HugganWhite Wealth Management

Protect Capital. Manage Risk. Provide Income.

Third Quarter 2017

"We don't have to be smarter than the rest. We have to be more disciplined than the rest."
~ Warren Buffett ~

When it comes to the world of investing, the majority of participants enter this formidable endeavour with the hope and intention of generating a return on their capital. Methods employed to reflect these aspirations are carried out over a plethora of strategies. The risk and return potential across these strategies vary tremendously. These include "get rich" schemes, real-time trading platforms, speculative venture capital "opportunities", low cost passively managed engineered products, options strategies and a host of other approaches that market to the mindset that investing is easy and quick returns are next to a sure thing. Certainly there are success stories within this realm of investing, but our experience shows the failures are far more prominent. Conversely, at the opposite end of the "capital allocation spectrum" reside strategies that adhere to far more reliable and consistent approaches. These include investing in high quality businesses, a focus on cash flow generation, analysis of sectors, recognition of various cycles, diversification across asset classes and emotionally detached decision making. The latter requires an unremitting focus on discipline, which can be challenging as external inputs often attempt to derail that discipline. Add in the difficult task of patience and using time to one's advantage (thinking longer term as opposed to short term) and the task becomes ever more demanding. Fundamentally, discipline is the foundation of every successful investment strategy. Without discipline, ad hoc decision making follows, strategies become opaque and processes cannot be repeated. To build wealth over time and generate a consistent return on invested capital, one doesn't have to be smarter than the rest, they simply have to be more disciplined that the rest, as noted above. Across our portfolio management team we stringently adhere to this tenet and work hard to ensure that our discipline remains at the forefront of the decisions we make on behalf of clients. Moreover, we continue to challenge ourselves to refine and improve upon that discipline as part of our ongoing responsibility to provide best in class solutions to clients.

Throughout the third quarter of 2017 we worked hard to manage the risks that were present (some resurfaced) and remain true to our discipline. Some of the major factors that investors faced during the quarter were ongoing tensions involving North Korea, political machinations in Washington, heated cultural issues in cities like Charlottesville, generational storms such as Harvey and Irma, mixed economic data and significant currency swings amongst G8 nations, just to name a few. Much to the surprise of many seasonality based investors, the typical summer doldrums were essentially non-existent as trading activity was elevated in response to these issues. At times volatility appeared to want to move higher, but despite the above noted perceived uncertainties, equity markets across North America, Europe and Asia finished the quarter on a positive note. On a relative basis, U.S. markets outperformed Canadian markets on the quarter with the broad based S&P 500 total return adding 4.5%, while the Toronto Stock Exchange tacked on 3.0%. Notwithstanding this upbeat quarter, the Canadian market was still showing a gain of just over 2% for the first three quarters, highlighting the difficulty our markets have endured throughout 2017. Speaking specifically to the Canadian data, one of the most impactful news stories from an economic standpoint was the Bank of Canada's successive decision to raise interest rates by 25bps, the first in July followed by another in September. Although the first was largely anticipated by markets, the second rate hike in September did catch a few by surprise, prompting the Canadian dollar to trade above .80 cents relative to the U.S. dollar. The 7.5% move higher in the loonie from early July to the peak of just under .83 cents on September 10th served as a headwind for Canadian investors who own U.S. assets as exchange rates were the largest influences of total return across our managed portfolios.

Politics and geopolitical tensions again served as the focal point for the fixated and obstinate media. The battle between Kim Jong and Trump elicited endless rhetoric on how one should prepare and protect their assets in the event hostilities boil over. In all fairness, the seriousness of the situation cannot be underestimated, but we prefer to make more conclusive decisions based on what markets are telling us, which is summarized in prices. Certainly the U.S President's approval rating remains at depressed levels, but the decision to reach across the aisle on September 6th and work with Democrats on the debt ceiling, proved that bipartisanship can largely be supportive of equity markets. Since that date, the U.S. 10 year treasury has spiked 30 basis points (1/3 of a percent) from 2.04% to 2.35%, while the U.S. equity markets have added an additional 3.5%. Markets closed the quarter in the U.S at a new all-time high again confirming the fact that price and trend summarize the collective thoughts of all inputs, whether good or bad. As the old Wall Street adage states, "Don't fight the tape".

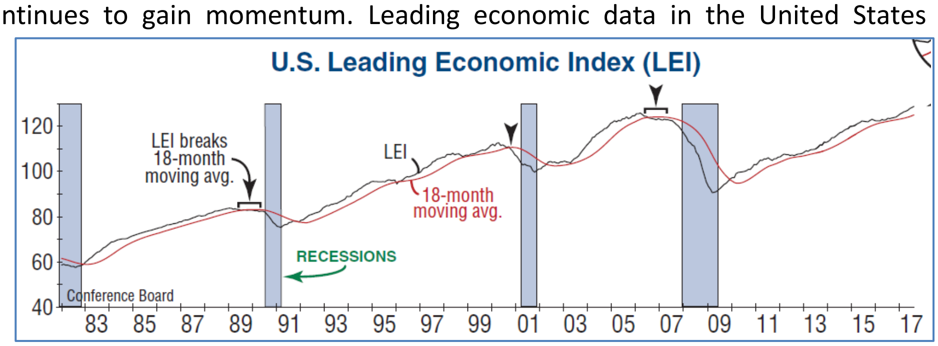
The question now becomes what should one expect as we move forward. Appropriately, we thought it would be an opportune time to address some of the main questions clients are asking and revisit some of the main themes that are guiding our investment management decisions and positioning going forward.

Theme #1: Asset Allocation

For the better part of nine years our core principle theme has been our favouring of equities over fixed income. This has been based on the belief that during the financial crisis, valuations represented generational buying opportunities and portfolios needed to be adjusted accordingly. The relentless pursuit amongst global central banks to stimulate growth through quantitative easing supressed bond yields, allowing for credit expansion. Accommodative monetary policy has served as a catalyst for growth, benefitting those who borrow and allowing for business to expand through easier financing. Unfortunately, the reduction in interest rates over this cycle has negatively impacted those who rely on fixed income as part of their asset allocation targets. Recall, yields offered by creditors are tied to interest rates and the thirty year trend of lower rates has served as a tremendous headwind as real rates of return (inflation adjusted) have largely been negative across developed markets. The benchmark 10 year U.S. treasury hit a low of 1.36% in June of 2016, which we continue to believe is the low for this cycle. As noted in past commentaries, global central banks are now embarking on a tightening cycle with the Federal Reserve raising rates three times over the past two years and the Bank of Canada moving twice this year as mentioned above. Higher rates will drive bond prices lower as yields and prices move inversely. Thus, we remain cautious on fixed income, in particular bonds with longer maturities (seven years or longer) as duration risk moves to the forefront. That said we do recognize that a well balanced portfolio should maintain exposure to fixed income to help reduce equity market risk. Within our PIMG accounts we have been selectively adding to a handful of individual opportunities that screen well from a yield, credit quality and duration perspective. The remainder of our exposure has been through <u>actively managed exchange traded funds</u>. In the near term, we are looking to add to our position in high yield fixed income that should assist in greater cash flow from this portfolio allocation. Weakness in equity markets should present this opportunity.

Theme #2: Economic Cycle Remains Healthy and Continues to Improve

The global synchronized growth story continues to gain momentum. Leading economic data in the United States continues to surprise to the upside and consequently, the likelihood of a recession in the next six months remains low. August data for the Conference Board's Leading Economic Index (LEI) moved up again for the 12th month in a row, and gained more ground than economists had expected. The health of the manufacturing industry is an



important part of the LEI, and the Institute for Supply Management (ISM) survey of the manufacturing sector for September climbed higher on strength in new orders and production. The overall Purchasing Managers Index is now at 60.8% – a 13-year high, all highlighting the fact that this economic recovery remains on firm ground (*tip of the hat to Investech Research for this data*). Unemployment rates continue to trend lower as well.

One of the most important changes in the capital markets this past quarter was the rise of longer-term interest rates. Since early September the yield on the important, 10-year US government bond has climbed from 2.05 to 2.35%, an increase that will eventually flow-through to mortgages and other consumer credit markets. In Canada, the same duration benchmark bonds are currently trading at a slightly lower yield, but the trend has also been toward higher rates. These are both considered healthy economic trends, indicative of slowly growing economies that continue to post healthy employment numbers, high levels of consumer confidence and robust manufacturing sentiment. It is important to note that increases in long-term interest rates have little to do with inflation at this time and are mainly triggered by the intention of central banks to end their quantitative easing programs.

The same economic indicators are predominantly positive in Europe, Asia and developing nations. The political news as well as natural disasters and frightening, man-made events have recently combined to literally overwhelm most positive economic developments. Much of the global technological and economic improvements that we are realizing are being ignored because of the devastating psychological effects of today's headlines. Stock markets tend to be indifferent to many of these events, so they have been chugging along to higher and higher levels because capital mainly relies upon clinical economic data for guidance. That vital data has been overwhelmingly bullish.

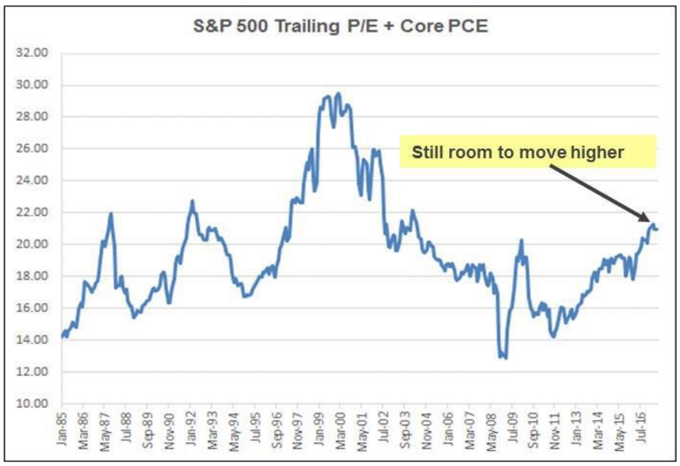
Theme #3: Earnings are Supporting Valuations

Over the next few weeks, third quarter earnings season will be in full swing. Expectations call for high single digit growth rates, which we feel are reasonable. If accurate, this will mark the fourth consecutive quarter of positive earnings growth (chart to the right), further confirming the earnings recession that began in the first quarter of 2015 and ended in the third quarter of 2016 is a distant memory. With tax cuts in the U.S. likely now pushed off into the first or second quarter of 2018, earnings will be closely scrutinized to determine forward guidance and the impact on earnings in response to envisioned (and hopeful) tax reform. Currently there is much debate over valuations as many critics continue to point to excessively high valuations (P/E multiples). As part of my weekend reading I came across the following commentary written by Bill Nygren of Oakmark Funds. It is one the best summaries I have read regarding current valuations.

Quarter	Start of EPS Season		End of EPS Season	
Date	Date	Growth	Growth	Diff.
3Q17	10/1/2017	5.9%		
2Q17	7/1/2017	8.0%	12.30%	4.3%
1Q17	4/1/2016	10.2%	15.3%	5.1%
4Q16	1/1/2016	6.1%	8.0%	1.9%
3Q16	10/1/2016	-0.5%	4.3%	4.8%
2Q16	7/1/2016	-4.5%	-2.1%	2.4%
1Q16	4/1/2016	-7.1%	-5.0%	2.1%
4Q15	1/1/2016	-3.7%	-2.9%	0.8%
3Q15	10/1/2015	-4.2%	-0.8%	3.4%
2Q15	7/1/2015	-3.0%	1.3%	4.3%
1Q15	4/1/2015	-2.8%	2.2%	5.0%
4Q14	1/1/2015	4.2%	7.0%	2.8%
3Q14	10/1/2014	6.4%	10.3%	3.9%
2Q14	7/1/2014	6.2%	8.6%	2.4%
1Q14	4/1/2014	2.1%	5.6%	3.5%
4Q13	1/1/2014	7.6%	9.9%	2.3%
3Q13	10/1/2013	4.5%	6.0%	1.5%
2Q13	7/1/2013	2.9%	4.7%	1.8%
1Q13	4/1/2013	1.5%	5.4%	3.9%
4Q12	1/1/2013	2.9%	6.3%	3.4%
3Q12	10/1/2012	-2.1%	0.1%	2.2%
2Q12	7/1/2012	6.0%	8.4%	2.4%
1Q12	4/1/2012	3.2%	8.1%	4.9%
4Q11	1/1/2012	8.3%	9.2%	0.9%
3Q11	10/1/2011	13.3%	18.0%	4.7%
2Q11	7/1/2011	10.2%	12.1%	1.9%
1Q11	4/1/2011	13.2%	18.9%	5.7%
4Q10	1/1/2011	31.9%	37.0%	5.1%
3Q10	10/1/2010	23.8%	31.2%	7.4%
2Q10	7/1/2010	27.0%	38.8%	11.8%
1Q10	4/1/2010	36.3%	58.3%	22.0%
4Q09	1/1/2010	203.1%	205.6%	2.5%
3Q09	10/1/2009	-24.7%	-14.7%	10.0%
2Q09	7/1/2009	-35.7%	-27.3%	8.4%
1Q09	4/1/2009	-36.1%	-35.5%	0.6%
Source: Thomson Reuters I/B/E/S			**Median**	3.5%

"Bears will also point to the very high CAPE ratio—or the cyclically adjusted P/E. That metric averages corporate earnings over the past decade in an attempt to smooth out peaks and valleys. But remember that the past decade includes 2008 and 2009, frequently referred to as the "Great Recession" because of how unusually bad corporate earnings were. I'll be the first to say that if you think an economic decline of that magnitude is a once-in-a-decade event, you should not own stocks today. But if it is more like a once-in-a-generation event, then that event is weighted much too heavily in the CAPE ratio. If the stock market and corporate profits maintained their current levels for the next two years—an outcome we would find disappointing—simply rolling off the Great Recession would result in a large decline in the CAPE ratio.

Higher P/E ratios are also caused by near-zero short-term interest rates because corporate cash now barely adds to the "E" in the P/E ratio. When I started in this business in the early 1980s, cash earned 8-9% after tax. Consider a simple example of a company whose only asset is $100 of cash and the market price is also $100. In the early 1980s, the $8 or $9 of interest income would generate a P/E ratio of about 12 times. Today, $100 would produce less than $1 of after-tax income, driving the P/E ratio north of 100 times. There is, of course, uncertainty as to whether that cash will eventually be returned to shareholders or invested in plants or acquisitions, but it seems that making a reasoned guess about the value of cash is more appropriate than valuing it at almost nothing.

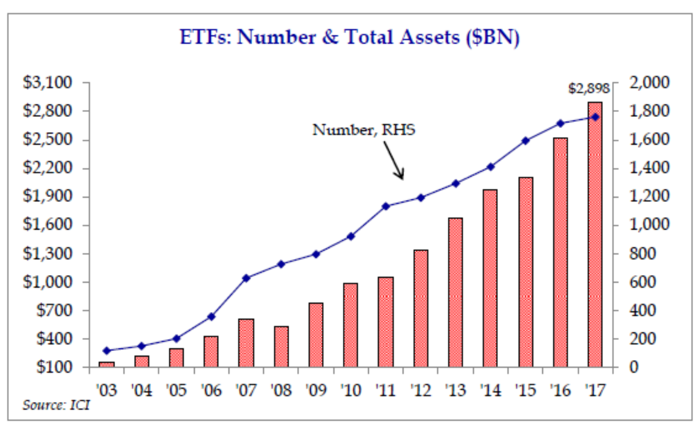


Source: Thomson Reuters DataStream/ Canaccord Genuity

A less obvious factor that is producing higher P/E ratios today is how accounting practices penalize certain growth investments. When a company builds a new plant, GAAP accounting spreads that cost over its useful life—often 40 years—so the cost gets expensed through 40 years of depreciation as opposed to just flowing through the current income statement. But when Amazon hires engineers and programmers to help it prepare for sales that could double over the next four years, those costs get immediately charged to the income statement. When Facebook decides to limit the ad load on *WhatsApp* to allow it to quickly gain market share, the forgone revenue immediately penalizes the income statement. And when Alphabet invests venture capital in autonomous vehicles for rewards that are years and years away, the costs are expensed now and current earnings are reduced.

The media is obsessed with supposedly bubble-like valuations of the FANG stocks—Facebook, Amazon, Netflix and Google (Alphabet). The FANG companies account for over 7% of the S&P 500 and sell at a weighted average P/E of 39 times consensus 2017 earnings. In our opinion, the P/E ratio is a very poor indicator of the value of these companies. Alphabet is one of our largest holdings, and our valuation estimate is certainly not based on its search division being worth 40 times earnings. If one removed the FANG stocks from the S&P multiple calculation—not because their multiples are high, but because they misrepresent value—the market P/E would fall by nearly a full point. And, clearly, more companies than these four are affected by income statement growth spending. In addition, no discussion of stock valuations would be complete without some consideration of opportunities available in fixed income. Many experts argue that investors should sell their stocks because the current S&P 500 P/E of 19 times is higher than the 17 times average of the past 30 years. By comparison, if we think of a long U.S. Treasury bond—say, 30 years—in P/E terms, the current yield of 2.9% results in a P/E of 34 times. The average yield on long Treasuries over the past 30 years has been 5.5%, which translates to a P/E of 18 times. Relative to the past 30 years, the long bond P/E is now 90% higher than average. We don't think the bond market at current yields is any less risky than equities." **Plainly, we agree**.

Theme #4: Active vs. Passive Investing



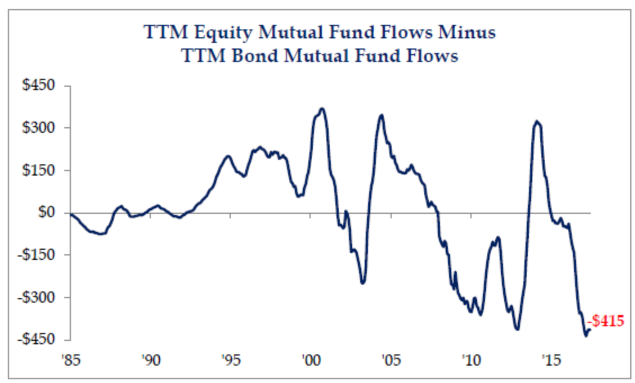
Our work leads us to conclude that an active investing approach will outperform a passive approach. In other words, "buy and hold" simply does not work in our opinion. Since the financial crisis of 2008/2009, there has been a relentless pursuit to downplay and dilute the advantages of active investing. Most of this has been formed off of the belief that an investor can't outperform their respective benchmark and a lower fee alternative is the only solution. Moreover, it is also based on the perception that the majority of assets are highly correlated (all securities trade in similar fashion). We respectfully disagree. Certainly fees and costs are a consideration we closely monitor, but over the past few years we have seen a significant shift in asset correlation. Thus, security selection is paramount. Across our portfolio management team, we have developed a rigorous investment process that allows us to screen through various asset classes and sectors to uncover best in class actionable ideas. This process is followed on a consistent basis and is always being improved. The end result is an offering that is thorough, repeatable and independent. It is not based on a relative return where we compete against a benchmark. Instead we focus on an absolute return basis, in which each portfolio return and profile corresponds to an investor's risk tolerance, objectives and goals. Confidently, we can state that our process has generated results that provide better risk-adjusted returns than headline indices, while displaying half to three quarters of the volatility. In summary, we can't understate the importance of employing an active approach, as the next bear market will clearly uncover those who are exposed to the unexpected risks of adhering to a passive approach. In simple terms, why own the "good and bad" names, when you can work hard to own just the "good names".

Theme #5: Investors are Still Widely Underinvested

The case may be largely circumstantial but it appears as if retail investors continue to view bonds as a proxy for cash or money market funds. As noted above, we feel there is inherent risk to this consensus and many investors will be negatively impacted by a more aggressive interest rate stance. As noted in the nine year data chart below, *(Strategas)*, net flows into mutual funds and exchange traded funds vastly favours bonds over domestic and international equity. Even as the equity markets trade to new highs, total trailing twelve month flows remain out of stocks. Thus, we think we are nowhere near the euphoric and greed stage often associated with equity market peaks.

Net Flows into Mutual Funds + ETFs ($BN)

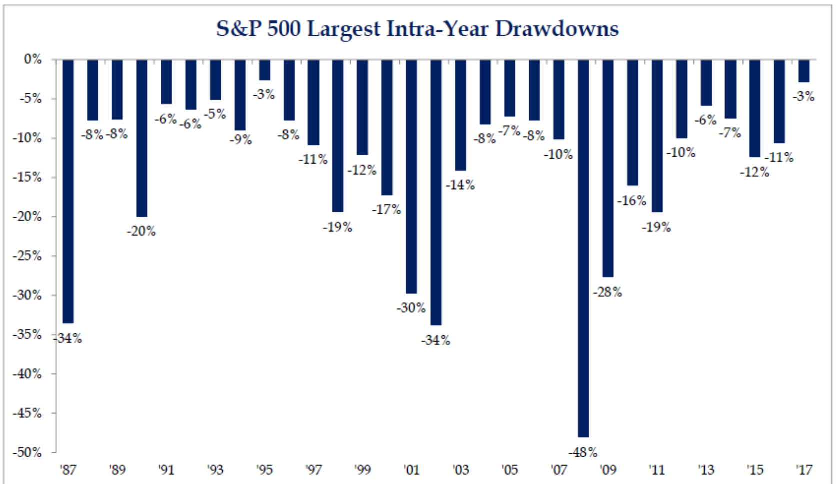
Year	Domestic Equity		International Equity		Bond	Money Mkt
	MF	ETF	MF	ETF		
2009	(27.6)	30.9	29.6	39.6	417.2	(539.1)
2010	(81.1)	46.7	56.7	41.5	262.0	(525.1)
2011	(133.3)	47.3	4.1	24.3	163.7	(124.1)
2012	(159.1)	80.9	6.4	51.9	358.5	(0.2)
2013	18.1	104.1	141.4	62.8	(59.0)	15.0
2014	(60.2)	141.5	85.4	46.6	94.5	6.2
2015	(170.8)	65.4	93.9	109.7	29.4	21.5
2016	(235.4)	167.6	(24.5)	20.1	190.1	(30.3)
2017 YTD	(75.2)	82.2	36.9	94.8	170.2	(100.1)
TOTAL	(924.5)	766.5	429.9	491.3	1626.6	(1276.2)



Theme # 6: Adhere to a Goals Based Approach

Investments and portfolios are a means to an end, whether the objective is a comfortable retirement, a child's education or a legacy for future generations. Backed by the wide array of resources, investments and tools available through Raymond James, we are well positioned to determine how to effectively address each client's needs, develop appropriate strategies, construct well-crafted portfolios, and help clients achieve their wealth management objectives. Recommendations are made after a comprehensive assessment of each client's complete financial picture, including balancing short-term requirements with long-term goals, and the amount and type of risk one can comfortably and appropriately assume. Within the investment business, there remains an unfortunate tendency to recommend "products". We view this as a sales tactic to win business, without taking into consideration the most important central point of the conversation -- the needs and wants of the client. By engaging with our clients and building upon the relationship and trust that accompanies it, a goals based approach provides a deeper and richer offering that adds tremendous value over any length of measurable time.

Although the list is not exhaustive, we continue to focus on these key themes that are driving our day to day management. In summary, we are very pleased with the positioning and performance of the portfolios over the quarter. Our focus going forward on the equity side will be on high quality, dividend paying names, while the fixed income component will be on shorter term, corporate issuances that carry a solid credit rating and offer attractive liquidity. As always, our main focus will be to protect your capital, manage the volatility and ensure that we provide an acceptable rate of return that complements your risk tolerance and longer term objectives. Looking at the current set up, with the recent run up to new highs we are expecting a softening of upward momentum as the market digests incoming earnings. Spouts of volatility should be expected, but we continue to view weakness as a buying opportunity. Fundamental analysis will drive these tactical calls. Finally, throughout the course of 2017, we have not experienced a correction or pullback of more than 3%. If past is prelude, we should expect something more in line with a 5%-10% correction as seen in the chart below over the last 30 years. And this just in from Technical Strategist Bob Dickey;



"The market volatility has been unusually quiet, especially for the past few weeks, which provides little clue as to which way the trend may be headed. These dull periods worry us most after the market has made a big move to the upside because the volatility does tend to move from one extreme to the other, just like most other market indicators. And so rather than becoming complacent due to the lack of excitement in the market, we would use this time to make sure that a portfolio is positioned to withstand a possible change from the current trend. There were several early warnings of a possible market correction months ago; the strength of the indexes over the past month has put those warnings on hold for now, but they also remain valid. We have seen this before—where a correction may start from a seemingly solid bullish position—and would avoid becoming too complacent during this time in the cycle."

We couldn't agree more at this juncture. Longer term, we remain in the constructs of a longer term secular bull market. We continue to invest accordingly.

Thank you for your trust and confidence in allowing us to manage your financial affairs. We will keep you updated moving forward.

Sincerely,

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