

Letters from Leib – June 2016

A Comment on the Markets after Brexit

Traditional investing strategies are being challenged by historically low interest rates. The silver lining is that slow growth is generally correlated with low inflation. Despite increases in volatility, global investment markets continue to be supported by government fiscal and monetary policies and, just as importantly, the absence of viable investment alternatives for individuals and institutions seeking sustainable income.

In the days immediately following the Brexit vote, selling in stock markets around the world wiped out three trillion dollars of value. This is more wealth than was destroyed at the time of the Lehman Brothers collapse that triggered the financial crisis of 2008. Government bond rates, already historically low, dropped even further.

The unknown consequences of Brexit are only some of a number of uncertainties facing investors: could Donald Trump become the next president of the United States? What are his actual policies? In Canada, how restrictive and how expensive could First Nation's claims become? In Europe, rising nationalism and protectionism are adding to geo-political uncertainty. The retreat from globalization, aging populations, and political and social instability caused in part by the concentration of wealth suggests that we have entered a prolonged period of slower growth and low interest rates, awkwardly combined with increased market volatility as massive flows of capital react and over-react in an age of instant communication.

How will this affect your wealth management plan?

The drive for income:

Most investors in today's world of historically low interest rates need to manage their wealth more actively to achieve their financial goals. This is true for retirees who need to generate income so they will not outlive their savings; for those in midlife anticipating as many as three decades of retirement; and for young people with life expectancies of 90 plus years. The same conundrum is facing institutional investors, particularly pension funds, life insurance companies, charitable foundations, and money managers with long term obligations.

The concentration of wealth has directed more capital into the hands of savers and less into the hands of spenders, creating a global glut of savings relative to attractive investment options. Conventionally safe sources such as bank interest, GICs, and government bonds provide little income – in fact, some provide no income at all!

Investing has been changed by low interest rates. Most investors will need to buy equities to achieve their financial goals and will need to take a more active and vigilant approach to managing their wealth.

The quest for growth:

The majority of investors need stable, safe cash flow. But investors also need growth over time in order to:

- protect against uncertainty
- maintain purchasing power
- guard against currency fluctuations that affect the cost of living

Unfortunately, there is little incentive for new capital expenditures in many traditional sectors of the economy. The world is awash in commodities and goods; there is too much of almost everything. This has happened for many reasons, including a decade of over-investment in commodity production; technological changes that increased supplies and reduced demand; and, the collapse of monopolies like OPEC that used to restrict supply. Growth in many developing nations has run out of steam. In the developed world, aging populations and low birth rates dampen expectations for future growth.

The areas of the economy where wealth will be created are probably going to change. Investors need to be alert to innovations and opportunities, both as sources of growth and also as possible long-term threats to “safe” investments currently held in portfolios. Even today’s safe investments (banks, utilities, tech giants) can be outmoded by change.

We are seeing a shift from commodities to digital industries and the service sector. Other areas where growth is predictable include non-coal utilities, high quality real estate trusts, connectivity industries, and medical technologies.

What does it mean for you and your family?

Is the lack of growth due to secular stagnation or uncertainty? Is greater government intervention the solution or the problem? Are we experiencing the impact of a fourth industrial revolution or merely a slow cycle?

While the big thinkers struggle with the big questions, we can move forward with some practical strategies.

1. Invest for cash flow.

Investments earning a sustainable 3 to 4 percent dividend provide good returns in a 1 percent world. Moreover, the global need for cash flow is driving up the share prices of companies able to provide safe dividends, further bolstering performance.

2. Don’t lose it.

It is especially important to stay out of trouble during a prolonged period of relatively low returns. Innovation and changes in political regulation require ongoing vigilance. We reduced holdings in oil, gas, mining, coal-based utilities, and traditional consumer retailers relatively early in the cycle. Be aware of the opportunity costs of holding on to underperforming assets. Tax efficient investing will maximize the amount you get to keep.

3. Don’t get left behind: buy into the change.

Change creates opportunity as well as risk. Position yourself for future gains by investing in knowledge based industries, companies committed to research, healthcare, technology, and American companies (still among the most stable in the world).

Managing Your Wealth

It has been calculated that, over the past two hundred years, investing in equities returned an average of 6.5 percent to 7 percent per year after inflation. Many analysts believe that we will not be able to get back to this average in the next decade. During the past ten years, the TSX index yielded an annualized average of 4.8 percent, measured in Canadian dollars with dividends reinvested but without accounting for fees or taxes. Over the past five years, this yield fell to 3.4 percent. Again it is important to remember that this has been a very low inflation environment.

Most investors are faced with limited choices: take on more equity risk, stay at work longer, or adjust budgets. Today's low return, highly uncertain environment presents many challenges. It is especially important to manage your wealth to make the most of your opportunities.

Services We Offer

Increasing wealth and longer life spans are a blessing, but the investment environment has become more complicated. Returns on money market, fixed income, and mainstream equities are relatively low; at the same time, political and economic uncertainty is relatively high. There are many new products and an increasingly complex tax regime that affect the real returns of different investments. The investment industry has responded by expanding services beyond investment management to include financial and estate planning. Access to a broad range of advisory services is included in your relationship with RBC Dominion Securities, including consultation and planning for tax, estate, charitable giving, and insurance. Contact us to learn more.

As always, thank you for your business and your trust.

Sincerely,

Leib

P.S. Bozana, who is still away on maternity leave, says hello to everyone!

Leib Zeisler

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