The Harbour Group
of RBC Dominion Securities

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Main Reception:
416-842-2300
Toll-free: 1-800-561-6431
theharbourgroup@rbc.com
www.theharbourgroup.ca

RBC Dominion Securities
Brookfield Place
Bay-Wellington Tower
181 Bay Street, Suite 1520
Toronto, Ontario M5J 2T3

Peter Coward, HBA
Vice-President & Director,
Investment Advisor

Graeme MacGregor, FCSI, CIM
Vice-President & Director
Portfolio Manager & Wealth Advisor

Christopher Newall, FCSI, CIM
Vice-President & Director,
Portfolio Manager

John Grant, CFA, MBA, MSc
Vice-President, Portfolio Manager
& Wealth Advisor

Robin Gullason, CFA
Vice-President, Lead Strategist

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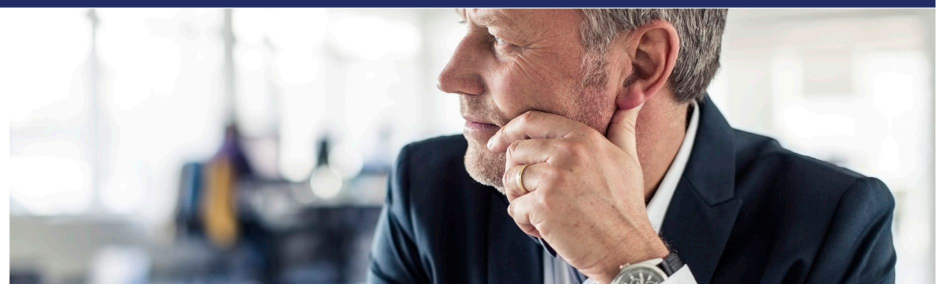

Speculation makes a comeback

- Recent months have seen headlines dominated by stories of eye-popping returns, but they are turning up in unusual places.
- Speculation in assets such as cryptocurrencies and marijuana stocks right here at home have hit a fever pitch.
- The action in these formerly obscure corners of the financial world have made the returns on low-risk, cash flow-generating securities look downright boring.
- It is times like these we like to remind ourselves what the other side of "parabolic" return patterns tend to look like.
- The best time to hold portfolio stabilizers such as high-quality fixed income is exactly when they feel like they are least needed.

As 2017 comes to a close, investor anxiety over valuations and what "inning" we are in of the investment cycle continues, and with good reason. We are approaching the ninth anniversary of the start of this investment cycle, and despite repeated assurances that "bull markets don't die of old age," skepticism toward stocks in general remains fairly high. To be completely clear, these are conversations we have amongst ourselves in the office daily, and there is no easy answer. One comforting factor that we have stuck by is that speculation on the part of investors seemed to be largely in check, but a few developments in the past several months have put that belief to the test.

As we mentioned in our blog post earlier this month, the rise in bitcoin has been nothing short of remarkable (Exhibit 1), and we have seen a similar trend play out in Canadian marijuana stocks. We don't think it is a stretch to call what is playing out in bitcoin a speculative mania, given the parabolic rise in price and wall-to-wall media coverage.

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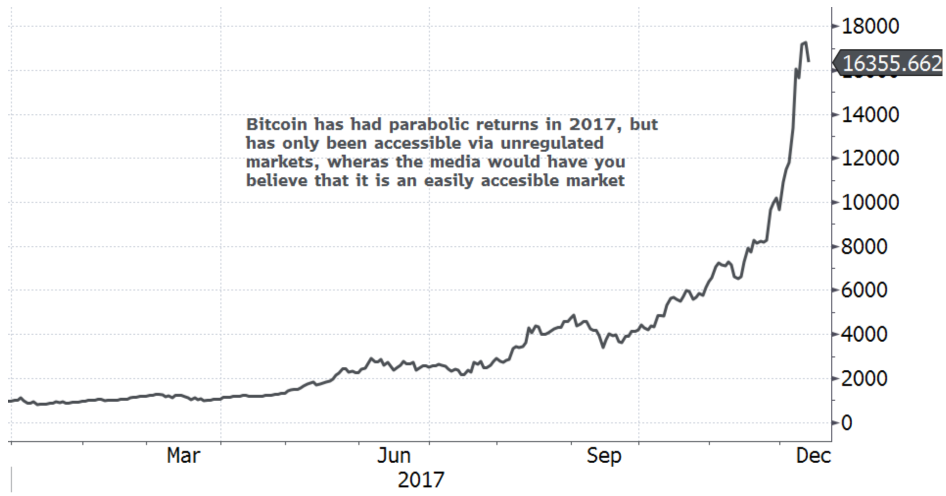
The graphic in Exhibit 2 depicts a typical investment mania pattern. It would seem pretty clear to us that we are well into the "mania" phase for bitcoin, given substantial media coverage, increasing adoption by the public and stories of "bitcoin billionaires" proliferating. Importantly, this phase can last for a long time, both in terms of duration and price upside. We make no attempt here to call a top, but in our experience, when these parabolic trends change they do not do so by going sideways.

We recently saw an interview with Brookfield Asset Management CEO Bruce Flatt conducted by Bloomberg News. He said that Brookfield thinks assets have intrinsic value when they generate cash flow or are able to convert into a cash flow producing instrument. On bitcoin, Flatt said "There are some assets in the world that don't fit that characteristic. We don't qualify them as assets. Therefore, bitcoin would be one of those. It has no intrinsic value. I don't know what it is. But it has no intrinsic value in our definition of intrinsic value. If someone else wants to speculate on it or invest in it, it's for them. It's not for us."

We couldn't put it any better.

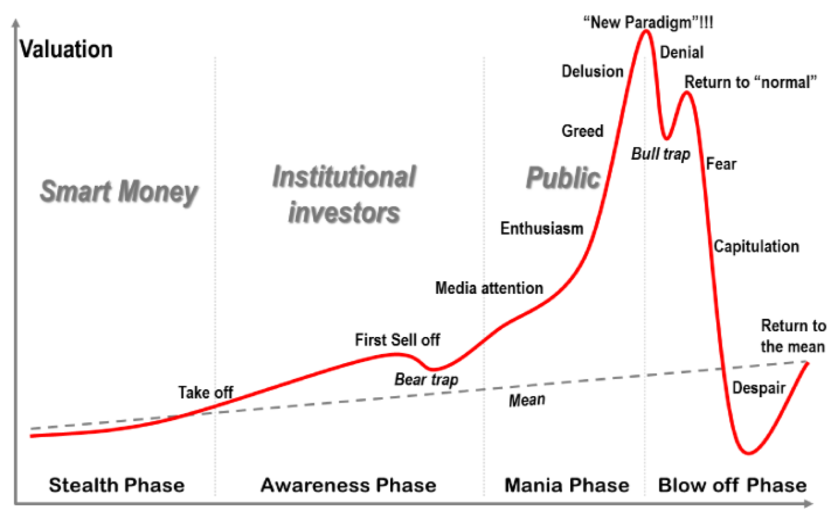
Call us old-fashioned, but we have a hard time ascribing value to an instrument with no end market use (unlike precious metals), no current cash flow, and no possibility of generating cash flow in the future. We understand that there is a scarcity argument in that only 21 million bitcoins will be mined, but we are also aware that there are an unlimited amount of competing cryptocurrencies that can be created to compete for users' attention. There is a high probability this is the ultimate "greater fool" investment, where performance is purely dependent on what the next investor in line will pay.

Exhibit 1 – Bitcoin year to date



Source: Harbour Group of RBC Dominion Securities, Bloomberg

Exhibit 2 – Typical mania pattern



Source: Dr. Jean-Paul Rodrigue, Dept. of Global Studies & Geography, Hofstra University

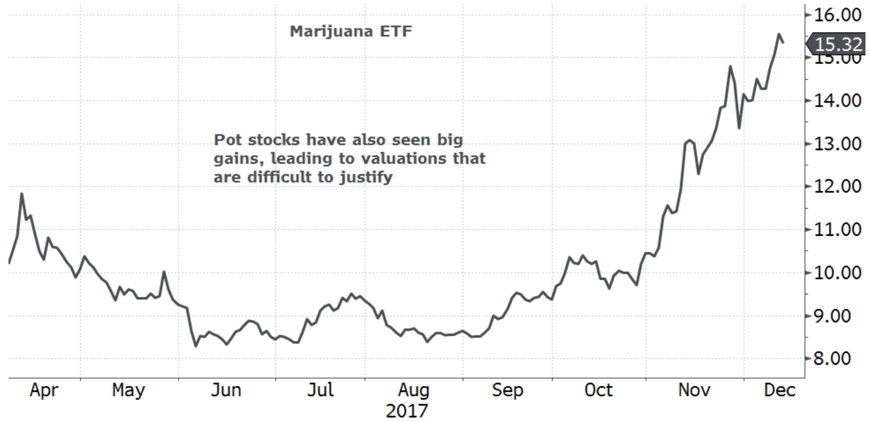
One final thought: how much is nine years of ultra-low interest rates playing into the demand for bitcoin? Would people be willing to spend US$16,355 on a bitcoin (as of December 13, 2017 at 2:23 p.m. – it will surely be different by the time you read this!) if they could earn 5% on cash or short-term government bonds?

Closer to home we have a budding cannabis boom

Unlike bitcoin, the marijuana stocks (Exhibit 3) that have captured the imagination of many Canadian investors actually do have sales (though few are generating profits) and have the potential to spin off cash flow in the future. Just how much cash, how far into the future, and who the winners and losers will be is the bigger question.

Similar to the internet bubble of 20 years ago, the true believers may be correct on cannabis adoption rates and profitability of these firms. We would note that government seems keen to keep a heavy hand in this industry, which may result in unintended consequences. Further, and also like the internet frenzy of the 1990s, current stock prices likely reflect profits generated well into the future, and that assumes legalization goes into effect without delay to the government's target. We don't believe that these companies are trading on fundamentals, but instead (and similar to bitcoin) are trading on pure speculation.

Exhibit 3 – Canadian marijuana stocks



Source: Harbour Group of RBC Dominion Securities, Bloomberg

Bottom line

We fully acknowledge it can be frustrating for investors to see a sector (no matter how speculative) posting blockbuster returns while they stay on the sidelines. Conservative balanced portfolios have put up solid results in 2017, but they certainly haven't put up parabolic returns. Nonetheless, these portfolios continue to do exactly what they were designed to do with each investor's unique circumstances and risk tolerance in mind. That typically includes high-quality equity securities that pay a dividend, and a component of safety in the form of fixed income to add ballast to the portfolio in times of stress.

While this asset allocation and quality bias will certainly lag the latest investment fads, it is a strategy that has stood the test of time through good markets and bad. We often find that times when investors are questioning the need for stabilizers in portfolios often ends up being a good time to be holding them. This is a year in which U.S. equities showed nary a blip, yet ever-present risks are still lurking in the background. There may be times in 2018 that we are all glad we hung on to these "boring" securities, as preservation of capital is a pretty exciting prospect once markets turn volatile.

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