Serber Speaking

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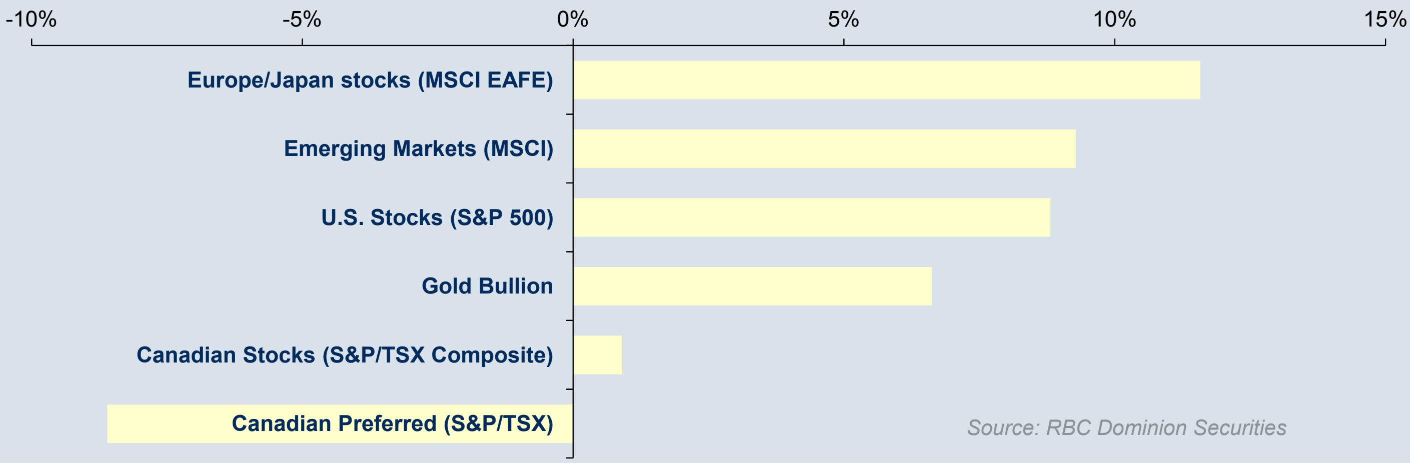
Commentary for the quarter ended June 30, 2015

A Two-Percent Haircut in Q2

The second quarter of 2015 delivered unusually uniform, albeit negative, financial market returns. The main asset categories I track, including Canadian stocks, U.S. stocks, gold, Europe/Japan stocks, emerging market stocks and Canadian bonds, were each down about two percent for the quarter, in CAD$ terms. The good news is that Q1 gains were very strong so, even with a soft second quarter, financial markets are still having a positive year, as seen on the graph below. A notable exception is Canadian preferred shares, which I'll address below.

Performance by Asset Class: January 1 to June 30, 2015 (in Canadian $)



The main culprit for the "two-percent haircut" in Q2 was a rise in longer-term bond-interest rates. For example, the yield on the benchmark U.S. 10-year Treasury bond rose from 1.9 percent to 2.4 percent during the quarter. When bond yields rise, the bond prices fall.

Also, rising interest rates have a negative impact on stocks. Stocks prices reflect, theoretically, the estimated present value of future profits. This calculation requires two inputs: an estimate of future profits and a projected long-term interest rate. Other factors holding constant, if the long-term interest rate goes up, the present value of future profits, i.e., stock prices, goes down. In addition, higher interest rates increase corporate interest expenses over time, thereby lowering profits. An increase in rates could also discourage leveraged stock buying, reducing demand and, therefore, stock prices.

The big question for market forecasters now is whether the recent increase in bond rates is the beginning of a rising trend or just a short-term bounce that will peter out? My view is that there is simply too much slack in the global economy to withstand any significant prolonged increase in interest rates at this time. Highly regarded forecaster BCA Research now projects rates in Europe will remain close to zero until 2020 or longer. If that is correct, then the current backup in bond yields should recede, and financial markets should recover their Q2 losses as 2015 progresses.

Of course, additional factors other than interest rates also influence the markets. The current round of anxiety over the financial fate of Greece is but one example. Most observers expect that the Greece situation, however it plays out, will not have significant long-term negative effects on the European economy or on global markets.

What's the deal with preferred shares?

The Canadian preferred-share market has taken a severe hit in 2015, down nine percent. I believe this drop is temporary and unwarranted and that preferreds now represent one of the best available risk/reward investments. Preferred shares are fixed-income investments, meaning that the investment return is based on known values and formulas and is not, like stocks, based on an unknown variable called "future profits." That being the case, we can evaluate the attractiveness of preferreds versus other fixed-income alternatives.

On the Yields and Spreads chart below, I have shown the yield for corporate bonds versus preferreds as they stood at December 31, 2014 and six months later on June 30, 2015.

Preferreds have slightly higher risk than corporate bonds. For this reason, preferreds trade at a higher yield or "spread" above corporate bonds. As can be seen on the chart, the yields on preferreds have gone up over the past six months while yields on corporate bonds went down. As a result, the spreads have ballooned to unusually wide levels. A typical bank reset preferred is now trading at a 2.8 percentage-point spread above corporate bonds while a typical utility/pipeline reset preferred is now trading at an unusually generous four-point spread.

Yields and Spreads	December 2014		June 2015	
	Yield	Spread (in percentage points)	Yield	Spread (in percentage points)
Canadian Corporate Bonds	2.7%		2.4%	
Bank Reset Preferred	4.7%	**2.0**	5.2%	**2.8**
Utility/Pipeline Reset Preferred	5.3%	**2.6**	6.4%	**4.0**

Source: Blackrock/iShares, Author's calculations.

Note: The yields and spreads above for preferreds are "interest equivalents" after adjusting for the favourable tax treatment of dividends. The yields and spreads would be lower if the preferreds were held in non-taxable accounts such as RRSPs. Also, the preferred yields are based on a model that assumes interest rates remain unchanged at current levels for the foreseeable future. Instead, if rates increase, the yield for the reset preferreds will be higher than stated, and vice-versa.

If there had been a general decline in creditworthiness for Canadian corporate borrowers over the past six months, the yields on both their corporate bonds and preferreds should have risen, to compensate for the higher risk. Since the yield on corporate bonds has gone down over the period, we know that credit quality is not the primary problem. The main issue is that preferred shares are complicated, illiquid and held mainly by retail investors who often make decisions based on emotions, rather than on math. For level-headed, value-oriented investors, this is a time to step up to the plate and buy when others are selling at low prices. As a result, I have been recently buying selected preferreds. It may take some time for the preferred market to find its footing, as more new-issue supply is expected and demand is weak. That said, I am willing to take a long-term view and use low prices as an opportunity to accumulate.

Advanced Wealth Planning

I recently attended a two-day conference put on by the **Society for Trust and Estate Planners**. This is an organization I intend to join as I am now spending more and more time, in conjunction with my in-house wealth management team, helping clients with retirement planning, estate planning and more advanced tax strategies. As such, I will be dedicating a portion of upcoming *Serber Speaking* newsletters to financial, estate and tax planning. Some of the strategies I will be explaining in upcoming issues include:

* **The Prescribed-Rate Spousal Loan**. Reduce taxes by shifting investment income to a lower-income spouse.

* **The RBC-DS Family Trust**. Pay private school and other child-care costs with pre-tax dollars!

* **Insurance and Annuities.** Make sure you are using all the available tools to achieve your financial and estate goals.

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Best and Worst Stocks, 2015 to-date

A decent crop of winners has helped our stock selections outperform the market indexes so far in 2015. **Cirrus Logic,** a producer of semiconductor chips for portable audio (largest customer is Apple), remains at the top of the list with a whopping 56 percent gain. Still, the shares are reasonable, trading at a multiple of 15 times earnings compared to the market average of about 19 times. **Valeant Pharmaceuticals** is a Canadian success story, growing its market cap from $8 billion to $85 billion over the past five years through an aggressive acquisitions strategy. The company is generating strong profits with high return on capital and equity. On the minus side, the stock is not cheap at about 20 times earnings and the balance sheet has a lot of debt. **Constellation Software** is another Canadian success story, growing from almost nothing to an $11 billion market cap over the past 10 years, also through a very active acquisition/ consolidation strategy. I like its continuing trend of high profitability and strong profit increases. However, it must maintain a steady stream of acquisitions in order to maintain growth. So far, so good. **Marathon Petroleum** is the fourth-largest U.S. oil refiner and also owns 3,000 gas stations under its Speedway brand. While oil producers have suffered with falling crude prices, refiners benefit as crude is an input to their business. Also, lower gasoline prices spur greater demand, boosting volumes and profits. To wit, Marathon shares hit an all-time high on July 1. **GameStop** is a leading video game retailer with more than 6,000 stores, generating annual sales close to US$10 billion. Strong profits and cash flow have allowed the company to buy back shares and increase the dividend, which now stands at a healthy 3.6 percent. The future release of virtual reality gaming should generate a strong revenue cycle for both hardware and software.

Best and Worst - YTD 2015 to June 30

	% Return
Cirrus Logic	56%
Valeant Pharmaceuticals	48%
Constellation Software	47%
Marathon Petroleum	44%
GameStop	39%
Micron Technology	- 42%
WestJet	- 20%
Tata Motors	- 19%
Canyon Services Group	- 18%
Freeport-McMoRan	- 16%

On the down side, **Micron Technology**, a U.S. semiconductor manufacturer specializing in memory chips, is having a rough year, and the stock fell 20 percent on June 26 after a disappointing quarterly report. The shares are now a bargain, trading at about five times expected 2016 earnings per share. **WestJet** shares have lost altitude in 2015 and are now a value play at eight times earnings. Low fuel prices should provide a major tailwind to profits this year and next. **Tata Motors** is India's largest automobile manufacturer, currently trading at six times earnings after its recent pullback, which should set it up for strong performance later this year. I sold **Canyon Services Group**, a Canadian oil-well services company in late January as falling crude prices took a bite out of its prospects. Ditto for **Freeport-McMoRan**, a copper and gold producer that is suffering as global demand for these commodities is currently trending lower.

I wrote in January that "portfolio returns in the four-percent to five-percent range for the year ahead seems like a reasonable expectation." While balanced portfolios gained around four to five percent in Q1 alone, they gave back about half of that in Q2 and now sit around plus two or three percent for the year. At this rate, I believe my original forecast of four to five percent for 2015 remains on track. Stay tuned...

David Serber, Vice-President and Portfolio Manager

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