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Commentary & Outlook

Worst December Since 1931

December 31st marked the end of a disappointing year for most investors, with nearly all assets except for cash and government bonds booking losses.

Despite a strong recovery from the sell-off experienced earlier in the year, the S&P 500 gave it all back and then some in the month of December. The index declined -10.24% from top to bottom for the worst December since 1931, and closed 2018 down -6.24% in the red for the year for the first time since 2008.

Like its U.S. counterpart, the main Canadian stock market index, the S&P/TSX Total Return Composite (TSX TR), also put in its worst year since 2008. The Canadian index ended 2018 down -8.89%, with much of the decline attributed to the energy and consumer discretionary sectors. That said, the TSX showed similar declines in both 2011 (-8.65%) and 2015 (-8.32%) and has shown little growth overall for the past five years.

Oil was down -25.30% on increased supply, a decline in emerging market growth prospects and OPEC's inability to coordinate supply cuts, but it has found some support as of the beginning of 2019.

Despite being down for the year and little changed over the past five, gold came back strongly into the end of the year, reclaiming its traditional role as a safe haven against stock market risk.

In summary, 2018 ended in uncertainty, with concerns for global economic growth prospects, monetary policy decisions and corporate valuations all weighing on investor sentiment. So far, without any clear guidance, it looks like financial markets continue to drag these anchors into the New Year.

Fund Performance

TCG 531 Equity

For the month of December, the Equity Fund finished down -6.74% while its benchmark, the TSX TR Index lost -5.40%

The Equity Fund closed out 2018 down -9.22% with the TSX TR benchmark down -8.89%.

The biggest drag on performance for the month of December came from technology stocks as investors oversold the leading performers out of uncertainty for continued global growth opportunities.

With selling in the major U.S. indices reversing after testing the lower limits of longer-term trend lines, and fundamental analysis on the growth prospects for many companies still suggesting an opportunity for upside at current levels, the Equity Fund continues to hold growth stocks while employing additional defensive strategies to offset the continued uncertainties.

Several put-credit spreads were initiated in the month of December, which were constructed to maintain exposure to the investments we wanted to own in a risk-managed way.

The benefits to put- credit spreads are two-fold:

First, the position can continue to be held with limited downside.

Second, less capital is committed to the position, which enables us to hold cash to be deployed on market pull-backs.

When markets become more volatile, these strategies help reduce the impact of significant pull backs and seek to benefit from a market that is trading sideways to modestly higher. However, while put-credit spreads and other hedging strategies do pay off in up-trending markets, they tend to underperform comparative to an outright bullish position. Since we are expecting another challenging year, we think the introduction of these strategies will help us to continue to both enhance return and manage risk.

TCG 534 Income Fund

The Income Fund lost -3.67% in the month of December compared to the Financial Post Index - Income benchmark, which was down -0.40%.

The fund closed out the year down -2.10% compared to its benchmark, which was down -0.11%.

Stock markets in the late stage of an economic cycle historically experience significant price swings. We saw this in the third quarter and late December sell-off, and then the subsequent year-end and early January 2019 swing higher.

The Income Fund is being managed in line with the Investment Committee's outlook that while global growth is expected to slow in 2019, corporate earnings will remain supportive and contribute to positive figures at year end. With corporate earnings still expected to grow at a 7.6% rate from here, the S&P 500's recent second-biggest decline on record in its forward price/earnings ratio should prove to be an opportunity.

However, given that the Income Fund's objective is primarily cash flow rather than capital gains like the Equity Fund, a heavier weighting in fixed income and more cautious Covered Call writing on the lower weighted equity allocation would be more prudent in this late stage of the financial markets' cycle.

With that in mind, the Investment Committee began moving towards a more defensive stance in the Income Fund in late October, which included:

- Increasing fixed income exposure from 33% to 50%
- Reducing exposure to higher beta or more volatile sectors such as Technology.
- Overweighting defensive sectors such as Healthcare and Utilities
- Adding a Covered Call strategy on gold companies, which tend to outperform during uncertain markets.

- And, in addition, to help reduce the impact of market volatility in general, we initiated a calendar put spread on QQQ, which is the ETF that tracks technology stocks. This strategy benefits from the income generated from selling short-term put options while owning a longer-term put option for its hedging properties.

The fund is maintaining its current weight to Real Estate but is converting the position to an equity holding with a liquid option market in order to integrate a covered call strategy.

TCG 539 Option Writing Fund

The Option Writing Fund's objective remains focussed on meeting client cash flow requirements. In order to meet these requirements, it has continued to employ covered call and other options writing strategies, and holds income trusts, high dividend paying stocks and preferred shares.

There were two challenges to the fund in late 2018 – the first being the sharp market decline, which does not immediately benefit the covered call and other options writing strategies. As fear and uncertainty increases in stocks, option premiums increase in value to reflect the anticipated risk… this delays the pay off from the time erosion that the option writer is after and impacts the value of the fund negatively for a period.

The second challenge was the fund's overweight exposure to preferred shares. Preferred shares were used as collateral for part of the option writing strategy because of the dividends they pay as well as their tax efficiency.

The Exchange Traded Fund (ETF) we used for our preferred share exposure dropped in value significantly as rates on the fixed-income holdings with in the ETF were reset in the 3rd and 4th quarter, resulting in a repricing of the ETF's value. We have moved out of this position and are now using Treasury Bills and fixed preferred shares, which will provide more stability.

The fund currently sits with 16% cash and remains overweight financials and technology. More than two-thirds (68.9%) of the fund has an option writing overlay using various strategies for income generation while more actively hedging downside risk into the current market strength. The fund has regained approximately 3.00% as of the 15th of January.

Outlook & Expectations

While December was difficult, the Investment Committee's view is that the longer-term outlook for the secular bull market remains intact. However, the economy is in the mature phase of expansion and market fundamentals are late-cycle. What does this mean in plain English? We expect further growth for the stock market, but with continued volatile price swings. In the short term, the Federal reserve has introduced some cautious language, which has calmed investor concerns that rates will go up too quickly. If the new guidance has been interpreted correctly and rates play out as expected, based on Fed Fund rate futures, current company valuations are cheap and stock prices are expected to rise. Even if interest rates rise half a percent, valuations are still attractive, and markets should find support.

That said, one of the challenges to the stock market currently is negative investor sentiment. If considering the old saying that a stock market is driven by fear and greed, fear seems to be the predominant headwind. With no short-term clarity on trade, monetary policy and economic growth prospects, this headwind is likely to remain, making it difficult for stocks to make new highs in the coming year.

Considering these challenges, we have made significant adjustments in our core funds to reduce the impact of the next market pull back, including rebalancing sector weightings, increasing add/trim/sell activities as well as overlaying a more active hedging program. The objective has been to reposition core portfolios into the recent market rally to benefit from our expectation for modest growth within certain sectors and industries while reducing downside risk exposure.

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