KEATSCONNELLY

ENRICHING YOUR CROSS-BORDER LIFESTYLE

March 31, 2016

REVIEW OF THE FIRST QUARTER

The first quarter saw a slight drop in performance in most Canadian accounts. In January both the Canadian and US stock markets dropped by almost 10%. Although there was mostly recovery after mid-February, it serves as a recent reminder of how quickly stock markets can turn down.

By the end of the first quarter, the Canadian stock market (as measured by the S&P/TSX 60) was up 4.2%. US stocks (as measured by the S&P 500) were up 1.4%.

Performance in Canadian accounts at KeatsConnelly saw a slight pullback in the first quarter related to currency. Accounts did not drop as much as the market during the January downturn due to the diversification into bonds and other asset classes. But the strengthening Canadian dollar (CAD) caused the diversification into US stocks and foreign stocks to lag Canadian stocks during the quarter. (This diversification away from CAD helped performance for the past two years).

Performance in KeatsConnelly accounts does not track the Canadian or US stock market. The stock market averages that are commonly quoted in the news are made up of Canadian and US large company stocks. For diversification purposes, most KeatsConnelly managed portfolios have less than a third allocated to Canadian and US large company stocks.

In addition to the stronger CAD, the increase in the price of oil in 1Q16 caused the Canadian stock market to be stronger. Oil dropped below $30 dollars per barrel and has now strengthened to around $40 (depending on which measure you watch). This has boded well for the energy sector; to which we have exposure through stocks. We also hold positions in gold and gold was up sharply in 1Q16.

Also, our emphasis on undervalued stocks has been out of favor for the past couple of years, and it has shown strength in 1Q16. If you read our commentary with the 4Q15 investment report, you are aware that there have been long periods of time where value has been out of favor but it has always come back to reveal stronger long-term performance over almost all 10-year periods since this data has been collected. There is a theoretical basis why the value effect should manifest itself over time. Emphasizing undervalued stocks is a "bet" away from market neutral stance. By definition, if you have more value than you have less growth. Since growth stocks are by definition stocks where the earnings, cash flows, and assets are not large enough to support their current valuations, then growth stocks are "over-priced". People pay too much for growth stocks. Market prices fluctuate, and these fluctuations cause stock prices to revert to mean valuations. No growth stock goes up forever; it has to come back to reasonable valuations sometime. If the market is valuing a growth stock as a larger allocation of the index than its index "should" support, then it is over-priced. So it will eventually drop in price.

The opposite is true of value stocks. By definition they are "underweighted" in the stock market relative to their earnings or book value. Therefore, by systematically allocating more to value stocks you should get outperformance as the market self corrects through its "reversion to the mean" process.

Benchmarks

On your quarterly report this quarter we have included an updated benchmark. We told many of you of this change during our investment review meetings and said there would be further communication at the time the benchmark change is made.

We have recast our benchmarks to be more in line with the actual investments in accounts. In the past we had a benchmark comprised of stocks, bonds, and cash. In accounts we hold other asset classes, like real estate and gold. In addition, the stock exposure in most accounts has “tilts” to value, small company stocks, and emerging market stocks. None of these tilts were reflected in the benchmark. Now they are.

A benchmark should be as simple as possible but also reflective of how the portfolio is invested. Over the past couple of years, performance in accounts has shown significant deviation from the benchmark because of these other holdings. The benchmark change will be more reflective of the actual portfolio investments. This is not a change to the actual investment strategy, but only a change to the benchmark. What you should expect to see in the future is a tighter distribution between the account performance and the benchmark performance.

The following changes were made to Canadian benchmarks:

The bond index has been changed from the Citi World Government Bond Index Hedged CAD to the Barclays Global Canada Total Return CAD index. This is more similar to the index that our Canadian bond funds track.

On the stock side, our benchmarks are now going to break out the small and value tilts in roughly the proportion we hold them in accounts.

We are adding the following additional pieces in benchmarks because they are held in portfolios:

Gold
Real Estate

In all cases we have chosen an index that we believe is most representative of the asset class. The index we selected in each case is often the same index that the fund held in the account is benchmarked to at the fund company. By way of example, for real estate, our benchmark is the S&P Developed REIT Index CAD. This is the same index that our primary holding, Dimensional Fund Advisors Global Real Estate, is benchmarked to.

We can provide more details on your specific account benchmark upon request. This change has us going from three indexes up to eight for some accounts, but it will provide a better representation of what accounts are invested in.

Investment Committee Update

Our investment committee spent a great deal of time on the proper benchmarking of portfolios in the first quarter. Switching out the benchmarks for all accounts is not an easy task and it is one we studied during every meeting of our investment committee during the quarter after significant work in the investment team to prepare for this change.

Our investment committee also started to look at how much value and small cap tilt to have in portfolios. As mentioned above, value and small cap were two tilts that lagged the overall stock market in the last few years. This wasn't a poor timing decision because these tilts have been in place for many years and helped performance in previous periods. Our investment committee is starting to discuss methods for adjusting these tilts based on economic or market conditions.

Another area that our investment committee is looking at is the area of market hedges and inflation hedges. In most portfolios we have allocations to asset classes other than stocks, bonds, and cash. In Canadian portfolios we are using gold and real estate in this area. We are revisiting our mix of alternative assets to see if any changes are warranted.

As always, we endeavor to provide a great investment experience to you. Please let us know if you have any questions, comments or feedback on your investment portfolio.

Sincerely yours,

KEATSCONNELLY

Robert F. Keats, CFP®, MSFP, CFP™ (Canada) and RFP (Canada)
President

John E. Rice, CFA®, CFP®
Chief Investment Officer