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Dominion Securities

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## Year End 2018

The S&P/TSX Composite Total Return Index was down 8.9% in 2018, which was eerily similar to its decline in 2015 (-8.3%) and 2011 (-8.7%). For the first time in 10 years, the S&P 500 Total Return was negative for the calendar year (-4.4% in U.S. dollars) but was positive (+3.7%) if measured in Canadian dollars. Although 10 years without a down year is a long time, negative years are actually quite common. As RBC Global Asset Management points out, since 1950 the U.S. stock market has fallen in 14 different years, or 20% of the time. The optimist in me prefers to point out that it has gone up in 80% of the years.

One of the things that I love about my business is how quickly things can change. In my last quarter's letter, written in early October, I explained that the rise in long-term bond yields had badly impacted the price of dividend paying defensive stocks (I cited Telecom Services, Utilities, Pipelines and Consumer Staples). My other complaint was that the FAANG stocks (Facebook, Apple, Amazon, Netflix, Google) had become so popular that they were goosing the U.S. stock market index. Of course, bond yields plunged with stocks in the last two months. The 10 year U.S. Treasury yield fell from 3.2% to 2.6%, unwinding all of 2018's rise in bond yields in just two months. The TSX defensive groups morphed into the leading sectors in the Toronto stock market. Meanwhile, in the U.S., the FAANG stocks lost some 25% to 30% from their highs of last September. What's a $trillion.

Swings in sentiment are the driving forces of volatility in the short-term but there is more than that going on. A reasonable assessment came from Federal Reserve Chairman Jeremy Powell. Speaking at the American Economic Association's Annual Meeting on Friday, January 4th, 2019, Powell began by noting the positive economic data such as low unemployment numbers and low inflation: "But financial markets have been sending different signals, signals of concern about downside risks, about slowing global growth, particularly related to China, about ongoing trade negotiations, about what maybe let's call general policy uncertainty coming out of Washington, and many other factors. […] you do have this difference between, on the one hand, strong data, and some tension between financial markets that are signaling concern and downside risks." As I wrote last quarter, the U.S. Federal Reserve Bank plays the tune and clearly the financial markets have caught the ear of the Chairman.

I have been through enough stock market bouts of volatility, corrections, bear markets, and crashes that I've worked out a standard operating procedure. We look for bargains in the fall (pun intended). We BODD (Buy On Down Days). We don't add new selections during clusters of volatility. We buy where there is "room" in a portfolio to do so. We buy gradually, always keeping money in reserve with which to buy more and to keep buying throughout the decline. Last quarter there were two parts to our stock market purchases. We focused on victims of tax loss selling, particularly thinly traded rate reset preferred shares and small companies' shares. We combined that with purchases of great blue chip stocks with unassailable balance sheets. Although stocks have rallied since December 24th, I have every confidence that there will be more good days for buying ahead.

For many years I have had two post-it notes on my desktop. One reads BODD, explained above. The other reads ROL which stands for Return on Luck. One of my great heroes, Dr. Stewart Walker, died in November. When a youth I won his book, *The Tactics of Small Boat Racing* (1966), and I became a fan. He coined various turns of phrase that went into the language of sailboat racing, such as "stay on the lifted tack". By that he meant recognizing that wind directions oscillate and to win sailing races you need to keep the swings on your side. In our context I interpret it to mean to invest in companies that stand to profit from long-term social trends. In his later years Dr. Walker came to focus on the role of psychology in sport. He urged racers to position themselves so they stood to benefit from changes in the wind direction and wind speed by moving a little more to the favored side of the race course than most of the competition, but just a little more, enough to get a Return on Luck. In the stock and bond markets, one of the ways I try to get a return on luck is to buy on down days and hope I will get lucky. Our feature article this month is a column Dr. Walker wrote about the psychology of luck.

I have been very lucky to have worked with Isabelle Cojocaru-Durand for these last almost 6 years. This is the last quarterly letter which she will help me prepare. Margarita and I have benefited from her consistent good cheer which has been immensely helpful to me, as I can get intense. Isabelle has always been passionate about the environment and I can only support her pursuit of a graduate degree in environmental studies in California. Somebody needs to save the world. Fair winds to you this year.

Sincerely,

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Portfolio Manager, Vice-President
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