April 17, 2017

Global equity markets performed well in the first quarter of 2017. In Canada, the S&P/TSX Composite Total Return Index ('TSX') was up 2.4%, and in the U.S., the S&P 500 Total Return Index ('S&P 500') was up 6.1%. In Europe, equity markets were up 5 to 9%. Given the threat of trade sanctions by the U.S., it might be somewhat surprising that one of the strongest markets in the world in the first quarter was Mexico, up 17.7% in US dollar terms.

Equity markets continue to benefit from the historically low interest rate environment.

Equity markets continue to benefit from the historically low interest rate environment. While interest rates have trended somewhat higher (and may continue to do so), they remain very low by historical standards. As we have alluded to in previous letters, the current interest rate environment provides a very attractive cost of capital for companies that need to borrow.

Equity markets are also benefitting from funds flowing in from fixed income markets.

Equity markets are also benefitting from funds flowing in from fixed income markets. The fixed income market is much larger in size than the equity market, so any change in asset mix that investors make from fixed income to equities can have a material impact. Fixed income investors are becoming concerned about the low rates of return that bonds offer. In the past 12 months, 10-year Government of Canada bonds have returned -1.4%, and similar 10-year government treasuries in the U.S. have returned -3.7%.

Positive fund flows, low interest rates, and solid earnings growth have resulted in North American equity markets trading at or near record highs. Equity valuations have moved higher, and the market is no longer cheap. Should investors be concerned? Are the markets more vulnerable to a pullback, and what should investors do in such an environment?

Timing the Market or Time in the Market

It is important that investors understand that owning equities means they have ownership in a number of different businesses. The purchase of a business should be made with much due diligence, with the expectation that you will want to be an owner in that business for the long-term, and with the understanding that every year may not be a great year. If an investor can align his time horizon with that of a business owner, then worrying about the day-to-day or month-to-month news and volatility in the market can be minimized.

An investor with a short investment time horizon will subject themselves to much more market risk because, while equity returns tend to be somewhat predictable over long time horizons, markets often endure periods of short-term volatility. Investment decisions may be influenced by the "market noise" that we hear and read about in the media. Even worse, emotional responses may lead to substantial underperformance of an investor's portfolio.

Financial services market research firm DALBAR, INC. has done an interesting study on investor behaviour and the impact on investment returns over time. What they found was that the leading cause of diminished return over time is investor behaviour. The following chart highlights the major causes of investor underperformance over a 20-year period.

The leading cause of diminished return over time is investor behaviour.

Major Causes of Equity Investor Underperformance (20 year analysis)

Cause	% Contributed to Underperformance	Underperformance ($Billions)
Lack of Availability of Cash to Invest [1]	0.54	44
Need for Cash (planned and unplanned)[2]	0.68	55
Fund expenses (including management fees)	0.79	65
Voluntary investor behaviour underperformance[3]	1.50	122
Total	3.52	286

[1]Lack of availability of cash represents the investor return that is lost by delaying the investment.
[2]Need for cash represents the percentage of investor return that is lost or gained by withdrawing the investment before the end of the period being measured.
[3]Volutary investor behaviour generally represents panic selling, excessively exuberant buying and attempts at market timing.

Source: DALBAR, INC.

Poor market timing decisions accounted for over 40% of the under-performance.

What this chart means is that relative to an index (i.e. S&P 500), the average investor lost 3.52% per year over a 20-year period. Instead of getting a market return of 9% per year, the average investor received just 5.48%/year (9%-3.52%). The largest contributor to this underperformance was the investor making bad investment decisions relating to timing the market. The poor market timing decisions accounted for over 40% of the underperformance.

As we have discussed at length in previous commentaries, we believe it is extremely difficult to time the market. We don't try to time the market and we believe it is critical for investors to have a long time horizon when considering investing in equities. Successful investors must learn to ignore the market noise and remember that they have ownership positions in good businesses that should be held for the long-term.

We have included an appendix in this quarterly mail-out that considers in more depth the importance of identifying appropriate time horizons for investors.

Investment Strategy and Outlook

With stock markets at or near record highs, investors may become concerned about the possibility of a correction. Short-term corrections are a normal part of investing, and should be expected by anyone investing in stocks. A Deutsche Bank study suggests that corrections occur on average every 357 days, and have an average duration of 14 weeks.

Corrections are defined as a market pullback of 10% or more. A correction should matter only to those investors with a short investment time horizon. For investors with long time horizons, a correction can be ignored or used as a buying opportunity. Trying to time corrections is extremely difficult and, based on empirical evidence of investor behaviour, will result in sub-par investment performance. Note that in many of the years that markets have had corrections, the markets still finish in positive territory. In 2016, the TSX fell over 10% in the first six weeks of the year, yet finished the year up more than 20%.

Corrections occur on average every 357 days.

We continue to favour equities in the current environment. We expect that low interest rates will persist for some time. Companies enjoy a very low cost of capital, and with the economy slowly growing, profits are maintaining a steady growth profile. We continue to believe that returns in the fixed income markets will be marginal. Low interest rates combined with a high taxation rate makes it likely that fixed income investors will realize negative returns after tax and inflation.

As always, please don't hesitate to contact any member of the Seymour team with any questions or feedback.

Warm Regards,

The Seymour Team

Suite 1000 | 1285 West Pender Street | Vancouver, B.C. | V6E 4B1
Main: 604-659-1722 | Fax: 1-877-778-3770
www.seymourinvest.ca

"What is your time horizon?"

This is usually one of the first questions that we ask our new clients. The answer plays a significant role in determining a client's target asset allocation. At Seymour we have a clear bias toward equities, which offer the highest return potential over longer time periods. We caution, however, that equity investing requires a longer time horizon because equity markets can be volatile in the short term. Investors with shorter time horizons require more conservative portfolios (think cash and short-term bonds) while clients with longer time horizons can withstand higher volatility, and hence a greater allocation to stocks.

A common answer to the question of one's time horizon goes something like this: *"I am planning to retire in four years, so I guess my time horizon is four years."* At this point, we take the time to explain that once our clients get to retirement, they typically will live for another 20 to 40 years! This would imply a very long time horizon and a requirement for growth to offset inflation and sustain their desired lifestyle. In actuality, what we typically see is that most of our clients have multiple time horizons. When entering retirement, clients may have pending expenses for education, medical bills or house purchases that all have very distinct time horizons. There may also be a general need to meet annual cash flow requirements for everyday expenses. Depending on personal risk tolerance factors like the level of cash cushion needed for peace of mind or to keep for a rainy day, we may recommend two to five years of cash flow needs be held in very low-risk investments. For longer-term investments, we would recommend greater allocations to equities. As our clients' time horizons approach 10 years and beyond, 100% equity portfolios may be appropriate to provide real growth in assets. Many clients hope to leave money to their children or to charities. In this case, the time horizon extends beyond our clients' lives and into future generations. Being too conservative with these assets may actually do a disservice to the beneficiaries.

The following chart illustrates the enormous differences in wealth creation from different asset classes when viewed over very long time horizons going back to 1926.

We have observed a tendency for charitable foundations with very long time horizons (i.e. as long as 100 years or in perpetuity) to also invest very conservatively. One explanation for this may be that the advisory boards view the time horizon as their tenure on the board (i.e. perhaps three to five years) and become averse to any loss of capital during their time of service. “Not on my watch” becomes a greater determinant of asset allocation than the longer-term growth for the deemed beneficiaries. Perhaps a better value-maximizing strategy would be to invest the short-term cash requirements (say two to three years of cash flow needs) conservatively and invest the balance in equities. Even in a market correction, an all-equity portfolio will generate dividend income which can pay for some portion of the short-term cash flow requirements. Following this strategy should result in significantly greater long-term growth in the value of the assets over a 10-20 year period. When a foundation's goal is to maximize value for its beneficiaries over 50-100 years, the long-term value expands exponentially.

In addition to investor misperceptions around time horizons, sell-side research analysts who work for brokers generally base their recommendations and target prices on short-term time horizons. We conduct hundreds of meetings each year with research analysts from bank-owned brokerage divisions as well as independent brokers. A typical meeting involves us asking the analyst about the stocks they cover that we may own or follow. We then ask if there are any other stock ideas that they find compelling. In almost every case, the target prices and recommendations are based on a 12-18 month time horizon. Once we have canvassed all of the best ideas from the analyst, we usually have a follow-up question: “How would your recommendations change if you had a five-year time horizon?” As you have probably already guessed, the top recommendations usually change once the analyst thinks about it from a longer term perspective. Unfortunately, sell side analysts get paid to make short-term recommendations.

The investment team at Seymour Investment Management takes a long-term view when selecting stocks. We hope to own our companies for five or ten years or longer. We believe patient long-term investing is a competitive advantage in a world where performance tends to be measured on a quarterly or even monthly basis. As a result, we strive to work with clients who share this view and have long-term time horizons of their own. When our clients’ investment goals align with our investment philosophy, there is a higher likelihood of our clients’ goals being achieved. Clients are much more likely to stick with their plan when they understand how we invest and why we invest the way we do. Client/manager alignment is critically important and having agreement on time horizons is a crucial part of that relationship.