RBC Wealth Management
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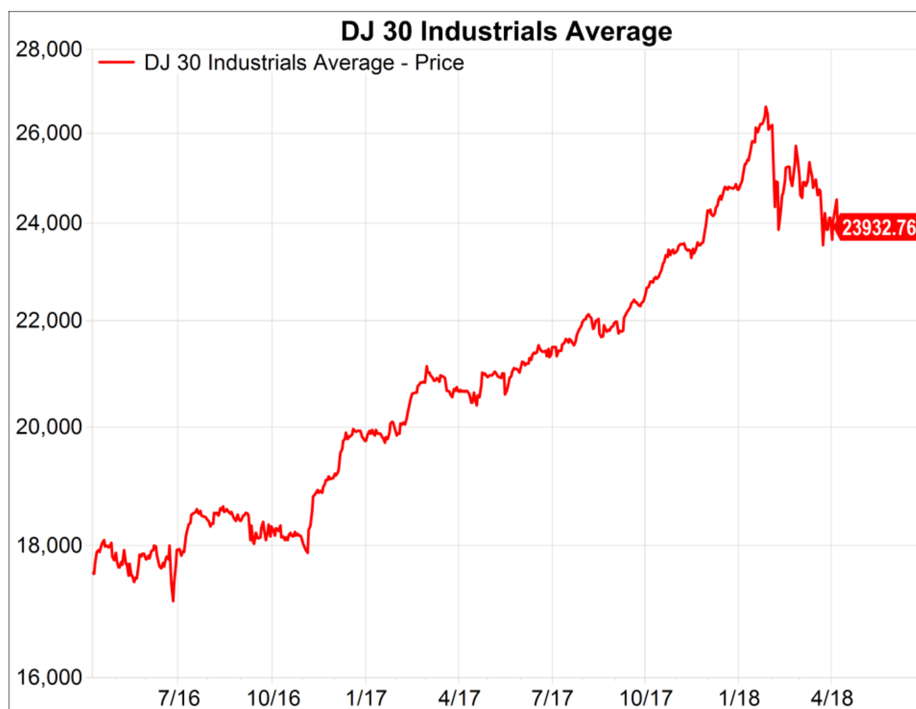
First Quarter 2018

After two years of steady gains in stock prices, the rampant volatility of the last couple of months has changed the investing atmosphere. Since peaking in early February, the Dow Jones Industrial Average has been having swings of 400 points or more seemingly almost daily. Last quarter, in my January letter, I warned of 1) High valuations, 2) Bullish sentiment, and 3) Speculative ardor. The day-to-day roller coaster of the last few months has mitigated all 3 factors but, gyrating stock prices appear to have especially dampened down the urge to speculate that was evident early this year. FOMO – fear of missing out – is not the force it was in January.



DOW 30 Industrials Average over a period of 2 years (Graph from FactSet)

The standard definition of a stock market correction is a decline of 10%. We've now had a correction for the first time since 2015-2016. The standard definition of a bear market is a decline of 20%. I prefer the non-standard definition: A correction is when other people's stocks go down; a bear market is when your stocks go down. To me, the market is feeling somewhat bearish now.

Warren Buffett's letter to shareholders, which was released on February 24, (www.berkshirehathaway.com) was shorter than usual but had more cautions than usual. "Our aversion to leverage has dampened our returns over the years. But Charlie and I sleep well. Both of us believe it is insane to risk what you have and need in order to obtain what you don't need." (Annual Report, p.4) Further on, on page 10, Buffett gets more explicit in his warning:

> "Berkshire, itself, provides some vivid examples of how price randomness in the short term can obscure long term growth in value. For the last 53 years, the company has built value by reinvesting its earnings and letting compound interest work its magic. Year by year, we have moved forward. Yet Berkshire shares have suffered four truly major dips. Here are the gory details:

Period	High	Low	Percentage Decrease
March 1973-January 1975	93	38	(59.1%)
10/2/87-10/27/1987	4,250	2,675	(37.1%)
6/19/98-3/10/2000	80,900	41,300	(48.9%)
9/19/08-3/5/2009	147,000	72,400	(50.7%)

> This table offers the strongest argument I can muster against ever using borrowed money to own stocks. There is simply no telling how far stocks can fall in a short period. Even if your borrowings are small and your positions aren't immediately threatened by the plunging market, your mind may well become rattled by scary headlines and breathless commentary. And an unsettled mind will not make good decisions."

Buffett has been prescient in the themes he chooses for his annual Chairman's Message. I hope not so this year.

Team Stedman has tried from time to time over the years to be opportunistic in our fixed-income investments. After the financial crisis of 2008-2009 governments introduced their near zero interest rate policies. Fixed income became attractive mostly for its insurance value, not so much for income. We bought Guaranteed Investment Certificates (GICs) for about the first time in my career then. Regulators were requiring banks to hold more collateral for their loans. GICs yielded little, but much more than government or even corporate bonds.

Then we went through a period, especially 2015-2016, when we found good value in rate-reset preferred shares, several of which we were able to buy, mostly in taxable accounts (because dividends are taxed favorably), at substantial discounts to the prices they were issued at. Before that, we'd hardly bought any preferred shares since the 1980s.

The yield from a five year government bond has moved up from near zero a year or so ago to 2% for Canada's and 2.8% for U.S. Treasuries. There is probably no better refuge from a stock market decline than short term government bonds. Now, and I think for the balance of 2018, we are pleased to be able to buy a selection of federal government short-term bonds trading at substantial discounts to their par values. The meaningful increase in yields over the past quarter has lowered the valuation risk in fixed income. At the same time credit spreads have greatly compressed, which is to say that a federally guaranteed Canada Housing Trust bond yields hardly less than a provincial bond or an A-rated corporate bond. Moreover, a good selection of these highly liquid and safe bonds can be bought at substantial discounts to their par values for the first time since the 1990s. Since only half of a capital gain is taxable (in Canada), these can be very attractive for taxable accounts. One example will illustrate:

The Government of Canada bond with a coupon rate of 0.50%, due on 03/01/2022, at a price of $94.47, has a yield to maturity of 1.97%, and an after tax yield of 1.32%. That is a taxable yield equivalent of 2.83% (for a resident of Ontario in the highest tax bracket). In other words, a 4 year GIC would have to yield 2.83% to match it after tax. But a GIC could never match a short term government bond for liquidity, that is to say, for flexibility. In a risky environment, flexibility is valuable. Over the balance of this year we hope to find more bonds at deep discounts to their par value.

As I write this my Peewee hockey team (I'm Head Coach) is looking forward to the Finals of the playoffs. After three years of coaching hockey, and with my three years on the yacht club executive over, I'm looking forward to having more time, and to some spring weather.

Sincerely,

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Portfolio Manager, Vice-President
Please visit us at www.georgestedman.com