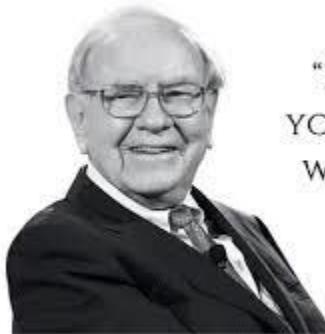


# MARKET REVIEW AND MANAGERS' COMMENTARY

## The Value of Good Advice

In a recent CNBC interview, Warren Buffett made mention of the fact that investors were overpaying for advice. The thrust of his position was that investors were paying high fees, which penalized their portfolio, effectively preventing them from reaching their goals. His focus was on mutual fund fees and fees paid to hedge funds that were as high as 2% of assets plus a performance bonus of 20% for returns above a certain threshold.

Being in the business of providing investment advice, these comments hit home from a couple of perspectives. On the one hand, I agree that mutual fund fees are too high. Investors with at least \$100,000 in assets should probably graduate to separately managed accounts with transparent fees that scale down based on the size of the individual's portfolio.



"PRICE IS WHAT  
YOU PAY. VALUE IS  
WHAT YOU GET."

- WARREN BUFFETT -

Secondly his comments on the fees associated with hedge funds were spot on. Investors who invest in hedge funds with a 2 and 20 fee schedule are grievously overpaying. The performance bonus alone provides significant advantages to the fund manager with virtually zero benefit to the unitholders. In fact, you could argue – which I have done in the past – that performance fees are a net negative to investors because they lead to risk taking that is rarely in the investor's best interest. I think of the over-weighted losing position that Pershing Square Hedge Fund manager Bill Ackman took in Valeant Pharmaceuticals as a case in point.

To underscore his position, Buffett wagered \$500,000 some nine years ago, payable to the charity of choice for any manager who could pick five hedge

funds that would outperform a passive investment in the S&P 500 composite index. There was only one taker: Ted Seides who, at the time, was co-manager of Protégé Partners, an asset manager known for investing in multiple hedge funds. He lost!

Buffet's bet was on solid ground because of his belief – supported by academic literature – that there are three "connected realities that cause investing success to breed failure." They are as follows: 1) a good track record attracts sizeable amounts of new money; 2) new money acts as an anchor on investment performance; and 3) the business of money management is to attract new capital because more assets under management means higher fees.

I agree with Buffet's position on the cost versus benefits when advice is tied to performance, but that's the rub! To link advice to performance would be akin to evaluating Buffet's role as a member of a Board of Directors on the basis of the stock's short term performance.

Buffett believes<sup>1</sup> that corporate governance is based on the position that company managers are stewards of shareholder capital. "The best managers think like owners in making business decisions. They have shareholder interests at heart but even first-rate managers will sometimes have interests that conflict with those of shareholders." His dissenting opinion as it related to executive compensation while on the Board of Coca Cola is the classic example of how Boards should deal with conflicts between management and shareholder interests.

Professional investment advice should be viewed within the same context. The value of advice should be viewed within the context of how Advisers (i.e., registered Portfolio Managers with a fiduciary duty to invest on behalf of our clients, versus "Advisors" [note the spelling difference] who are only required to sell clients a "suitable" financial product) position a portfolio based on the

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<sup>1</sup> <https://corpgov.law.harvard.edu/2013/03/29/governance-buffett-style/>



# MARKET REVIEW AND MANAGERS' COMMENTARY

investor's objectives and risk tolerance. The resulting portfolio allocates capital across asset classes (i.e., cash, income, equities and alternatives), subdivided by geographic diversification, tax efficient income (i.e. dividends and capital gains versus interest), sector optimization and investment management style.

That's very different than saying a fund manager cannot beat the S&P 500 index or the Canadian equivalent the S&P/TSX 60 index. Fact is, most investors should not hold a portfolio that is 100% invested in any one asset class or investment style – for example, including only Berkshire Hathaway (NYSE: BRK.A and BRK.B).

The key issue when it comes to investment performance is dealing with investors' reaction to bad markets. It is one thing to say that the S&P 500 composite index returned "X" percent over some period, it is quite another to look at how investors fared during the same time line. Studies show that, while they say they want growth, investors often substantially underperform the market because they are unable to tolerate short term volatility.

One study<sup>2</sup> authored in September 2011 by Brad M. Barber and Terrance Odean, provided an overview of stock trading behaviors that deleteriously affect the financial well being of individual investors. This research documents that individual investors: 1) tend to hold undiversified stock portfolios; 2) sell winning investments while holding losing investments (the "disposition effect"); 3) are heavily influenced by limited attention and past return performance in their purchase decisions; 4) engage in naïve reinforcement learning by repeating past behaviors that coincided with pleasure while avoiding past behaviors that generated pain; and, thus 5) under-represent and underperform standard benchmarks (e.g., a low cost index fund). The bottom line is that investors do not stay with positions when the market is moving against them. Instead they attempt to time when to move in and out of the market, which rarely ever works to the investor's advantage.

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<sup>2</sup> <https://www.umass.edu/preferen/You%20Must%20Read%20This/Barber-Odean%202011.pdf>

This is one example where professional advice has value. Helping investors stay the course in a portfolio that manages volatility within the investors' risk tolerance to produce more consistent returns is, perhaps, not as sexy as promoting a vibrant track record, but it is appropriate and valuable advice. The question is, at what cost?

Most professional investment managers charge a percentage of the investor's portfolio, usually scaled down based on the size of the relationship. These fees are tax deductible on non-registered assets and, ideally, should include all transaction and custody costs and no performance bonuses.

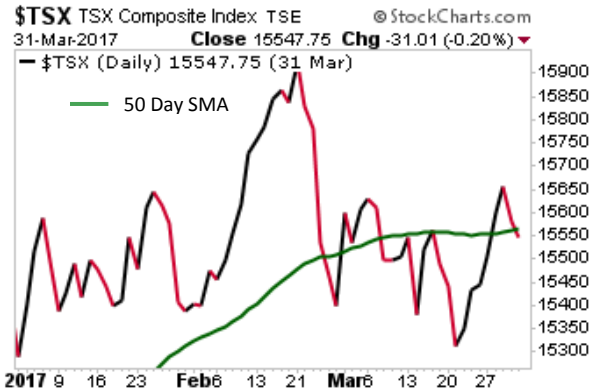
The objective is to ensure that the compensation for advice is aligned with clients' best interests. Performance bonuses, mutual fund loads and transaction costs generally do not align with investors' interests because they can lead to excessive use of leverage in search of excess returns and superfluous trading to generate commission revenue.

Not surprisingly, this is a view shared by Regulators who are pushing for more transparency at significantly lower costs. As your licensed Portfolio Manager, Croft Financial Group welcomes these changes and will continue to strive to enhance the transparency and value of the discretionary financial advice we provide. Because in the end, what's important for you as an individual investor is to understand the role and cost of good advice, and to assess whether that cost is worth the value you are receiving.

# MARKET REVIEW AND MANAGERS' COMMENTARY

## Canada

The S&P/TSX Composite ended the first quarter up 1.70%. The biggest gains came from the consumer discretionary and technology sectors with the most drag coming from the healthcare and energy sectors. Overall, eight of the ten sectors registered positive performance for the quarter. The dividend yield on the S&P/TSX Composite remained relatively flat to close the quarter at 2.70%. Relative to the Government of Canada 10-year bond yield of 1.62%, the composite continues to outperform.



In terms of our currency, the Canadian dollar continued to weaken slightly over the quarter to end off at \$0.747 USD/CAD.

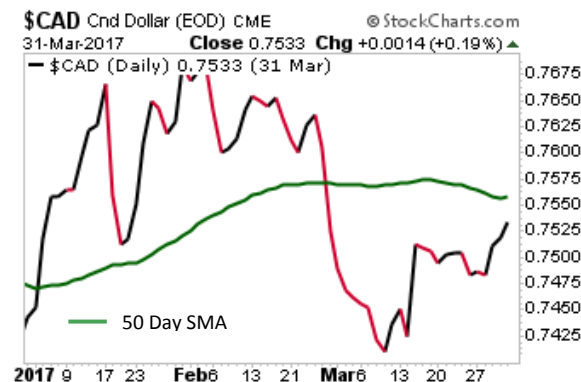
Recent economic data show that growth in Canada has been better than expected and analysts are revising their forecasts upward. While 2016 was another year of relatively sluggish growth, the year-end transition began to show some momentum. The Canadian economy was driven by consumer spending and housing demand on the back of strong job creation. Both were fueled by easy credit and the housing wealth effect.

Looking further into employment, 273,000 jobs have been added over the last eight months. Most of the jobs added have been full time. With the employment/population ratio near a peak and the labor force participation rate at a new high, the Canadian labor force seems to be in good shape. However, wage growth is still not part of the story, which is easy to

understand when you consider how many high-paying jobs from the energy sector were lost in the last couple of years. While many of these workers have found employment in other segments of the economy, generally these jobs have not been at the same income level.

Admittedly, as 'lagging indicators' we can't use flat-to-declining wages nor low core inflation to conclude that Canadian economic growth will slow down again. Both measures fail to indicate whether the economy may be growing when you look ahead. Instead, the reasons the BoC continues with its dovish stance on interest rates may have more to do with the Canadian dollar and balance of trade issues. When you evaluate the possible outcomes, it becomes easy to see the difficult position Stephen Poloz is in.

It appears there is risk to both increasing and decreasing interest rates. On one hand there is the problem of international competitiveness. To support Canadian exporters the BoC needs to keep interest rates low. Low rates prevent the Canadian dollar from appreciating and making Canadian goods more expensive for our partners to the south.



At the same time, higher interest rates might be the only effective way to curb the housing bubble that has been created in some of Canada's biggest cities. If prices continue to climb and other measures are ineffective, the BoC may have to intervene and in the end interest rates will

have to go up. When and if that happens, could we see a repeat of the 1989 housing crash? Consider that between 1985 and 1989 there was a large inflow of immigrants, unemployment was low, speculators were active in the market,

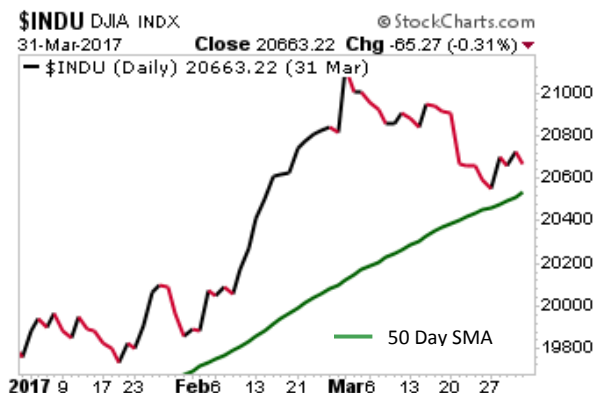
# MARKET REVIEW AND MANAGERS' COMMENTARY

and average house prices went up 113%. Much of that has striking similarity to what's going on today.

So, while recent Q1 measures (as of February) indicate that Canada might boast the highest 2017 GDP growth among the G7, it is understandable why Governor Poloz wants to maintain a cautious stance. Anything else risks a Canadian dollar rally, which could undermine any progress made in the export sector and provide a further obstacle to business investment growth, two things Canada needs for sustainability. However, as long as the labor market continues to strengthen and no downside risks (such as unfavorable NAFTA renegotiations) materialize we would expect the BoC to shift to a less cautious outlook over time. It appears the road to recovery continues, but as with any road, there will be bumps and hazards along way.

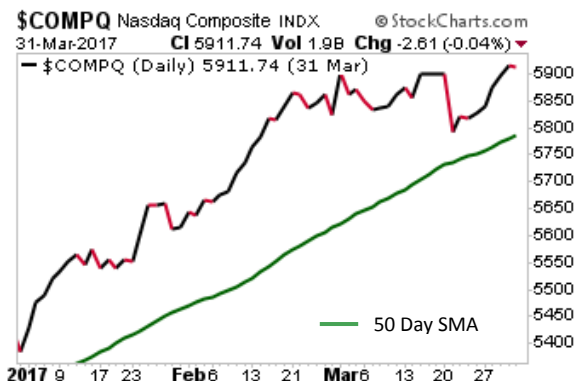
## United States

In anticipation of stimulus spending from the newly elected Trump administration, the Dow Jones Industrial Average surged a history-making 900 points in the first quarter blowing past the level of 20,000, which investors previously seemed to view as a ceiling.



Despite muted year-over-year inflation and GDP growth, U.S. financial markets continued their advance with little volatility against a backdrop of strong corporate profits from select sectors (namely U.S. automakers and financials), good job gains and a steady unemployment rate. Even the prospect of

tightening fiscal policy, given Fed Chairwoman Yellen's identical quarter-point rate hikes in December and March, had little counteractive effect.



reiterated would be the first of three rate hikes in 2017, it became clear to investors that, while a 'Dovish' tone in the Reserve's official release statements remains, investors have a new monetary environment to deal with that will involve a stronger U.S. dollar, higher yields/ lower prices for bonds, and perhaps lower stock prices, which on a P/E basis have become more expensive over the last 18 months.

Meanwhile, the outlook for the Trump administration's new fiscal policy faltered. On March 24<sup>th</sup> the bill to replace "Obamacare" with a (cheaper) Republican alternative lost support so rapidly it was suspended with no near-term plans to retable it. This initial failure to capitalize on nominal Republican control of the administration and legislatures raises questions about the ease with which promised stimulus measures – not to mention the ambitious overhaul of the entire federal tax system – will be passed.

The good news is despite fiscal uncertainty, U.S. equity markets still should be well-positioned to respond favourably to any positive momentum in corporate earnings over 2017. Many U.S.-based multi-nationals remain broadly exposed to international markets and, according to the WTO, growth, innovation and

Of the three major U.S. stock indices that finished the quarter strong, only the NASDAQ ended at a new high, the Dow and S&P500 giving up gains in March on higher volatility. From March 16<sup>th</sup> onward when the Fed followed through with what Yellen

# MARKET REVIEW AND MANAGERS' COMMENTARY

recovering trade seem to be producing the first co-ordinated increase in global GDP since the 2008 recession.

## Europe, Asia and Emerging Markets

### Europe

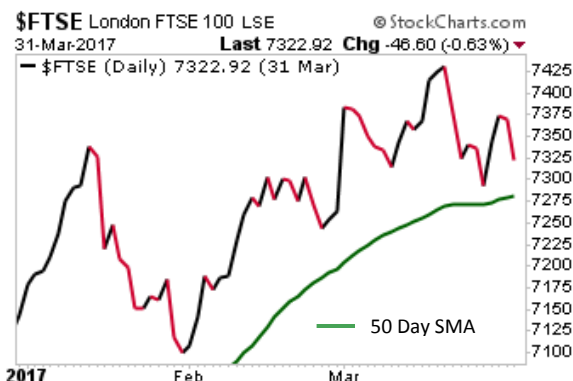
The Eurozone's economy continues to strengthen led by the German economy, which is benefiting from a low euro and increased global demand. 2016 Q4 GDP grew 0.4% quarter-over-quarter overall and growth seemed to gain momentum in Q1 as business confidence continues to climb. Despite this general economic improvement inflation remains within desired bands, and the ECB revised their real GDP growth forecasts for 2017 and 2018 to an annualized 2.0%.

Despite a temporary easing of European electoral concerns when Dutch voters rejected Geert Wilders' populist party, there remains some anxiety concerning the upcoming French Presidential Elections in April/May and the German National Elections in October.

Equity fund outflows have reversed and are now positive as investors shrug off such populist electoral concerns and focus on relative lower valuations compared to their U.S. counterparts. Despite tough looming Brexit negotiations member support for the Euro is at an historic high of 70% last reached in 2012.



### United Kingdom



There are initial signs that the British economy is cooling off. Since the Brexit vote and the subsequent drop in the British Pound, consumer price inflation (CPI) increased from an average of zero in 2015 to its current level of 2.30%. With the inflation rate expected to continue to increase significantly beyond the BoE's 2% target, a future UK rate hike will be necessary.

Historically, UK consumers have been the main supporters of economic growth but the recent effects of high inflation have lowered household purchasing power and resulted in lower retail spending. Capital investment has been put on hold or cancelled outright as the uncertainties with the Brexit transition weigh on the economy. Despite some positive offset because of increased public spending, the overall UK GDP growth rate is expected to slow to 1.6% in 2017 and 1.4% in 2018.

### China

Officials have been struggling to maintain control of domestic and international flow of Chinese money. Over the past 5 years there has been increased regulation to stop the Chinese funds leaving the country, which shifted the investment inwards into the Chinese housing market.

# MARKET REVIEW AND MANAGERS' COMMENTARY

The overabundance of housing inventory in the second- and third-tier Chinese cities has been diminishing with housing sales now exceeding housings starts by 19%.



China still maintains its net foreign creditor status (15% of GDP) and has a 1.8% of GDP current account surplus.

The government's attempts to direct the flow of funds from leaving the country and from the housing market is now showing benefits for both domestic consumption and Chinese equity markets. Consumption is up, earnings momentum has turned positive, and the overall mood is the most optimistic it has been in the past six years

## Emerging Markets

Prices and overall valuations for Emerging Market equities are trading close to their 10-year lows. Specific metrics such as price to book are at their 15 year lows when compared to developed markets. Despite improving fundamentals and economic outlooks, the main reason financial markets continue to discount Emerging Markets assets is the looming risk of more U.S. protectionist policies from the new Trump administration.

Funding their large domestic fiscal expansion has resulted in a gradual drop in Chinese foreign currency holdings. The reduced foreign reserves have, in turn, caused a tightening of interbank lending. The 3 month SHIBOR has increase to 4.4% from 2.8% seen in

October. India, which has a more domestic-oriented economy and is thus somewhat insulated from other global developments, has seen some especially strong

GDP growth because of increased government spending and better than expected yields in the agricultural sector. There is a long-term secular shift within the Indian economy as the government builds a foundation for long-term growth focusing on improving trade, maintaining balanced government budgets, and implementing economic reforms.



## Sector Report

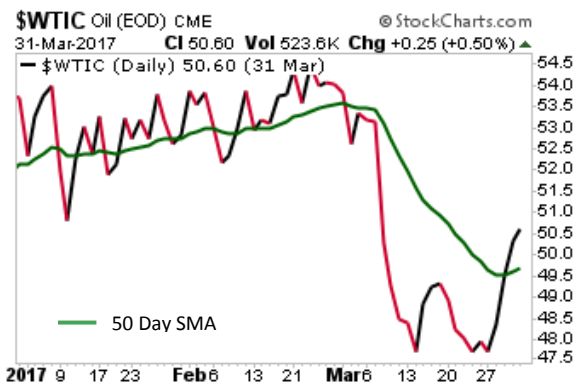
The "Trump rally" might be running into some hard economic realities. Secretary of the Treasury Steven Mnuchin has indicated that it will take some time for anticipated fiscal policy reforms to have an impact on growth. Taking those comments into consideration, the rally in industrial and infrastructure stocks may be premature.

S&P Sector	Q1 Return
Consumer Discretionary	7.62%
Consumer Staples	5.38%
Energy	-7.36%
Financials	1.84%
Health Care	7.95%
Industrials	4.33%
Materials	5.05%
Real Estate	2.89%
Technology	10.14%
Utilities	5.62%
S&P 500	5.53%

# MARKET REVIEW AND MANAGERS' COMMENTARY

Average hourly earnings have risen 2.8% over the past 12 months and low interest rates should support consumer borrowing and spending. The Conference Board's Consumer Confidence Index continues to increase but there is restraint from consumers spending on traditional retail items effecting the Consumer Discretionary sector. Despite some positive news with online retailers experiencing 12% annual growth, same-store sales fell 3.2% year over year as Americans are no longer willing to increase their debt levels and department stores are feeling the brunt of that restraint.

The large run up in the Financials sector has not raised significant concerns as the price to book ratio of major financial firms remains well below the 20-year average, and the sector's current price to earnings ratio of 15 is still below the overall S&P 500 index valuation of 18. From a risk measurement standpoint, the beta is (a lower-than-average) 0.74 vs 1.01 for the S&P 500 overall.



In the Energy sector, OPEC continues to cut production with a surprisingly 90% of the group reporting compliance. As oil prices increase, more U.S. shale producers coming online and increase production. Recent U.S. output figures have risen by 300,000

barrels per day since July, and are expected to increase further.

In the U.S. Real Estate sector, residential housing continues to recover, and the apartment and office markets sub-segment continues to experience earnings growth driven by strong demand and increased rents. There are concerns regarding increased housing supplies, which will affect margins. We are at the beginning of a long-term trend away from brick-and-mortar retailers putting downward pressure on retail REITs due to competition from e-commerce.

## Market Summary

	31-Dec-16	31-Mar-17	Q1 2017
S&P/TSX Index Composite	15,287.59	15,547.75	1.70%
S&P 500 Composite	2,238.83	2,362.72	5.53%
Nasdaq Composite	5,383.12	5,911.74	9.82%
MSCI EAFE	1,684.00	1,792.98	6.47%
MSCI Emerging Markets	862.28	958.37	11.14%
MSCI World	1,751.22	1,853.69	5.85%
CBOE Volatility Index	14.04	12.37	-11.89%
FTSE TMX Bond Universe	1,011.41	1,023.90	1.23%
Gold	1,145.90	1,244.85	8.64%
WTI Crude Oil Spot Price	53.75	50.60	-5.86%
USD/CAD FX	0.75022	0.74705	-0.42%

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