SSQ Financial Group
Values in the right place

2018 ECONOMIC PERSPECTIVES

Interview with Cambridge Global Asset Management, a division of CI Investments

CAMBRIDGE
GLOBAL ASSET MANAGEMENT

Comments from Cambridge, led by CIO, Brandon Snow and Market Strategist, Bob Swanson

What are the main risks that could threaten investors in 2018 and which investment strategy would you recommend to minimize the impacts?

With markets at all time highs and risk appetite elevated, we recommend reducing exposure to equities and have done so within our own asset allocation strategy. While earnings growth has reaccelerated, multiple expansion has been the main contributor to the gain in equity markets. With multiples now at cycle highs, we continue to apply a disciplined investment philosophy and process when making new investments. We recommend being focused on capital preservation and err on the side of caution. In this euphoric market, it is better to be patient, deploy capital at a level that will present a better risk-reward opportunity or be invested with a professional money manager that will react swiftly to changes in the market environment and re-engage back into equities when the time is right.

What is your position for another potential increase in rates by the Bank of Canada and by the FED in 2018? What would be the impact on the bond market?

The hawkish tilt of the Bank of Canada has changed market dynamics and the opportunities to generate alpha in fixed income. The U.S. Treasury yield curve is becoming less attractive than the Canadian government yield curve. As a result, we have started to lower our foreign bond holdings. We have also been lowering our corporate weight and high grading the credit quality of the corporate portfolio. We believe the market is pricing in too many rate hikes and an overly aggressive pace of tightening from the Bank of Canada. The Canadian bond market could potentially present a surprising result for investors despite current inflation and market expectations.

What is your point of view on the Canadian residential real estate sector and its potential impact on individuals and businesses? How do banks get impacted as they represent over 25% of the S&P/TSX Index?

We believe our job is to manage risk, consider various scenarios and invest only when the odds are stacked in our favor. While someone can always build an optimistic scenario for the Canadian consumer, strength of the banks, economy and housing market, we believe there are multiple red flags that warrant caution today. Given the elevated level of indebtedness for the Canadian consumers and potential increases in interest rates, the resilience of the residential real estate market will be tested in 2018. More than 700,000 Canadian borrowers could be facing payment shock on their debt obligations if interest rates rise by a quarter point. That figure rises to as many as one million people should rates go up by 1%.

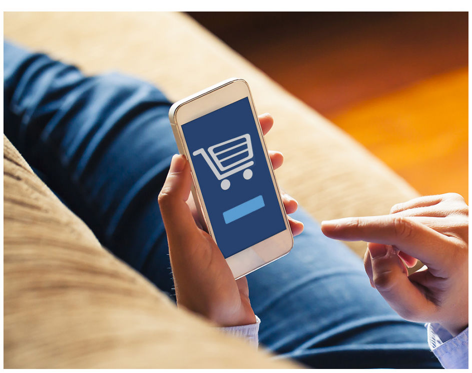
Furthermore, besides rate increases, CMHC has waved the red flag on Canada's housing market as half of working Canadians are living paycheque-to-paycheque and would be hard pressed to meet their financial obligations if their paycheque was delayed for a week. For these reasons, we are cautious both on real estate and indirectly, the Canadian banks.

Growth stocks have largely outperformed during 2017. In fact, the Russell 1000 Growth index which measures the 1000 largest growth stocks has realized a 30% return this year while the Russell 1000 Value index lagged with a 10% performance this year. Do you believe this will continue next year?

As investors become return-seeking, they tend to increase their risk profile and speculative exposure. This is because in order to stay invested in a market they believe is overvalued, they need to expect higher returns to justify the increasing risk they are taking on. Across many industries we have seen a huge divergence in performance by growth vs. value and disruptors vs. established companies this year.

When we put your hard-earned dollars to work, we will remain focused on the potential reward as well as the potential risks, even when the market isn't. We are invested alongside our clients and will do what we think is right to protect and compound wealth over the long term and stick to getting good value for the businesses we buy.

Amazon seems to disrupt some businesses and has the potential to disrupt more in the future. When Amazon acquired Whole Foods, grocery shops stock dropped. What do you think about the disruptive power of Amazon and which industry could be affected in the future?



A few of our companies have been impacted this year by the threat of disruption, compressing their multiples and providing opportunities to add to our positions. This is not to say that disruption will not occur, or is not occurring, but rather to point out that when a narrative builds in a speculative market about one or two companies destroying entire sectors, it tends to result in opportunities.

For example, the market decided that some of the conservative companies we own (i.e. - Walgreens, Kroger) would be disrupted by the likes of Amazon, compressing their multiples below our expectations. We believe this disruption is providing attractive investment opportunities over the long term.

Which sector(s), financial asset(s) and region(s) (Canada, U.S., global markets, emerging markets) will you favor in 2018?

We typically do not make calls on a regional basis given we look for opportunities globally and try to find the best companies within the best sectors regardless of country of residence. As discussed, because of valuation concerns, we have reduced our weights in many areas including technology, US banks, and industrials. On the other hand, more defensive sectors, including health care, consumer (mostly staples) and utilities have seen increased allocations, as sentiment has been weak and valuations have improved. Even within fixed income, we have reduced weights to credit particularly high yield in favor of quality. We want the most liquid assets available in case markets collapse and we need to put money to work into equities with agility.

What asset mix do you recommend for 2018 from a reference portfolio of 40% bonds / 60% equity?

As part of our investment process, we spend a lot of effort trying to better understand "what's priced in" and weighing the fundamentals against what we're willing to pay. We've all heard the expression that a great company can be a bad stock if you pay the wrong price; that same analogy can be applied to markets. With valuation levels having expanded along with the economic cycle, you're already paying for an improving economic backdrop. Therefore, we continue to enter 2018 on a defensive tilt. During the last quarter of 2017, we adjusted our balanced strategy asset mix, keeping equity and cash exposure low and increasing fixed income exposure. Our strategy began the quarter at about 47% equity exposure which increased to about 49% because of the market run. The selloff in the Canadian bond market created opportunities to increase the allocation to fixed income, as that weight rose to nearly 48% and we reduced non-producing cash further to 3%. As we look forward from these levels, return expectations need to come down to reflect this current market environment where we're not being paid to take additional risks. .

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