Seymour Investment Management

April 16, 2018

Volatility returned to global equity markets in the first quarter of 2018. This comes as little surprise following 2017, a year which saw volatility at the lowest level since the early 1960s. As we have written in previous letters including our Q4 2017 commentaries, market volatility and corrections are a normal part of equity market behaviour.

In Canada, the benchmark S&P/TSX Composite Total Return Index ('TSX') was down 4.5% in the first quarter of 2018. The U.S. benchmark S&P 500 TR Index ('S&P') was down 0.8% in the quarter, although in Canadian dollars the S&P was up 1.7%. Results in other global equity markets were mixed; however, most equity market indices suffered losses in local currency terms.

Within the quarter, both the TSX and the S&P suffered declines of just over 10% in the first few weeks of February. (A decline of more than 10% is classified as a 'market correction'.) Prior to this quarter, we had not seen a market correction for over a year. Markets typically experience corrections every 12-18 months, a normal characteristic of rising markets. The correction experienced during the first quarter was limited to just 10% with markets rebounding quite soon after; however it remains to be seen whether we have seen the last of this correction cycle.

"To invest successfully, one needs a sound intellectual framework for making decisions and the ability to keep emotions from corroding that framework"
Warren Buffett

Should investors be concerned about the rising volatility of the market? Volatility can be unsettling for investors as volatility is more often than not associated with market declines. Contributing to the volatility are concerns surrounding global trade, NAFTA, political uncertainty, and rising interest rates. With the exception of rising interest rates, we believe that the other issues are more short term in nature and will be resolved in time. We will address the issue of rising interest rates later in the letter.

As previously mentioned, we believe that corrections are a normal part of a bull market. For investors with additional liquidity, corrections can be used as an opportunity to buy high-quality stocks at lower prices. For all investors, it is important to maintain a disciplined approach and focus on long-term investment objectives. In the words of Warren Buffet, *"To invest successfully, one needs a sound intellectual framework for making decisions and the ability to keep emotions from corroding that framework"*.

Suite 900 | 1285 West Pender Street | Vancouver, B.C. | V6E 4B1
Main: 604-659-1722 | Fax: 1-877-778-3770
www.seymourinvest.ca

Successful Investing is Emotionally Difficult

Behavioral finance is a field of finance that proposes psychology-based theories to explain stock market anomalies

We recently attended a presentation by C. Thomas Howard on Behavioural Portfolio Management. Mr. Howard is a pioneer in the application of behavioural finance for investment management. Behavioural finance is a relatively new field that seeks to combine behavioural and psychological theory with conventional economics. The theory attempts to provide explanations for why people make irrational financial decisions.

One aspect of behavioural finance examines a number of human emotions that can cause investors to make poor investment choices. Some examples are as follows:

1. **Investment Anchoring** – This occurs when investors base their decision making on irrelevant figures and statistics. An example would be to sell XYZ stock when it is down 15%, even though it is up 100% from its original cost. The investor is 'anchored' on the recent decline from the highest point in the stock price, while ignoring what a good long-term investment XYZ has been.
2. **Confirmation Bias** – An investor is more likely to look for information that supports his or her original idea. This would include seeking out bad news to support a decision to sell stocks.
3. **Hindsight Bias** – The investor believes that the onset of some event was predictable and completely obvious, when in fact it wasn't. The hindsight bias can lead to overconfidence, as the investor has growing conviction in his or her 'predictive powers'.
4. **Herd Behaviour** – There is a comfort that comes in following a group, with the rationale that it's unlikely a large group could be wrong. This is a particularly dangerous behaviour at market peaks and bottoms. Investors who follow the herd may feel compelled to sell at market bottoms and buy at market peaks.
5. **Availability Bias** – This is when investors weigh their decisions toward more recent information, making their opinions based on the latest news. An example would be how investors reacted to last year's Brexit news, with some interpreting the news as a reason to sell.
6. **Myopic Loss Aversion** – This is a very frequently occurring investor trait, and occurs after a period of negative returns. Most people have a greater aversion to losses than to similar gains, and a tendency to evaluate outcomes frequently. Investors who once had a ten-year time horizon for their investments suddenly have a very short-term horizon. They just 'want to get out' and sit on the sidelines. This behaviour makes investors susceptible to selling in the middle of a bear market. They may never recover their losses, as by the time confidence returns, the market will have moved significantly higher.

The biggest risk for investors in volatile markets is succumbing to emotional behaviours

These investment behaviours are very common, and are more prevalent during times of market volatility. In fact, the proponents of behavioural finance believe that the *market volatility is actually a result of investor emotions*. Emotional crowds are made up of investors who base their decisions on recent events and unfolding news. *The biggest risk for investors in volatile markets is succumbing to one of the emotional behaviours listed above* and making a poor investment decision that will lower expected returns and increase the risk of the portfolio.

Investors must remain disciplined and focus on their long-term objectives.

How does an investor avoid making a poor decision in times of market volatility? *Investors must remain disciplined and focus on their long-term objectives.* Because investors are naturally averse to short-term losses, they are significantly challenged to think long-term. Instead of a ten-year investment time horizon, investors may look at their portfolio as a series of one-month time frames. Having a short-term investment time horizon will undermine the performance of the portfolio as emotional decision-making impairs long-term results.

On a daily basis, the market is up 55% of the time. On an annual basis, the market is up 75% of the time.

On a daily basis, the market is up 55% of the time. It would be very difficult for investors who watch their portfolio daily to maintain a long-term approach to their investments given they would be disappointed in their returns almost half the time. *On a monthly basis the market is up 65% of the time*, *and on an annual basis, the market is up 75% of the time* (see chart in the Appendix). Investors must remain disciplined in an emotionally-charged world of round-the-clock news, and maintain a long-term time horizon. If they can do this, they will increase their chance of investment success much more than those who react to short-term events.

Successful investing is not just emotionally difficult, but it requires a disciplined approach with an objective of maintaining a long-term time horizon.

Successful Investing Requires a Long-Term Time Horizon

There are numerous examples of well-managed, industry-leading Canadian companies that operate in industries with favourable dynamics and high barriers to entry. Many of these companies have provided patient investors with excellent long-term results. In the commentary below we examine two such companies – CN Rail and Royal Bank of Canada – to see how volatility has impacted their returns over a 20-year cycle.

Both CN Rail and Royal Bank have provided investors with excellent long-term returns. The compound annual total return (including all dividends, which are assumed to be reinvested) for CN Rail over the past 20 years has been 17.5% per year. For the Royal Bank the return has been 14.5% per year. Note that during this time, the stock market has had two significant corrections of over 50% - one during the technology bubble in the years 2000-2002 and then again in 2008-2009.

The share prices of CN and Royal Bank were not immune to the volatility during this period. In fact, both stocks had price corrections of at least 10% in almost every year of the 20-year period. In addition, there were seven periods of time in the 20-year period where CN's stock fell by more than 20%. The Royal Bank experienced eight such periods.

While investors in these companies were able to earn annual returns of over 10% per year, they had to suffer through corrections of at least 20% almost every 2-3 years. Volatility has always been part of investing, and successful investors must maintain a long-term time horizon in times of market turmoil.

Investment Strategy and Outlook

As we write this letter, markets are once again exhibiting volatility. We believe that concerns such as NAFTA, global trade issues, and political uncertainty are more short term in nature and there will be greater clarity regarding these issues in the next year or two (maybe not with politics!). There are always issues that will concern the market and we believe that these current issues are not dissimilar to what we have seen in the past.

We have likely seen the bottom in interest rates

As we alluded to earlier in the letter, the rise in interest rates could be more long term in nature and we believe that we have likely seen the bottom in interest rates. Interest rates began a secular decline in the early 1980s, and this decline has had an important impact in equity valuations for over 30 years. Equity prices benefit from lower interest rates, and this has been the case during this cycle of declining interest rates.

If interest rates continue to move higher, how will equity prices respond? Previous interest rate cycles suggest that higher interest rates will constrain equity markets from achieving historical market returns. The current interest rate cycle was been characterized by interest rates that were well below equilibrium levels, as monetary authorities dealt with the financial crisis of 2008-2009. We believe that interest rates will move higher, but are moving towards a more normalized level.

We believe that equity markets are still in a bull market phase and expect that corrections may be a recurring theme

The yield on the 10-year U.S. Treasury Bond hit an all-time low in the summer of 2016, with a yield of 1.38%. Today, it trades at a yield of nearly 2.8%, approximately double the rate of less than two years ago. The S&P 500 managed to increase over 20% during this timeframe, indicating that returns can still be attractive in a rising interest-rate environment. Though interest rates are likely to move higher, we believe that they will remain historically low and provide companies with an attractive cost of capital.

We believe that equity markets are still in a bull market phase, yet caution that we expect that corrections will be a recurring theme. Although unsettling, volatility can provide opportunities for long-term investors to buy well-managed businesses at more attractive valuations.

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

Warm regards,

The Seymour team

Please Note: We are moving! Effective Monday April 16th our office will be moving from the 10th Floor to the 9th Floor at 1285 West Pender Street. We welcome you to stop by and visit us in our new space.

Markets Have Always Been Volatile