KEATS CONNELLY
ENRICHING YOUR CROSS-BORDER LIFESTYLE

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REVIEW OF THE FIRST QUARTER

As we move into mid-year 2015, we wanted to write about the thinking behind the various investments we recommend in portfolios and how they work together to make up the entire portfolio.

The best way to describe how your portfolio is constructed is to think about it in three parts. One part is fixed-income and that includes cash and bonds. One part is stocks and that includes investments in diversified mutual funds and exchange traded funds that invest in stocks around the world. A third part is a mix of asset classes that include gold and real estate.

Each of these three categories serves at least two purposes in your portfolio. The bonds and cash provide stability and income. The stocks provide growth in rising markets and also pay dividends. Dividends historically (since the 1950s at least) have not provided as much income as bonds, but recently stock dividends have rivaled bonds as income generators. The third category contains both inflation hedges and assets with growth potential that may not move in lock-step with stock markets.

I would like to make a few comments about each of these three categories of assets to give you a better idea as to why these specific assets were chosen for your portfolio.

The two primary functions of the fixed income (bonds and cash) are stability and income. Stability is needed in a portfolio because stocks can drop dramatically in some years. In 2008 the Canadian stock market dropped more than 30% as measured by the S&P/TSX 60 TR Index. Many stock markets around the world lost even more. Contrast this to bonds, where losses of 10% in any given year are rare. Even if the Bank of Canada started to raise rates and bonds declined in value, the losses in bonds are likely to be very small in comparison of what can be lost in the stock market in a bad year. We believe that portfolio risk should be taken in the growth side of the portfolio and not in the income side.

The income generating ability in high quality bonds has been very low since the economic downturn of 2008. Some of you will remember investing in the early 1980s when you were able to get double digit yields in fixed income investments. It has been hard to find yields much above 3% in high quality bonds since 2008. There are some areas of the markets where yields are much higher, but we have made a decision not to sacrifice safety by reaching for higher income.

The stocks have one primary function and one secondary function. The primary function is to produce capital appreciation. The secondary function is to produce income through dividends. Over the last few years stock markets have been strong. Other than the loss in 2011, the Canadian stock market has risen in five out of six years since the economic downturn. The US stock market has risen every year from 2009 – 2014.

The allocation to stocks in your portfolio will depend on your financial goals and both your willingness and ability to assume financial risk. We advise allocations to stocks for growth, but we want to balance the portfolio into other asset classes because stock market investments can lose money quickly when market corrections occur.

There is regional diversification in your stock market allocations. The investments we have chosen for you include exposure to US and Canadian stock markets as well as foreign developed markets and emerging markets. Then, inside these regions we have to determine the best holdings. For most stock market exposure, we rely on funds from Dimensional Fund Advisors, also known as DFA. DFA is an institutional investment management firm that constructs mutual funds using quantitative approaches to get optimal exposure to asset classes. The firm was founded in 1981 by academics out of the University of Chicago business school to put financial theory into practice. Like many of the most successful investment managers, DFA does not advertise to the public and restricts access to their funds. Restricted access protects investors in their funds by keeping costs down and preventing short-term activity from disrupting the long-term investment strategies. Two of the long-term strategies that DFA emphasizes in their funds are higher allocations to small cap stocks and value stocks. In both cases these strategies have achieved higher incremental performance over long periods of time, although there are times when they are out of favor. DFA also keeps an eye on trading costs and has recently, over the past two years, implemented a quality bias in their funds. We believe DFA funds will continue to provide winning long-term performance over active funds where managers are picking stocks and over passively managed indexed allocations to stocks.

The third category of assets is a mix of assets in portfolios for purposes of inflation hedging and protection against market downturns. For this category we use real estate and gold, although not all portfolios contain both. Real estate has provided very strong returns over the past three years. Gold has not fared as well recently but is still a good asset to hold for both inflation protection and protection against future economic crises. This is an area we are devoting additional research efforts in 2015. Some clients need more protection against inflation than others. All clients want to participate in the growth that is available when markets are going up but also be protected against falling markets. We are often working with two competing objectives when we build portfolios. We want growth and we also need to build in protection against downturns.

We hope this discussion has provided you with a greater understanding of how we construct portfolios. During 2014, because of the global diversification, strength of the dollar and falling energy prices, returns in portfolios were mediocre at best. Recently, the dollar and energy prices have stabilized and both of these changes have provided economic tailwinds to many parts of the world. For example, we saw strong returns for stocks in Europe during the first quarter of 2015. But this is just one quarter and our job is to look after portfolios over a multi-year time frame. If you have not had a personalized review of your investment policy and portfolio yet in 2015, we look forward to setting up that conversation with you in the near future.

Sincerely yours,

KEATSCONNELLY

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