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SQUAWK BOX DETOX

"How the '*Worst Christmas Eve Ever*' wasn't. Is there any correlation between what the media is saying and future returns?"

CUMBERLAND
Private Wealth

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Client Asset Allocation Process

By Gary Perron, CFA
Vice Chairman*

We write this newsletter with winter behind us and looking forward to spring. This is an important year for both Canada's and Alberta's political elections which will affect the investment sentiment in Canada. Will these elections change Canada to be more welcoming for foreign and domestic investment? Our thoughts are that we may see a change of attitude and this will affect the "Asset Allocation" of our clients' financial portfolios.

We, as asset managers, must understand your financial needs, goals, risk tolerance and investment time horizon.

The most important investment decision any investor makes is the asset allocation in his portfolio. The three major asset allocations are Cash, Fixed Income, and Equity with a fourth developing asset class in Alternative Investments talked about in a separate article. The expected returns and risks from these asset classes are listed low to higher respectively, with Cash returning the least, Fixed Income providing income and some growth, and Equity providing growth and some income. The asset class decisions are based on geographical locations, industry sectors and investment styles.

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Below are the historical returns of the various industry sectors, for the last 5 years.

TSX Returns (CAD)		
Sector	**5 year return**	**Annual Average**
Health Care	-65.70%	-19.27%
Energy	-33.25%	-7.77%
Information Technology	148.98%	20.01%
Financials	27.15%	4.92%
Industrials	61.77%	10.10%
Consumer Staples	90.92%	13.81%
Consumer Discretionary	37.70%	6.61%
Materials	-3.49%	-0.71%
Utilities	13.53%	2.57%
Telecommunications	32.23%	5.75%

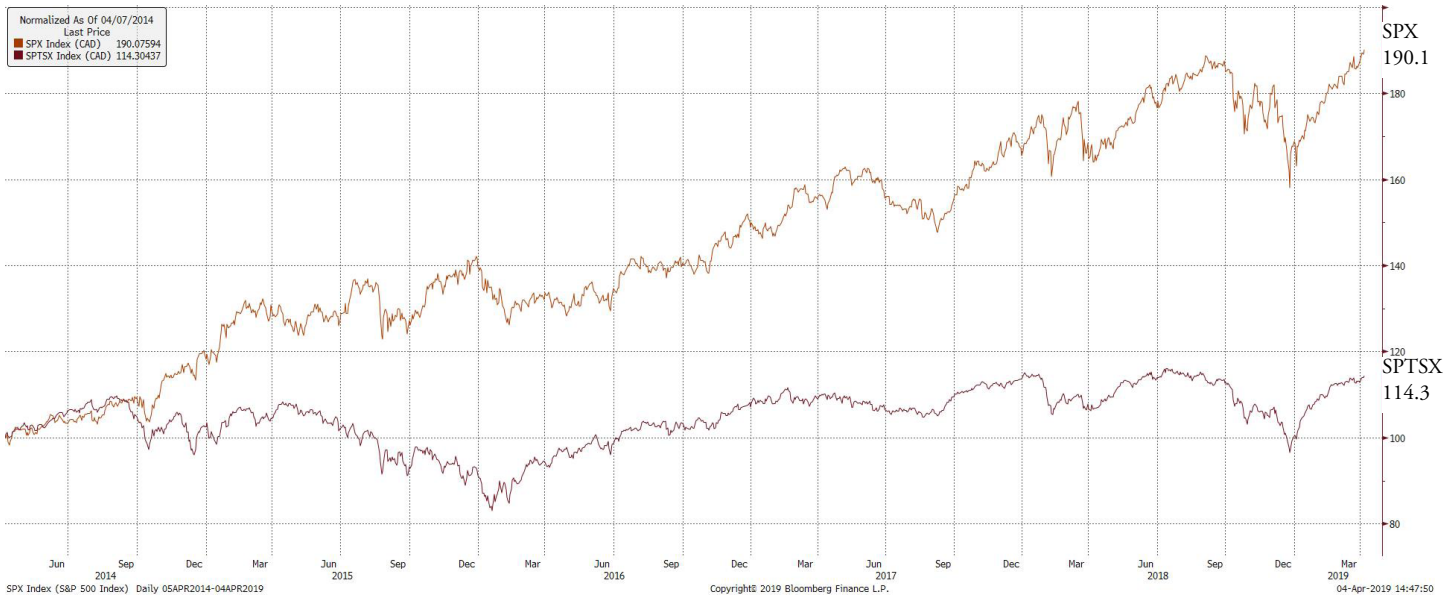
S&P 500 Returns (USD)		
Sector	**5 year return**	**Annual Average**
Health Care	56.93%	9.43%
Energy	-25.03%	-5.60%
Information Technology	117.85%	16.85%
Financials	41.90%	7.25%
Industrials	40.31%	7.01%
Consumer Staples	31.27%	5.59%
Consumer Discretionary	75.55%	11.91%
Materials	16.40%	3.08%
Utilities	40.12%	6.98%
Telecommunications	2.13%	0.42%

The historical data proves how ineffective the Canadian sectors/companies have been in delivering decent consistent returns. Financials and Telecom have been the main consistent sectors delivering close to dividend yield returns with no growth. The technology and healthcare sectors consist of a handful of companies (5-10) with the majority not being investable companies. The resource sectors (materials and energy) have been wealth destroyers. We call these sectors cyclicals because they have cycles which are difficult to consistently forecast. Canadian resource sectors offer a short list of quality investable companies. Their time will come again, but when?

That brings us to the US S&P 500 5-year returns. The data shows the more consistent returns from each sector with the main exception being Energy. Healthcare and Technology have the most consistent returns with many investable companies, compared to Canada. We have over-weighed Healthcare and Technology in our global mandates and will continue with this strategy.

Therefore, asset allocation within the various industry sectors is strategically important to your investment portfolio. We constantly look at optimizing our industry positions with quality growing businesses within those sectors.

Performance SPX vs SPTSX, 5 Years



Source: Bloomberg

We have historically invested more equity outside of Canada as we have found better quality businesses (Stocks) to invest in, providing a currency hedge outside of the Canadian dollar. This potential asset allocation outside of Canada may change if we see steps taken by the Government to be beneficial for domestic businesses and resources. Canadian governments will have to become more fiscally disciplined (like how we manage our family finances) for investor confidence and foreign investment to return to Canada. At this time, we will continue to overweight our global (non – Canadian) asset allocation until we see a firm change in Canada.

One of the leading indicators is the Canadian dollar relative to other major currencies. A strong currency will attract foreign investors and capital and is a leading indicator of better economic growth in Canada. The chart above identifies how much Canada has underperformed relative to the S&P 500, in the last 5 years.

The geographical allocation in your investment portfolio again is a very strategic decision which needs to be monitored at least quarterly. The underperformance of the Canadian TSX has been very costly for Canadian investors and we will be maintaining most of our equity allocation outside of Canada until we see some key changes to underlying growth in revenues and earnings within the TSX companies.

The third but every bit as important decision is the Investment (strategies) style of the portfolios. The data below summarizes returns from various investment (strategies) styles over the last 5 years.

CPMS Canadian Strategies (as of Mar 31, 2019)		CPMS US Strategies (as of Mar 31, 2019)	
Investment Style	5 year Annualized Returns	Investment Style	5 year Annualized Returns
Asset Growth	7.50%	Asset Growth	8.30%
Bargain	-7.40%	Asset Value	7.60%
Dangerous	-10.30%	Dangerous	3.60%
Dividend Growth	5.30%	Dividend Growth	7.60%
Earnings Momentum	2.90%	Earnings Growth	6.30%
Earnings Value	1.80%	Earnings Momentum	5.30%
Income	0.90%	Earnings Value	3.80%
Industry relative	1.40%	Income	8.30%
Momentum	-2.50%	Industry Relative	8.40%
Predictable Growth	9.00%	Momentum Breakout	9.10%
Value	3.90%	Price Momentum	9.70%
TSX Composite	5.40%	Value	-1.00%
		S&P 500	10.90%

Our portfolios are currently exposed to the Growth, Dividend Growth, and Predicable Growth (GARP, Growth At Reasonable Prices) styles. The Canadian data identifies Asset Growth, Dividend Growth and Predictable Growth investment styles as the better performing styles in the last 5 years. The best performing US styles are Asset Growth, Dividend Growth, Income and momentum-based investment strategies. The performance of various investment styles differs between Canada and the US. That is why we have always blended certain style managers into client portfolios. Your portfolio should not be dependent on one investment style, as you would be taking more specific style risk. As an example, a millennial client portfolio should be more exposed to growth styles, while a retired client should be more exposed to Dividend Growth and Income styles. Growth style will have more volatility but better long term rates of return versus a retired portfolio which requires less volatility but still needs a smaller percentage of growth style in the portfolio.

In summary, asset allocation is an art, not a science, and requires experience and judgement to properly allocate to a portfolio mandate. We are constantly monitoring future outcomes to determine the best asset allocation for each client, dependent on their needs and stage of life. If you require a more personalized detailed analysis of your asset allocation portfolio, please let us know.

Sincerely,
Perron Team

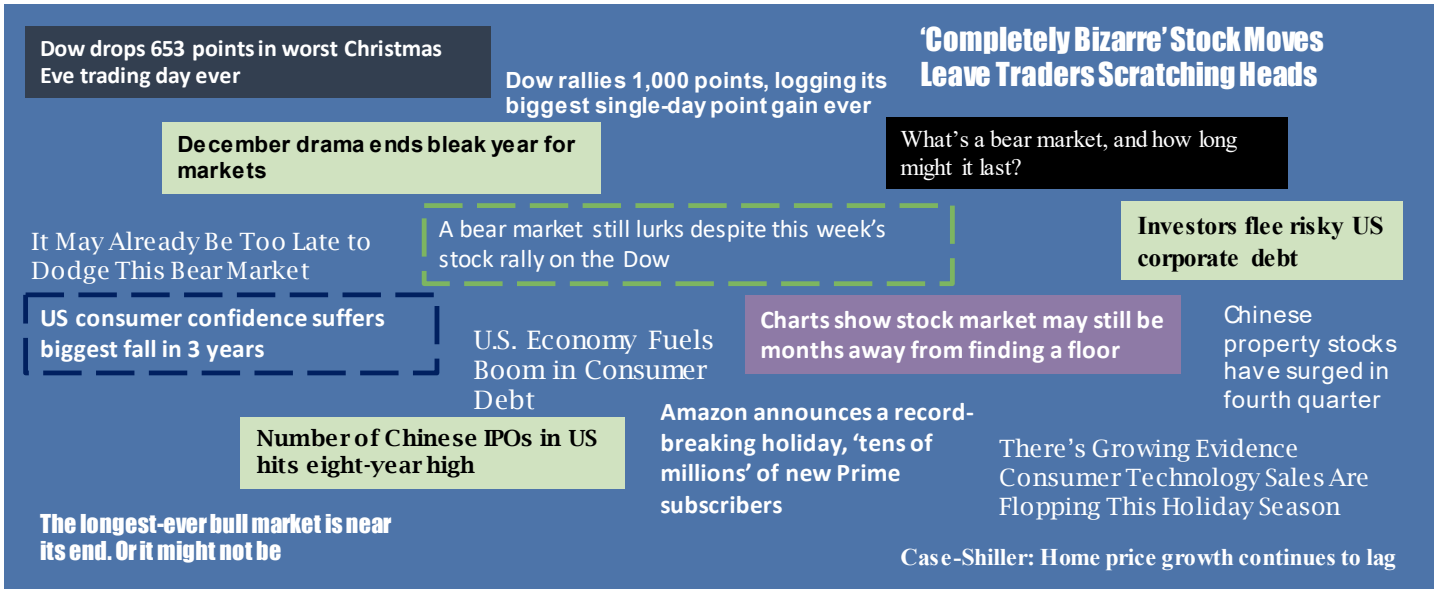
Squawk Box Detox

A look at the impact the financial media has on the markets

By James Nickerson, CFA
Portfolio Manager*

As we exit what has been the best returning 1st quarter for the S&P 500 since 1998, we thought it would be an interesting process to show the impact that the financial media (CNBC, BNN, CNN etc) has on the markets. Is there any correlation between what the media is saying and future returns?

Dec 24, 2018 saw what would be the bottom of the Q4 2018 correction. The major financial news outlets were flashing red across the board talking about a US led recession, a shrinking monetary base, flattening yield curves and how the markets had experienced the "worst Christmas eve ever." One of our research providers put together this compilation of headlines from the week of Dec 24, 2018, a look back at it 3 months later may cause some heads to shake.



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Over the 10-year bull market, there have been a number of negative events which caused chaos in the markets and sent the media outlets into a kerfuffle. Things like the US credit downgrade, Greece default, PIGS (Portugal, Italy, Greece, Spain risk of default), Chinese slowdown, Brexit and the first 6 hours of the 2016 US Presidential election come to mind, but the market has continued to grind higher. During what media sometimes conceives as "Black Swan" like events, quality businesses, those which show reasonable valuations and high profitability, present themselves as great buying opportunities.

One of our favorite visualizations is the trailing returns of the S&P 500 following a popular CNBC Special "Markets in Turmoil".

Markets in Turmoil	S&P 500 Close	S&P 500 Forward Total Returns following CNBC Markets in Turmoil Specials					
		1-Week	1-Month	3-Month	6-Month	9-Month	12-Month
5/6/2010	1128	2.7%	-5.6%	0.5%	9.8%	17.6%	21.2%
5/7/2010	1111	2.3%	-4.7%	1.4%	11.3%	19.8%	23.6%
5/9/2010	1111	2.3%	-4.7%	1.4%	11.3%	19.8%	23.6%
6/4/2010	1065	2.6%	-0.2%	3.1%	16.1%	25.9%	23.2%
8/4/2011	1200	-2.2%	-2.7%	5.0%	13.5%	16.0%	18.8%
8/7/2011	1199	-1.6%	0.2%	5.7%	13.9%	16.1%	19.5%
8/8/2011	1119	7.7%	6.2%	14.7%	22.2%	23.9%	28.1%
8/9/2011	1173	1.8%	-1.3%	5.5%	15.8%	17.5%	22.4%
8/10/2011	1121	6.6%	3.9%	11.3%	22.0%	23.2%	28.3%
8/11/2011	1173	-2.7%	0.2%	8.4%	16.5%	17.3%	22.5%
8/12/2011	1179	-4.6%	1.1%	6.8%	15.3%	15.4%	21.8%
8/14/2011	1141	-4.6%	1.1%	8.8%	15.3%	15.4%	21.8%
8/18/2011	1130	1.6%	5.6%	7.2%	20.4%	15.5%	27.1%
9/22/2011	1278	2.8%	11.2%	12.7%	26.5%	20.2%	31.9%
6/3/2012	1971	3.8%	7.7%	10.5%	11.6%	22.7%	29.9%
8/23/2015	1893	0.9%	-1.5%	6.5%	0.2%	5.7%	13.4%
8/24/2015	1868	4.2%	2.2%	11.0%	4.1%	11.5%	17.5%
8/25/2015	1941	2.5%	3.6%	12.5%	4.7%	13.8%	18.9%
8/26/2015	1914	0.5%	-2.8%	8.3%	3.1%	9.5%	14.3%
9/1/2015	1880	1.5%	2.2%	7.7%	5.8%	11.9%	16.0%
1/18/2016	2649	-0.2%	2.2%	12.5%	16.9%	15.3%	23.5%
2/5/2018	2581	0.3%	3.7%	2.4%	8.9%		
2/8/2018	2728	5.9%	7.4%	6.3%	10.4%		
10/11/2018							
	Average	**1.5%**	**1.5%**	**7.4%**	**12.9%**	**16.9%**	**22.3%**
	% Positive	74%	65%	100%	100%	100%	100%

Source:Charlie Bilello via Seeking Alpha

CNBC had pretty good timing of the Special on Oct 11, 2018 as the S&P 500 continued lower for the next 2 months, but as we are currently coming up on our 6-month anniversary from that special the return has turned positive (up 5.1% as of this writing). Looking at the average subsequent 12-month return from these specials really paint the media in a poor light, with their overreaction to market corrections often completely flawed.

As we enter our next reporting season, we want to highlight some of the businesses we own and were able to add to during this "Markets in Turmoil" period. It shows that even though the media outlets were screaming panic, the underlying businesses were performing quite well throughout that period of market volatility.

Stryker

Stryker is a world leader medical technology company. They have a wide array of operations but are primarily known for their Orthopedics segment which includes reconstructive systems (Knee and Hip replacements). While it is no secret that the globe is facing an aging population epidemic that will require more and more knee/hip replacements what is truly most interesting about Stryker is how they have managed to capitalize on the space. Stryker made a $1.65 billion splash in 2013 when they bought a company called MAKO surgical corp. MAKO had developed a surgical robotic arm to assist surgeons with partial knee and total hip replacements. While the growth that MAKO had was impressive, Stryker saw an opportunity to buy the technology and pair it with their leading orthopedic parts. Essentially, they could take the technology that MAKO had for knees and hips and add it across all their surgical segments. In addition, it created a nice cross-selling feature for their sales staff with a warm lead for surgeons who already used Stryker's parts.

An interesting tidbit about surgeons is that they tend to be very sticky clients to the product companies. They get very comfortable with the certain products and once a sale has been made, that surgeon typically continues using that product for an average of 15 years. By being able to cross-sell MAKO's robotic arm Stryker has done 2 things: It has allowed for a stickier relationship with its surgeons and has allowed the company to grow at a faster clip than the industry, growing market share. Q4 2018 saw Stryker's best quarter in a decade with organic growth up 8.6% (beating estimates by 1%) and saw continued MAKO growth with another 54 hospital placements and growth of 55%. The superior execution seen today from Stryker will no doubt be a benefit in the future when the overall market starts to see more growth.

Anthem Inc

Anthem is a Managed care provider in the US that serves 40.2 million medical members. There are two kinds of benefits that US citizens can have: Health benefits and Pharmaceutical Benefits. Customers want a one stop provider for both and up until this decade, managed care providers had typically outsourced the pharmaceutical benefit business as it was a slower growth, tedious business. This proved to be a good strategy until United Health changed the game earlier this decade. They brought their Pharmaceutical Benefit Management (PBM) in-house as projections started to show that prescription drug spending was beginning to outpace hospital care spending. This in turn was going to make it so that the PBM was an attractive place to be. In June of 2011, United Health began the process of bringing their segment in-house ignoring a lot of the nay-sayers in the market. United Health did a fantastic job with the execution and were able to grow their PBM business by bringing it in-house, surpassing two other players and becoming the second largest PBM business in the US. Based off the success seen by United Health, quite a few of the managed care providers have begun the process of bringing their PBM segment's in-house. We feel as if Anthem has an advantage in this department as their CEO was actually part of United Health during this process at the beginning of the decade and has seen the road map to success. In our opinion this element makes the probability of successful execution higher with Anthem than some of it's other competitors.

Originally not scheduled until 2020, this quarter saw the announcement that this transition is going to happen a year early in 2019. Our math suggests that by doing this there will be a $4 billion savings in drug costs of which $800 million will drop to earnings. Additionally, we think that this is going to allow the entire company to grow faster as a whole. This view has been confirmed by management who have declared that long term earnings growth should be 12%-15% per year. This is in addition to $800 million that we know we are going to achieve just from bringing the PBM in house. Anthem will occasionally, as it is currently, get caught up in headline risk in regards to government news (healthcare costs) but we are very optimistic about the long-term growth prospects for this company.

Danaher

Danaher is a health care conglomerate with life sciences, diagnostics, environmental and dental segments. While it is looking to spin-out it's dental segment so the market will view it more as a pure life science/diagnostics company, it still has been a great performer in our portfolios. It wasn't so much the quarter that we wanted to highlight but what they were able to do due to some of the stress shown in the market. Danaher has a history of doing tuck-in acquisitions while maintaining a clean balance sheet. It has been a recipe for success over the years and has seen Danaher grow from a more traditional industrial type company into a modern healthcare-oriented company. Danaher's management team is as smart as they come and are able to spot a deal when they see one. By not over-extending themselves earlier on in the cycle they were able to come in as buyers and buy valuable assets of a struggling business. General Electric, as some of you may know, is selling a large portion of their business in efforts to de-lever and survive. Danaher was able to purchase General Electric's BioPharma business at a very reasonable valuation all due to a disciplined process. The deal will add an additional $3.2 billion of healthcare related revenue to Danaher's portfolio and further, the company is transforming itself from a traditional industrial to a more modern new age company. Most of the press involved with this deal revolved around General Electric but as Danaher shareholders we are very excited to see more in the future of exactly what this transaction entails.

Understandably investors get emotional when it comes to losing money. However, this bias towards loss aversion typically tends to be much higher than the desire to potentially make money when an opportunity presents itself. One thing to remember when viewing the financial 'talking heads' is that the goal of the media company itself isn't necessarily to give proper advice but to find a captivated audience which will lead to higher revenues. When it seems like the world is going to hell in a handbag, fear sells much better and when it seems that nothing can go wrong a segment like "what the traders are buying" tends to be seen in a better light. We're not saying that the financial news is always wrong, but what we are saying is that more often than not, taking a breath, analyzing a situation and having a cool head prevails.

The Importance of Sacrifice in Financial Planning

By Jon Cornish, CFA
Wealth Advisor*

Seems like everyone is having trouble saving for retirement, no matter what the income. What's the common denominator? Income? Age? Gender? Young to old, high to low income, every group has challenges saving for retirement with 29% of working age people believing they will be financially comfortable when they retire[1]. There isn't a single group immune to this, including those in the highest income bracket. From professional athletes to entrepreneurs to doctors and lawyers, across all income levels, many people spend as much as they make often with little financial restraint shown. This is despite knowing the outcomes are never as good when you don't exhibit some amount of financial sacrifice.

Financial sacrifice is about giving up some amount of current spending to save for a goal or the future in general. Everyone knows about delayed gratification but why does the question "Would you be okay with a lower standard of living?" always have the same answer?

When we focus on retirement, especially early retirement, and put in continual effort over time, this tendency can be reversed, seeing savers live their best life all the way through retirement and beyond.

We're living in a country where on average people are saving just 1% of their income[2]. To put that in perspective, the historical average since 1981 was 7.25%. People have long sought to replicate their friends, family and associates' achievements and it's understandable, as we all want to have nice things. What many don't often consider is the true cost of our current lifestyle; not just in monetary terms but in terms of your retirement. Often assets are bought on credit, increasing their cost further and it's only become more expensive to keep up, with the invisible hand of inflation increasing Canadian consumer prices by 184% since 1981[3] despite wages barely increasing over the same time. It might have been great to have a million dollars to retire on in 1995 but now that balance won't help you if you're spending $100,000 per year in retirement. More than ever, sacrifice through saving and fiscal discipline is required to create a comfortable retirement.

* Cumberland Private Wealth Management Inc., Calgary

When working to improve your life, you put the necessary time and focus into your objectives. I learned the importance of sacrifice during my time on the football field as I didn't see success overnight, instead needing to focus each day, putting in the time to improve. Just like investing, the biggest factor in the return is time. When you give yourself time by saving now instead of intending to in the future, you are setting yourself up well and not just for retirement.

A study by Ally Bank[4] found that when people had more money in the bank, they were happier. Almost no one walks into a plush retirement, instead it takes a lifetime of effort, saving here and there, to set yourself up. A simple $250 monthly contribution growing at 5% over 25 years ends up being almost $150,000. This difference could potentially mean going on multiple vacations a year, paying for your childrens' college fees, perhaps establishing a trust to take care of your loved ones no matter what, or making a large donation to your favorite charity. The point is, only you know what your ideal financial picture looks like now and in retirement. The primary way to achieve both is to put in the focus and time, sacrificing some small luxuries to increase your savings today.

Personal sacrifice can be found wherever you look, whether it's a parent staying home to raise their children, the cost of gaining one's education or the risks you take when you start your own business. These people have all chosen what they're focused on and with that focus, comes the need to sacrifice, giving time to become better, focusing on learning to become greater.

It's not that people don't sacrifice every day, it's that they don't necessarily sacrifice financially. Put another way, financial sacrifice is the ability to focus on the financial goals which matter truly to you. We live in a world of distraction so there's always some new shiny object to glorify and need. Focus, in this case, is one's personal ability to know what they want, rejecting the distractions and taking the steps necessary to achieve their goal. I believe that when you're focused on your goals, you tend to achieve them and saving for retirement is no different.

Retirement is your time; time for your family, your friends and legacy. When your time is truly yours, will you have some regrets or will you enjoy the fruits of decades of labour? Thinking about this question now is the first step in having the retirement you want.

Sources:

1. HSBC Report for Canada 2017 - https://www.hsbc.ca/1/content/canada4/pdfs/personal/for_canada_report_2017_en.pdf
2. Canadian Economic Trends, https://tradingeconomic s.com/canada/personal-savings
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Why Include Alternative Assets?

By Jason Isaac, CFA, CAIA
Portfolio Manager*

Despite entering the year with extreme pressures and uncertainty on three major economic fronts, namely, global trade tensions, concerns with Chinese growth prospects and doubts over the Fed's ability to navigate interest rate hikes, 2019 has started off rather strong. As of the end of March, the first quarter of 2019 has delivered a decent start to the year for the markets right across the board. There was strong positive performance in all major equity markets with the SP/TSX Index up 14.1%, SP500 Index up 14.6% (12.4% CAD), European Stoxx 50 up 12.9% (8.5% CAD), Japanese Nikkei 225 up 6.8% (4.4% CAD) and even the MSCI Emerging Markets Index churned out a respectable total return of 10.3% (8.1%CAD).

Upon reflection, most prognosticators were laser-focused on the direct impact on growth from the three issues noted above and their knock-on effects on supply-side economics in the second half of 2018. However, the stresses on the global system manifested themselves in a less direct way through conservative corporate capital allocations and tighter lending standards from financial institutions. Thus, the aggregate effects of reduced access to funds, lower capex spending, and less total investment weighed heavily on global growth. This was felt most acutely in China which exacerbated problems as that country was already wrestling with a tightening cycle of its own. Further, the Fed's policy stance aggravated the situation as Chairman Powell seemed to be stuck on a pre-set tightening path despite rising economic headwinds. Jumping to today, it is the easing of the pressure on these three pain points that has served to arrest the fears of the global economy stalling out and jolted the markets to reignite.

To begin with, the Fed signaled some flexibility on its policy rate path and acknowledged that its monetary normalization plans will be data dependent. Trade tensions eased and China's domestic situation and credit growth has picked up which has helped to rekindle optimism about the global growth outlook. Going forward, the Investment Committee at Cumberland Investment Counsel is increasingly confident that 1Q19 will mark a trough for the global growth mini-cycle and that 2019 will prove to be a solid year.

From an opportunity point-of-view, we are looking with keen interest outside of North America, towards developing markets and "Alternative Assets" in particular.

* Cumberland Investment Counsel Inc., Calgary

This dovetails nicely into a recurring theme and is one of the major differentiators for Cumberland** asset mix strategies. Namely, the focus on the risk side of the equation in the investment process and the inclusion of Alternative Assets to provide a counterbalance to your investment portfolio.

By way of background, Alternative Assets is a term placed on a very wide range of assets that fall outside of the traditional classification of investable securities (Cash, Bonds & Stocks). At the core, what these assets are attempting to do is nudge the investment experience as understood by modern portfolio theory to a more favorable outcome, either by enhancing return or reducing risk. Typically, risk and return go hand-in-hand and in order to capture a greater potential payoff, one must accept a greater degree of uncertainty around the possible outcomes of that payoff.

By definition, Alternative Assets are complementary to traditional assets, so their return profiles should (and often do) display little or low correlation to the rest of the assets in a portfolio. This provides the key benefit of the inclusion of Alternatives, which is broader diversification. This reduces (or smooths) the overall portfolio volatility and ultimately results in greater stability of returns for the investor. In financial terms, this is called enhancing portfolio efficiency, or more simply, by including Alternatives in the construction process, a portfolio can be generated that significantly minimizes the amount of risk assumed given a desired return expectation.

Typically, global REITS, global high yield, and alternative strategies like long/short equity, 130/30 portfolios, and market neutral funds are popular investments in the Alternative Space. More recently, there has been the emergence of other assets that have gained traction and some examples include direct investment in commodities (copper/gold/water), real estate, infrastructure, timberland & farmland and insurance-linked securities.

With the vast and diverse possibilities that make up the Alternative Selection universe, the task of choosing can be daunting. The Investment Committees at Cumberland** have significantly simplified this process by focusing on protecting the portfolio from the biggest risk or augmenting returns given its prevailing views on the markets. Specifically, any allocation to Alternatives will seek to achieve one of the following primary objectives;

- Dampening volatility / downside protection
- Preserving purchasing power / inflation protection
- Maximizing growth potential of the portfolio
- Maximizing income generated from the portfolio

To this point, our view over the past few months has remained consistent in that, while ultimately, we believe 2019 will be a decent year performance-wise the current geopolitical, monetary and economic environment does create a level of uncertainty that will cause continued market volatility at a level that has been unprecedented in recent years. As a result, portfolios with Alternatives exposure will continue to focus on downside protection and portfolio stability through potential exposures to Gold, Real Return Bonds, Global Real Estate, Global Infrastructure and Equity Income Options strategies.

** Refers to Cumberland Private Wealth Management Inc. and Cumberland Investment Counsel Inc.

Navigating the Exchange Traded Fund (ETF) World and Sidestepping Unnecessary Risks

By Chris Dry, CIM
Associate Portfolio Manager*

ETFs are a vital tool in our investment tool-belt with regards to creating a suitable asset allocation structure for a clients' portfolio. Generally, we'll use ETFs in our Cumberland Investment Counsel ("CIC") Managed Solutions to fill asset/global sector overlay allocations our proprietary Kipling Pool Funds do not cover (i.e. allocations to certain countries like Japan and/or overweighting certain sectors like Global Health Care, Preferred Shares, etc.). But those ETFs require some extra due diligence, as there are many headwinds and pitfalls that can have adverse effects on your portfolio's return.

For the most part, ETFs are cheaper, more tax efficient, more transparent, and more liquid than mutual funds, but let's run through some risks that can be reduced with some extra due diligence.

Whether it's an open or closed-end mutual fund, an ETF, or a Fund of Funds, the most common risks funds have, but not limited to, are market risk, interest rate risk, foreign security risk, foreign currency risk, manager risk, risks associated with the use of derivatives, liquidity risk, and counterparty risk.

If we dig deeper, there are other risks that investors need to know before buying an ETF that we analyze in our process before investing in any, domestic or US listed ETF. Those are: alternative tax treatment, alternative weighting scheme, the fund is actively managed, hidden fees, credit risk, less liquid holdings, low volume, discount/premium issues, leverage, & potential Futures roll costs. We also look at their assets under management (AUM), Management Expenses Ratios (MER), and their overall metrics (i.e. Price/Book, Price/Sales, Price/Earnings, etc.).

ETF marketing is a powerhouse. New ETFs are launched almost on a daily basis driving investors to that shiny new toy. We've now seen the first launch of a negative management fee S&P 500 ETF, currently at -5bps. But, as we dive deeper, this is only short lived as once the ETF reaches $100M in AUM, the fee jumps to 29bps.

While there are a lot of great new ETFs that come to market, you should be wary of anything promising a free lunch.

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Study the marketing materials closely, work to fully understand the underlying index's strategy and don't trust any back-tested returns.

Rule of thumb says that the amount of money invested in an ETF should be inversely proportional to how much press it gets. That new Social Media/3-D Printing/Machine Learning ETF? It's not for the core of your portfolio. We typically avoid niche ETFs unless we have a high conviction towards the theme/story behind the fund.

The "crowded trade risk" is related to the "hot new thing risk." Often, ETFs will open up tiny corners of the financial markets where there are investments that offer real value to investors. Bank loans are a great example. A few years ago, most investors hadn't even heard of bank loans; today, more than $10 billion is invested in bank-loan ETFs. The warning here, as money rushes in, the attractiveness of a particular asset can diminish. Moreover, some of these new asset classes have limits on liquidity. If the money rushes out, valuations could be harmed. This also rings true in emerging markets with allocations to countries with less liquid equities and bonds than most developed countries.

There are a lot of ETFs out there that are very popular, and there are a lot that are unloved. Each year, about 100 of these unloved ETFs gets put out of their misery.

An ETF shutting down is not the end of the world. The fund is liquidated and shareholders are paid in cash. It's not fun, though. Often, the ETF will realize capital gains/losses during the liquidation process, which it will pay out/pass along to the shareholders of record. There will also be transaction costs, uneven tracking and various other grievances. One fund company even had the gall to stick shareholders with the legal costs of closing the fund (this is rare, but it did happen).

Most of the time, ETFs work just like they're supposed to: happily tracking their indexes and trading close to net asset value. But sometimes, something in the ETF breaks, and prices can get way out of whack.

Often, this is not the ETF's fault. When the Arab Spring occurred, the Egyptian Stock Exchange shut down for a period of weeks. The Market Vectors Egypt ETF was the only diversified, publicly traded way to speculate on where that market would open when things settled down. During the closure, Western investors were heavily bullish, bidding the ETF up sharply from where the market was before the revolution. But when Egypt opened back up again, the market was basically flat, and the ETF plummeted in value. It wasn't the ETF's fault, but investors did get burned.

Again, ETFs are a useful tool when creating an asset allocation mix for your portfolio, but doing your homework is paramount. There are 2077 US and 765 Canadian listed ETFs on various exchanges that are tradable here in Canada. With almost 3000 ETFs to choose from, it's imperative that you understand the fundamentals of the ETF you are considering adding to your portfolio. The extra due diligence you do can alleviate stress throughout your investment time horizon.

1Q19 CIC Managed Solution Balanced Strategy

Cash (underweight) Call is for frictional levels only.

Fixed Income (underweight) The Fixed Income exposure remains at neutral. We continue to stay short duration, utilizing the Kipling Strategic Income Fund as the core component of the asset class, with an allocation to Canadian Preferred Shares providing yield and diversification benefits. Emerging Market Debt remains relatively attractive due to better yields and FX appreciation potential. We do not anticipate any further rate hikes, Canada or US, until possibly 4Q19.

Equities (neutral) Call is to be neutral equities. We think the most likely scenario will be for equities to retest market lows in the short-term, with that said, we do not anticipate a global recession and remain bullish on the longer-term for equities. Our managed solutions program trimmed the Alternatives exposure and sold the iShares MSCI EAFE Small-Cap ETF. We directed the proceeds of both of these transactions to emerging market exposure. Namely, the Vanguard FTSE Emerging Markets ETF and our award winning NCM Entrepreneurs Class Fund. We also increased our exposure to Large Cap Health Care by adding to the Harvest Health Care Leaders ETF position. From a global point of view, peak EPS and EBIT margins have been reached, cycle highs in US bond yields, and the spectre of an inverted yield curve all argue for an increase of equity volatility as the market transitions to a more defensive posture reflecting the late stage cycle we are entering. While overall, equities remain our favoured asset class, the aggressive tilt within equities has been reduced.

Alternatives (overweight) The goal of the Alts allocation is to introduce assets that exhibit a low correlation with the standard asset classes (Bonds & Equities) while also benefiting from an increase in current income making them excellent additions for portfolio diversification. We continue to employ exposure to gold directly through the SPDR Gold Trust ETF (GLD) and have a position to short term US Inflation Protection Bonds (SCHP). Furthermore, we are also utilizing the volatility dampening and downside protection of the Purpose Premium Yield Fund (PYF).

Credits: etf.com, Cumberland Investment Counsel

Current US vs. Canadian Oil and Gas Valuations

By Chris Bolton, CFA
Portfolio Manager*

It is an understatement to say that it has been a difficult environment for oil and gas investors over the last five years. Rising global production, seemingly inconsistent signals from the Organization of Petroleum Exporting Countries (OPEC), and a decline in investor interest in the sector have all lead to poor equity returns. The S&P Oil & Gas Exploration & Production Select Industry Total Return Index declined by approximately 53% from June 20, 2014 to April 3, 2019.

It has been even more difficult for Canadian oil and gas investors. The S&P/TSX Oil & Gas Exploration & Production GICS Sub Industry Total Return Index has dropped from 4,605.71 in June 2014 to 1,884.84 in April 2019. This represents a decline of nearly 60%.

Thus far, Canada has struggled to approve the necessary infrastructure to allow Canadian oil & gas producers to fully access world markets and realize world market prices.

Pipeline projects such as Energy East and Northern Gateway have been cancelled/abandoned entirely. Other expansions such as Keystone XL, Trans Mountain and Enbridge's Line 3 expansion continue to be delayed due to opposition from various parties. This has resulted in many Canadian producers shipping production by rail (typically at higher cost than pipelines) and/or simply being forced to accept less than world prices for their production. These issues have also contributed to the Government of Alberta mandating production curtailments for larger oil producers in the province.

Likewise, on the natural gas side, Canada arguably once had an opportunity to be a world leader in Liquified Natural Gas (LNG). LNG development would have allowed Canadian natural gas producers to realize higher prices for their production by liquifying the production and shipping it to foreign markets. Unfortunately, Canadian natural gas producers have been forced to watch from the sidelines as other countries (Qatar, Australia, Malaysia, Nigeria, Indonesia, United States etc.) have been busy building LNG export facilities, while Canadian

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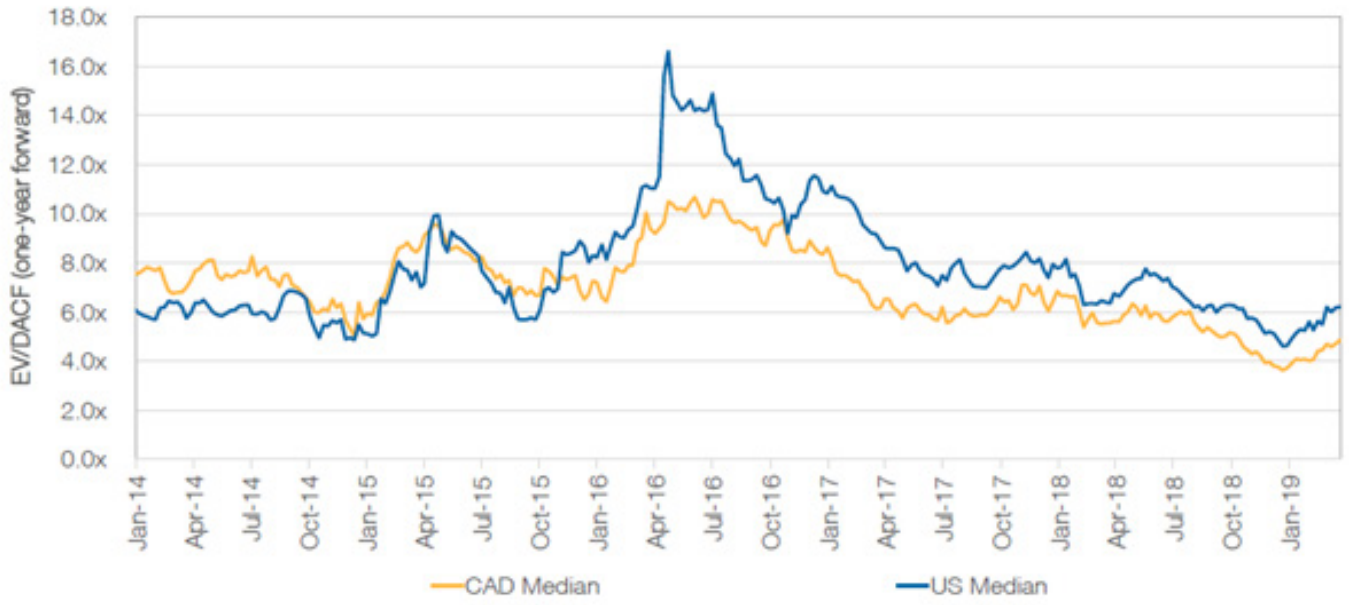
proposals have faced opposition and delays. While LNG Canada plans to construct and operate an LNG export facility on Canada's west coast by mid-next decade, Canadian natural gas producers are left to forever wonder what could have been.

As a result of these issues (and likely others) Canadian producers are trading at discounts to many of their U.S. peers. For example, based on estimates from BMO Capital Markets, Canadian large cap producers are trading a 3.8x 2019E price-to-cash flow, while U.S. peers are trading at 4.9x. This means that Canadian large cap peers are trading at a 22% discount based on this metric. This discount holds for most other valuation metrics: 2019E price-to-earnings (Canadian producers at a 32% discount), net asset value (Canadian producers at a 40% discount), 2019E enterprise value-to-earnings before interest, taxes, depreciation and amortization (Canadian producers at a 21% discount).

There are various possible explanations for the valuation discrepancy. BMO forecasts U.S. producers to grow production by 8% in 2020 when compared with 2018, while Canadian producers are only forecast to grow production by 3%. U.S. producers are forecast to have higher netbacks and better returns on their capital expenditures. Arguably, if sufficient pipeline capacity existed for Canadian producers to realize world prices for their production, they would have higher netbacks and more cash flow to pursue growth.

Sentiment also plays a factor. Figure 1 shows that Canadian producers traded a premium valuation to U.S. peers for much of 2014 and 2015. U.S. producers began commanding a premium in approximately the fall of 2015. While possibly a coincidence, a federal election also occurred in the fall of 2015 that resulted in the Liberal Party of Canada (led by Justin Trudeau) forming a new Canadian federal government. While anecdotal, we have heard that since 2015 certain large institutional investors have asked questions such as "Is Canada investable?" and "Is the political risk in Canada greater than in Nigeria?".

Fig 1: CAN vs US historical EV/DACF (one-year forward - Factset consensus)



Source: FactSet, Macquarie Research, March 2019

There are other factors to consider. Various areas in the United States (such as the Permian basin in west Texas) continue to yield generally solid drilling results. Furthermore, this production is far closer to refineries and export terminals on the U.S. Gulf Coast than Canadian production is and pipeline approvals in Texas face far fewer hurdles than in Canada.

It remains to be seen if the discounted valuation Canadian producers are currently experiencing is structural or cyclical. There are reasons for optimism. While delayed, Enbridge's Line 3 expansion appears to be making progress towards completion in 2020. President Trump issued permits in March 2019 designed to help accelerate the Keystone XL expansion. Various petrochemical developments in Alberta should help Canadian propane producers to realize higher prices and LNG Canada continues to make progress. A Canadian federal election is scheduled for October 21, 2019 and the Conservative Party of Canada is currently leading the Liberal Party of Canada in the most recent polls. We believe a change in the Canadian federal government would be positively perceived by investors in the sector.

While some uncertainty lingers, we think investors ignore the sector at their own peril. In the Kipling Monthly Income Fund we have focussed our oil and gas sector exposure on midstream/pipeline companies. We believe, these investments provide a solid combination of minimal commodity price exposure, barriers to entry (and in some cases near monopolies), growing cash flows and growing dividends.

Start Talking!

By Shawna Perron, MBA, CIM, FEA
Portfolio Manager*

When it comes to estate planning or preparing our will, we traditionally do not share our intentions or goals with our family and the beneficiaries that are named within the documents. How come? Why do we keep this a secret? Literature today would suggest that keeping any of these plans a secret could be detrimental in the end. Preparing the next generation and beneficiaries to receive wealth and manage it appropriately can create a legacy, one worth having. The keys to achieving this – communication and trust.

How important is it to you to make sure the next generation is prepared to manage your estate or the assets and businesses you will leave behind? Do you assume they will take the role on willingly? Interestingly, in a study done by Roy Williams & Vic Preisser, it was discovered that a breakdown in communication and trust resulted in unsuccessful transitions of wealth. Globally, 70% of wealth transitions fail! That statistic is alarming. Why do these transitions fail? The authors concluded 60% of failures are due to a breakdown of communication and trust, 25% due to unprepared heirs, and the remainder due to misuse and legal issues. Misuse can range from luxury expenditures, to drugs, to poor investments (unprepared trustees).

When it comes to estate planning, there are qualitative and quantitative decisions to make. Choosing how you deal with the qualitative factors will impact your estate outcome most significantly.

Have you ever heard the expression "being controlled by the grave?" Or better yet, "That's not what they promised me" or "they will figure it out, I won't be here to worry about it." All are classic examples of estates being poorly planned and communicated. It is best to be upfront and as transparent as possible about your plans and intentions while you are living.

In addition, the larger the estate the more preparation might be required to ensure your wishes are carried out with appropriate intention. The entire exercise is to prevent the assets of the estate from being expended on resolving contentious claims so that your fortune can enhance the lives it was left for. So, help us improve the wealth transition success rate and start talking now!

For more information about estate planning or a one-on-one consultation to see how we can help, please contact your Cumberland Client Portfolio Manager.

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