HugganWhite Wealth Management

Protect Capital. Manage Risk. Provide Income

Market Insight & Investment Strategy

April 2015

The "Framing Effect"

Investing is hard work. There are no shortcuts to investment success. Markets do not operate with the financial well-being of its participants in mind. They are fickle. They are stubborn. They are impulsive. They can also be very rewarding. To achieve investment success not only are investors pressed to sift through the unrelenting flow of data, charts, opinions and strategies, they are also forced to overcome one of the most demanding hurdles; the psychology of investing.

As often stated in these commentaries, emotions largely impact the mindset of retail investors. Fear runs rampant when markets perform poorly, while greed moves to the forefront when investment returns are favourable. Investors base their investment decisions on the expected outcome of future events and the potential gain or loss associated with this expectation. A large contributing factor that forms these decisions is based on the context in which they are "framed," known as the Framing Effect. According to Wikipedia, the framing effect is an example of cognitive bias, in which people react to a particular choice depending on whether it is presented as a loss or as a gain.

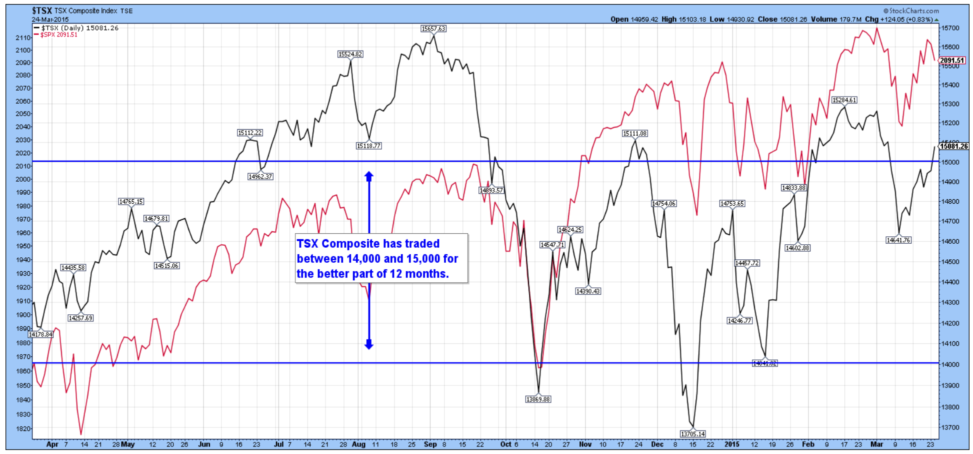
In a 1981 study, Amos Tversky and Daniel Kahneman explored how different phrasing affected participants' responses to a choice in a hypothetical situation. Participants were asked to choose between two treatments for 600 people affected by a deadly disease. Treatment A was predicted to result in 400 deaths, whereas treatment B had a 33% chance that no one would die but a 66% chance that everyone would die. This choice was then presented to participants either with positive framing, i.e. how many people would live, or with negative framing, i.e. how many people would die.

The results were overwhelming. Treatment A was chosen by 72% of participants when it was presented with positive framing (saves 200 lives) dropping to only 22% when the same choice was presented with negative framing (400 people will die). The end results though as we all know, are identical. The key determining factor was the context in which the outcome, good or bad, was presented.

Consider the following example when applied to investing; Portfolio 1) a well-balanced, diversified income strategy carries a 67% likelihood of providing positive returns, while 1/3rd of the time the returns will be negative. Portfolio 2) a well-balanced, diversified income strategy carries a 33% likelihood that it will lose money, while 2/3rds of the time returns will be positive. Based on framing, I can only assume that most investors would gravitate towards Portfolio 1 as it is framed with a positive bias, while portfolio 2 carries a negative connation. The outcome as we know in each situation is identical.

Unfortunately negative framing continues to dominate retail investing today. Despite a sharp rise in most global equity markets since the financial crisis, investing is still seen as a dangerous endeavor by many. "Bears" point to softening economic data and reduced corporate profits, while "bulls" focus on a favorable environment spurred by low interest rates, reduced unemployment and improving global markets. Both opinions are referenced and supported by a cognitive bias towards a negative or positive outlook. As our readers know, over the past number of years our strategy has fallen within the latter bullish group; hence our relatively positive framing bias. Over the past 6 years this strategy has served our clients well as performance and returns have been rewarding. The question as we move forward, should a positive bias continue to be the focus? Based on our work, we believe so.

In this month's newsletter we will update a number of charts and technical indicators we follow, review our outlook going forward, before concluding with a personal comment of my own. My sincere apologies for neglecting to provide recent commentaries, but the last few months have been extremely busy as my wife and I welcomed the newest addition to our family, a healthy baby girl. In any event, I hope you enjoy this month's read!



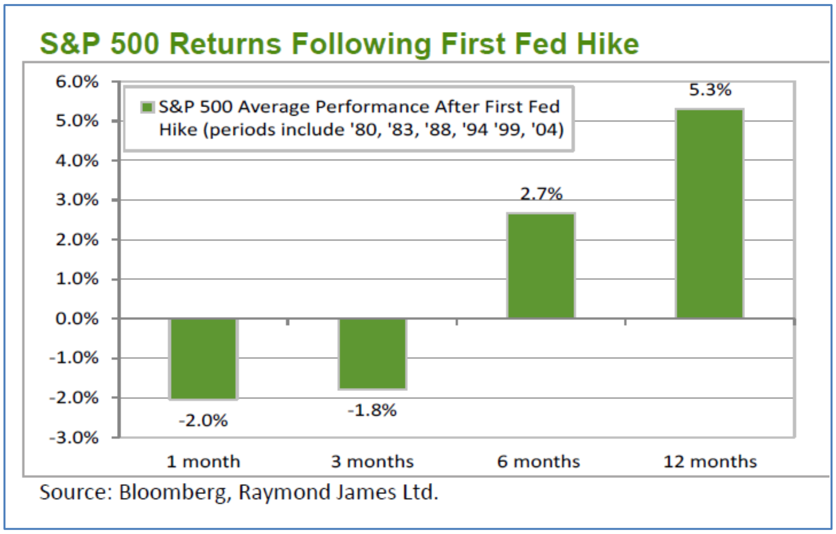
Over the past year and throughout 2015, we have stated on numerous occasions that patience and commitment to current income strategies is vitally important. As illustrated in the chart to the right, we can see that the TSX Composite Index (black line) has travelled within a trading range between 14,000 and 15,000 for the past year. The U.S. based S&P 500 (SPX) (red line) has managed to outperform its Canadian counterpart, due to a more robust economic environment. At the time of writing, the TSX has managed to produce a return of ~2% year-to-date, while the SPX is showing a gain of less than 1%. Although the TSX has attempted to break out of this longer term trading range on a number of occasions (and surpass its all-time high of 15,657), it has been held back by soft energy prices. Crude oil, with its precipitous drop to a low of $42.43 U.S./barrel more recently, continues to weigh on our resource heavy index.

How much lower can oil prices go? In our most recent conference call, we stated that it is our belief that oil prices are in the process of forming a bottom. The following chart of crude oil highlights what appears to be a bottoming process in the low-mid $40 range. At this time the duration of this bottoming process is unknown, but we feel a break-out above $53/barrel could strengthen our view and possibly confirm the lows of last week are indeed the lows for this cycle.

Not surprisingly, weaker commodity prices are having an impact on the Canadian economy and the Canadian dollar. Several economists expect that low oil prices will continue to weigh on Canadian economic growth, corporate profit and employment levels this year, but the stronger U.S. economy, weak Canadian dollar and low interest rates should provide an offset. The result: a forecast for subpar growth of 2 per cent in 2015 and 2016 – unchanged from an earlier forecast – with the unemployment rate rising to 7 per cent by the end of this year and hovering there for some time. With the Bank of Canada cutting interest rates in January and leaving them unchanged during its March announcement, the expectation for a rate increase in Canada has most likely been pushed out until 2016. A low interest environment and softer economic data should keep the "loonie" around current levels vis-à-vis the U.S. dollar. A lower Cdn. dollar should give a boost to growth and competitiveness in Canada's manufacturing and tourism sectors. The catalyst that will likely have an impact on the direction of the Cdn. dollar is commodity prices.

Turning to the U.S., most of the attention as of late has been focused on interest rates and monetary policy. On March 18th, the U.S. Federal Reserve (Central Bank) once again confirmed its stance that interest rates will remain unchanged. That said, after 7 years of benign interest rates, markets are anticipating a rate increase in the second half of 2015. The Fed has indicated that any potential increase in interest rates will remain data dependent, with the focus on labour markets and inflation expectations. The former continues to show improvement, while the latter is below the Fed's targeted rate of 2% at this time. Data released on March 24th confirms inflation remains subdued with year over year core CPI coming in at 1.7% for the U.S. economy. Many believe an increase in interest rates will stall economic growth and negatively impact equity markets. We disagree with this assertion for the following reasons: 1) higher rates would signal that the economy is getting stronger and no longer requires intense monetary support and 2) it would provide the Federal Reserve with some ammunition should the U.S. economy weaken at some point in the future.

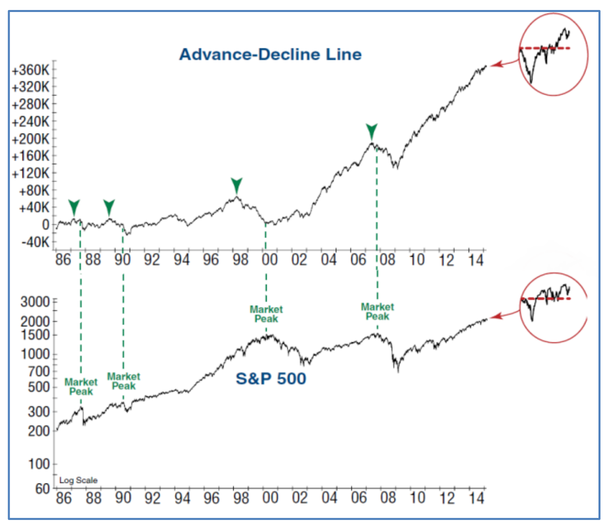
Furthermore, history suggests that equity markets generally perform well after a rate increase. This can be seen in the following chart which illustrates the performance of the S&P 500. As Raymond James's Canadian Private Client Strategist Ryan Lewenza points out, *"Historically the S&P 500 has risen in the six and twelve months following the first Fed rate hike. We examined the S&P 500 returns following the start of each tightening cycle since 1980 and found that the S&P 500 is up on average 2.7% and 5.3% in the six and twelve months, respectively, after the first Fed rate hike. In fact, of the previous six tightening cycles since 1980 there was only one occurrence (1984) where the S&P 500 was lower 12 months after the first increase. From our perspective, the beginning of Fed tightening is positive as it signals an improving economy, which is consistent with stronger corporate earnings growth and higher equity valuations."*



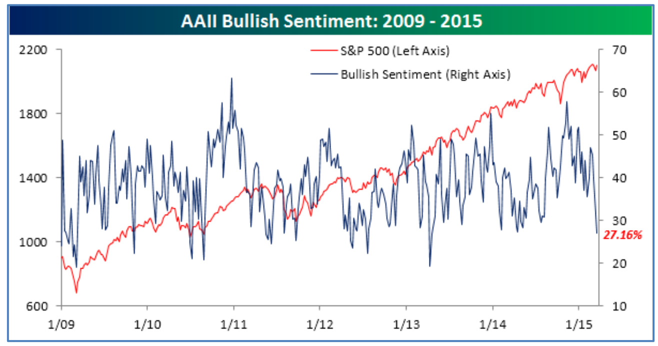
Source: Bloomberg, Raymond James Ltd.

Plainly, we agree with Ryan's comments, which is why we have not significantly altered our exposure to equities over fixed income. Moreover, our increased allocation to U.S. equities over the past number of years has rewarded client portfolios with higher prices via strong earnings growth and a higher U.S. dollar (currency trade).

Further evidence supporting our favorable outlook towards U.S. equities can be seen in a number of technical indicators we follow. First off, the often quoted Advance/Decline Line (right chart), which measures market participation, remains broad based and there are no signs currently of a negative divergence (weakening market internals), which often precedes a market top. The recent advance to new all-time highs in a number of U.S. based indices, in conjunction with a stronger A/D line, confirms the healthy internal readings for equity markets. Secondly, the American Association of Individual Investors Bullish sentiment survey, which measures the percentage of investors who are bullish, neutral or bearish for the next six months forward, recently dropped to a multi-month low. In fact, the recent reading at 27.2% is one of the lowest levels in over 12 months and is substantially lower than the longer term average of 38.9%. From a contrarian perspective, this is promising as markets are susceptible to a meaningful decline when sentiment is overly optimistic and the retail investing are resoundingly bullish. Clearly, this is not the case at this time.



That said we are closely monitoring a number of indicators that may cause potential headwinds for equity markets. In particular, the strength in the U.S. dollar and its parabolic rise over the past quarter has caught our attention. Generally, a strong dollar worries many investors as it can negatively impact the earnings of U.S. businesses that operate in foreign markets. As products and services are sold in foreign currencies, the repatriation of these funds results in fewer U.S. dollars (higher currency) for U.S. based reporting companies. With ~40% of S&P 500 listed companies having their earnings domiciled non-U.S. dollars, the impact in the coming quarters could be material if the dollar continues to rise. (As a side note, this is why we also believe the Federal Reserve is reticent to raise interest rates any time soon as any increase would further push the U.S. dollar higher.) Considering most global central banks are cutting interest rates to spur economic growth, we find it hard pressed to see a material decline in the value of the U.S. dollar in the near future.



Turning over to portfolios, the primary focus remains on equity income. As noted above, the increased exposure across all of our income based strategies to U.S. based names has enhanced total returns year-to-date. Relative to the TSX Composite index, our exposure to energy related names remains significantly underweight, with most portfolios having less than 10% exposure. The bulk of the names we do own are mid-stream energy names responsible for moving the product to market (pipelines) and a handful of large cap dividend paying names that are already producing. The remainder of portfolios are invested in various asset classes including banks (Canadian and U.S.), insurance companies, technology, consumer discretionary, a handful of REITs and industrials. At this time we are very confident in the current asset allocation across all of the portfolios as diversification spans various sectors, business models and geographic regions.

One of the challenges we are encountering is finding higher yielding equity names in North America. As fixed income yields have declined over the past number of years, the demand for equity income has increased dramatically. The result has been higher equity prices and reduced yields. This has forced us to look beyond our borders in search of higher yielding names. The good news is, there are a plethora of solid investment opportunities that we can take advantage of. The table below illustrates the scope and diversity of dividend producing names on a global basis. As we can see, of the 825 total stocks in the MSCI All Country World Index that offer a dividend yield of 3% or higher, Canada

Significant Yield Opportunities Reside Outside of North America

Number of Stocks in the MSCI All Country World Index with a Dividend Yield over 3%

	Canada	United States	Rest of The World
Consumer Discretionary	2	12	66
Consumer Staples	0	7	37
Energy	18	16	60
Financials	15	23	210
Health Care	0	1	10
Industrials	1	3	92
Information Technology	0	5	33
Materials	4	5	59
Telecom Services	3	5	53
Utilities	2	22	61
Total	**45**	**99**	**681**

As of December 31, 2014.

represents less than 6% (45 of 825). The U.S. represents a marginal increase at 12%. The remaining 82% or 681 names represented by the "rest of the world" is verification that global markets offer considerable investable opportunities. In the coming months look for more information, commentary and strategies from our team that will complement this global dividend theme.

In summary, our strategy remains unchanged. We continue to focus on income as a major component to total return, with a further emphasis on dividend growth. During times of transitioning markets (which we are seeing now), there is a tendency amongst investors to modify existing strategies. As we have learned, this is generally the wrong tactic. One of the hardest principles to adhere to that often riddles investors is the concept of patience. A seasoned investor on the other hand, recognizes the value of patience and looks beyond the short term. We indeed remain patient, prudent and confident, using our cognitive bias to "frame" a longer term, rational strategy.

The last section of this newsletter is accompanied with both happiness and sadness. As many of you know, our colleague, team member and good friend Mr. John Skelton (JS) will be retiring at the end of this April. For 10 years now JS, myself and the entire HugganWhite team have worked closely together and have called Raymond James home. Over the years, the relationship all of us have formed has indeed become irreplaceable. On a personal note, JS has truly been a mentor. His vast depth of knowledge, education and experience that he so generously offered has truly taught me an enormous amount about financial markets and the investment business. More importantly, he has always stressed the value of a trusting relationship and the fiduciary care that is bestowed upon us as financial advisors. This was no further evident than during the depths of the financial crisis when John and I often sat in his office reminiscing. At the time, it truly felt like the world was coming to an end. John, in his search for answers, worked relentlessly to find a window of light in what seemed like a period of unrelenting darkness. There was no personal benefit sought at that time; rather, it was the utmost attention, care and concern for the financial well-being of his clients. JS always has and always will put others ahead of himself. That is why he is so widely respected. Admittedly, JS and I have had our fair share of disagreements and conflicting opinions on a number of topics (computer trading, Central Banks, gold, global warming), but we always managed to find common ground, a good laugh or at least agreed to disagree. One thing for certain though that we can all agree upon; he will be greatly missed. After 40+ years in this business, happy retirement my friend! Thank you John.

Once again we want to thank you for your continued trust and confidence in allowing us to manage your financial affairs. As always, we will keep you updated going forward.

Until next month,

Craig White, CIM, FCSI
Senior Vice President | Private Client Group | Raymond James Ltd.
T: 250.979.3044 | TF: 1.877.979.2700 | F: 250.979.2749|
craig.white@raymondjames.ca
Suite 500, 1726 Dolphin Ave | Kelowna | BC | V1Y 9R9 | Canada
www.hugganwhite.com

Upcoming Events

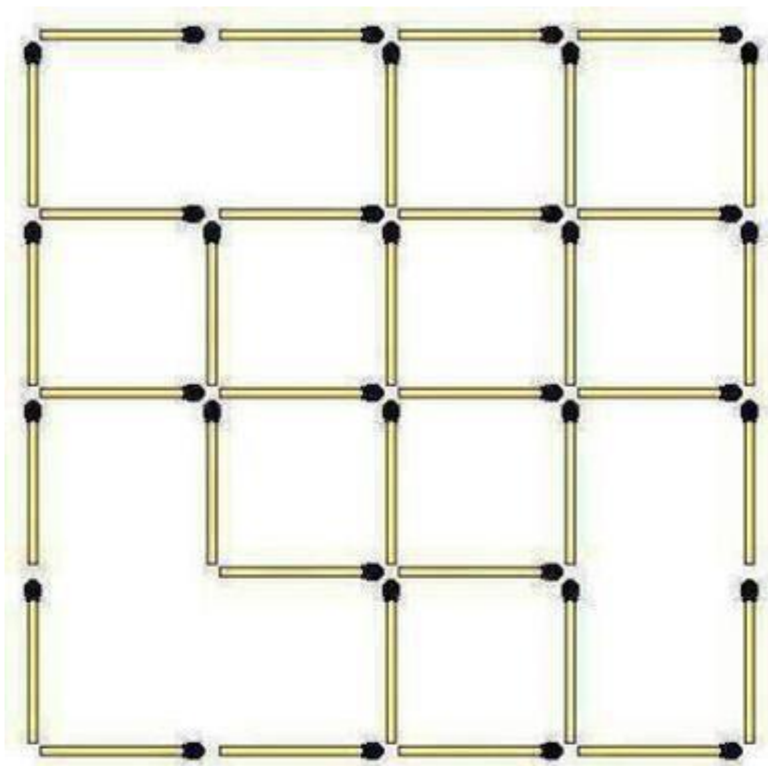
Our next monthly conference call is scheduled for Thursday, April 23rd @ 9:30am PST.

Vancouver Presentations: We have confirmed May 6th as the date in which we will be hosting two presentations with guest speaker David Burrows of Barometer Capital. Location and times to follow, but please email or call if you or any guests are interesting in attending. More details in the coming weeks.

This newsletter has been prepared by Craig White. This newsletter expresses the opinions of the writers, and not necessarily those of Raymond James Ltd. ("RJL"). Statistics and factual data and other information in this newsletter are from sources RJL believes to be reliable but their accuracy cannot be guaranteed. This newsletter is furnished on the basis and understanding that RJL is to be under no liability whatsoever in respect thereof. It is for information purposes only and is not to be construed as an offer or solicitation for the sale or purchase of securities. RJL and its officers, directors, employees and their families may from time to time invest in the securities discussed in this newsletter. This newsletter is intended for distribution only in those jurisdictions where RJL and Craig White are registered as a dealer in securities. Any distribution or dissemination of this newsletter in any other jurisdiction is strictly prohibited. This newsletter is not intended for nor should it be distributed to any person residing in the USA.

Commissions, trailing commissions, management fees and expenses all may be associated with mutual fund investments. Please read the prospectus before investing. There can be no assurances that the fund will be able to maintain its net asset value per security at a constant amount or that the full amount of your investment in the fund will be returned to you. Privacy legislation requires that anyone you are referring consents to having his/her information provided to me. ***This provides links to other Internet sites for the convenience of users. Raymond James Ltd. is not responsible for the availability or content of these external sites, nor does Raymond James Ltd endorse, warrant or guarantee the products, services or information described or offered at these other Internet sites. Users cannot assume that the external sites will abide by the same Privacy Policy which Raymond James Ltd adheres to.***

Raymond James Ltd. Member Canadian Investor Protection Fund



96% Failed this test. Can you answer it? How many squares are there? :)