RICHARDSON GMP

September 11, 2017

MARKET ETHOS

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Core Income Refresh – Part 1 Rate Sensitives

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Anchoring bias and regret aversion bias are two behavioural investment biases that can impact how an investor views existing holdings or positions. These can lead to preconceived notions or views on a company enduring, even when the available information has changed. Or the desire to not feel regret by crystalizing a negative outcome. To combat these biases that exist in all of us, the Connected Wealth team periodically conducts what we call a "refresh".   Starting from a blank slate, each of the analytical team members independently researches each sector. If starting anew, how would you allocate money today to be best positioned for the future? Each member also reviews every position, testing the thesis. Essentially, we answer the question: As of right now, where would you allocate capital, regardless of current allocations?

Additionally, for each company we conduct a pre-mortem. Cognitive dissonance, a behavioural bias, is a state of mind where you hold two or more contradictory ideas. The mind does not like to have inconsistent thoughts and tries to rationalize information to make thoughts consistent. However when investing, this can lead investors to miss or underweight information that is counter to your pre-existing view. A pre-mortem is a method to manage cognitive dissonance in a framework that is more constructive when investing. Pre-mortems require you to formulate how your existing thesis could be wrong, highlighting risks that could negatively impact the position.

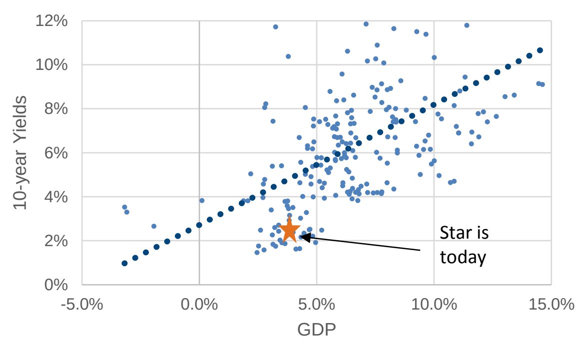
We find this exercise very useful in our process and thought users of our services, other portfolio managers and investors may find the abbreviated output useful. Grouping sectors into three buckets: Interest rate sensitives, Cyclicals and Defensives, this is part 1 – Interest Rate Sensitives.

Intro & Macro

Interest rate sensitive sectors, Financials, Real Estate, Telecommunication Services and Utilities, tend to be the sectors more sensitive to changes in interest rates or bond yields. Our macro view is that economic data, both domestically and globally, is improving. While this improvement has yet to flow into the inflation data, it will follow in the quarters ahead. As a result, central banks have embarked on a

Chart 1

GDP and Yields over the past 50 years



tightening cycle, whether by ending quantitative easing or actually raising short term rates. We believe the longer yields in the bond market are underestimating the economic improvement and the trend in both short rates and longer yields will be to the upside (see Chart 1).

Financials

This sector is comprised of three key groups – Banks, Insurance and Diversified Financials. Broadly speaking higher rates are a lift for this sector to varying degrees, as long as rates don't move too far. We have a healthy 22% in Financials, a lower weighting than our benchmark which is skewed by the Financial weight in the TSX (Chart 2).

Banks – we like the banks, but don't love them. The Bank of Canada has started raising rates due to improving economic growth. This is mostly positive for the Canadian banks which benefit from a healthy economy and potentially from improving net interest margins. Valuations are attractive in the 10-12x price to earnings range and dividend yields are great. Holding us back from loving them is the heavy reliance on the housing industry, which we view as a risk. Canadian home sales have accelerated over the past several years. As a result, mortgage origination has become a large part of the banks' businesses and has created concerns about the level of household debt.

We are positive on the U.S. banks. After being in the penalty box for so long following the financial crisis, we believe we are nearing a period of rising return on equity and increased dividends. Again this group benefits from high net interest margins and we could see regulation softening. There are some risks, namely auto loans and the U.S. consumer may be tiring.

We continue to prefer TD, Royal Bank and the Bank of Montreal. Our most recent transaction was in BMO. We added to the name based on valuations and following underperformance relative to the peer group. All three of these banks have been growing their U.S. businesses, with TD and BMO focusing on retail banking and Royal more on capital markets. All three provide the fund with attractive 3.5+% yields and are committed to growing their dividends. They should continue to perform, so long as our economy continues to grow. That said, we would lower our allocation following a deterioration in the Canadian housing market. We also like the above names because they have lower exposure to housing relative to CIBC and National Bank (Table 1).

In the U.S., we own BB&T bank, one of the largest regional banks in the U.S. Historically, the company has had a positive correlation with rising rates (Chart 3). If economic data in the U.S. continues to improve in the 2nd half of the year and into 2018 then we would expect bond yields to rise and regional banks to perform well. The biggest risk to our thesis is if we are wrong on the direction of yields or that political impasse delays deregulation for banks.

Insurance - One of the best ways for us to protect our portfolios from rising rates is to invest in Canadian life insurance companies. We have meaningful positions in Manulife and Sun Life in both the fund and in our other Canadian investment solutions. Manulife is a globally diversified

Chart 2

Sector Weights: SPX vs. TSX

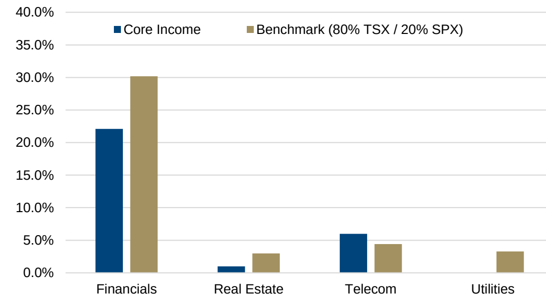
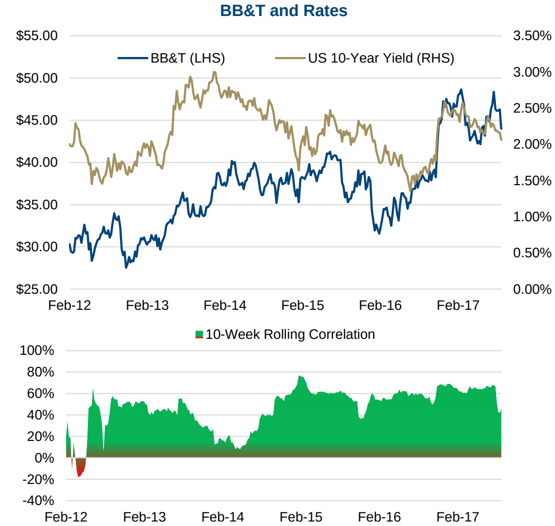


Table 1

(C$ Billion)	BMO	CIBC	Scotia	RBC	TD	NBC
Mortgage Exposures						
Canadian Residential Mortgages	$104	$190	$197	$221	$188	$45
Canadian HELOC	$30	$21	$20	$41	$68	$20
Total Loans	*$383*	*$331*	*$507*	*$549*	*$618*	*$127*
% of Loan Book	35%	64%	43%	48%	41%	51%

Chart 3

BB&T and Rates

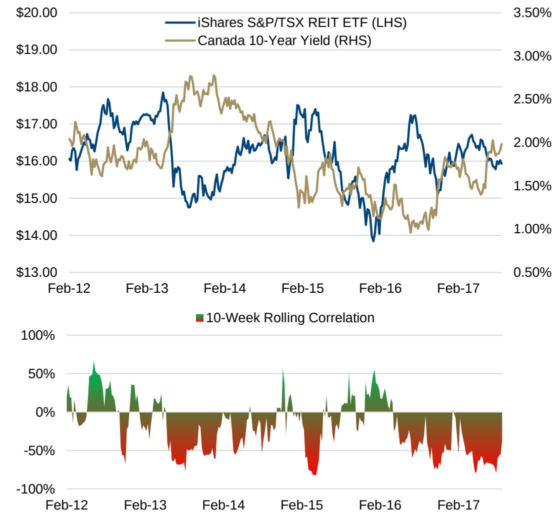


business, with less than a quarter of its revenues generated domestically. This gives it exposure to the synchronized growth we are seeing across the globe. Manulife's Asian asset management business has been flourishing, thereby supporting earnings growth. With only 19.0% of revenue originating in Canada, the company does have increased foreign exchange risk. Sun Life is more focused on North America, offers a larger yield than Manulife and has been a less volatile stock historically, which led us to own both names. Again, the largest risk to these holdings is that our call on rates does not play out as expected.

Diversified Financials - The two other positions that round out our Financial sector exposure are Lazard and Virtu Financial. Lazard is now the 6th largest M&A advisor in the world, behind only large blue chip players. We like exposure to the M&A thematic because deregulation and the need for consolidation in a digital era should foster more transactions. Virtu is an interesting company that provides liquidity in thousands of products across the global financial markets. Many of its competitors (the banks) have reduced exposure market making due to increased regulation in the wake of the global financial crisis. Unlike most companies, Virtu earns more when volatility spikes. The stock also has a low correlation to both the S&P 500 and the TSX. Both of these characteristics make Virtu a unique portfolio diversifier.

Chart 4

REITs and Rates

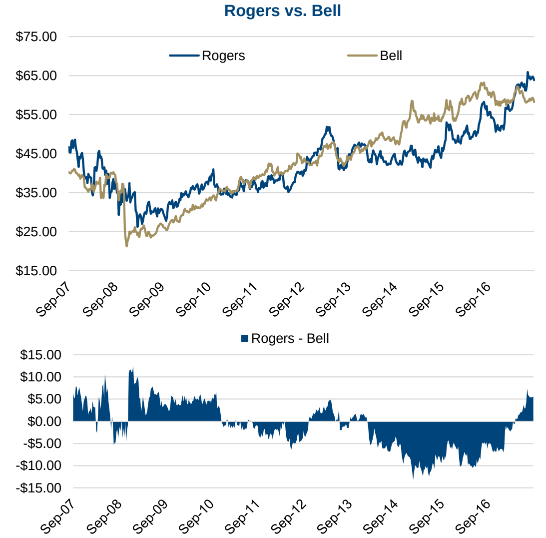


Real Estate

We find it challenging to allocate a meaningful amount of capital to this sector at this time for a few reasons. Real estate does poorly in a rising rate environment (Chart 4). We also believe that residential housing remains expensive and a risk. If there is a correction in Canadian housing, it would likely have a negative residual impact on all real estate to varying degrees. Currently, our only holding is Pure Industrial REIT. The stock has done well over the past year; but, we can still justify a modest position because of its 5% yield and its solid growth prospects.

Chart 5

Rogers vs. Bell



Utilities

Utilities is another sector that tends to underperform in a rising rate environment. We have no exposure in the sector at this time. The valuations in this high-yielding, low-growth, defensive sector have ballooned as investors search for dividend yields as an alternative to bonds. We foresee that the multiple expansion that has occurred over the past few years will contract at some point, giving us a better opportunity to buy. That said, we are keeping our eyes on a few interesting plays that have exposure to the changing global energy mix.

Telecom

Historically, Telcos have demonstrated a degree of interest rate sensitivity. Even so, the group trades more on fundamentals. The sector has some extremely firm tailwinds. Every day, more devices become connected. Moreover, the internet of things is only going to proliferate that growth. If broadband technology is what connects all of these devices then the providers of that spectrum, telcos, should be one of the largest beneficiaries. Pricing for mobile users is flattening. As such, it is purely a game of scale in our country. This benefits Rogers and BCE, the providers with the largest user bases and the biggest economies of scale. Rogers has vastly outperformed BCE so far this year. Still, there has been a historical tendency for divergences between the two stocks to correct and for the spread between them to revert back to equilibrium (Chart 5). Both companies are innovating and adapting in a quickly-evolving media and mobile market. We like the wide moats of both companies and will likely always have exposure to them in varying degrees. The biggest risk to these two companies is government intervention, which could affect them from both a pricing and a competition stand point.

Charts are sourced to Bloomberg unless otherwise noted.

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