

## The Raintree Report Issue #6: Winter 2016/17



### Happy New Year!

Happy New Year! Raintree experienced a great deal of success in 2016. In March we held our first annual International Women's Day Conference. Furthermore, we received several accolades and awards including four PCMA Deals of the Year awards in April, and placed on *PROFIT 500's* Fastest Growing Companies list and *Alberta Venture's* V250 list in September. And, to start off 2017, Raintree Financial Solutions was listed as one of *Alberta Venture's* Fast Growth 50 companies.

We are excited to enter 2017 with further plans to assist our clients in seeking higher risk-adjusted returns while also preserving their capital.

In the coming months we expect to announce an expansion to our service lines to deliver a greater offering to the market place. With this in mind, the Winter issue of the Raintree Report will provide you with a review of the past year and an outlook for 2017.



### Investment Updates

#### Victoria Rocket LP

The Victoria Rocket LP was a hotel-to-apartment conversion project in Victoria, BC. The project completed in 2016, and sold in December. Investors were immediately issued their capital plus returns of 15% per annum.

#### Regimen Equity Partners

In December, Regimen Equity Partners announced its fourth transaction, the acquisition of All Gold Imports Inc, an importer and distributor of speciality food ingredients based in Markham, Ontario. Regimen also added two new team members last quarter: Hai Tran-Viet, VP Private Equity and David Koa, VP Strategic Development.

# A Year in Review

It's that time of year again when market commentators throw caution to the wind, dust off the crystal ball and make bold predictions for the coming year. At Raintree, we don't spend a lot of time creating our own predictions of future market performance. Rather, we assess the current market and review possible future outcomes and probabilities. This is a key reason why we focused on alternatives six years ago, when markets were continually being priced to offer lower future returns. Unfortunately, the traditional investor's options today don't provide many opportunities for optimism. Equity markets are making new highs, bond yields are still extremely low by historical comparison, and what's more, these overvaluations are pervasive across a number of markets and sectors globally. Logically, other asset categories have followed suit as investors "reach for yield". For those of us charged with determining how to allocate our clients' wealth, or our own, this is particularly troubling. What doesn't seem to be getting a lot of press these days is that we are in what might be the most difficult period in the last 80 years to determine what a portfolio should hold. Recent periods of turmoil don't look all that bad when you consider the options that were available. The 2000 tech bubble was isolated to a specific area of the equity markets and in 2007 equities may have been expensive but cash rates were still attractive. Today it appears stocks and bonds are highly valued (almost) across the board.

How did we get here? Quite simply it seems to have been driven by central bank policy. In reaction to the global financial crisis, central banks around the world have kept rates extremely low and in many areas, below zero. Whether those policies are right or wrong is a topic for another time, but the impact low rates have had is important. Let's touch on a couple of key themes for 2017.

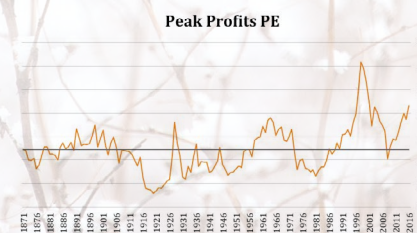
## Energy

The popular saying is, the best thing for low oil prices is, low oil prices. We would agree. As a recent Bloomberg report highlighted, new oil discoveries are the lowest they've been since 1947. Prices are simply too low to justify the capital spend required to

explore for new oil. Instead the price is balanced by the marginal cost of production, or in other words, the price that allows oil producers to earn a profit when ignoring the sunk costs they've spent drilling the well. Supply will naturally begin to decline as depletion isn't replaced with new production, and prices will gradually move upward. This is of course an oversimplification but does represent the dynamics that govern cyclical resource markets.

## Equity Markets

We believe deeply in taking a long-term view and remaining aware of behavioural biases that frame our decision making. When taking a view on equity valuations our preferred method is the Cyclically Adjusted PE Ratio (CAPE), also known as the Shiller PE, and Graham Dodd PE. The current value on the S&P 500 is approximately 28 times, which is higher today than immediately prior to the global financial crisis. This might seem alarming, but the CAPE has come under pressure recently from critics that believe "this time is different" (legendary investor Sir John Templeton believed those were the four most expensive words in the English language). Specifically, they point out that the calculation of earnings (the E in CAPE) has changed in recent years as a result of accounting reforms such as IFRS. While research has shown the difference to be relatively small let's explore another valuation measure all together, peak profits. The idea is to examine market valuations based on the highest recorded earnings to that point in time. The thesis is that even if earnings are lower today than in the past they will eventually return to new highs. For our purposes, this removes the concerns that accounting rule changes have on cyclical earnings. Below, this metric gives us a similar signal as the CAPE that we are trading in an over-valued market.



Source: Shiller

Based on the above, it's probably clear that we're pessimists when it comes to equity market valuations and future returns available from being long the S&P 500. At Raintree, our takeaway is that based on current valuations our expected return from equity markets is adjusted downward. With revised expectations we can move on from blindly using historical returns and start planning for various future outcomes. To be clear, we are not advocating a complete move out of S&P 500 or other equity markets. However, trimming equity exposures, examining other strategies, protecting a portfolio to the downside (e.g. allocations to cash) and finding other sources of diversification or return, is prudent.

## Central Banks

It's nearly impossible to discuss the equity market outlook without discussing central bank policy. Our view is that these policies have been the key catalyst for heightened financial market valuations. The idea of dropping rates to spur economic activity is relatively simple. Lower rates incent spending now rather than savings later and greater spending equals greater economic activity. What we've witnessed, however, is the opposite. Savings rates in Canada and the US are 5.8% and 5.5%, respectively. More than double that of 2008 – 2.1% and 2.5%.

One possible explanation is that lower rates (and the 2009 market shock) have put into question the assumptions of retirement model returns. If those planning for (or in) retirement are not able to meet their financial goals given lower expected returns, their only course of action is to work longer or save more. The very opposite of the desired effect! This appears to be playing out, particularly in Europe, where yields are low and in certain cases have gone negative.

In addition, central bank policy seems to have created an overconfidence in investors who believe that regardless of the situation they will stand ready to support the market during times of crisis. This is dangerous thinking. The action of central banks is a key theme we will be watching in 2017 and beyond.

— Greg Bainbridge, CFA

# The Search for Investment Bargains in 2017

Wondering where to invest your money in 2017? It's a good question – one that we spend a lot of time assessing and managing. In times like these, it is more important than ever to have broad asset class diversification – with laser-like security selection.

After all, traditional asset classes are expensive.

Take stocks for example: The post-election “Trump rally” has driven equity valuations to all-time highs. What's more, investors appear to have forgotten about risk! We monitor a number of indicators that measure investor fear and we become concerned when it falls as low as it is today. Investors are feeling over-confident.

Bonds have experienced a “bull market” streak of rising prices/falling yields over a couple of decades. We believe many fixed income investors are not aware of the risk in their bond portfolios today.

What about alternatives, like real estate? Prices for multi-residential, commercial/retail assets are also frothy, due in part to insatiable investor demand for income-producing investments and an influx of foreign buyers.

What is an investor to do in this environment? And what is the Newport Investment Committee doing in the portfolios we manage?

## Review Asset Mix - Rebalance as Needed

First, start by looking at your overall asset mix. How much is invested in equities – directly and indirectly? If you own balanced funds, what percentage is in equities?

We perform this type of analysis every day for prospective clients and many are shocked to discover that their “conservative” portfolios hold 70%-80% equities. **We would be very nervous with that kind of exposure.** In fully valued markets, make sure you understand your equity exposure.

**We are at the mid-point of our target ranges for equities.** For a balanced portfolio, we hold 17% in Canadian equities and 29% in global equities. We are also underweight investment-grade bonds. In both cases, the security selection is actively managed by specialists.

## Exploit Niche Pockets of Opportunity

There are a few alternative asset classes where we are adding to our holdings. Private debt is one. Private real estate is another. We selectively added to our apartment building portfolio this year. Admittedly, these investments are less about our liking the asset class and more about our confidence in the singular ability of these niche real estate managers to buy the properties well and add value through their operational expertise.

We believe it is important to have the expertise of an active investment manager with proven expertise in traditional and alternative asset classes. After all, that's how we manage our own money.

## Keep Cash on the Sidelines

**We also currently have a high level of cash – approximately 16% in a balanced portfolio.** Holding cash does two things. It protects capital in the event of a major correction, and it allows us to profit from a correction by having the cash to buy when stocks and other assets go “on sale.”

## But Not Too Much Cash...

We would urge against going to 100% cash however. Trying to time the market is a mug's game. You have to have perfect execution on two decisions and history is not on your side.

The first decision is when to sell; the second is when to buy back in. You could easily miss a bounce back and the capital markets have a notoriously long record of surprising investors – both up and down. Remember the night of the U.S. election? U.S. futures plunged 800 points before the market opened, only to recover and rally 6% in a matter of weeks! Few investors would have predicted this.

Visit [www.newportprivatewealth.ca](http://www.newportprivatewealth.ca) for information about Newport Private Wealth's investment approach.

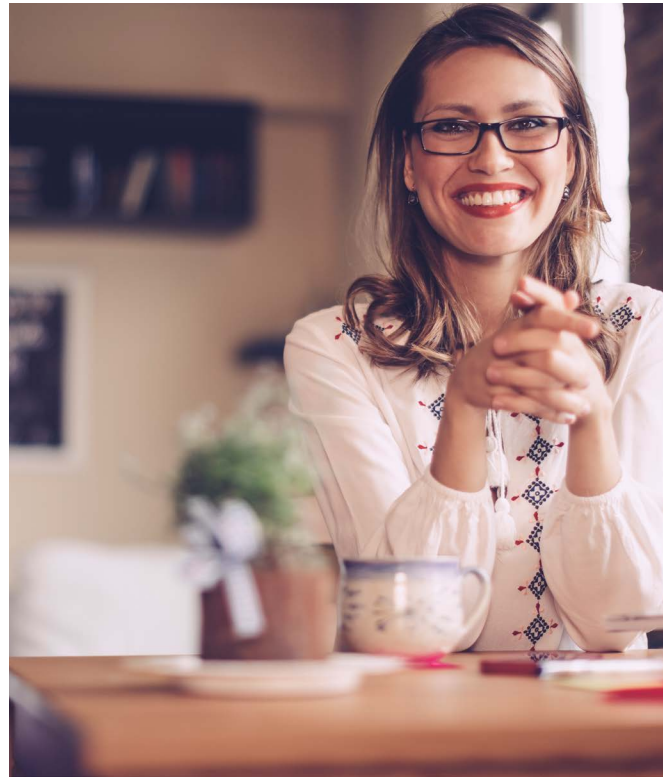
— Newport Private Wealth Inc.

# 2nd Annual International Women's Day Conference

We will be hosting our second annual Women and Wealth Conference to celebrate International Women's Day on March 8th, 2017 at the DoubleTree by Hilton in Edmonton. The conference will also be live streamed for those who would like to take part, but do not live in the local area.

This year the theme is "Celebrating Women's Entrepreneurship". Women play a major role in driving the world economy. According to the 2015 Global Entrepreneurship Monitor, women control about \$20 trillion in annual consumer spending (a number expected to rise to nearly \$28 trillion by 2020), they make up 40% of the global workforce, are earning professional degrees in record numbers, and companies have implemented programs to remove organizational biases in order to increase the number of women in leadership positions. Yet a gender equality gap remains. Overall, women in comparison to men continue to suffer from higher rates of unemployment, are less likely to participate in the labor force, and face higher risks of vulnerable employment with conditions such as inadequate earnings. According to Catalyst Canada, Canadian women earn \$0.82 to every \$1 earned by men.

The goal of our conference is to help women feel supported, enabled and empowered to flourish in business and to continue the momentum behind closing this gender gap. Stay tuned to the [event page on our website](#) over the next couple of weeks for more information including how to obtain tickets.



## Behavioural Finance: Hindsight Bias

Hindsight bias happens when a person believes (after the fact) that the onset of some past event was predictable and completely obvious, whereas in fact, the event could not have been reasonably predicted. Almost every investor displays this behavior.

Many events seem obvious in hindsight. Psychologists attribute hindsight bias to our innate need to find order in the world by creating explanations that allow us to believe that events are predictable. The hindsight bias is considered

to be one of the most dangerous mindsets of an investor because it leads to an over-confidence in the investor's ability to pick the "best" investments or avoid the "worst". The reality is, no one can predict the future – no matter how similar an investment may seem.

### How To Avoid It?

Hindsight Bias does not suggest that there aren't important lessons to learn from history. It is really to avoid relying too heavily on the past to predict

the future. While financial and economic experts will try to predict the future or speculate the market, each event is unique. It is important to avoid placing too much confidence in the similarities of a situation – to blind oneself to other information that may impact the outcome significantly.



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