"The Marshmallow Experiment – Revisited"

"This time it's different." The infamous four words often proclaimed at critical turning points, as clouded investors attempt to justify the current landscape and market trend by arguing that the past carries no relevance to the present. Unfortunately, the majority of the time these prognostications carry little credibility as the similarities between the past and the present are clearly summarized in the old adage "History doesn't repeat itself, but it often rhymes."

Certainly there is a lot of truth to this. Markets, economies, sentiment, earnings, investor behaviour etc. all have a tendency to repeat the same cycles of an era gone by. Bull markets and bear markets. Recessions and expansions. Overvalued stocks. Undervalued stocks. Fear, hope and greed. They roll in and roll out like the tides of the Pacific. Understandably, each "cycle" is impacted or swayed by a plethora of new inputs, but as we look back on the past we often learn that the more things change, the more things stay the same. That is why it is important at times to refresh what we have learned from our experiences so we can better apply this knowledge to our current and forward thinking.

Roughly four years ago I wrote a piece titled "The Marshmallow Test" in which I discussed the concept of delayed gratification, a human trait examined back in the 1960s by Columbia psychologist Walter Mischel. For those not familiar with the experiment, it was the study of the human trait of self-control and willpower. In the case of the marshmallow test, researchers presented a preschooler with a plate of marshmallows. The child was then told that they were going to be left alone for a short period of time, but not before the researcher offered two choices to the child. If the child waited until the researcher returned, they would be rewarded with two marshmallows. But if temptation overtook self-control and the child consumed a marshmallow, a second treat was not offered. Thus, it tested the basic premise of delayed gratification. Preschoolers who displayed strong self-control sacrificed the immediate pleasure of one marshmallow for the satisfaction of twice the reward at a later time. This characteristic was not only found in children, but in adults as well, as Mischel and his colleagues discovered in later studies.

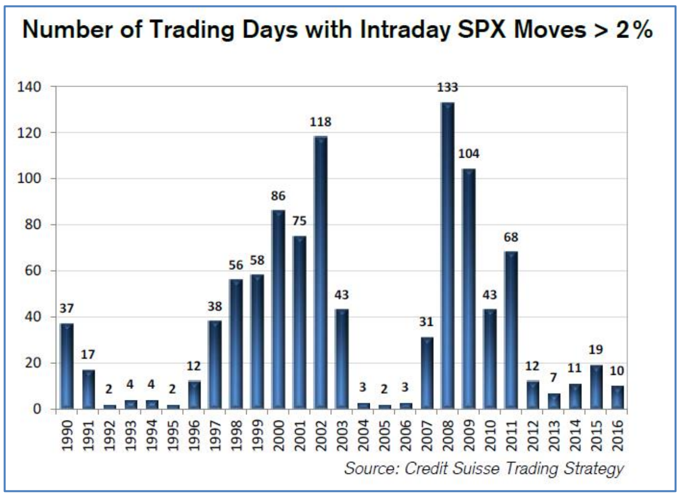
The result of the study is what is referred to as the "hot and cool" system and explains why human willpower succeeds or fails. As Mischel discovered, the cool system is cognitive in nature. It is a thinking system, incorporating knowledge about sensations, feelings, actions and goals. While the cool system is thoughtful and reflective (should I eat the first marshmallow or not?), the hot system is responsible for quick, reflexive responses that are carried out without regard for the longer term implications of that action. When willpower fails, one`s exposure to "hot" stimulus overpowers the "cool" stimulus, triggering a negative response. Not surprisingly, this trait can be found across all facets of life; shopping, relationships, addictions, crime, spending and fittingly for this commentary, investing. While the cool system may be the angel on your shoulder, the hot system is likely the devil on the other. Which do you control?

Indeed the devil was resting firmly on the shoulders of many investors in the month of January, in an attempt to quickly raise the temperature of the "hot" stimulus to evoke one's negative response. The first 20 trading days of 2016 were evidence of this as volatility re-emerged, selling pressure spiked, and emotions were tested. In fact, the month of January produced some of the most dramatic and divergent readings we have seen in years, resulting in many third party cries that the equity markets were teetering on the verge of collapse and action must be taken. As always, the team at HugganWhite Wealth Management takes a much more rational approach and uses our collective knowledge and experience to assess the landscape and draft a more educated response. This month`s newsletter offers some insight, allowing investors to see the current environment through our lenses and hopefully addresses any hot or cold feelings that some may be feeling at this time.

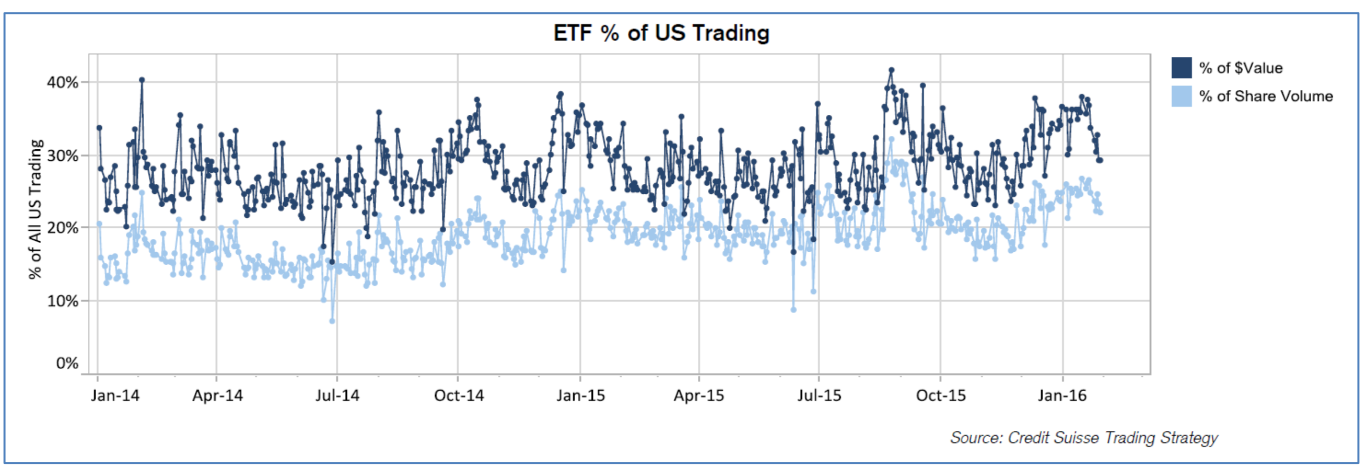
Let me once again begin by providing our view on risk and volatility. Risk is the permanent loss of capital. Risk is allocating capital to speculative investments that carry a high degree of future uncertainty. Risk can be reduced by not speculating with one's capital. Risk can be reduced by diversifying across asset classes (cash, fixed income, and equities), sectors and geographic regions. Risk cannot be eliminated and will always be present. Volatility is the fluctuation of asset prices across different time frames. Volatility is driven by supply and demand and the speed of which that operates. Volatility is largely impacted by the invention of new products, the emergence of high frequency trading and the reduced holding period of assets. Volatility cannot be eliminated and will always be present. As we do not speculate with our client's capital, we rarely use the term risk in our conversations. Volatility, on the other hand, is a word we are more inclined to discuss.

So what has been the driving force behind the recent volatility, and are markets functioning in a completely new paradigm? The first part to the question carries a more fundamental detailed response (to be discussed later), while the second part is more quantitative in nature. Let's address the second question first.

As stated, market advances and declines and associated spikes in daily volume go hand-in-hand with volatility. January 2016 was proof of this, as 10 of the 19 trading days in the month saw moves of 2% or more, with a number of days registering intraday swings of ~3%. To put this into perspective, these 10 trading days surpass all of 2013 in terms of 2% moves or more, and 2016 is already closing in on 2012, 2014 and 2015 (chart below). Furthermore, the average daily dollar value traded in the U.S. for January was \$343 billion, which is the 6th highest in history, while the average daily share volume was 9.2 billion shares per day, the 16th highest month in history. With the large increase in ETFs over the past decade, these structured products have contributed significantly to the daily trading volume as seen in the chart below. ETFs in January alone represented approximately 30% of the total dollar value traded and 23% of the daily share volume. As a number of these ETFs replicate the daily performance of various indices, and in some cases are leveraged, it is reasonable to conclude that ETFs have added to daily volatility. In fact, one of the most widely traded ETFs, the S&P 500 SPDRs, turns over its entire float every 4.5 days.



In days of extreme stress, as seen in mid-January, this ETF turned over its entire portfolio in a single trading day. Investment or trading vehicle? I will let you draw your own conclusion. Furthermore, the advancement of global markets, in particular emerging markets, is contributing greatly to the overall dollar and volume amount of shares traded on a daily basis. With markets trading 24 hours a day, with real time data and information instantaneous, the



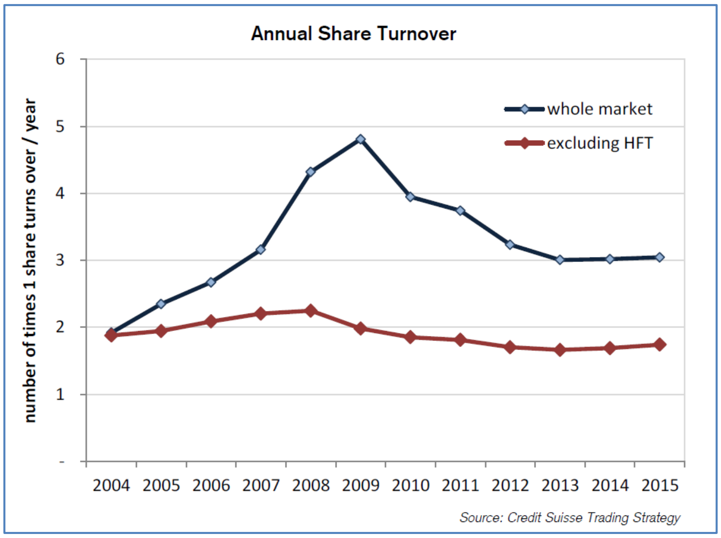
interconnectedness, speed and correlation across markets has never been greater. This, in our opinion, is the predominant factor behind volatility.

One thing is for certain, volatility is here to stay. In the short term though, volatility provides opportunity to allocate capital to high quality names that remain fundamentally strong. Regrettably, many investors fail to recognize this, as much is made of the stock markets day-to-day direction. According to one RBC technical analyst, "*Watching the daily movement too closely likely makes it more difficult to tell what the trend may be, but the allure and excitement of the process makes it an irresistible thing to watch for some investors. Often it seems that the market changes direction on a daily basis, with the reason for the move sometimes being a pretty weak excuse. This is because the daily market moves are driven more by the emotion that gets tied to the daily news rather than the fundamentals that determine the long-term success of investing. If the market moved only in relation to the facts, they would be easier to understand, but once you throw emotion and confusion into the mix, it gets pretty confusing.*"

Confusion perhaps, but more fittingly, unpredictable, when time horizon is shortened. The table below illustrates how the movement of the market is more or less a coin toss when viewed in the context of days or even weeks. That said, the benefit of a longer term horizon increases the success rate by 20%, when years relative to days are evaluated. This is why we view volatility as opportunity. If the market misprices an investment based on short term fear and unsupported selling, we can capitalize on this, thus taking advantage of volatility in search of longer term profitability.

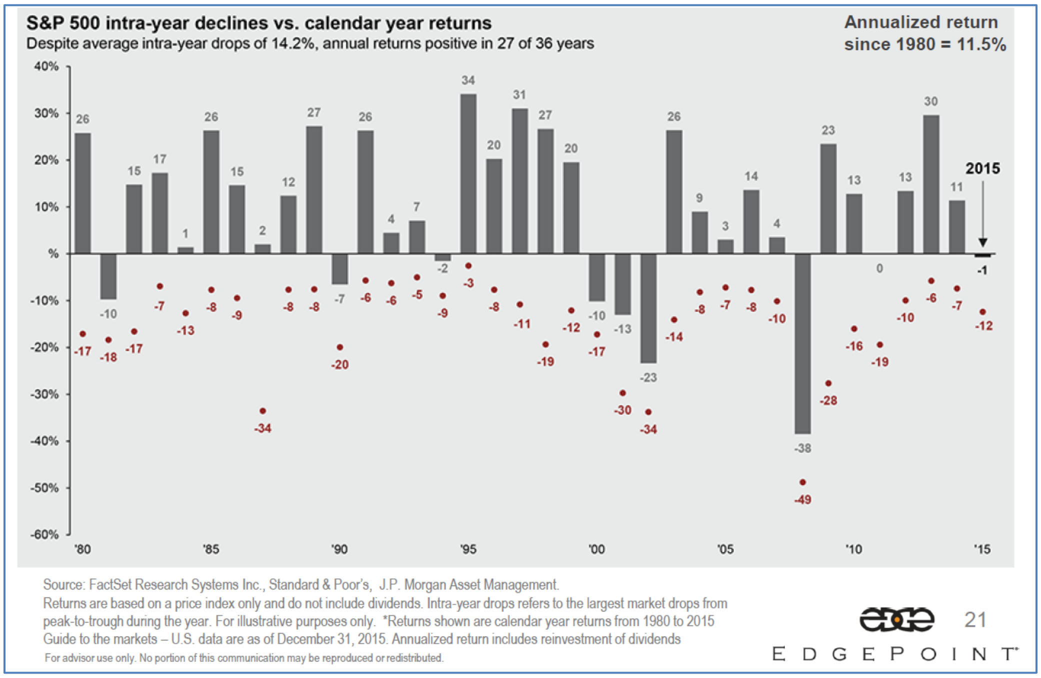
Percentage of Time the S&P 500 has been up over the past 65 Years	
Daily	53%
Weekly	56%
Monthly	59%
Quarterly	64%
Yearly	73%

Even more disconcerting and evidence of the short-sightedness of investors, is the rate of share turnover seen today. As Credit Suisse points out in their latest trading strategy report, the average U.S. stock turns over 3 times per year, which is down from 2009, but still alarmingly high. Remove high frequency trading however, and we can see that the retail investor holds a stock on average for a mere 7 months! This begs the question; are investors allocating their capital to businesses, or are they borrowing stock with the expectation of a quick gain? We prefer to follow the principle that one brilliant portfolio manager stated recently, <u>"Investors need to start thinking like the owner of quality businesses and stop behaving like the renters of volatility."</u> Need we say more?



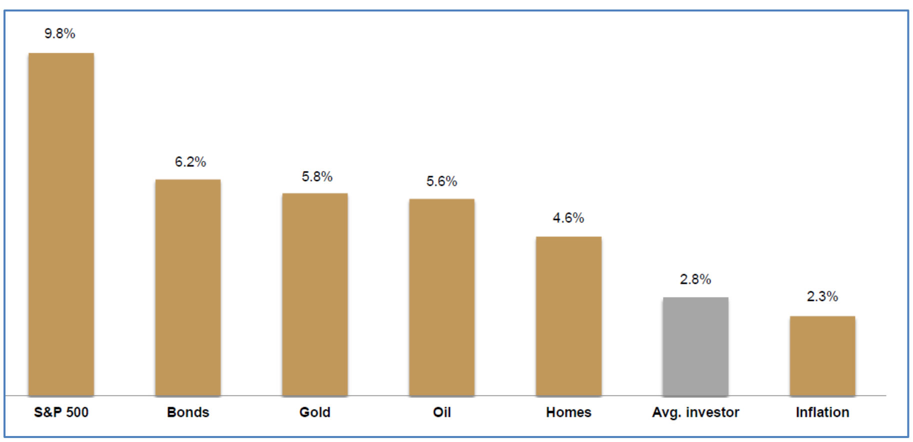
If volatility is a permanently fixed characteristic of the market, often associated with declines, then it is appropriate to examine the occurrence of downward price action as a result of increased volatility. As often stated, markets are always susceptible to pullbacks, corrections and bear markets. As we can see, the average intra-year decline for the S&P 500 over the past 36 years is 14.2%, as indicated in the chart at the top of the next page.

In fact, a number of calendar years suffered dramatically worse drawdowns over a 12 month basis. 1987 is a clear example of a market that suffered a 34% loss from peak to trough, yet recovered those losses to finish the year with a 2% gain. More recently, 2009 experienced an intra-year loss of 28% and still managed to return a 23% gain at the end of the year, while 2015`s August correction fell within the confines of the 36 year average. Many will point to the seven negative years in this chart, but the majority of these losses can be linked to a recession, an overvalued market or a financial crisis, none of which are apparent today based on our work. Nevertheless, 27 of the past 36 years produced positive returns, with an annualized rate of return, including reinvested dividends, of 11.5%. These are outstanding numbers considering the hurdles the market overcomes each year. So what investors are experiencing currently, and in August 2015 (most topical), is par for the market. This is why I so often ignore the notion and chatter that we are operating in newly uncharted waters.



This supports the case, in part, for why we have adhered to a longer term approach with our investment strategies. The weight of evidence supports this view. Admittedly, you don't have to be the smartest investor to recognize the value of a longer term approach, as the odds are 77% stacked in your favour for a positive return based on the 36 years above, but you do have to recognize that every rolling time period is subject to negative performance. Successful investors recognize this and have the ability to overlook the short term, with the understanding that the longer term will bear fruitful returns. Not only that, they avoid falling victim to emotions, always resorting back to the benefit of delayed gratification. Once again though, the average investor never achieves these results as highlighted in the asset return table below (source: Bloomberg LP).

Thankfully, 98% of our clients fall within the former, as opposed to the latter. Perhaps that's a function of their appreciation for the longer term. Possibly it's a result of the principles we follow, which we so often remind them.



Regardless, some of the sagest advice we can pass on, is that success should be measured in years, not days or months. That said, a tactical strategy must be part of an investors arsenal as trends do move in and out of favour. There are times when reducing or increasing exposure to certain sectors or asset classes is warranted. This is generally a reflection of macro events, economic data and fundamentals. Let`s review a few key issues currently rattling our minds.

China and the U.S.

Certainly two of the main culprits of market strain can be directly attributed to the world`s two largest economies, China and the U.S. China is in the midst of a slowdown, as it moves from an industrial based economy to a consumer lead economy, while the U.S. is muddling along showing signs of economic growth, albeit small. Despite the fact that they are operating at opposite ends of the monetary spectrum, the two countries are effectively tied together as the Chinese yuan is loosely pegged to the value of the U.S. dollar. The U.S. Federal Reserve announced back in December its first rate increase in roughly nine years, prompting the U.S. dollar to trade higher relative to global currencies. The People`s

Bank of China (PBOC), on the other hand, has recently implemented a series of `quantitative easing` measures to foster economic growth. As the yuan is loosely pegged to the dollar, it has appreciated substantially at a time when a falling currency is needed most for the Chinese. The combination of slow growth and an overvalued Yuan has led to a significant capital flight out of China in recent months. This has put further pressure on the PBOC, as they attempt to arrange an orderly devaluation of their currency, within the framework of what they perceive as "currency self-governance." In response, the PBOC has had to inject roughly $8oo billion of their own foreign exchange reserves to devalue the yuan. This is a form of liquidity tightening and reduces the ability of the Chinese to utilize its own balance sheet for domestic growth. As they are realizing, free markets often determine direction and value. The spill over effect has been increased market volatility until the yuan or U.S. dollar settles.

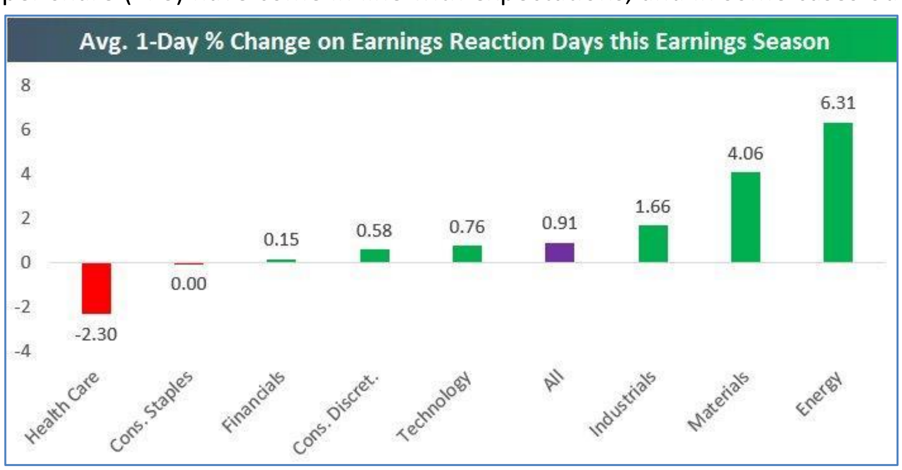
As the Chinese transition between these two economies, the demand for hard assets has decreased. What was once a major consumer of base metals and commodities, at 40% of global demand, the Chinese economy is relying less and less on export based economies that provide these hard assets. Countries such as Canada, Australia, Brazil etc., are the victims of this shift. This is not new news though. Economies such as the U.S. alternatively, are less reliant on exports to China, thus the ability to drag the U.S. into recession is limited. The bottom line is this transition will take time. The end result should be a benefit as the Chinese economy adopts an approach based on consumption as seen in other developed markets. This is good for China and good for their people.

Energy

The strength of the U.S. dollar has put further pressure on an already depressed energy market. As crude oil is priced in U.S. dollars, the impact has been magnified. From our perspective, the demand for oil has not materially changed in recent years, as the entire issue continues to be on the supply side. Neither OPEC or non-OPEC want to deviate from their current production levels and until this is resolved, it is likely crude prices will remain low. As the correlation between energy prices and equity markets is in the 90th percentile currently, oil needs to stabilize for equity markets to find solid ground. We do humbly admit that our call from a few months ago that the $38 price level was the low turned out to be dead wrong. Thankfully, our exposure to energy is far underweight benchmark indices so the rout in oil has had limited direct impact on our portfolios.

Earnings and Valuation

We are currently in the middle of fourth quarter earnings season and so far the results have been mixed. While earnings per share (EPS) have come in line with expectations, and in some cases outpaced consensus, top line sales and revenue growth has been soft; the corollary of a slow growth environment. Given the market turmoil this year, it is worthy to note though that the majority of stocks are trading higher on "earnings reaction day" by roughly 1%. Even the beaten up energy and material sectors are trading considerably higher with a gain of 6.3% and 4.1% respectively after their earnings release (Bespoke). Moving forward, the cumulative earnings guidance for 2016 currently resides around $123 for the S&P 500. Considering the historical P/E multiple is 17x, we can see that based on forward expectations, the equity markets are not all that expensive. In fact with a current P/E of 15.5x (S&P 500 @ 1,900/$123 =15.5x), one can make the case that stocks are attractively priced at this levels. Certainly they are not expensive.



HugganWhite Wealth Management

The cause and effect of a slow growth environment, softening earnings and currency fears is a market that refuses to make any positive headway. From the peak of May 2015, the equal weighted S&P 500 index is down ~15%, while the S&P/TSX Composite Index is down 19%. Many are calling this a stealth bear market, masked by strong performance over the past year by a couple of large index constituents (Facebook, Google). We believe this to be a fair assessment, yet also believe that this negativity is priced into the market, as it has already discounted the sum part of every headline and opinion. We know earnings are soft, oil prices remain supressed, China is slowing, central banks are easing and the Federal Reserve is likely on hold for its next rate increase. Unless a black swan event occurs, we remain cautiously optimistic that this is indeed the case and better days lie ahead.

We are pleased to report that not one of our balanced strategies is showing weakness reflective of these indices. If relative performance is the measurement of investment success, then we hope clients are content with the recent performance of our dividend strategies, as they are performing exceptionally well given the challenging backdrop. As always, we tend to ignore relative performance and focus on absolute performance instead, ensuring our clients capital is protected across all environments.

In summary, we remain committed to the recommendations we have in place for our clients at this time. We are cognizant of the fact that a number of headwinds continue to unnerve the markets and investors, but when has the market not faced adversity? We understand that a number of these issues are real risks, but we also believe that they are transitory risks, not fundamental or structural risks. There is no indication that this is 2008 or 2009 all over again. Remove this deliberation from your dialogue! In a slow growth environment, where interest rates remain low, we have seen that dividend strategies provide solid risk adjusted returns. Tactically, we continue to look for any signs of market deterioration that would provoke us to alter our asset allocation. We trust the indicators that have served us so well in the past, and lean on them strongly in times of turbulence. Our clients have employed us to manage their affairs and have put the ultimate faith in our team's abilities. We are working hard to ensure that we preserve that loyalty and always strive to provide the best advice we can, even if the gratification is delayed.

Once again we want to thank you for your continued trust and confidence in allowing us to manage your financial affairs. If you have any questions or comments, please do not hesitate to call or email any member of our team.

As always, we will keep you updated going forward.

Until next month,

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Reminders

RRSP contribution deadline for 2016 is February 29

Allowable TFSA contribution room for 2016 has been reduced to $5500 from $10,000.

Annual minimum RIF payments have been reduced to reflect the 2015 Federal Budget. Contact our team for details on new minimums.

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