Where's my 14% Return?

QAM Perspectives – October 2017

Quadrant's regular newsletter that highlights topics we believe will affect markets or are important in understanding them.

"On average, five times as many people read the headline as read the body copy."

- David Ogilvy

(1911-1999, advertising tycoon, founder of Ogilvy & Mather, and known as the Father of advertising)

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Yes, just over 14% is what the S&P 500 (U.S. equities) returned for the first 3 quarters of 2017. Over the past nine months you've probably seen many headlines touting these double digit returns and continual new record highs for equity markets.

Is your portfolio's return in line with this? Probably not, but with good reason due to:

- Currency effect of foreign investments, and
- Not having 100% of your portfolio invested in U.S. equities.

In writing a news story, what's important is a headline that will grab a reader's attention (I.e. "Where's my 14% Return"). Have you ever read an eye-catching headline only to discover that the news story didn't reflect full information? Here's an example. Earlier this year, a well-known Canadian news source published details regarding a study by the Canadian Pediatric Society with regards to the impact of guns on youth. The headline read "One child or youth suffers a gunshot injury almost every day in Ontario, study finds." What's misleading about the headline and article is the fact that the study statistics also included injury due to Nerf and paintball guns.

Just as you would be wise to read more than the headline of any news story, in evaluating your portfolio's performance you need to look beyond the financial news headlines. It's important to understand what headline investment returns are based on and how they translate into comparable information relative to your portfolio.

Equity Market Performance

	Return Currency	Q3 2017	YTD Q3 2017
Canadian Equities Large Cap (S&P/TSX Index)	CAD	3.7%	4.4%
U.S. Equities Large Cap (S&P 500 Index)	USD	4.5%	14.2%
International Equities Large Cap (MSCI EAFE)	USD	5.5%	20.5%

This past quarter (and most of 2017) was marked with countless headlines about record setting equity market returns for U.S. equity markets and to a slightly lesser degree, international equity markets. The Canadian equity market had lower relative returns given its dependence on the resource sector which has not enjoyed the same returns as other equity market sectors.

Canadian investors, however, need to translate their foreign currency denominated investment holdings into Canadian dollar equivalent returns.

As can be seen above, the Canadian dollar relative to the U.S. dollar has appreciated approximately 10% since the middle of June, 2017. The strength in the Canadian dollar reflects the two interest rate increases made by the Bank of Canada this past quarter (July and September). A strengthening Canadian dollar negatively affects foreign currency denominated investment returns for Canadians. In other words, foreign currency holdings translate into less Canadian dollars than they would have at the beginning of the year.

Example:

At the beginning of 2017 you invest $100 Canadian dollars in the U.S. equity market at an exchange rate of $0.75 CAD/USD (investment is $75.00 U.S.). On September 30, 2017 the exchange rate was $0.80 CAD/USD. This means that the $75.00 U.S. invested at the beginning of the year is now worth $93.75 Canadian (as opposed to the original $100 Canadian), excluding the impact of any investment returns.

The chart below recasts the index returns noted earlier into Canadian dollar terms.

Returns (Canadian dollars)	Q3 2017	YTD Q3 2017
Canadian Equities Large Cap (S&P/TSX Index)	3.7%	4.4%
U.S. Equities Large Cap (S&P 500 Index)		
Return in U.S. dollars	4.5%	14.2%
Foreign currency impact	(4.1%)	(8.2%)
Return in Canadian dollars	0.4%	6.0%
International Equities Large Cap (MSCI EAFE)		
Return in U.S. dollars	5.5%	20.5%
Foreign currency impact	(4.1%)	(8.7%)
Return in Canadian dollars	1.4%	11.8%

The 14.2% U.S. equity return quoted earlier is over 57% lower when translated to a 6.0% Canadian dollar based return which does not make for a very exciting headline. In taking a closer look at the third quarter returns in isolation, U.S. equities returned a mere 0.4% in Canadian dollars while international equities did slightly better at 1.4% (Canadian dollar based).

While we have demonstrated how foreign currency translation affects investment returns, your mix of asset classes has the most impact on your portfolio's performance.

Don't put all your eggs in one basket

Portfolio construction takes into account time horizon, risk tolerance and investment objectives of the client in determining the weightings of the main asset classes (equity, fixed income and cash). One of our previous newsletters "The 4 Ds of Portfolio Management" is a good reminder of the importance of diversification as one of the fundamental elements of a sound and successful portfolio management process.

Diversification across asset classes is a key tool in maximizing the return/risk utility of a portfolio (maximizing returns for a given overall risk level). Equity, being the riskiest of the asset classes, generally provides higher long-term returns but also has higher levels of volatility which can result in significant outperformance or underperformance versus the other asset classes on a short-term basis. On the other hand, fixed income typically has lower long-term returns but provides a portfolio with stability given the reduced volatility of this asset class as compared to equities.

When comparing your portfolio's performance to headline returns you must assess how all of the asset classes in your portfolio have performed.

Fixed Income Performance

The broad Canadian bond market, as measured by the Canadian Bond Universe Index, posted a negative total return for the quarter (-1.8%) and was flat on a year-to-date basis (0.4%) due to an upwards shifting yield curve (interest rates and bond prices have an inverse relationship). This is the result of the tightening monetary policy conditions we have seen with the two recent interest rate increases made by the Bank of

Canada this past quarter. Consequently, fixed income returns have lagged equity markets on a year-to-date basis for the first three quarters of 2017.

Tying it all Together

In this simplified example, based on the assumption of an average Canadian investor who is invested 40% fixed income and 60% equities (split equally as above), the weighted average portfolio return is 0.4% for the third quarter of 2017 or 4.6% on a year-to-date basis (based on the index returns above), which is a marked contrast to recent headlines.

All returns in Canadian dollars	Portfolio percentage	Q3 2017 return	Q3 2017 YTD return
Fixed Income (Canadian Bond Universe)	40%	-1.8%	0.4%
Canadian Equities Large Cap (S&P/TSX Index)	20%	3.7%	4.4%
U.S. Equities Large Cap (S&P 500 Index)	20%	0.4%	6.0%
International Equities Large Cap (MSCI EAFE)	20%	1.4%	11.8%
Weighted average portfolio return		**0.4%**	**4.6%**

"Return alone – and especially return over short periods of time – says very little about the quality of investment decisions"

- Howard Marks, co-founder of Oaktree Capital Management and renowned investment author

Quadrant

In response to current market conditions, Quadrant remains mindful of relatively high equity market valuations in the monitoring and rebalancing of portfolios. With regards to fixed income, we continue to maintain a shorter duration in fixed income holdings to position our portfolios defensively against rising interest rates, as having a lower duration will reduce bond price volatility while still providing a stable income stream.

In addition to responding to current market dynamics, Quadrant, as always, continues to maintain a long term view and focuses its efforts on asset allocation policy, manager selection, and systematic rebalancing in light of each client's individual financial circumstances.

If you or someone you know could benefit from our services, please have them contact our offices at 204-944-8124 or email us at inquiries@quadasset.com.