RBC Dominion Securities Inc.

McDowell Financial Management Team
News Bulletin

Wealth Management
Dominion Securities

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RBC Dominion Securities Inc.

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Shot Across the Bow!

Volatility has returned and you would be happy to know we are prepared

Wow that was fun! The start of 2018 brought a healthy correction to both Canada and the U.S. markets of more than 10%. Rising interest rates are now upon us and it is important to listen closely to market signals. The U.S. Federal Reserve has indicated they are comfortable with rising interest rates, leaving investors to have their eye on 10 year US treasury yields. On this side of the boarder the Canadian government appears to be struggling in NAFTA negotiations, their tax reforms have falling flat and now they are at risk of entering into a trade war with the U.S.

So why is this so important? Markets don't like uncertainty, they don't like governments that appear to be behind the eight ball, and they don't like higher interest rates since it directly impacts corporate profits. But more than anything, this is important because it will greatly affect the bond market. If interest rates rise too quickly bonds will not be able to adjust in time. A fact that is often overlooked is that the bond market is much larger than the stock market; making most of the power and risk in the overall economy center on bonds. In the 90s, Bill Clinton famously said *"You mean to tell me that the success of the economic program and my re-election hinges on the Federal Reserve and a bunch of f#!&ing bond traders?"* after realizing that the real economic power was not in Washington, like he had presumed. Not very poetic, but I can see Bill's point.

What to do? What to do?

Short Term Thinking - *We Took Advantage of the Corrections!*

When stocks go on sale and the short term economic news is light and generally positive, that's when you take action – and we did. On February 5th we purchased four stocks for our clients in sectors that were oversold. By using clients cash reserves we increased their holdings of Google, Stryker, and Johnson & Johnson and added Finning International into the portfolio.

We waited till 15 minutes before market close to confirm all buying factors and in that moment all our clients received the exact same price and owned these stocks at the exact same time on the lowest market price of the day. This highlights our ability to take quick action when needed which ultimately adds value to your bottom line. To follow up, we added in McDonalds to our core portfolio on March 5th when it was trading down by 13%. Its acting on buys like these builds a solid foundation in your portfolio.

Longer Term Approach – *Heed the Warning Signs*

With our new partner RBC Dominion Securities, we embarked on a real time journey to use the new resources available to us to help adjust our current portfolio to

maneuver upon the new realty of strategy. I am very pleased with all the support and the rising interest rates. During this process, we have come up with two very good ideas that should work quite nicely – developing a bond portfolio and a hedging strategy. I am very pleased with all the support and the depth of talented people available at RBC DS to help us quickly deliver at this time.

The First Issue: *How to Manage the Bond Portfolio*

Over the past several years we have relied on Bond ETF's in part to help us manage our bond portfolio. It's a simple solution that works well in a low interest rate environment with yields expected to remain low for a long period of time. These instruments have proven to be a good investment. They have given us liquidity and a higher tax efficient yield than we ever could have achieved in a straight bond portfolio with the same underlying risk rating. With this in mind, in a rising interest rate environment these bond ETF's will struggle since they have no maturity date and thus an infinite duration. If rates rise too quickly these ETF's value will drop in tandem. To prevent these potential headwinds we have sold these ETF's and have replaced them with high quality bonds that are trading at a discount.

To understand why this will work you need to understand some basic bond knowledge: All bonds mature at $100, but if you buy them during their issue period you will pay the market price for the bond. The market price is based on the current standard interest rate compared to the interest payment the bond is offering with its underlying risk factored in. If a bond is off offering a higher interest payment than the standard market rate, then the bond will be sold for a premium price above its maturing value of $100. The opposite is true, where if a bond is paying a fixed interest payment lower than the market rate then the bond will be sold at a discount below its maturing value of $100, but the price will appreciate over time as it will be redeemed on its maturity date for its par value of $100. In the end, either way you should be achieving the standard market return based on the credit risk you are taking.

The advantage we are undertaking is that bonds selling at a discount will incur a capital gain to maturity. This capital gain is much better because although the return is similar, the benefit incurred as capital gain are taxed at half your tax rate, whereas interest income is taxed at your full marginal tax rate. With this bond portfolio we know and control the exact risk we are undertaking, the time period until the bonds will be redeemed, and the market expected interest rates. All of this allows us to build a bond portfolio knowing the return we are going to achieve, and buying at a discount allows us to achieve this in a tax efficient way.

The Second Issue - *How to Hedge against a Possible Bear Market*

It's beginning to look a lot like the end of a business cycle; stock market and economic growth, increased volatility, governments tightening monetary policy, and rising interest rates. As we get closer to the end of the cycle we can anticipate a stock market downturn before it turns itself around again into a new business cycle. To help manage the risk of decline in the stock portfolio over the next two years we have built a hedging strategy using options in an index participating in an absolute return structured product. *This is going to be new to most of you so I'll explain:*
This investment will have the Dow Jones and the TSX as its underlying index and will profit from both the **up** and **down** side of the TSX or the Dow. The end value will be based on the index with the worst performance over the next two years, giving us an opportunity to hedge our bets between the USA and CND.

- If the DOW or TSX **drops** 20% this fund will go up 20%
- If the DOW or TSX goes **up** we will participate in 63% of the upside. For example the TSX goes up 20% we will earn 12.6.
- If the DOW is down -25% then this product is only down -5%
- Its 100% liquid from day one no cost to sell

This product will fluctuate in price but these types of examples are guaranteed after only a 2 year term. This product is also 100% percent liquid and can be sold at any time with no cost, so we will be tracking it very closely. If it meets its maximum profitability to the downside of 20% before maturity we will sell out of it if it's prudent. We will be providing even more information about this in the next few days, I'm happy to introduce the McDowell Financial Management Team Buffered Twin Win Strategy:

Going Forward

Over the next few years we are going to be vigilant and we have a plan. It is true that volatility is back and markets are not going to be on autopilot any longer. But that's ok! We are ready and excited about the possible opportunities the next few years will provide and we have worked very hard to have all our bases covered to meet this new reality. We are at your service if you need anything or have any questions please call me or invite me to lunch. I like to eat.

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