ISSUE
05
OCT
2018

CROFT
FINANCIAL GROUP

Commentary & Outlook

Headwinds

U.S. equities reached all-time highs during the month of September, in line with the 10th year anniversary of the Global Financial Crisis of 2008. These market highs have been met with some skepticism and concern about the sustainability of what is being dubbed *the longest bull run in history*.

At the time of this writing, U.S. equity markets have sold off their highs amid interest rate and inflation concerns. With yields on the 10-year treasury bonds crossing 3.00%, Fed Chairman Jerome Powell's comments around maintaining a *hawkish stance* on interest rate policy back in September became a real concern. The federal reserve maintaining a hawkish stance suggests that they will likely continue to raise interest rates to slow economic growth and curb inflation. Raising interest rates can be effective at curbing overheated asset prices, but that is typically not so good for the stock market.

With the benchmark 10-year U.S. Treasury bond yield creeping higher, the risk of a slowdown became all too real for investors. As witnessed in February of this year, these types of pull backs can happen very quickly as market participants lock in profits, worried investors run for the exits based on the headlines and short sellers look to capitalize on the drop.

On the Canadian front, the revised U.S., Mexico and Canada free trade deal, formerly NAFTA and now referred to as the USMCA, were well received. However, adding to investor concerns, there is still some question as to when, and if, the U.S.-China trade issues will be resolved, related metal tariffs lifted and whether U.S.-imposed foreign trade restrictions in USMCA will hurt Canada. On balance, the settlement of the USMCA offered little to counter other Canadian equity market uncertainties.

While continued speculation in cannabis stocks helped the healthcare sector, the energy sector saw little benefit from higher oil prices as the Canadian heavy-oil discount to WTI (West Texas Intermediate) reached new highs on further regulatory delays to the Trans Mountain Oil Pipeline expansion in Western Canada.

Gold and the gold mining sector continued to trade at 2018 lows through September, however the recent sell off in equities has led to a jump in prices, at lease for the short term, as investors move into the precious metal as a hedge.

With all this in mind, it is important to remember that financial markets do not always trend upwards nor advance in a straight line, and some market sell offs and reversals should always be factored into your investment expectations.

Fund Performance

TCG 531 Equity Growth

For the month of September, the Equity Growth fund finished down -1.14% while its benchmark, TSX Total Return Index gave up -0.82%

As of the end of September, Year to date, the Equity Growth fund is up 7.09% with the TSX TR benchmark trailing at 1.36%.

Lead manager Alex Brandolini cites that given the strong performance of certain growth stocks over the month, the decision was made to close out a synthetic position on Activision (ATVI), one of our technology holdings. With the US dollar peaking, a synthetic stock position was created using options as an effective way to hedge against the currency exposure. The profits were redeployed into Open Text (OTEX), a Canadian Technology stock with better valuation multiples.

During the month, Alex also notes that we closed a combination long stock/put write position on Shopify (SHOP) as this tech stock came very close to its twelve-month price target. While Shopify still has significant growth potential based on the Investment Committees research, it's also very volatile and a decision was made to hold exposure to the stock in a more risk managed way using options.

Bigger picture, Alex notes that the 7.2% rise of the S&P 500 in Q3 was the best quarterly gain in four and a half years. The advance was driven by Health Care, Technology, Industrial and Consumer Discretionary stocks. This performance continued to be supported by a strong economy, tight labor market, tax cuts and record share buy backs.

September 28th marked the end of the 3rd quarter and, with markets likely having priced in all the good news, investors started to focus on new data points that were less supportive of equites. With earnings season around the corner, concerns regarding tighter operating margins from high labor costs and energy costs began to surface, and fears about a prolonged trade war with China also began to weigh on investor sentiment. Add in the higher interest rates mentioned earlier, and you have enough of a head wind for investors to re-evaluate equity market valuations and reduce exposure to growth stocks. Signs of this emerged on the last trading day of Q3 and have continued to impact the Equity Growth Fund's performance into mid October.

TCG 534 Income

The Income fund finished the month of September down -0.83% compared to the Real-World Index Income benchmark which was down -1.22%.

Year to date the fund sits positive at 5.32% compared to its benchmark which trails at 0.04%.

Notable changes in the Income Pool's asset allocation included a 3% increase to fixed income allocation and a corresponding reduction in exposure to equities. Lead Manager Mark McAdam adds that the Investment Committee will, based on current market conditions, continue mitigating risk by increasing exposure to income-based assets, which are usually better insulated from market price movements, and through the continued inclusion of protective options to help reduce the impact of market fluctuations on equity-based assets.

Broadcom (AVGO), Estee Lauder Companies Inc (EL), and Consolidation Brands (STZ) all experienced strong returns during the month of September and were sold out of the fund as part of our profit taking strategy. Mark adds that we were able to exit our exposure to Northrop Grumman Corp (NOC) when the stock rallied 5% mid-month. NOC subsequently pulled back to its monthly low where, we were able to re-establish the position as a synthetic covered call strategy.

Notable trades included Marsh & McLennan Companies Inc (MMC), Facebook (FB), and Thor Industries Inc being added to the fund. Each of these companies has experienced multiple contractions of equity values, which the Investment Committee deemed to be a temporary price adjustment due to one-time corporate issues that are expected to reverse. The Fund also covered these stocks with call options (or wrote puts against short-term cash). With implied volatility on the options higher than normal due to the pull back in share prices, the increased premium collected helps further reduce the cost basis of the shares and enhances the Fund's cashflow.

TCG 539 Option Writing Fund

Both the Option Writing Fund and its benchmark, the Montreal Exchange Covered Call Writers Index (MX CWI) finished September relatively flat – down -0.15% for the Fund and -0.01% for the benchmark.

Year to date the fund sits positive at 4.28% compared to its benchmark, which trails at 3.59%

Lead manager Richard Croft indicates that volatility has been rising since the beginning of October. As approximately 53% of current short option positions expire at the end of the October monthly cycle, new positions will be added and, assuming volatility remains where it is or increases above current levels, we expect to extend the term to expiration.

As far as factor allocation in the fund is concerned, Richard has stayed the course with value stocks representing about 50% of the portfolio, and momentum stocks 44%. The cash position has been reduced from 16% to 6% to take advantage of new opportunities, and a hedge in the form of a bearish put spread on the S&P 500 was added to help offset some of the broader market risk.

Outlook & Expectations

Financial markets hitting all time highs during the 10-year anniversary of the Global Financial Crisis, geopolitical tensions, trade wars and tariffs, and interest rate concerns – all have shaken investors' confidence and caused professional investment managers to adjust their risk exposures. As mentioned during the introduction, markets never move in a straight line and after a significant

CROFT
FINANCIAL GROUP

Commentary & Outlook

recovery from the February lows, stocks were due for a pull back or correction.

With that in mind, we are watching Q3 earnings closely. As Richard Croft, our Chief Investment Officer suggests, we are witnessing a one-two punch from tariff threats and rising wages at a time when earnings growth is flat to down. On the positive side, corporate America is benefitting from lower taxes and the U.S. economy continues to grow above trendline, which may be enough to mitigate some of the impact from the aforementioned challenges facing businesses.

Currently, the Investment Committee is viewing this recent market selloff as part of the longer-term bullish trend. That said, our longer-term outlook factors in slow to modest growth, and our Portfolio Management team has been actively capitalizing on the pull back and increased volatility in the options market, while continuing to reduce risk exposure where applicable.

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