ISSUE
06
NOV
2018

CROFT FINANCIAL GROUP

Commentary & Outlook

Some November Relief

October was one of the worst months for equity markets since 2011.

Concerns around fading tailwinds from tax cuts, rising interest rates, rising corporate costs and the potential for tighter profit margins, trade wars as well as the U.S. mid-term election continued to drive investors and money managers to the sidelines during the month of October to escape uncertainty.

Oil continued to slide while gold moved modestly higher, but remained range bound despite its history as a “safe haven” during market selloffs – perhaps an indication that things weren’t as dire as the quick and violent drop in the equity markets might have suggested.

So far, November has offered some relief to investors with all major stock market indices gaining back some lost ground.

The most significant move higher to date has taken place just after the U.S. mid-terms. Historically speaking, the S&P 500 has posted gains in the 12 months after every mid-term election since 1954 (Yardeni Research Inc., as reported by Barron's). So far, stocks are off to a good start, with investors perhaps confident in the belief that history will repeat itself.

However, it is important to remember that there are still several uncertainties overhanging the markets. While our fund performance should benefit in this market environment from our recent repositioning of assets, we have not lost sight of the remaining headwinds.

Fund Performance

TCG 531 Equity

For the month of October, the Equity Fund finished down -9.21% while its benchmark, the TSX Total Return Index gave up -6.27%

At the end of October, year-to-date, the Equity Fund is down -2.77% with the TSX Total Return benchmark trailing at -5.00%.

Lead Manager Alex Brandolini suggests that when the market has a quick change in sentiment, such as it did in October, it creates a damned-if-you-do, damned-if-you-don’t scenario. In the past (i.e., up to August or September of this year), if an equity portfolio didn’t hold U.S. “FANG” stocks like Google, Amazon or Facebook, it likely underperformed. During the October selloff, these same holdings contributed most to the volatility in the Equity Pool.

In addition, rising interest rates have caused a slowdown in housing and housing-related companies. Three of the Equity Pool's holdings did experience a pullback due to this factor.

Often, it is useful to take cues from other asset classes to get a reading on what may or may not be happening in equity markets.

High yield bonds tend to be very sensitive to macroeconomic factors. With that in mind, the *spread* or difference between high yield bonds over corporate bonds has been stable throughout the month. Comparatively, these spreads increased significantly as markets dropped during the corrections of 2008, 2011 and 2015. Spreads being relatively stable through this latest sell-off helps us remain positive on equities overall.

What does that mean going forward?

While we remain positive on equities overall, any growth in housing-related stocks may take a long time to materialize.

As for technology stocks, these business models still have a long runway in front of them and still warrant investment. However, given that several investor concerns, including rising interest rates and continued trade war fears, have yet to be resolved we will look to manage risks related to holdings in this sector with tactical option strategies.

TCG 534 Income Fund

The Income Fund finished the month of October down -3.73% compared to its Real-World Index Income benchmark, which was down -2.25%.

Year-to-date the fund sits positive at 1.39% compared to its benchmark, which is down -2.21%.

During the first week of October, as a result of continued market expectations of Fed monetary tightening the 30-year US Treasury yield increased 0.21% to 3.40%. A few days after that increase equity markets experienced their most recent correction.

Historically, aggressive tightening of Fed Monetary Policy has been associated with approximately half of the last 45 recessions, and therein lies the concern for investors.

In response, the Income Fund, which traditionally has an allocation to fixed income in the 33% to 37% range, made a significant shift in asset allocation. Lead manager Mark McAdam confirms that the Investment Committee made the decision to reduce the exposure to equities and covered-call strategies, and to shift the weighting to 50% fixed income.

CROFT FINANCIAL GROUP

Commentary & Outlook

During the correction the protective S&P 500 puts held by the Income Fund increased in value and the positions were closed. As an additional hedge, the Fund was also holding a covered-call strategy on a gold-mining company. As the market sold off, the position was closed profitably reducing the overall impact of the market correction on the Income Pool. After the correction the same covered-call strategy was re-established with an adjustment to benefit from the high time decay in the options and increase the hedging properties.

TCG 539 Option Writing Fund

The Option Writing Fund finished October down -7.52% while its benchmark, the Montreal Exchange Covered Call Writers Index (MX-CWI), dropped -2.87%.

Year-to-date the fund is down -3.55% compared to its benchmark, which still sits positive at 0.62%

Lead manager Richard Croft confirms that the Fund's exposure to FANG (Facebook, Amazon, Apple, Netflix and Google) stocks contributed significantly to the under-performance during the month of October.

During periods where markets react violently and quickly, we raise cash within the Fund and reset the portfolio to take advantage of a recovery.

Normally we see option premiums spike significantly when markets experience this type of sharp sell-off. This provides an opportunity to sell longer dated options and take advantage of the higher implied volatility as was the case in February of this year.

However, in this instance, premiums did not spike to levels experienced during past sell-offs, which is why we have not significantly extended the term to expiry of current positions, which averaged 38 days at the end of October.

On the surface, this low-key response among option traders to the selloff seems to suggest that market participants believe this is a correction within a continuing bull trend. Or perhaps more specifically, a simple rotation out of momentum (i.e., FANG stocks) into value stocks.

As of the end of October, the Option Writing Fund's overall allocation was 50.74% value stocks, 17.27% momentum stocks and 31.98% cash.

Outlook & Expectations

While the equity market correction was intense and difficult, the Investment Committee's outlook remains consistent with last month's commentary. We are focussed on capturing opportunities in the recovery from recent lows and continue to expect slow-to-modest growth moving forward. However, we have taken a more generally defensive stance in managing the funds given that sporadic and intense market volatility is likely to be more the norm than the exception.

Such defensive steps have included increasing the utilization of option strategies to help reduce volatility and manage risk, increasing exposure to fixed income when and where appropriate as well as actively harvesting profits and increasing cash holdings to reduce equity exposure and to take advantage of opportunities during the pull-backs.

To help put some of the recent market volatility into perspective, please review the following article.

R N Croft Financial Group
877.249.2884
www.croftgroup.com

Investment Review Committee

Richard Croft	PM
Kenneth Mulders, CFA	PM
Christopher Croft, CFA	PM
Alex Brandolini, CFA	PM
Mark McAdam, CFA	PM
Jack Morris, CIM	PM
Paul Fettes, CFA	PM
Christopher Heaman, CIM	PM
Bo Chew, CIM	PM
Robyn Thompson, CFP, CIM, FCSI	APM
Rod Burylo, CIM, FCSI	APM
Jason Ayres, DMS	Analyst
Kelly Morris	Analyst

CROFT FINANCIAL GROUP

Commentary & Outlook

Rise of the Machines

You have probably heard a lot about artificial intelligence or "A.I." if you have tech savvy friends. There was news this week that Canada was bidding on a new A.I. space arm for the unmanned moon orbiter that the U.S. is planning to launch in the next few years. The space arm needs to be able to learn simple tasks so that ground personnel can manage the orbiter by telling it to execute this or that rather than manipulating the arm through a complex series of movements. The IBM Watson project is another A.I. example where learning software tools optimize data collection and dissemination.

I raise this issue because A.I. software is driving many of the investment decisions for Wall Street hedge funds. A.I. software digests new information and makes trading decisions based on sophisticated algorithms. The problem is that it can have a major impact on your portfolio and the fallout can occur in a matter of minutes.

We have seen this play out over the past couple of weeks. Notable was the activity on Oct. 10 when the Dow Jones Industrial Average fell 800 points in one day. Much of the move occurred in the afternoon, when stocks appeared to fall off a cliff.

As expected, there was "insightful" spin on financial networks advancing reasonable cause and effect explanations. Market rotation was at the top of the list as analysts opined that managers were shifting focus from momentum (i.e. FANG) to value stocks (i.e. banks and utilities). Economists also weighed in, citing higher interest rates, trade tensions causing a sharp sell-off in Chinese markets, and more recently, concerns around the Italian budget deficit.

These are all reasonable arguments that, longer-term, will influence market trends. But the sell-off on Oct. 10 was more about A.I. then with any single motivating factor. You could see it during the day. Trades were triggered when the yield on the US ten-year Treasury note crossed 3.25%. There was a clear rotation away from FANG stocks (Facebook Amazon, Netflix and Alphabet (i.e. Google) and small caps with high debt to equity ratios into banks that benefit from higher rates.

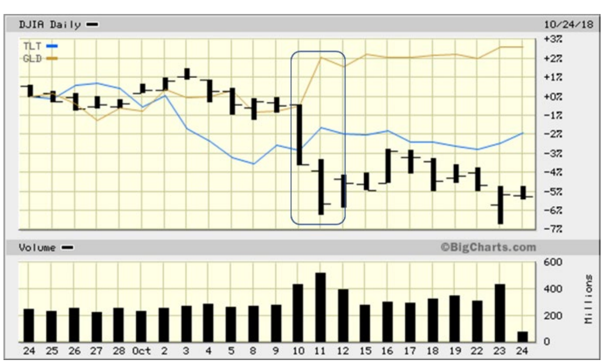
The quick and sharp sell-off caused widespread angst, which carried over into virtually all sectors. At one point there were ten stocks down for every one that was up. For some perspective, the March 2009 post financial crisis bottom occurred at a point when there was a nine to one ratio of down to up stocks.

CROFT
FINANCIAL GROUP

Commentary & Outlook

What makes me believe this was based on an algorithm was the fact that despite the Oct. 10 across the board sell-off we did not see significant capital movement away from stocks as an asset class into bonds and gold. To that point, I draw your attention to the accompanying chart showing the Dow Jones Industrial Average (the black bars) relative to the TLT (20-year Treasury bond ETF) and GLD (Gold bullion ETF). Notice when the Dow fell 800 points on Oct. 10, TLT and GLD barely moved. As the Dow fell another 400 points on Oct. 11, TLT moved higher by 0.8% and GLD was up about 2.5%. TLT and GLD have for the most part, remained at Oct. 11 levels.

I suspect the reaction on Oct. 11 was caused by the follow through in price action on the Dow. Investors were taking the move more seriously and wanted to shift some assets into safer havens. We saw a rebound on Friday, October 12, which, based on the action this week, seems to have been a bear market bounce.



This preamble sets the stage for the importance of staying focused through market turmoil. A.I. has simply shortened the time line of seismic shifts. It used to take weeks for traders to transition from bullish to bearish. It now happens in days and hours.

I'm not a big fan of money management via algorithms. It is not new and previous iterations have not benefitted investors. For example, the 1987 stock market crash was exacerbated by program trading, where algorithms systematically raised cash when specific price points were breeched. As the market fell through pre-determined levels, selling picked up. That caused further downside movement. The speed of the October 1987 sell-off caused wide spread panic and in the end did not protect investors in the way it was originally intended. Program trading went down as a failure and was pushed to the sidelines through much of the 1990s.

But in Wall Street, what goes around comes around. As a result, algorithms now account for as much as 30% of the trading activity on any given day. And this at a time when there are fewer shares to trade because of significant stock buybacks and institutional investors who follow a buy and hold approach (think Warren Buffett).

Make no mistake, NYSE and NASDAQ market makers who are charged with providing liquidity are keenly aware when they are taking the other side of a trade triggered by an algorithm. They also know that a machine is acting on electronic impulses and market makers will take advantage of that by shifting the bid and ask prices in accordance with the direction being taken by the algorithm. For the rest of us, that creates a trading pattern where we get sporadic volatility spikes interspersed with longer periods of narrow price swings.

It is virtually impossible to trade within these variables. I only hope that by understanding what is happening behind the scenes provides some comfort that will allow you to stick with an investment plan through turbulent times.

Longer Term Focus

If you believe, as I do, that intraday gyrations are more noise than substance, then you can focus on the factors that have real long-term implications. If institutional investors are shifting strategies from momentum to value, banks should benefit and FANG stocks should weaken.

It's the same with the interest rate scenario. Higher rates should benefit banks, insurance companies, and large cap tech companies with sizeable cash hordes. Higher rates will be detrimental to small cap stocks because borrowing costs will rise. They will be particularly harmful to companies with significant leverage. I'm not sure that the current rate environment will have any major repercussions, but clearly the 3.25% rate on U.S. ten-year Treasury Notes is the current demarcation line.

But here's the rub! Suppose we are correct about what is driving investment decisions. The point of our A.I. preamble is that much of what we think will happen has probably been priced into the market. The reaction time is simply too short to make moves after the fact, which means it is better to hedge your risks with a portfolio that can function within a multitude of detrimental scenarios.

By Richard N Croft

R N Croft Financial Group
877.249.2884
www.croftgroup.com