Seymour Investment Management

January 15, 2016

The volatility that characterized equity markets in 2015 continued in the fourth quarter, contributing to a relatively difficult year for investors. As we begin 2016, market jitters are continuing to push stocks lower. In this quarterly letter we discuss some of the reasons for the market's recent weakness, provide some context from a historical perspective, and discuss implications for our longer-term outlook for equities, which remains positive.

Uneven global economic growth and divergence in central bank policies have contributed to volatility and lackluster returns

Around the globe, most equity markets posted lackluster or negative returns in 2015 on the back of sluggish economic growth. Uneven global economic growth and divergence in central bank policies contributed to the volatility that plagued equity, bond and currency markets throughout the year. In Canada, the benchmark S&P/TSX Composite Total Return Index (TSX) generated returns of -1.4% in the fourth quarter and -8.3% for year.

Canadian equities underperformed U.S. equities for a fifth consecutive year in 2015. The U.S. benchmark S&P 500 Total Return Index climbed 7.0% in the fourth quarter and eked out a return of +1.4% for the year with the help of dividends. In Canadian dollar terms, the S&P 500's 2015 return was 20.7% due to a 17% decline in the value of the Canadian dollar relative to the U.S. dollar, which benefitted those Canadian investors that invested in U.S. equities on an unhedged basis.

Volatility and negative returns are an unpleasant but normal part of equity investing. Rarely do markets produce annual returns that resemble their long-term average rates of return in any given year. Rather, equity markets tend to gyrate with economic surprises and sentiment in ways that no one can reliably predict, producing outsized returns in some years and negative returns in other years. This is precisely the reason that we believe equity investing requires a longer-term time horizon. It is only over longer time periods that equities produce somewhat predictable annualized returns, underpinned by growth in corporate profits.

Equity investing requires a longer-term time horizon

As the chart below illustrates, the TSX has generated a compound annual return of 5.3% since December 31, 1999. During this timeframe, the TSX enjoyed positive total returns in 11 calendar years but experienced negative returns on five occasions: -12.6% in 2001; -12.4% in 2002; -33.0% in 2008, -8.7% in 2011; and -8.3% in 2015, as illustrated in the chart below.

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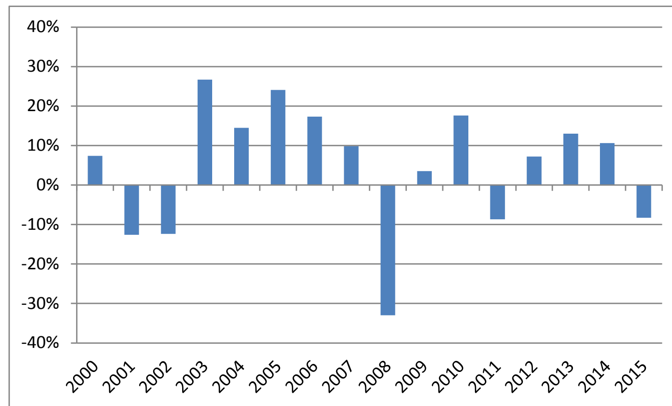
S&P/TSX Composite Total Return Index – Annual Returns

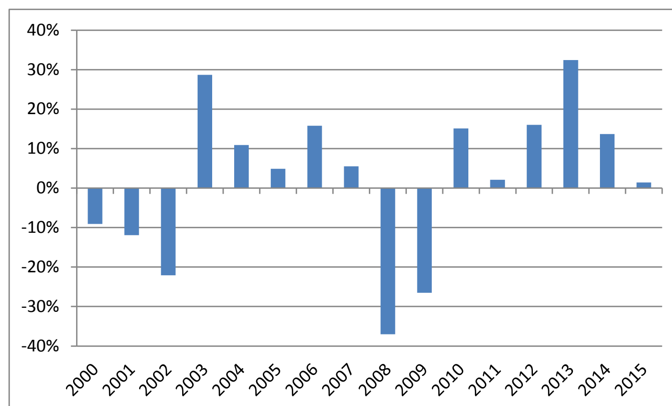


Source: RBC Capital Markets, Seymour Investment Management Ltd.

The TSX and S&P 500 have produced negative annual returns in 5 of the last 16 years

Similarly, the S&P 500 TR Index produced a 4.1% compound annual return in the 2000 – 2015 timeframe, during which time U.S. investors enjoyed positive returns on 11 occasions but faced negative returns in five calendar years: -9.1% in 2000; -11.9% in 2001; -22.1% in 2002; -37.0% in 2008; and -26.5% in 2009.

S&P 500 Total Return Index – Annual Returns



Source: RBC Capital Markets, Seymour Investment Management Ltd.

We have seen a steep correction in crude oil prices and the Canadian dollar in the last year-and-a-half

While volatility and negative annual returns are a normal part of equity investing, what is more of a rarity is the steep correction in crude oil prices that we have witnessed over the past year-and-a-half, and the corresponding decline in the Canadian dollar. After trading above US$100/bbl in July 2014, WTI crude oil prices have fallen 70%. This has contributed to a decline of nearly 30% in the value of the Canadian dollar from 95 cents to 70 cents. (Diverging central bank policies also played a role in the Canadian dollar's decline, as the U.S. Federal Reserve moved to tighten interest rates while the Bank of Canada surprised the market with interest rate cuts last year). A change of that magnitude in the price of crude oil and the value of the Canadian dollar has far reaching implications for economic growth and for the value of a wide range of businesses.

The severe correction that we have seen in crude oil and other commodity prices has served as a good reminder of 1) how dependent the Canadian economy is on energy and other

resource exports and 2) how heavily weighted the benchmark S&P/TSX Composite Index (and many other Canadian indices) are to resource equities. We have long advocated that an active, bottom-up approach to stock selection can help minimize commodity exposure and diversify risk.

A slowdown in Chinese manufacturing and investment is contributing to a supply glut and weak commodity prices

As we begin the New Year, China is once again dominating headlines. Chinese stocks have tumbled in the aftermath of the equity market intervention by Chinese securities regulators and on renewed concerns about slowing growth. A slowdown in Chinese manufacturing and investment, while somewhat expected, is helping to exasperate a supply glut and contributing to weakness in commodity prices. This in turn is adding to market jitters, given the importance of China to commodity markets. (China is, for instance, the world's largest consumer of industrial metals). As we write this letter, WTI and Brent crude oil prices have been setting new lows in the US$29-$34/barrel range (levels not seen since 2003 – 2004) and the Canadian dollar has set a new 13-year low against the U.S. dollar, falling below 70 cents. Copper prices are testing six-year lows below US$2/lb and prices of other commodities including coal and aluminum are similarly under pressure.

Weak commodity markets have weighed heavily on the Canadian economy due to its dependence on resource production

Weak commodity markets have weighed more heavily on the Canadian economy relative to other industrialized nations because of our country's dependence on resource production. Prior to the plunge in crude oil prices, the oil & gas industry accounted for more than one-quarter of Canada's total business investment. (Oil & gas industry capital expenditures have not surprisingly declined sharply as lower energy prices have stressed corporate profits and balance sheets).

Natural forces will eventually return commodity markets to balance as low prices spur demand growth and as resource companies are forced to cut production amid unsustainably low commodity prices

We are hopeful that much of the downside in commodity markets is now behind us, yet we see little in the way of near-term catalysts. In the case of crude oil, global production has proven to be surprisingly resilient due to the implementation of new technologies and as the Organization of Petroleum Exporting Countries (OPEC) producers battle for market share. Commodity markets, including crude oil, natural gas and most metals, remain in oversupply and a strong U.S. dollar is also putting downward pressure on commodity prices. (A rising U.S. currency makes dollar-denominated commodities more expensive for non-U.S. buyers). As such, we expect weakness in commodity markets will continue to weigh on the Canadian economy and equity markets in the near term. Ultimately, we would expect natural forces of supply and demand to return commodity markets to balance as low prices spur demand growth and as resource companies are forced to cut production amid unsustainably low commodity prices.

There appears to be a growing disconnect between actual fundamentals and sentiment

Although weak commodity prices certainly create a headwind, <u>we don't believe the outlook is nearly as weak as media headlines or equity market volatility might suggest</u>. Moreover, as we discuss later in this letter, the recent sell-off has actually improved the outlook for longer-term equity returns. In our view, there appears to be a growing disconnect between actual fundamentals and sentiment, which is creating opportunities for patient, long-term investors.

Media headlines, which are carefully crafted to draw readers, would suggest a pretty dire outlook yet it is worth keeping in mind that the outlook is rarely as bleak as the media would have us believe. The media has a tendency to focus on bad news, particularly as it relates to the economy, and present economic news as unambiguously negative when in reality, there tends to be winners and losers from economic events. Moreover, a market economy has self-equilibrating mechanisms whereby natural stabilizing forces tend to offset or limit destabilizing forces. For instance, although lower crude prices are negative for Canadian producers, a corresponding decline in the value of the Canadian dollar helps reduce the severity. While crude oil prices are clearly a net negative for the Canadian economy, there are parts of the economy that actually benefit from lower crude prices and/or a weaker Canadian dollar. The impact tends to be positive for Canadian manufacturers, who benefit from lower input costs and enjoy improved competitiveness of their exports owing to a weak currency. Similarly, consumers benefit as lower gasoline prices puts more money in their pockets. A weaker Canadian dollar is also helping to boost tourism.

Parts of the economy benefit from lower crude prices and a weaker Canadian dollar

It seems to us that the media and the market are increasingly focused on the very near term, which we suspect has resulted from the proliferation of the internet and improved access to time-sensitive data. Research analysts are encouraged to focus on the upcoming quarter or year, but few analysts talk about their expectations for earnings growth over the next five or ten years. Certainly in the very near term there are always uncertainties or reasons for concern, however with a longer-term view (which we try to have) it is much easier to find reasons for optimism.

The global economy continues to recover, led by the U.S.

The global economy has continued to recover (albeit, it has been a long, slow, and sometimes painful process), helped by central banks' accommodative policy. In the U.S., economic data has generally improved. U.S. employment has shown substantial improvement (the U.S. unemployment rate has declined to 5%), helping fuel the housing market recovery, which we think is still in the early innings. Consumer sentiment and spending remain robust, which is helping drive U.S. domestic and import demand.

We have been optimistic about the U.S. economic recovery for some time and have positioned our portfolios accordingly. As we outlined in our Q1 2015 pooled fund commentaries, many of the Canadian-domiciled companies that we have invested in generate the majority of their revenues in the United States. In our Q1 commentaries, we estimated that 86% of the Seymour Canadian Equity Fund was invested in companies with significant U.S. and international sales, and nearly one-half of the Fund's holdings generated the majority of their revenues outside Canada. It is worth noting that not only are these companies benefitting from strong U.S. demand for their exports, but they are increasingly benefitting from having U.S. dollar denominated revenues and in many cases, Canadian dollar denominated cost bases. The majority of the companies that we own continue to generate strong and steady earnings growth.

Our conviction in our holdings and our confidence in the longer-term outlook for equities allows us to maintain an optimistic outlook

It is both our conviction in the high-quality companies that we invest in and our confidence in the longer-term outlook for equities that allows us to maintain an optimistic outlook. We know that over longer time horizons, equities tend to generate attractive, predictable

annualized returns, underpinned by growth in corporate profits. Moreover, equities tend to outperform other asset classes including bonds and cash over the long term (see chart below), as evidenced by more than 100 years of historical data spanning many economic and market cycles. Our bias toward equities is further reinforced by current, historically low levels of interest rates. In addition to offering low yields, we would expect fixed income investments to come under pressure in coming years as central banks eventually follow the path of the U.S. Federal Reserve and move to reduce stimulus and increase interest rates toward more normalized levels.

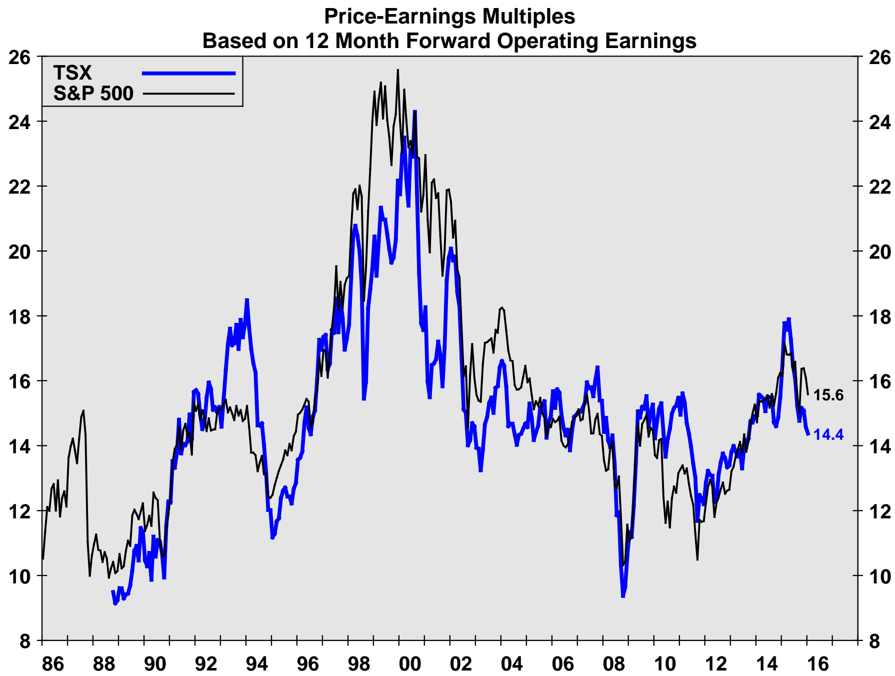
We continue to prefer equities over fixed income securities

Historical Investment Returns

The recent pullback in equity markets only serves to increase our confidence in the longer-term outlook for equity returns going forward. Equity markets tend to overcorrect in both directions, and as we have seen historically, market corrections tend to be followed by periods of outsized returns.

Following the recent pullback, we are finding compelling value in some high-quality, well-capitalized companies that we would like to own for the long term

Following the recent pullback, we are finding attractive value in selected areas of the market. The S&P/TSX Composite Index was trading at a price-earnings multiple of 14.4 times 12-month forward bottom-up consensus earnings estimates at year-end, below its historical median of 15.0x, and below the S&P 500 Index's 15.6x multiple, according to data compiled by TD Securities (see chart below). Broadly-speaking, we view the Canadian equity market's valuation as fair to attractive. What an average doesn't show, of course, is its components, and following the recent sell-off we are finding compelling value in some high-quality, well-capitalized companies that we would like to own for the long term. We are increasingly viewing the current equity market sell-off as a compelling entry point for long-term investors (recognizing that the near-term outlook is highly uncertain).



M84 Bottom Up Earnings Based on CPMS (TSE) and IBES (S&P) Consensus JAN 2016

Source: TD Securities

We wish to thank our clients for your continued support. We encourage you to call with any questions or concerns that you may have.

Warm regards,

The Seymour team