Seymour
Investment
Management

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The Canadian market underperformed its US counterpart this quarter, with the S&P/TSX Composite Total Return Index falling 0.6% in contrast to the S&P 500 Total Return Index increasing 7.7%. Despite outperforming in the second quarter, the S&P/TSX lags the S&P 500 year to date, returning a total return of 1.4% and 10.6% respectively.

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Global trade tensions, in particular the uncertain future of NAFTA, weighed on the Canadian market in the latter months of summer. In addition, Canadian Energy and Materials sectors showed weakness over pipeline progression (or lack thereof) and uncertainty around commodity price sustainability.

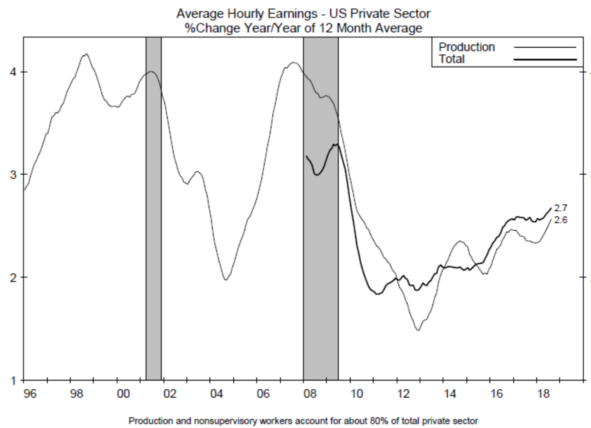
Canada is not alone in underperforming the US this past quarter; many global equity markets posted negative returns despite global economic growth still running at an above-average pace. We see this resulting in global valuation levels below their historical average; notably the TSX Composite forward price earnings multiple, as at October 15th, sits at approximately 13X, below the historical average of 15X. In contrast, the US, S&P 500 sits at approximately 16X, in line at its historical average.

Rising rates both in Canada and across the border will act as headwinds to equity markets

The strong labour market and historically low unemployment rates are contributing to upwards pressure on wages and consumer prices, as detailed in Exhibit 1. This has resulted in Canada's inflation rate rising to 3% in July: its highest level since 2011. In response to these signs of economic strength, it is widely anticipated that monetary policy will continue to tighten gradually over the coming quarters.

Rising rates both in Canada and across the border will act as headwinds to equity markets, which, in the face of monetary tightening, are anticipated to experience volatility. With an anticipated sustained period of rising yields in the coming years, as we have outlined in past letters, we feel bonds offer a less compelling risk-reward profile in comparison to equities.

Exhibit 1: Percent Change in Average Hourly Earnings Year to Year



Source: TD Securities

United States-Mexico-Canada Agreement (USMCA) supporting continued free trade in North America

At long last, the back and forth negotiations to replace NAFTA have resulted in a proposed deal known as the United States-Mexico-Canada Agreement (USMCA) pending approval by the three participating countries. Perhaps the greatest result of the new USMCA is the removal of the uncertainty that has weighed on the Canadian marketplace since these trade discussions began 13 months ago. The agreement has a number of positives for Canada: it precludes the imposition of tariffs on the automotive industry and keeps the dispute resolution process intact (known as Chapter 19, typically and successfully used to dispute imposed tariffs) in exchange for a concession on dairy market access. Notably, the USMCA agreement does not revoke the recent steel and aluminum tariffs imposed by the US under a national security provision. Although the protectionist rhetoric has not subsided from the tweets of our neighbor to the south, a renegotiated NAFTA agreement is positive for Canadian market sentiment.

<u>Interest Rates and Debt Service</u>

With Bank of Canada interest rates progressing upwards, and consumer key rates following suit, Canadians are beginning to feel more of the impact on household loans.

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Canadians are not immune to the impact of rate increases. How Canadian households will respond will have an impact on consumer spending and ultimately Canadian economic growth. Already the debt service, a ratio of repayments of both principal and interest in relation to disposable income, sits at 14.2% in Q2 2018. It is below its peak of 14.9% but anticipated to climb when rate increases are passed down. The Bank of Canada has inferred that due to high debt loads, households are likely to be more sensitive to interest rate increases. Although we anticipate that wage inflation, discussed above, will help increase disposable income, households will need to adjust their saving habits or their spending habits to cope with the greater household debt load. The impact on growth in the Canadian economy remains to be seen. Although anticipated to be gradual, we will await the result of the gradual monetary tightening taking place.

With household saving habits and consumer discretionary spending in mind, we take a look at how lifetime spending needs can be met by your portfolio.

Meeting Lifetime Spending Needs

Whether you are planning for retirement or enjoying the post-retirement life, drawing a road map of your spending habits and available asset base will help to avoid common financial headaches in the future. To help better understand the common fear of outliving your assets, we break down sustainable withdrawal rates and target asset mix below.

The term 'sustainable withdrawal rate' refers to the amount at which you can reasonably anticipate to withdraw from your portfolio and be confident your money will not run out during your lifetime.

The term 'sustainable withdrawal rate' refers to the amount at which you can reasonably anticipate to withdraw from your portfolio on an annual basis, **adjusted each year for inflation**, and be confident your money will not run out during your lifetime. This is the rate at which, according to financial theory, your asset base could last your lifetime.

To begin thinking about sustainable withdrawal rate, we first define a withdrawal rate. This is the amount that an individual takes out of their portfolio in a given year, expressed as a percentage of total assets. Importantly, this number reflects both inflows and outflows. For example, income sources including pension, rental income, and social security are netted against annual expenses. Annual expenses could include lifestyle spending, fixed mortgage or other payments, and taxes. The net amount, whether surplus or deficit, reflects what you can contribute or withdraw from your portfolio. The withdrawal rate is a fluid number that changes each year. Understanding this number is a key component of establishing your financial security.

Using historical market returns dating back to 1926, an influential study referred to as the "Trinity Study" has considered the probability of maintaining sufficient assets over the course of the investor's life at various withdrawal rates, termed the 'Portfolio Success Rate'**.** The study calculates this based upon two primary factors: the retirement time horizon in years and the asset mix of the portfolio (stocks and bonds).

Success rates improve for lower withdrawal rates, shorter time horizons in retirement, and higher stock allocations

Conceptually, we can observe that success rates improve for lower withdrawal rates, shorter time horizons in retirement, and higher stock allocations. Results of this study for a thirty year time horizon are included below, updated to 2017.

Exhibit 2: Inflation Adjusted Portfolio Success Rates, 30 Year Time Horizon 1926 – 2017

Withdrawal Rate	100% Bonds	75% Bonds 25% Stocks	50% Bonds 50% Stocks	25% Bonds 75% Stocks	100% Stocks
3%	83	100	100	100	100
4%	44	87	100	98	94
5%	22	44	70	78	78
6%	10	21	46	59	67
7%	3	10	25	48	56
8%	0	3	10	37	43
9%	0	0	2	13	37
10%	0	0	0	3	21

Source: Cooley, Philip L., et al. "*Retirement Savings: Choosing a Withdrawal Rate That Is Sustainable.*" Journal of the American Association of Individual Investors, Feb. 1998. Updated to 2017 by Wade D. Pfau. Ph.D., CFA

Assumptions: *Inflation-adjusted withdrawals based on Consumer Price Index, withdrawals made at the start of the year. Returns of stocks represented by S&P 500 returns and Intermediate-Term Government Bonds to represent Bonds compiled from Ibbotson's Stocks, Bonds, Bills, and Inflation Data, 1926 - 2017.*

Using the above table, you can see the significant impact even a 1% change in withdrawal rate has on long term success of the portfolio, highlighting the important concept of compounding, discussed in previous letters. Generally, as a high-level rule of thumb, **the above studies suggest 4% can be considered a sustainable withdrawal rate.** What this means is on a portfolio of $1 million, you can be reasonably comfortable that an annual withdrawal starting at $40,000 and **increased each year for inflation**, can be sustained over the retirement time horizon.

4% can be considered a sustainable withdrawal rate.

Under the current low interest rate and higher stock valuation environment, some studies suggest a more conservative withdrawal rate closer to 3%. Three percent is considered sustainable given stresses such as challenging economic times, longer retirement horizon etcetera. As always, we reiterate that although history provides us useful guidelines and rules of thumb, it is important to assess your own situation and the viability of different withdrawal strategies going forward.

The table above can be used to develop an appropriate withdrawal rate given your portfolio size, or alternatively can be used to establish a target portfolio size using a projected withdrawal during retirement. For those planning in advance, working backwards you can assess what you will need at retirement to maintain a desired lifestyle based upon the suggested withdrawal rates and take steps to meet that goal.

It is important to note, as demonstrated in the above table, the sensitivity of the graph to various inputs. For instance, the presence of bonds in the portfolio helps increase certainty at low to mid-level withdrawal rates but at the expense of higher sustainable withdrawal rates supported by stocks. A healthy dose of equities helps to provide more flexibility for future withdrawal rates. In addition, a more active monitoring approach to your withdrawal rate has been shown to allow for a higher withdrawal rate while maintaining a similar level of success. For instance:

An active approach can help maximize your sustainable withdrawal rate

1. Monitoring spending habits and adjusting if needed in relation to portfolio performance
2. Sourcing other income to delay withdrawal needed during challenging time periods
3. Minimizing taxes through asset location and managing distributions.

Overall, your time horizon, fluctuating income needs, portfolio mix (stocks vs bonds), and comfort level play a role in determining your sustainable withdrawal rate. Whatever approach you take, finding a withdrawal rate that is sustainable will set you up for the best chance of long term success.

New Team Member

We would like to take this opportunity to welcome our newest team member: Dennis Chan. Dennis began his career in 2005 in equity research with Phillips, Hager & North, covering a variety of industry sectors and companies. Since 2010, Dennis has been a portfolio manager, directly managing $4B of Canadian Equity assets including Small-Cap, Dividend Income and SRI mandates. We are confident he will make a great addition to our team and are very excited to have him on board!

As always, we welcome your thoughts and questions. Please do not hesitate to reach out to any member of our team.

Sincerely,

The Seymour Team