning his assumptions. He placed a considerable focus on the Fed's interest rate policy, which ultimately led to his famous mantra "Don't fight the Fed." Simply put, for Zweig, the trend of Fed interest rate policy was a key determinant of future stock market performance. Rising rates were bearish for stocks and declining rates were bullish.

The rationale behind this approach is that, as interest rates rise, government bonds become more attractive, and investors will sell "riskier" assets, such as real estate and equities. If Zweig were around today, I suspect that the current trend of Fed rate policy would be worrisome.

We recently reviewed data going back to the 1950s to see how equity markets performed during rising rate cycles. Our only conclusion was that history did not offer many answers. Markets performed well during some cycles, and lost value during others - of course, no two cycles are ever the same. Numerous articles have been written about what to expect as the current rate cycle unfolds, but as is usually the case, many smart professionals reach polar opposite conclusions from studying the same data.

In March, the Fed raised rates again and indicated that the tightening cycle will continue. For the first time, it also addressed the issue of unwinding its policy of quantitative easing, which helped to keep bond yields at record low levels.

If valuations were cheap, we would be less concerned, but the price-to-earnings ratio of the S&P 500 is approximately 25x, well above its long-term average of 16x. Real estate investors have been acquiring properties for yields as low as 4%, due to low borrowing costs. Low interest rates have supported these markets since the financial crisis.

Maybe markets and the global economy will thrive regardless of rising rates, but history suggests that holding some cash on the sideline is warranted.

High Yield Bonds

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

Final Thoughts

Charlie Munger's (Warren Buffett's partner at Berkshire Hathaway) quote at the top of this letter resonates with me. As anyone on our investment committee will tell you, I agonize about every investment decision we make. Countless hours are spent examining the risks of each potential investment. Is there too much debt? Are the shares cheap enough? Is the business model sustainable? How will the company fare in a recession?

We spend a lot of our research effort trying to avoid big mistakes, rather than trying to predict the future.

By steering clear of what we do not fully understand, and focusing on common sense criteria, we hope to stay out of trouble. It is true that there have been many potential investments that we passed on, which ended up performing well. However, those of you who have been clients for several years may notice that we have made very few mistakes - which has resulted in preservation of capital and long-term growth.

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

Sincerely,

Lorne Steinberg
President