# Interest Gained™

Our best insights and updates | Winter 2019 Issue No.15

## NO "FOMO HERE"

"Are we surprised that people have a Fear Of Missing Out? People crave the attention and being a 'part of the inner circle'. "

CUMBERLAND
Private Wealth

# Contents





# 2020
## How should I invest in a late cycle, low yield world?

By Gary Perron, CFA
Vice Chairman*

Investing in a late cycle, high yield world is a challenge for most investors, and we continue to stress the importance of the overall asset allocation for your portfolio. The global economy is close to completing its 10th consecutive year of more than 3% growth, and bond yields are close to multi year lows. Investors have enjoyed impressive returns in almost all asset classes (excluding energy) over the past decade. In a late cycle, low yield environment, we believe investors should tilt their equity holdings toward quality and dividend investments. Investors worried about market downside should consider more of a balanced mandate between fixed income and equity with a specific focus on short duration bonds. We do have some significant headwinds in 2020 that could affect the overall investor sentiment. In particular, the US consumer which makes up 70% of US GDP is the key to future growth of the US economy. In this newsletter, we can't cover all the potential events in 2020, but will address one of the major questions the US consumer faces:

### *"What does the US election mean for my portfolio?"*

Interestingly one of our European research providers' 2020 forecast, is that the Democrats will win the US house, presidency and Senate. How would this affect US consumer and investor confidence? Most of the incremental Democratic support comes from the millennials who are focused on climate change, health care and social benefits. National elections tend not to affect global investors, but the US presidential vote is an exception to the rule. The US market makes up nearly 55% of the MSCI All Country World Index. The treasury bond yield is a benchmark for global financial asset valuation, and the US dollar is involved in 88% of currency transactions worldwide. So, investors both inside and outside the country will need to monitor the number of key US election issues, which are as follows.

* Cumberland Private Wealth Management Inc., Calgary

Corporate Taxes- Trump lowered Corporate taxes from 35% to 21% helping boost the S&P 500 earnings close to 10%. Democrats are proposing higher tax rates – Biden is proposing 28% which would lower S&P earnings by 3-4%. Elizabeth Warren is proposing higher rates which would lower earnings by 7%, and Bernie – who knows?

Trade Policy- The US-China trade conflict has been the primary driver of volatility over the past year. It is important for investors to diversify globally to reduce exposure to individual risks. We believe that companies that derive a high proportion of their revenues domestically are likely to be more stable choices in a more protectionist world.

Technology Regulation-The world's five largest companies are US technology firms – together they make up 16% of the S&P 500 market value and have contributed around 15% to the performance of the US market over the past five years. Investors should prepare for greater scrutiny of big tech. It seems the regulators are focused on this sector and both the Democrats and Republicans have it on the radar.

Environmental Legislation- The Trump administration has loosened environmental regulations while any Democrat president would almost certainly retighten them. Bigger policy changes such as the Green New Deal are unlikely to pass if Congress is divided. The carbon-based energy sector could come under pressure to curb carbon emissions. Elizabeth Warren has pledged to ban fracking by executive order.

Redistribution- Income tax rates for wealthy Americans would likely rise, with the federal minimum wage and Social Security payments increasing. Proposals for a higher minimum wage and Social Security payments, if enacted, would strengthen the theme to add to exposure to consumer investments.

These are some of the key 2020 US election topics which will affect markets, but the markets and economies face a long list of forecastable variables; global central banks are highly unlikely to remove the punch bowl (supporting a low rate environment) anytime soon. Not only will it take some time before global deflationary forces recede, monetary authorities in the G10 want to avoid the Japanification (deflationary trap of collapsed demand for over a decade) of their economies. As a result, they are already announcing that they will allow inflation to overshoot their 2% target for a period. This will ultimately raise the need for higher rates.

The US consumer remains in good shape thanks to healthy balance sheets and robust employment and wage growth prospects. Meanwhile, corporate profits and capital expenditures should benefit from a decline in global uncertainty and a pick-up in global economic activity.

Oil should have upside next year. Crude will benefit from both supply-side discipline and a recovery in oil demand on the back of the improving growth outlook. Therefore, Canadian energy stocks should have a position in portfolios. We are witnessing all-time low valuations in the energy sector with all the headwinds of climate change, ESG (Environmental, Social, and Governance) ratings, and domestic policy.

We have been finding better investment opportunities outside of Canada in most sectors except for the oligopolistic sectors (banks, telecom and pipelines). Canadian political uncertainty will certainly have an effect on foreign investment capital which will affect Canadian capital markets. Canadian minority governments have a history of not lasting more than 2 years, therefore we see a reasonable probability of an election in 2020. We continue to monitor but currently we are overweight global investment in our portfolios.

This is only a short list of many dynamic variables which will affect the 2020 investment markets. It's always the unforeseen or unpredictable variables that can surprise and have a significant effect on market

volatility. We must remain opportunistic on sector and security selection. The market usually provides very timely volatile opportunities.

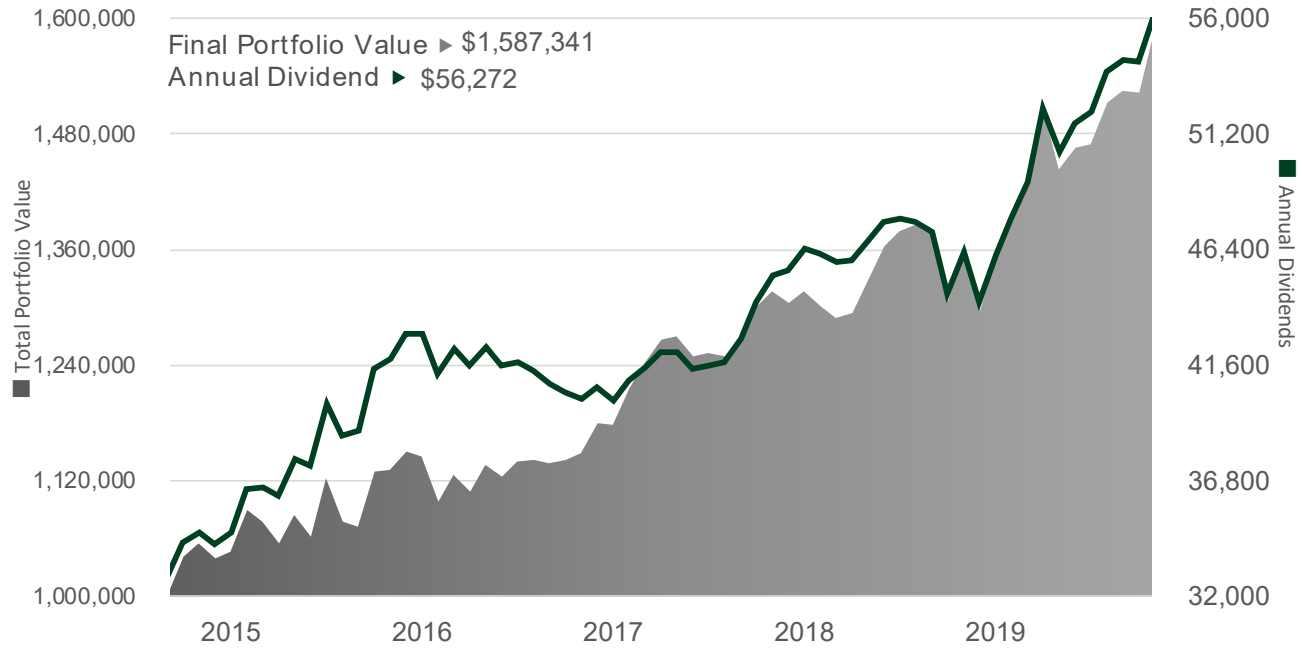
How does this effect our asset allocation and specifically our equity strategy? We have various investment processes in house which provide the opportunity to create a blended asset allocation. At this time in the economic cycle we would overweight the "Dividend Growth investment process". Our Kipling Global Enhanced Dividend Fund which now has five years performance history, focuses on global dividend growers. Below is the mountain chart for Kipling Global Enhanced Dividend Fund and the key benefits of the strategy;

**Growing dividend stream –** The initial dividend yield was $35,000 on initial investment of $1,000,000 and is now approximately $56,000 – the dividend growth has been 9.1% a year since inception, per chart below, resulting in a total portfolio value of $1,587,341.

**Portfolio of growing businesses** – 3 year revenue and earnings growth is expected to grow annually at 5.8% and 15.3% respectively. The portfolio's primary focus is free cash flow and return on equity. Free cash flow is crucial for consistent and continued dividend growth, share buybacks and lowering capital costs for business expansion. Return on equity is an indicator of the operations and growth of the company and a measure of a company's ability to generate income from the equity available to it.

**Reduced market risk with the enhanced portfolio structure** – The Global Enhanced Dividend Fund in the 3 month period ending December 2018 outperformed the benchmark** on a relative basis by 2.4% (-6.1% vs -8.5%). During our best return over three months (Feb. – Apr. 2019), the mandate outpaced the benchmark by 2.2% (+11.4% vs +9.2%).

## Kipling Global Enhanced Dividend Fund
## Dividend Income of a $1,000,000 Portfolio



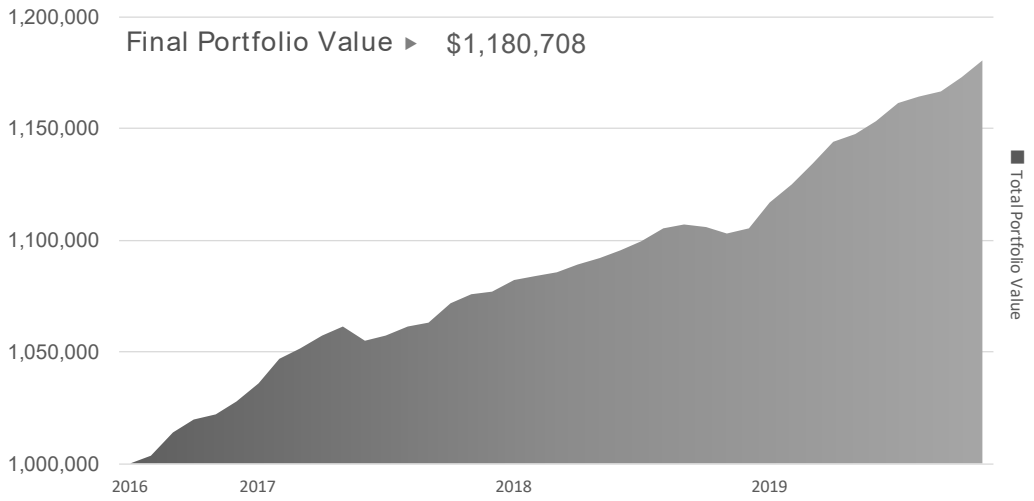

Past performance does not guarantee future results.
Kipling Global Enhanced Dividend Fund is used only to illustrate the effects of the compound growth rate and is not intended to reflect future values of Kipling Global Enhanced Dividend Fund or returns on investment in the investment fund.
**The benchmark is comprised of 40% XIU, 30% SPY and 30% EFA

## *What is our fixed income strategy?*

In this newsletter Diane Pang outlines the benefits and strategy of our Kipling Strategic Income Fund, which has three years of performance. We have used this fund to help balance portfolios dependent on their risk profiles. Below is the mountain chart.

In summary, asset allocation is critical to long term performance of financial assets. We believe a balanced approach is warranted at this stage of the economic cycle. The Global Dividend growth and Investment grade bond investment processes we use should be the dominant styles within your portfolio structure.

**Kipling Strategic Income Fund**
**Value of a $1,000,000 Investment since inception (August 5, 2016)**




Past performance does not guarantee future results.
Kipling Strategic Income Fund is used only to illustrate the effects of the compound growth rate and is not intended to reflect future values of Kipling Strategic Income Fund or returns on investment in the investment fund.

*We would like to take this opportunity to wish you and all our clients a very peaceful, healthy and prosperous New Year.*

*Perron Team,*
*Cumberland Private Wealth Management Inc.*

# An Ode to the Deflationary 10's with the Hope of Roaring 20's

By: James Nickerson, CFA
Portfolio Manager*

As I was watching Jerome Powell's speech on October 30, 2019, as the FED had made the decision to lower interest rates for the third time in 2019, I was amused to hear phrases such as "inflation continues to run below…" or "inflation pressures remain muted", or "inflation will be realized over time". Looking back through the transcript of the speech, the term "inflation" was mentioned 53 times with "prices" stated an additional 6 times. Considering that the press conference was roughly 30 minutes long, the topic of inflation and perceived lack thereof, came up every 30 seconds. As I was watching this press conference play out I thought that, although unintentional, this speech was one of the best summaries one could have had for the decade.

This decade, especially the back half, will most likely be remembered for its fun Jim Cramer acronyms such as FAANG, FAMG or WATCH, it should be remembered as a decade with most of the financial news/returns revolving around the 3 D's-Demographics, Debt and Deflation due to technological advances. While headline returns look very impressive for the decade, and the S&P 500 had an annual return of 12.38%** at the time of this writing, a look more closely at certain sectors shows a different story. Looking at some of the sectors that were a play on two of the D's shows very impressive returns, the US Tech sector had a 15.46% annual return with the US Healthcare sector putting up a 13.58% annual return. However by looking at the Energy sector, which typically is a benefactor of high inflationary periods shows a very different story: the US Energy sector had an annual return of 2.99%** significantly underperforming the broader index. In addition the most widely accepted inflation hedge in the financial community, Gold, also performed poorly with the GLD ETF having an annual return of 2.56%**.

Arguably, the actions of central banks have become some of the most important factors when it comes to making an investment decision. The mantra originally coined by Martin Zweig, "Don't fight the FED" became one of the most common sayings for the 2019 calendar year in the financial community. For those that don't know, the original primary responsibilities of central banks revolved around keeping prices stable (a normal level of inflation) and having an economy run at full employment.

* Cumberland Private Wealth Management Inc., Calgary
** Returns in USD from Jan 1, 2010-Nov 29, 2019

It is the former of those that seems to be at the forefront of every discussion around central banks. In academics, the magic number for inflation is a 2% per year level; this is drilled into everyone that enters Macro Economy 101 class. It is interesting to look at developed country inflation rates, chart below, showing that in developed countries the only country with an inflation rate of 2% is the Netherlands. Reasonably one could look at something like this and come to one of two conclusions. The first is that central bankers are bad at their jobs with the second being that perhaps we measure inflation incorrectly. Since the average central banker probably has an IQ approximately 30 points higher than the writer of this article, perhaps the most logical answer is that what we measure in our inflation calculations is now incorrect due to some of the changes that have happened this century.

| Country | Inflation Rate |
|---|---|
| Switzerland | -0.30% |
| Germany | 1.10% |
| Netherlands | 2.70% |
| Sweden | 1.50% |
| Denmark | 0.60% |
| Finland | 0.90% |
| Austria | 1.20% |
| Japan | 0.20% |
| France | 0.70% |
| Belgium | 0.48% |
| Ireland | 0.70% |
| Spain | 0.10% |
| Portugal | 0.04% |
| Italy | 0.30% |
| United Kingdom | 1.70% |
| Australia | 1.70% |
| New Zealand | 1.50% |
| Canada | 1.90% |
| United States | 1.70% |

As at October, 2019

Technology advances since the turn of the century have been rampant and have primarily allowed consumers to purchase goods at lower prices as well as have businesses to produce goods in a more cost effective manner. Some of the growth that has come from these advances is astonishing. Everyone is aware of the Amazon story, but think how these things have not only changed the way we consume things but also the pure volume we consume.

A staggering number is the growth in the amount of pictures taken on an annual basis. This growth has been globally enabled with the invention of the smart/camera phone but fueled by social media websites such a Facebook, Instagram, Twitter and Snapchat. All creations of the 21st century.

The 2018 year saw an estimated 2.5 trillion photos taken, which is more than had cumulatively been taken in the first 120 years of the camera. In 2010, the number of pictures taken was estimated to be 300 billion and at the turn of the century the number was 85 billion. That works out to an annual growth rate in photos taken of ~30% since 2010 and ~20% since the year 2000. The majority of the growth (reasonably close to 100%) has come with zero incremental cost. Think back to the days of Polaroids and Kodak cameras. When one took a picture there were all sorts of costs associated with it. You had to buy a camera (which is now your phone), you had to pay for film (how many of you even know where you can buy film now) and then you had to pay to get the film developed. While not overly expensive, the cost was higher than zero to the consumer and there was a supply chain with the whole process. Even if the cost of taking a picture was only 25 cents with 2.5 trillion being taken annually you end up with a pretty big number. The way GDP calculations work the 20% annualized growth seen since the turn of the century has detracted from calculated GDP and in turn is a deflationary force.

Google's parent company, Alphabet, provides more examples of some of the deflationary forces we've seen explode over the last decade, displacing traditional businesses and offering a service for free. Nine of their services have over 1 billion users and a tenth has 800 million users. At the base level, their services are all provided to the consumer for free

and have created an influx of further deflationary pressures. There are approximately 3.5 billion searches per day on Google's search engine and more content has been uploaded in the last 60 days on YouTube than the entire TV industry has created in the last 60 years. All of the searches and the majority of the YouTube content are provided at no cost. The same with the majority of the YouTube content. An MIT study done last year estimated that the average user would require compensation of $17,530 to not use a search engine for a year. Think about what that number would be for a corporation.

On the flip side, there have been some inflationary pressures that have happened over the last 10 years. One is the cost of renting a home. Home ownership in the US peaked in the fourth quarter of 2004 with 69.2% of American households owning a house, today that number is 64.8%. This has led to just under 10 million more renting households today than there were 15 years ago. The median rent for vacant units has gone from $600/month in 2004 to $1000/month in 2019, an increase of 66%. Compare that to home ownership costs where, although housing prices have gone up, a lot of this cost has been offset by lower mortgage rates. The average monthly mortgage payment on a 30-year mortgage, assuming a 20% down payment, has gone from $614.50 to $816.54 an increase of 32%. Without getting into a conversation about the wealth gap, this portrays that over the last 15 years 10 million households have experienced a 34% higher rate of inflation than one would have thought. This is a cost pressure that can no longer be cured by lower rates and could possibly get worse because of low interest rates.

With overall interest rates at all time lows credit card rates tell a different story. The average credit card interest rate hit 17% this year, up from 14.74% in 2006. This is during the same time when mortgage rates have been cut in half and the Federal Reserve rate has gone from 5.25% to 1.75%. Things like bank account fees, cable/internet bills, and cell phone bills all tell a similar story. With $8.4 trillion in credit card debt and the majority of the population having the services listed above this does affect a consumers ability to spend. The consumer is roughly 70% of the US economy and it's these inflationary pressures that present a different idea than a constant level of "muted inflation".

At present time someone telling you they know exactly what is in store for the next decade in the financial markets should be met with a ton of skepticism. If we look back at previous decades, there does seem to be a pattern of assuming what

**The top 10 stocks by market cap seldom make it to the end of the next decade**

| 1980 | 1990 | 2000 | 2010 | 2019 - June |
|---|---|---|---|---|
| IBM | NTT | Microsoft | Exxon Mobil | ***Microsoft (US$1.035trn)*** |
| AT&T | Bank of Tokyo-Mitsubishi* | General Electric | PetroChina | ***Amazon (US$936bn)*** |
| Exxon | Industrial Bank of Japan | NTT DoCoMo | Apple Inc. | ***Apple (US$913bn)*** |
| Standard Oil | Sumitomo Mitsui Banking* | Cisco Systems | BHP Billiton | ***Google (US$766bn)*** |
| Schlumberger | Toyota Motor | Wal-Mart | Microsoft | ***Facebook (US$538bn)*** |
| Royal Dutch | Fuji Bank | Intel | ICBC | ***Alibaba (US$421bn)*** |
| Mobil | Dai-Ichi Kangyo Bank | NTT | Petrobras | ***Tencent (US$412bn)*** |
| Atlantic Richfield | IBM | Exxon Mobil | China Construction Bank | Johnson & Johnson (US$371bn) |
| General Electric | UFJ Bank* | Lucent Technologies | Royal Dutch Shell | JP Morgan Chase (US$360bn) |
| Eastman Kodak | Exxon | Deutsche Telekom | Nestlé | Exxon Mobil (US$320bn) |

* Merged entities

| Prominent beliefs: peak oil; US businesses are better run | Prominent beliefs: Japan is going to take over the world | Prominent beliefs: this time is different; US is big TMT boom winner | Prominent beliefs: peak oil, China is taking over the world | US is the cleanest dirty shirt; tech will deliver growth thanks to monopoly |
|---|---|---|---|---|
| ↓ | ↓ | ↓ | ↓ | ↓ |
| Underweight the US and energy | Underweight Japan and banks | Underweight the US and TMT | Underweight China and commodities | ***Fifth time lucky?*** |

has happened over the past few years will continue to happen for eternity. This recency bias is best shown above with each decade producing extremely different results from its preceding decade and from what was expected to happen.

Looking back, the last 10 years could be viewed as having the biggest productivity boom the world has ever seen. One of the assumptions that has come with this is that the productivity advancements will continue in perpetuity and in turn inflation will be benign forever. While this could very well continue forever due to the quality and financial positioning of some of the deflationary culprits, history would suggest that perhaps the pendulum is ripe to swing back to the other side. The argument of inflation and if it's here or where it's heading is a very important discussion that one should have when it comes to one's portfolio. In a world where negative interest rates have grasped hold on headlines with inflation hedges such as commodities as secular shorts it is quite apparent that the "no inflation forever", trade is a crowded one. As central banks have tried to increase inflation, there could be a thought process to be careful what you wish for. Rapid inflation has historically caused more headaches than the deflation boogey man

History may not repeat but it does tend to rhyme. As we enter a new decade, history would suggest that some form of regime change is coming. Whether that regime changes happens in the next 5 years or next 12 months is tough to say: I don't have 20/20 vision.

Sources:

https://www.fanniemae.com/singlefamily/required-net-yields-to-1985
https://apnews.com/1c4bbc2472244caba337cc1cbc9b674d
https://www.census.gov/housing/hvs/files/currenthvspress.pdf
https://mitsloan.mit.edu/ideas-made-to-matter/how-much-are-search-engines-worth-to-you

# No FOMO Here

By Diane Pang, CPA, CA, CFA
Portfolio Manager*, Kipling
Strategic Income Fund

## FOMO = Fear Of Missing Out

### Highlights of the Kipling Strategic Income Fund ("KSIF" or "the Fund"):

- **Returned 5.13% CAGR** since inception – our target distribution is 3.5%, above the benchmark return of 2.2%
- **Reduced volatility** with a standard deviation of 1.2 since inception vs. benchmark standard deviation of 2.5
- **92% the time the Fund had up months (positive return)** vs the benchmark only had up months 64% of the time. The Fund's benchmark is comprised of 50% of the iShares Canadian Bond Fund ETF and 50% of the iShares Canadian 1-5 Year Laddered Corporate Bond Index ETF
- **Another special distribution at the end of 2019,** which will be our 4th consecutive annual special distribution since the inception of the Fund
- **75% of the Fund is in Investment Grade** – consistent with historical allocation to investment grade

In today's society, technology keeps people constantly connected and expecting instant responses/validation. People have on average 7 social media applications on their phones. Americans on average check their phones 52 times a day while millennials specifically check their phones 150 times a day. Following people (friends, family, influencers, famous people, or sometimes even just random strangers) through the digital world has become the norm. Not only that, but individual users can obtain instant feedback easily via ratings, the number of likes or just commentary feedback within minutes of posting information. As a result, more and more individuals have been driven to a state of mental or emotion strain or anxiety. Individuals can see what their friends are doing via social media ( and see what they are missing out on), and, within minutes of posting a Tweet or a picture on Instagram, individuals can see who have liked their post or commented on them (or even worse, paid no attention to them at all). Even taking a car ride now through the car sharing applications, individuals are rated instantly after their ride.

* Cumberland Investment Counsel Inc., Toronto

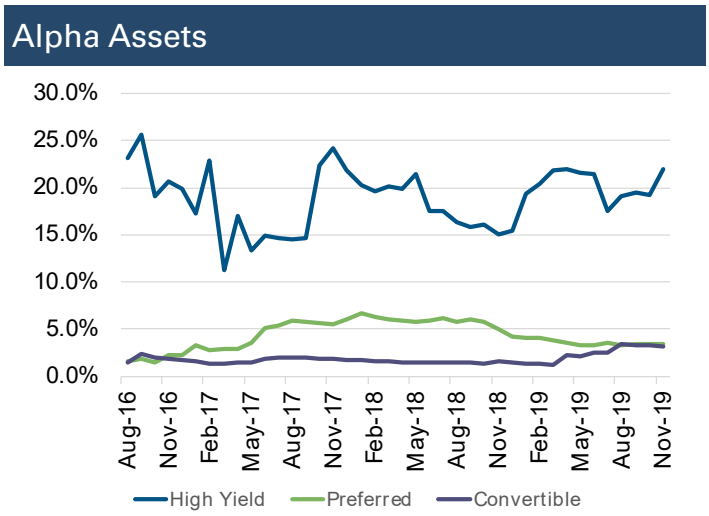
*Are we surprised that people have FOMO? No. People crave the attention and being a "part of the inner circle."*

Managing a fund is no different – based on decisions we make for the Fund, we can easily track how we are doing seconds after a trade. Bond markets are a bit different than equity markets though, as Canadian bonds are traded over the counter so there is not a lot of transparency in the trading volumes. Investors can only get a sense of how well (or poorly) the corporate bonds are trading from the compression (or widening) of spread quotes from individual dealers or from commentary from individual dealers' trading desks, both of which investors have to piece together to understand the full environment. Every new bond deal launched is marketed as a "hot" deal and FOMO is always instilled into the investor. Year to date, there has been $98 billion of Canadian corporate bond issuance alone, with every deal pretty much oversubscribed, but not all perform well. There are just under 1,000 different corporate bonds outstanding in the Canadian investment grade corporate bond universe.

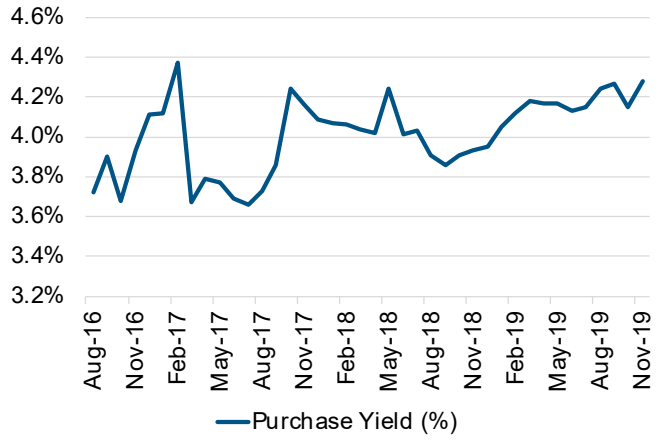
Clearly, the Fund cannot differentiate itself from participating in every deal – so we don't. We have "stuck to our knitting" since the beginning and not have paid much attention to what "everyone else" is doing, which makes our Fund unique in some respects. Given our goal and strategy is different from most, we are focused on us. Our goal is to target a 3.5% distribution, to preserve capital by being conservative (keep majority investment grade rating), and maximize return without taking on outsized risks.

Since the inception of the Fund, overnight interest rates increased from 50bps to its current 175bps; however, during that same period, 5-year Government of Canada Bonds have moved from 57bps to a high of 248bps, retreating to 149bps at the end of November. Canadian investment grade corporate bonds are yielding about 90bps lower than the what they were yielding at inception of the Fund (average is 2.71% at the end of November).

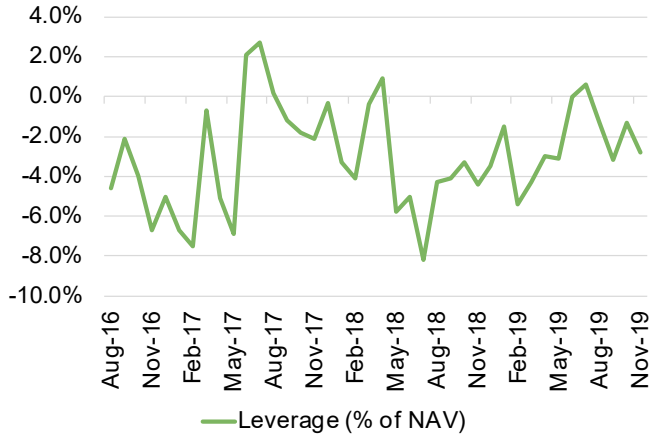
So the obvious questions are: Have we gone further down the credit quality spectrum to make up yield for our investors? Are we taking on more risk? NO. The charts below highlight since inception of the Fund to the end of November: the levels of our alpha assets (high yield bonds, preferred share holdings and convertible bonds), the purchase yield, leverage, and duration. While we can hold up to 40% in High Yield bonds, we are only at around 20% today, still consistent with historical behaviour of the Fund. In addition, our holdings in preferred shares and convertible bonds are also in line with historical positioning and actually on the lower end of the range relative to how we have invested in before. Purchase yield is still within historical levels as leverage is even more modest than in our history.



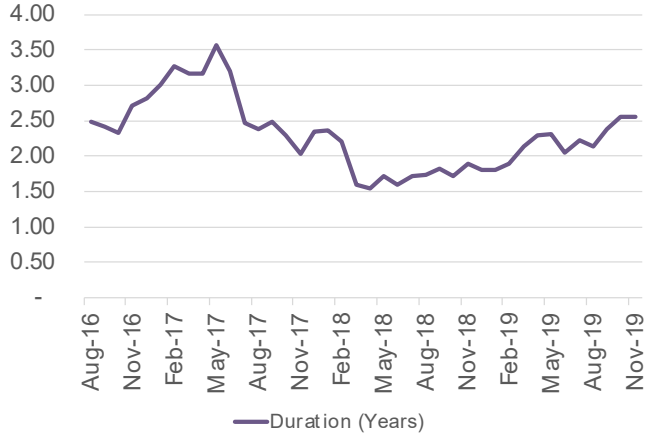
## Purchase Yield (%)




## Leverage (% of NAV)




## Duration (Years)

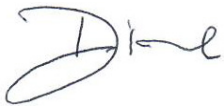



## *How we are positioned for 2020*

- **Our strategy has not changed** – we are still looking to add value and are patient in finding opportunities.
- **We continue to be very short duration** in corporate bonds given there is not a lot of incremental value to be further out the curve. The yield curve is inverted in parts and relatively flat otherwise and 3 month Tbills yield more than 30 year Government of Canada bonds. (at the end of November)
- **We continue to be selective on names** and continue to look for opportunities that compensate the Fund for the risk taken. We are patient with opportunities and are not stretching for yield, given only 22% of the Fund is currently in high yield and we have a maximum capacity of 40%.

We saw the Fund grow by more than 25% in net new inflows this year and we are grateful to have your support. We look forward to 2020 as we head to our fourth anniversary for the Fund and we are very comfortable in our current positioning to take advantage of opportunities this market will bring us.

All the best for 2020,



Sources:
https://www.omnicoreagency.com/social-media-statistics/
https://blog.rescuetime.com/screen-time-stats-2018/
https://www.inc.com/john-brandon/science-says-this-is-the-reason-millennials-check-their-phones-150-times-per-day.html

# Canadian Small Cap

By Chris Bolton, CFA
Portfolio Manager*


*To state the obvious, 2019 has been a challenging year for Canadian small cap investors, at least when compared to their larger cap brethren. While it is difficult to pinpoint the timing, we believe there is reason for Canadian small cap investors to be more optimistic in 2020.*

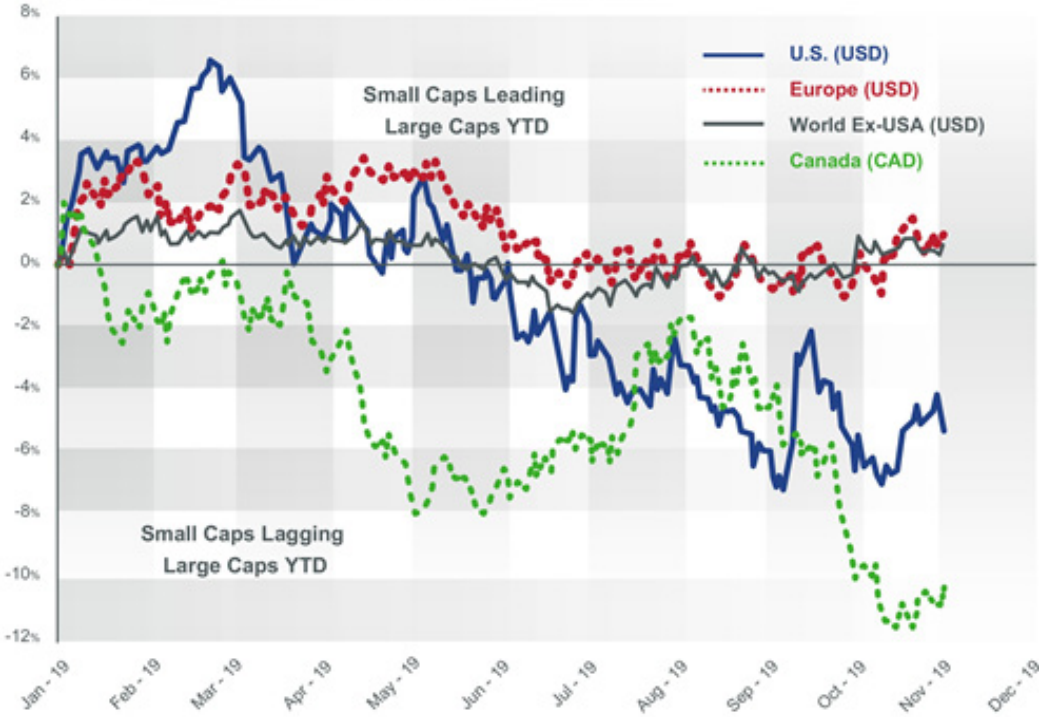
## Reversion to the Mean

It is interesting to note that the underperformance of small cap stocks has been more of a North American phenomenon. As the following chart shows, the gap in performance between large caps and small caps in North America has been quite pronounced in 2019. The Canadian small cap benchmark has underperformed the large cap benchmark by more than 10% year-to-date. Likewise, in the United States, the small cap benchmark has underperformed the large cap index by approximately 6%.

Globally, the story is different. European small cap investors have done better than their large cap peers for most of 2019, particularly in the first half of the year. North America is clearly an outlier compared to the rest of the world and taken one step further, Canada is an outlier within North America.

* Cumberland Private Wealth Management Inc., Calgary

## Small Caps vs. Large Caps - 2019 YTD Performance




Based on MSCI indices unless otherwise indicated
Source: Scotiabank GBM Portfolio Strategy, Bloomberg

The underperformance of the S&P/TSX Small Cap Index vs. the S&P/TSX Composite Index has been largely driven by three sectors. Firstly, we think it would surprise many investors to learn that large cap energy stocks have actually generated a positive return of 5% in 2019 (through the end of October). Meanwhile, small cap energy has struggled, posting declines of 35% which equates to a performance gap of 40%. One reason behind this is that the large cap energy benchmark contains integrated names such as Suncor and Imperial Oil that tend to be more stable. We sometimes refer to them as Industrials because of their numerous and diversified product lines. The large cap benchmark also contains midstream and pipeline companies such as Enbridge, Pembina Pipeline and TC Energy (formerly known as TransCanada).

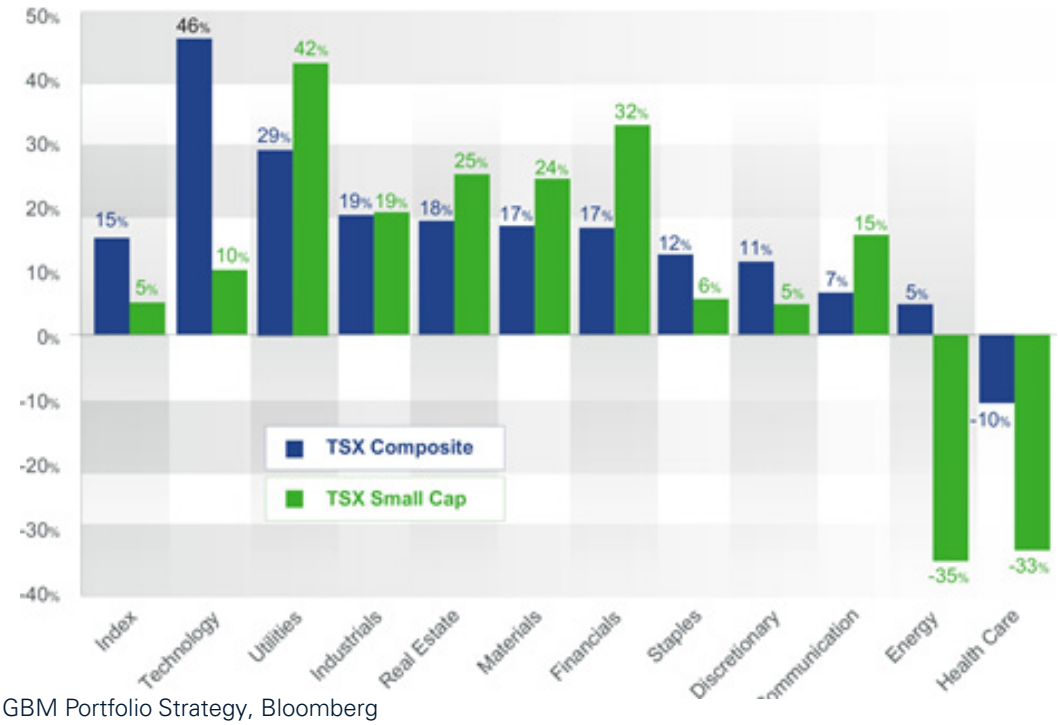
On the other hand, the small cap benchmark has much more exposure to junior producers and oilfield service companies that have faced egress headwinds and general investor apathy.

Canadian healthcare in both large and small caps generally lacks the breadth and depth that an investor would find in the United States. In Canada, Bausch Health is the largest Healthcare company with a market capitalization of approximately $9.2 billion. The remainder of both large and small cap benchmark is in marijuana producers and seniors housing. While neither large cap nor small caps in the healthcare sector have been performing well, the disparity in their returns is still apparent. The stock price of many marijuana producers has struggled in 2019 as the revenue, cash flow and growth some investors were expecting has not materialized. We have been cautious about allocating the capital of our clients to the marijuana industry given the uncertainty and valuations. Within the technology sector, large capitalization stocks (+46%) have outperformed smaller cap stocks (+10%). Worth noting, Shopify has more than doubled in price during the first ten months of the year.

While small caps in the above three sectors have lagged, small caps in Utilities, Real Estate, Materials, Financials and Communication Services sectors have all outperformed their large cap competitors. As in most years, sector allocation has made a big difference in returns so far in 2019.

If you subscribe to the "reversion to the mean" theory when it comes to returns, there is a reason for Canadian small cap investors to be optimistic. While small cap investors in the rest of the world have done better than large cap investors, Canadian investors have underperformed by over 1,000 basis points. It seems odd to us that Canada is so much of an outlier and our analysis indicates that the underperformance is largely limited to the three sectors discussed above (Energy, Health Care and Technology). While we cannot pinpoint when it will happen, reversion to the mean would suggest there is a substantial catch up trade coming at some point. Despite the negative sentiment around Canada in general and small caps in particular, we continue to have our portfolio focused on high quality, cash generative businesses that we believe will reward our investors in due course.

## TSX Composite vs TSX Small Cap: YTD (%) Performance - October 31, 2019




Source: Scotiabank GBM Portfolio Strategy, Bloomberg

## Valuations

Given the underperformance of small cap stocks in recent years, the valuations of small cap equities are generally more attractive than the valuations of larger capitalization stocks. As shown in the following table, members of the S&P/TSX Small Cap Index are forecast to grow their earnings much faster than larger cap stocks over the next few years. Despite the faster growth, small cap stocks are trading at much more attractive Price to Book Value, Enterprise Value (EV) to Sales, EV to EBITDA (Earnings Before Interest Taxes Depreciation and Amortization) and Price to Cash Flow ratios than larger cap peers. Once again it is hard to predict the timing with precision, but it is fair to say that this gap should close over time.

| | S&P/TSX Composite | S&P/TSX Small Cap Index |
|---|---|---|
| EPS Growth 2019E/2018 | 3% | 29% |
| EPS Growth 2020E/2019E | 9% | 54% |
| 2020E P/Book Value | 1.70x | 1.01x |
| 2019E P/Book Value | 1.68x | 0.96x |
| 2019E EV/EBITDA | 11.1x | 7.6x |
| 2020E EV/EBITDA | 10.7x | 6.7x |
| 2019E EV/Sales | 2.79x | 1.39x |
| 2020E EV/Sales | 2.74x | 1.34x |
| 2019E P/Cash Flow | 9.4x | 5.2x |
| 2020E P/Cash Flow | 8.6x | 4.7x |

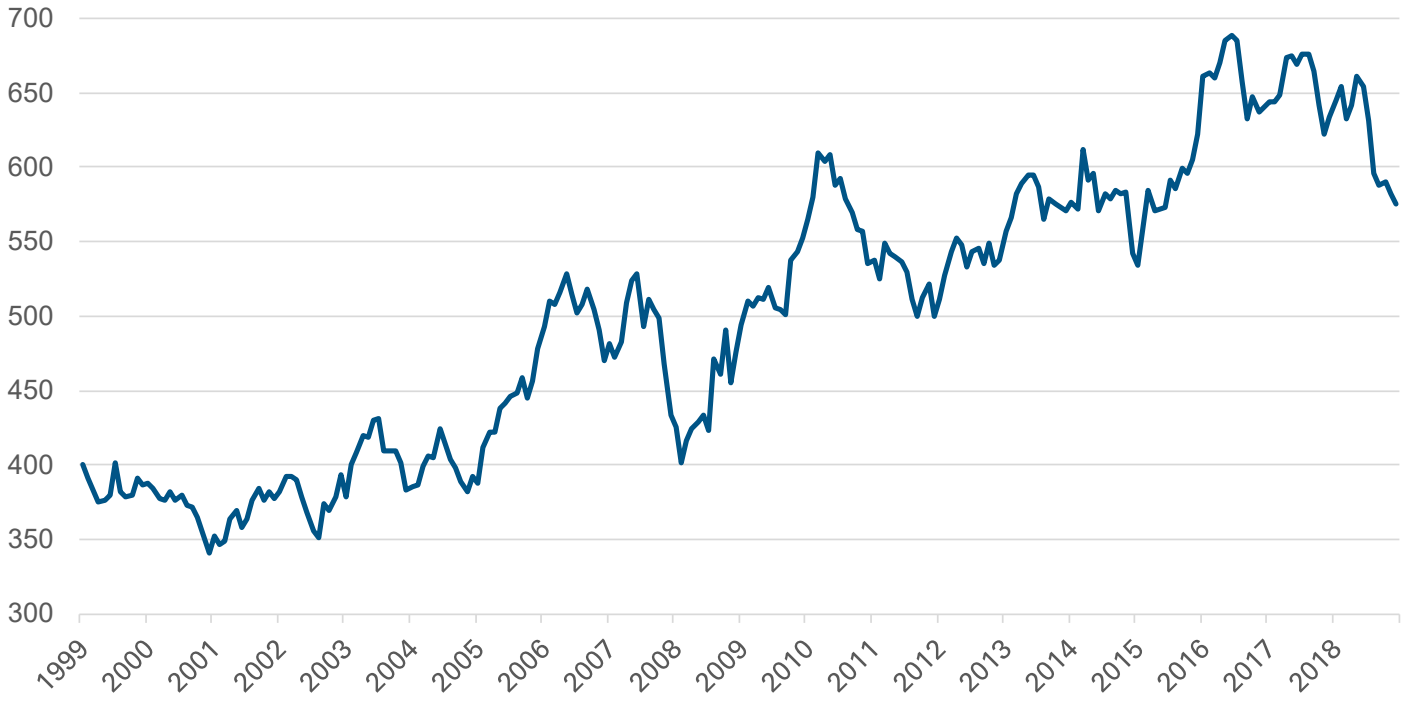
Source: Bloomberg

## Commodity Prices

One of the factors that is likely weighing on small cap indices is commodity prices. Equities in the Energy and Materials sectors comprise approximately 41% of the S&P/TSX Small Cap Index. These two sectors only make up about 27% of the S&P/TSX Composite Index. Furthermore, as mentioned above, a number of the equities in the large cap energy index are pipeline companies and integrated oil companies. These equities will have different risk and return profiles than the oil and gas producing companies that comprise much of the energy stocks in the small cap index.

Commodity prices have generally been under pressure. The Commodity Research Bureau Raw Industrial Index comprises a wide variety of commodity prices including metals, energy, forestry and agricultural commodities. The index reached a peak in the spring of 2017, but has declined over 16% since then. While nothing is certain, if global growth accelerates (due to a U.S. China trade deal or otherwise) this should be positive for commodity prices. A rise in commodity prices should have a disproportionately positive impact on Canadian small cap indices relative to larger cap indices (all things equal).

## Commodity Research Bureau Raw Industrials Index




In summary, while the timing remains unclear, we continue to recommend that our clients focus on growth maintain exposure to Canadian small caps in their portfolios overall.


# CIC Managed Solutions and the Kipling Funds

By Jason Isaac, CFA, CAIA
Portfolio Manager*

Chris Dry, CIM
Associate Portfolio Manager*

It is widely understood that in pretty much every aspect of life, risk and reward go hand-in-hand. In fact, the entire discipline of portfolio management is based upon the idea that a desire for higher returns means that an investor must be prepared to assume a higher degree of risk (i.e. portfolio volatility). Conversely, a lower tolerance to risk means acceptance of lower expected returns. Pretty simple stuff, right? Yes, it is. However, there is one sneaky part about this universally recognized gem that is often overlooked. That is, in the world of investing one does not get paid to take "unnecessary" risks. Investment professionals know this, and they live it. Moreover, everything institutional investors and pension managers do is designed to minimize and/or eliminate unnecessary risks.

Why do professional money managers do this? Well, in finance lingo this concept is known as the Dominance Principle, which specifically refers to the superiority of one investment over another. While it is somewhat intuitive, it's always a good idea to review what it means and how it applies to what your professional money manager is doing for you.

> The Dominance Principle states: Among investments with the same rate of return, the one with the least risk is most desirable.

Sounds like common sense, right? It seems only logical that an investor would find the most practical investment decision to be the one that balances the expectations of gains with the lowest anticipated losses. Unfortunately, without a constant eye on the dominance principle most investors fail miserably to adhere to this fundamental investing tenet.

* Cumberland Investment Counsel Inc., Calgary

No doubt you have heard innumerable times that asset allocation is THE most important decision an investor will ever make. Well, it is true. The actual individual selection of securities pales in comparison to the degree of importance as to how the overall allocation of funds are split across the asset classes. Namely, the total proportion of the portfolio allotted to cash, bonds, stocks, and alternatives and real assets in the portfolio have a significantly larger effect on the portfolio's performance than any specific investment in a single bank, energy or tech stock. Asset allocation ensures adherence to the dominance principle, provides unequaled risk management through diversification, and always keeps the purpose of the portfolio at the forefront.

While it is true that there is no simple one-size fits all formula for the correct asset allocation, it is timely to run through four of the most basic themes that all institutional investors, such as endowments, pensions, foundations and mutual funds utilize to ensure their investment program stays on track while paying homage to some of the greatest investors of all time:

1. **Have a Plan for the Funds:** This is typically referred to as an Investment Policy Statement. This can be very simple or extremely complex but ultimately it provides the overarching goals, objectives, constraints, parameters and strategies that will be employed in the management of the portfolio. Besides explicitly noting return expectations and risk tolerances, other issues that affect the management of the portfolio can be: time horizon, taxes, estate planning, liquidity & income needs. "An idiot with a plan can beat a genius without a plan" – Warren Buffett
2. **Embrace the Power of Compounding:** Whimsically compounding can be thought of as "earning money on money already earned." It means the reinvestment of your returns on your initial savings so you can earn interest on the new total – the original amount plus the interest. The longer the time frame, the more significant the impact. "Compound interest is the eighth wonder of the world. He who understands it, earns it … he who doesn't …. pays it." – Albert Einstein
3. **Volatility is Normal:** Volatility in the equity markets tends to average around 15% but it does move around a lot from one period to the next. Although most of the time it generally falls within a range of 10% to 20%, there have been periods when volatility was unusually high and periods when it was unusually low, and more often than not excessive periods in one direction are followed by periods at the other extreme. "The fundamental law of investing is the uncertainty of the future" – Peter Bernstein
4. **Diversification Works:** Diversification reduces volatility more efficiently than most people understand. Due to a statistical concept known as covariance, the volatility of a diversified portfolio is less than the average of the volatilities of its component parts. "Successful investment is about managing risk, not avoiding it" – Benjamin Graham

## Cumberland Investment Counsel (CIC) Managed Solution Program

As 2020 approaches, we'd like to take a few minutes to review with you our CIC Managed Solutions Program. The portfolios have been expressly designed to adhere to the same four points above with the key benefits as follows:

- Diversified, low-cost portfolio of pooled funds, mutual funds and top-tier exchange-traded funds (ETFs)
- Actively managed asset allocation across the 4 asset classes: Cash, Fixed Income, Equities & Alternatives
- 4 individual strategies that maximize returns for a given portfolio risk tolerance
- Geographic and sector diversification beyond our domestic market

**Income with Growth** - The objective of this tactical investment strategy is to achieve a mix of higher current income with modest exposure to long-term growth for diversification. This solution will primarily invest in a blend of Fixed Income and bond pooled funds, along with investments in Equities and Cash instruments either directly or indirectly, using private pools, third party mutual funds or exchange-traded funds (ETFs).

Risk Profile: Low to Medium

**Balanced** - The objective of this tactical investment strategy is to achieve a balance of income and long-term capital growth at all times by combining investment in Equities, Fixed Income and Cash instruments, either directly or indirectly, through the use of private pools, third party mutual funds and or exchange traded funds (ETFs).

Risk Profile: Medium

**Growth** - The objective of this tactical investment strategy is to provide significant exposure to long-term capital growth with a slight allocation towards fixed income assets for diversification. This is achieved by investing primarily in Equities, Fixed Income and Cash instruments either directly or indirectly, using private pools, third party mutual funds or exchange-traded funds (ETFs).

Risk Profile: Medium to High

**Maximum Growth** - The objective of this tactical investment strategy is to always provide significant exposure to long-term capital growth with little to no allocation towards fixed income assets. This is achieved by investing primarily in Equities, and Cash instruments either directly or indirectly, though the use of private pools, third party mutual funds or exchange-traded funds (ETFs).

Risk Profile: High

## Review of 2019 CIC Managed Solutions;

As of November 30, 2019 the yearly performance of the CIC Managed Solutions mandates has been strong. Our mandates favor active management and global exposure. The Kipling Funds provide the core coverage in these areas for the program. Over the year, the Kipling family of funds were our best performing assets in 2019. Below is a brief description of each fund and their respective roles and responsibilities within the Managed Solutions Program.

# Kipling Funds

## STRATEGIC INCOME FUND (KSIF)

A low duration focused strategy that utilizes both long and short securities while maintaining exposure to a broad basket of fixed income securities. Its primary purpose is to provide stable, steady income while reducing capital risk from both an interest rate and credit quality perspective. Within the Managed Solutions Program, the KSIF is used as the core fixed income component for the private client portfolios with a target total maturity of 5 years (or less).

Priority of Goals:
1 – Reduce Risk
2 – Enhance Return
3 – Broaden Diversification
Risk Rating: Low

## GLOBAL ENHANCED DIVIDEND FUND (KGED)

A low volatility equity strategy that utilizes both long and short security positions while maintaining ~100% exposure to global equities. The Managed Solutions Program uses this as the core component of the equity allocation focusing on dividend growth and reduced volatility. Shorts will be primarily paired against the long positions to mitigate risk within the portfolio.

Priority of 130/30* Goals:
1 – Reduce Risk
2 – Enhance Return
3 – Broaden Diversification
Risk Rating: Low to Medium

## GLOBAL ENHANCED GROWTH FUND (KGEG)

This strategy utilizes both long and short security positions while maintaining ~ 100% global equities. The Managed Solutions Program utilizes the KGEG to provide long term capital growth by focusing on superior global companies as these companies enjoy the opportunity to reinvest in multi-decade capital projects at higher rates of returns. It is used as the core growth vehicle within the equity allocation through global companies that have demonstrated a successful ability to reinvest their cash flow. Shorts are primarily used as sources of funds for better capital allocations.

Priority of 130/30* Goals:
1 – Enhanced Return
2 – Broaden Diversification
3 – Reduce Risk
Risk Rating: Low to Medium

## CANADIAN ENHANCED DIVIDEND FUND (KCDF)

A low volatility focused strategy that utilizes both long and short security positions while maintaining ~100% exposure to Canadian equities. The purpose within the Managed Solutions Program is to provide direct exposure to large cap Canadian equities and is intended to provide investors a growing Canadian dividend stream while minimizing the volatility of the fund. Shorts are often paired against the long positions to reduce risk.

Priority of 130/30* Goals:
1 – Reduce Risk
2 – Enhance Return
3 – Broaden Diversification
Risk Rating: Low to Medium

## Exchange Traded Funds (ETFs)

As mentioned, our Kipling Enhanced Funds make up the lion's share of investments in the CIC Managed Solutions Program. To achieve comprehensive and proper global asset allocation, ETFs have been utilized to garner exposure in areas deemed critical to diversification of the solutions program. Specifically, where we do not hold "in-house" expertise, the CIC Managed Solutions will employ ETF or 3rd party fund managers to provide the necessary exposures. For example, we are overweight in Health Care and Global Real Estate as equity sector overlays. In those cases, ETFs have been used to gain exposure to those sectors.

Throughout 2018 and 2019 the CIC Managed Solutions were overweight Emerging Markets (EM), although it detracted slightly from our returns, we remain bullish on EM going forward. We sold our position in KraneShares' MSCI One Belt One Road ETF as it wasn't performing as well as we had hoped. Environmental and social risks will play a part in determining our EM exposure in 2020 as demand for Environmental, Social, & Governance (ESG) investing grows globally. We expect that EM will outperform developed markets in the coming years, however, volatility within EM is expected to remain high.

The following are ETFs currently utilized in the models:

### FIXED INCOME

ISHARES 0-5 YEAR HIGH YIELD CORPORATE BOND ETF
The iShares 0-5 Year High Yield Corporate Bond ETF seeks to track the investment results of an index composed of U.S. dollar-denominated, high yield corporate bonds with remaining maturities of less than five years.

- Exposure to short-term U.S. high yield corporate bonds

ISHARES J.P. MORGAN USD EMERGING MARKET BOND ETF
The iShares J.P. Morgan USD Emerging Markets Bond ETF seeks to track the investment results of an index composed of U.S. dollar-denominated, emerging market bonds.

- Exposure to U.S. dollar-denominated government bonds issued by EM countries
- Access the sovereign debt of 30+ emerging market countries in a single fund
- Higher yield

### EQUITIES

HARVEST HEALTHCARE LEADERS INCOME ETF
The Fund invests in an equally-weighted portfolio of equity securities of 20 healthcare issuers from the Healthcare Leaders Investable Universe that have a minimum market capitalization of US$5 billion at the time of investment and have options in respect of their equity securities listed on a recognized options exchange.

- Global: Global trends driving long-term growth
- Diversified: Portfolio of 20 large capitalization global healthcare leaders
- Attractive Income: Monthly income with opportunity for capital appreciation
- Covered Call Strategy: Enhance portfolio income and lower portfolio volatility

ISHARES GLOBAL REAL ESTATE INDEX ETF
Exposure to 75 publicly-traded global real estate companies.

- Used as a global sector overlay

VANGUARD US SMALL-CAP ETF
Seeks to track the performance of the CRSP US Small Cap Index, which measures the investment return of small-capitalization stocks.

- Diversified and convenient way to gain exposure to the Small Cap universe in the US

WISDOMTREE EMERGING MARKETS DIVIDEND INDEX ETF

The Index is comprised of all dividend paying companies within countries classified by WisdomTree as emerging markets that meet minimum listing, market capitalization and liquidity requirements.

- Gain exposure to dividend paying emerging market companies
- Use to satisfy demand for growth potential and income focus

## ALTERNATIVES

PURPOSE PREMIUM YIELD ETF

Diversify risk and generate income through a dynamic option-writing strategy.

- Cash-covered options strategy that mines volatility from a portfolio of stocks we love
- Generate stable yield selling puts at typically 8-10% out of the money
- No leverage and tight risk management
- Selects stocks based on screens of quality, value and sentiment factors
- Monthly distributions

SPDR GOLD SHARES ETF

Direct access to physical gold

- Hedge against Inflation and a weak USD
- Global store of value during geopolitical and macroeconomic troubles
- Low correlation with both stocks and bonds

### Sample of the Balanced Solution Portfolio

| BALANCED - 30/11/2019 | Symbol | Description | Portfolio Weight | YTD Rtn |
|---|---|---|---|---|
| CASH | Cash | Canadian Dollars (CAD) | 2.7% | 0.00% |
| FIXED INCOME | KIP1105 | Kipling Strategic Income Fund | 27.7% | 6.79% |
| | EMB US | iShares JP Morgan USD EM Debt ETF | 4.6% | 9.35% |
| | SHYG US | iShares 0-5 YEAR High Yield ETF | 4.8% | 5.51% |
| LARGE CAP EQUITY | KIP2011 | Kipling Global Enhanced Dividend | 15.8% | 22.47% |
| | KIP2007 | Kipling Global Enhanced Growth | 13.6% | 18.38% |
| | KIP2015 | Kipling Canadian Enhanced Dividend | 7.6% | 17.90% |
| | HHL CN | Harvest Health Care Leaders Income ETF | 4.1% | 9.72% |
| | CGR CN | iShares Global Real Estate ETF | 2.1% | 16.04% |
| SMALL CAP EQUITY | VB US | Vanguard US Small Cap ETF | 4.2% | 21.50% |
| EMERGING MARKETS | EMV.B CN | WisdomTree Emerging Markets Div. ETF | 5.0% | 7.64% |
| ALTERNATIVES | PYF CN | Purpose Premium Yield ETF | 3.9% | 5.90% |
| | GLD US | SPDR Gold Trust ETF | 4.0% | 13.04% |

## % of Portfolio Invested in Internal Funds: 64.7%

| Asset Class | Current |
|---|---|
| CASH | 2.7% |
| FIXED INCOME | 37.1% |
| LARGE CAP EQUITY | 43.2% |
| SMALL CAP EQUITY | 4.2% |
| EM MKTS EQUITY | 5.0% |
| ALTS | 7.9% |

Source: Bloomberg (Returns in CAD terms)

**Please join us the first week of March at Contemporary Calgary for a private viewing of Museum of the Moon.**

UK artist Luke Jerram's Museum of the Moon, is a scale model of the Moon measuring six metres in diameter and featuring 120dpi detailed NASA imagery of the lunar surface. Suspended from the top of the 13m high Dome, the luminous Museum of the Moon offers an uncanny and powerfully emotive experience. Heightened with musical compositions created by BAFTA and Ivor Novello award winning composer Dan Jones, Contemporary Calgary will also present a series of lunar inspired events beneath the Moon.

Further details of this exciting event will be released early 2020, please watch for them.


## With three offices to serve you:

### Cumberland Private Wealth Management Inc.

**Calgary**

**Perron & Partners**

Dome Tower, TD Square
Suite 1800, 333 – 7th Avenue SW
Calgary, Alberta T2P 2Z1

(403) 705-1200

**Toronto**

**Head Office**

Suite 300, 99 Yorkville Avenue
Toronto, Ontario
M5R 3K5

(416) 929-1090

**Kingston**

218 King St East
Kingston, Ontario
K7L 3A6

(613) 929-1090

CIPF
Canadian Investor Protection Fund
MEMBER

IIROC
REGULATED BY
Investment Industry
Regulatory Organization
of Canada

cumberlandprivatewealth.com