BAKER & EDWARDS FINANCIAL

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MARKET UPDATE – NOVEMBER 2018

We think that the events of October are a minor blip on your investing future – but we also think that a more significant trend will develop over the next 2-3 years. For that reason we have prepared this more lengthy explanation of what we expect, and how we build your portfolios in preparation.
October has once again surprised most of us with the swiftness and extent of the market drops. Should you be concerned and "run for the hills"? The short answer is NO. These sudden drops (and gains) are a normal part of the investing process and over the longer term happen about twice per year. Since 1980 the average drop within a year has been 13.8% for the S&P 500 index yet most of those years have ended with strongly positive numbers. October's drop seems surprising because it has been 7 years since we last experienced the average drop – that is the unusual aspect.

To help put the current situation into perspective, it is worth stepping back and examining the "bigger" picture. For the last 30 odd years – basically all of our investing lives – we have been investing into a world of declining interest rates. Some of you will remember the days of 5 year GICs paying 18% interest, versus 3% now. Since 2008 we have been investing in a world of almost free money as central banks pushed interest rates to almost zero in an effort to prop up economies devastated by the 2008 financial crisis. This situation changed in 2017 as the US central bank began raising interest rates because the economy was growing strongly. In 2018 they added another dimension as they began removing the stimulus money they had injected into the economy. These two factors have considerably "tightened" the money supply. This in turn changes the "risk premium" that investors are willing to pay for riskier investments such as stocks. This in turn means that they are not willing to pay the exaggerated prices that stocks had reached – thus the price falls, and we have the results in October.

From an economic perspective, the two big fears are always inflation and recession. The basics for higher inflation are present, especially in the US. They have strong growth, low unemployment, and inflated government spending – but, so far, these have not resulted in strong wage growth. The central bank is raising rates to counteract these forces. A recession is not likely at this stage – most fund managers tell us that they do not see one in the next two years.

What does this tell us about how your investments should be positioned for the future? Most of you are not expecting the highest possible return. You would prefer a more reasonable, consistent return in the 5-8% range with reduced drops in the downturns. Historically, this would result in a range of 60-70% invested in stocks and 40-30% invested in bonds. The very strong growth over the past 7 years may have distorted your range in terms of a higher stock percentage – this is one risk factor we are looking for as we review your portfolios. **The largest risk factor we need to consider is a slowing economy in the years to come.** This comes down to a look at our investing beliefs and how we construct your investment portfolios.

ACTIVE VS PASSIVE INVESTING

Active investing means a fund manager makes decisions about every stock (usually 30-40) that is in the fund. He/she selects them based on many criteria and analysis, and buys or sells them based on changes within the company, economy, and markets.

The resulting funds look nothing like the indexes we hear about every day and the results can be greatly different than the market headline results.

Passive, or index investing means creating a list of all the stocks that fall into a particular category and then buying all of them in the same proportion that they represent in the market. The resulting investment vehicle is called an Exchange Traded Fund or ETF. There are literally thousands of them, some in stock market format and others in mutual fund formats. Their advantage is that they are cheap and they capture almost of that particular markets gains each day. The disadvantage is that there is no human judgement involved on a day to day basis for most of them, so there is no selectivity in what is bought and sold so they capture all of the downside of that particular market every day.

We strongly believe in active management of your investments.

GROWTH VS VALUE STYLES

A growth manager looks for companies that are outgrowing their peers in terms of sales and profits. He/she is willing to pay a higher price for the shares with the expectation that the growth will continue. This style has been in favour for the past 10 years because of the rapid growth in the economies of the world.

A value manager is "looking to buy a dollar for 50 cents". He/she is looking for solid companies that are out of favour for some reason – that can be corrected. The lower price gives the manager a margin of safety to wait for the correction to take hold, and provides some protection in down markets. This style has been out of favour for the last 10 years but should stand out in a slowing economy or recession.
The different characteristics of the styles mean that both have a place in your portfolios and it is probably time to be increasing the value percentage.

FIXED INCOME VS INCOME

Traditional bond or balanced funds have been called fixed income because they invested in government or highest quality corporate bonds. The "fixed" comes from the nature of a bond – it pays a fixed rate of interest for a fixed period of time. This offered a good level of protection to a portfolio when the bonds could produce a 4-5% level of interest, but not for the last 10 years when they could only get 1-3% interest. Today's rising interest rates actually damage the value of existing bonds.

Newer balanced funds come with a more flexible mandate aimed at producing a consistent distribution of 5-6%. They use 6 types of investments to produce the return: equities for dividends and capital gains, preferred shares for dividends, bonds for interest, high yield bonds for higher interest, infrastructure equity for their distributions, and real estate equity for their distributions. They also search the world for the best opportunities rather than restrict themselves to one country. We think this flexibility will be critical to earning steady returns in the future.
The goal of this exercise was to help you understand the factors we consider when building your portfolio, and why we think it is time to prepare for a slowing economy in the years ahead.