Luft Financial Model Portfolios

2018 Review

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Your Vision

Our Goal

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Market Review – The Worst Year in a Decade

The worst year for global equities in a decade – that was the key takeaway from a challenging 2018 that was capped by the biggest December plunge for the S&P 500 and Dow Jones Industrial Average (DJIA) since 1931[1]. In retrospect, 2017 did turn out to be the calm before the storm – as we had surmised in this publication a year ago – although the market gyrations of 2018 were merely a series of squalls compared with the relentless Category 5 hurricane of 2008.

2018 was a strident wake-up call for investors lulled into complacency by the declining volatility of the preceding couple of years. Here's one comparative volatility statistic. The S&P 500 only had eight daily moves of more than 1% in all of 2017; it had nine such daily moves in December 2018 alone, and a total of 64 in the year[1,2]. That statistic not only represents reversion to the mean (the tendency for a variable to return to its long-term average) for S&P 500 volatility – given that the median number of 1% daily moves per year for the index since 2010 is 49[3] – but also underscores the unusual market placidity of 2017.

The year had started with a bang, as major U.S. indices had one of their best January performances on record, before global equities were wracked by a sudden bout of volatility in the first half of February. As markets recovered in the second quarter (Q2), the TSX Composite outpaced its North American peers with its best quarterly performance in 4½ years. The index reached a new record high of 16,586.46 in July, before commencing a slide that began gradually and picked up steam in Q4, lopping off 2,800 points or approximately 17% from the index's peak to its December 24 trough.

Overall, the TSX finished the year down 11.6%, ranking it 68th among 93 equity indices worldwide for 2018 performance, and leaving it little changed from its levels at the beginning of 2015. This was the worst annual performance for the index since 2008, exceeding its 11.1% decline in 2015.

On a total returns basis (including dividends), the TSX had a return of -8.9%, compared with +9.1% in 2017. Eight of the index's 11 sectors had negative returns in 2018, led by the Energy (-18.3%), Consumer Discretionary (-16.0%) and Health Care (-15.9%) groups (Figure 1). The Information Technology sector was the best performer, while Real Estate and Consumer Staples managed to eke out positive returns in 2018; however, with a combined index weight of 11%, these sectors are too small to make much difference to the TSX Composite's performance.

The Energy group – the only negative TSX sector in 2017 – endured another volatile year as crude oil (WTI) reversed its 26% advance in the first three quarters of 2018 with a 44% peak-to-trough plunge in Q4 to finish the year down 25%. Adding to the misery for Canadian energy producers, the local benchmark Western Canada Select (WCS) traded at a record discount to global oil prices for much of the year. The heavyweight Financials sector that constitutes one-third of the TSX returned -9.3% in 2018, as Canadian banks slumped despite solid earnings, while lower commodity prices led to a return of -9.3% for the Materials sector as well.

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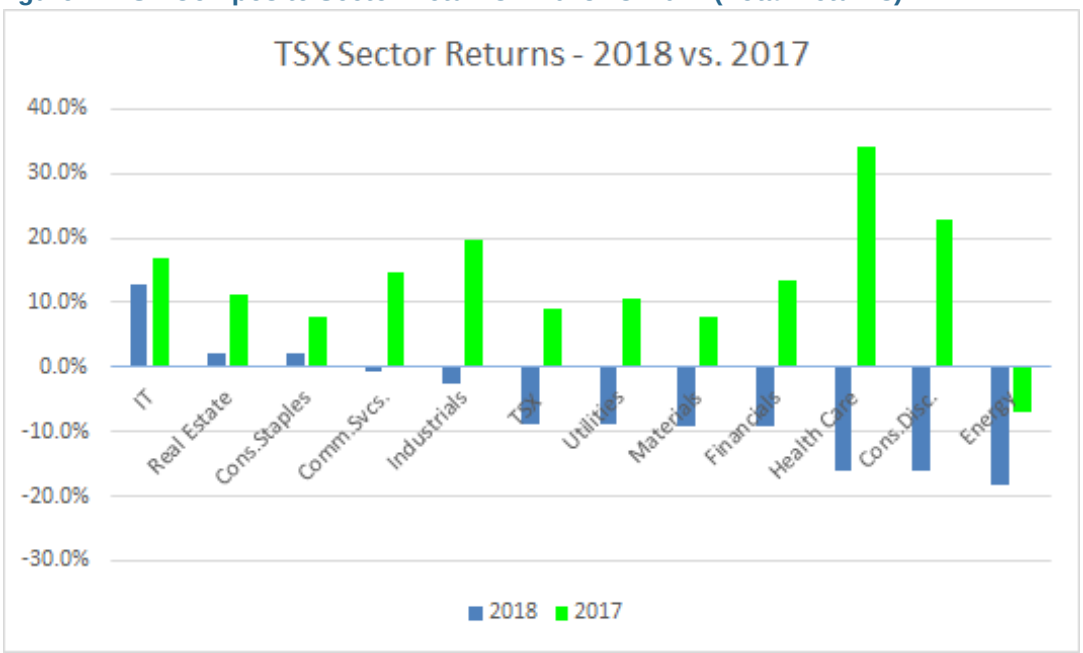
In the U.S., the S&P 500 and Nasdaq Composite reached all-time highs about a month apart in Q3, while the DJIA peaked on October 3, before double-digit percentage plunges in Q4 led to their worst annual performance in a decade. The S&P 500 finished the year -6.2%, with the DJIA -5.6% and Nasdaq -3.9%. The S&P 500 briefly tumbled into bear-market territory – defined as a decline of more than 20% – on December 24, when U.S. indices recorded their worst-ever Christmas Eve performance. However, the index bounced back with a 5% surge on December 26 as U.S. indices registered their biggest one-day advance since March 2009[5].

International bourses also fared poorly in 2018, with only a handful of indices advancing over the year. Weighed down by Brexit concerns and fractious budget deficit negotiations between Italy and the European Union, most European indices recorded double-digit declines in the year. Emerging markets slumped after strong gains in 2017, as the intensifying U.S./China trade war and the strengthening US dollar affected risk appetite. The BRIC emerging giants again had a mixed year. While Brazil and India were among the few bright spots globally with gains of 15.0% and 5.9% respectively, China was the worst global performer in 2018, with the Shanghai Composite -24.6%. (All data sourced from FactSet).

Overall, global market capitalization peaked at $89.8 trillion in January 2018 but then fell steadily over the year to $74.3 trillion at year-end, a 12.9% decline from end-2017. (Source: World Federation of Exchanges). The global equity rout exemplified the investing hurdles in a year when nothing seemed to work and almost every asset class finished in the red. With the decade-long equity bull displaying visible signs of deterioration, 2018 was the year when Cash finally was King[6] (see Figure 3 on page 6).

Figure 1: TSX Composite Sector Returns – 2018 vs. 2017 (Total Returns)



Source: FactSet

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Portfolio Constituents – Major Movers

- In 2018, the top three performers among our portfolio constituents (based on total returns in Canadian dollar terms) were: **Visa Inc.** (NYSE: V, +26.3%), **AstraZeneca Plc** (NYSE: AZN, +23.3%) and **Verizon Communications** (TSX: VZ, +20.6%). Two other stocks posted double-digit returns in 2018: **Loblaw Cos.** (TSX: L, +13.5%) and **Berkshire Hathaway** (NYSE: BRK.B, +11.7%). Visa was the best performer in our portfolios for the second straight year. The dominance of U.S. stocks among our best performers can partly be attributed to the Canadian dollar's 8.3% decline versus USD in 2018.

- **General Electric** (NYSE: GE, -51.6%) and **High Liner Foods** (TSX: HLF, -44.8%) were our worst performers for the second successive year. The **BMO Equal Weight Oil & Gas Index ETF** (TSX: ZEO, -25.6%) rounded off the bottom three performers among our portfolio constituents in 2018.

- In terms of contribution to portfolio return – which, in addition to total returns, takes into account the portfolio weight of each constituent – the five biggest positive contributors to our large model portfolios in 2017 were: Visa, AstraZeneca, Verizon, **Mackenzie Ivy Foreign Equity Fund** (MFC077) and Dy**namic Alpha Performance Fund (DYN394)**. The biggest detractors from returns in our large model portfolios, in addition to General Electric, High Liner Foods and BMO Oil & Gas ETF, included **Purpose Canadian Preferred Share Fund** (NEO: RPS) and **BMO MSCI EAFE (hedged to CAD) ETF** (TSX: ZDM). (Source: SIACharts.com).

Q4 Portfolio Changes and Rationale

- Q4 was an exceptionally busy time for us as we rebalanced portfolios around key events.
  - Having built up cash balances over the spring and summer as risk factors were mounting, we undertook a major rebalance of client portfolios in the first week of October, as the successful renegotiation of NAFTA dispelled a major overhang for the Canadian economy. As part of the rebalance, we replaced the underperforming **First Asset Canada Value ETF** (TSX: FXM) with the **First Asset Canada Momentum Index ETF** (TSX: WXM), since we had little exposure to Canadian growth stocks such as Shopify and Canada Goose.
  - In November, during the week of the U.S. mid-term elections, we added to our U.S. exposure and trimmed our international / Europe holdings by replacing our full position in the **FA MSCI Europe Low-Risk Weighted ETF** (TSX: RWE.B) and part position in the BMO EAFE ETF (TSX: ZDM) with the **Invesco S&P 500 Top 50 ETF** (NYSE: XLG).
  - In December, we rebalanced a number of portfolios that had significant cash balances. We also sold positions in General Electric and High Liner Foods in larger non-registered (cash) accounts in order to crystallize losses for tax purposes, and replaced these positions with the XLG ETF.
- We also selectively added to positions in the first two weeks of October in Canadian stocks that had sold off sharply, such as **Manulife** (TSX: MFC), **Magna** (TSX: MG), and **SNC-Lavalin** (TSX: SNC), viewing their pullbacks as an opportunity to increase our positions in these global leaders.
- New model portfolios launched in 2018 included a Socially Responsible Investing (SRI) portfolio in Q3, and in Q4, a "Preservation" model that focuses on capital preservation.

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Looking Ahead – Staying Defensive

The outlook for the global economy is not as rosy as it was a year ago, when the widespread view was that the synchronized global growth that commenced in 2017 for the first time in a decade would continue for the next couple of years. Reflecting the reality of a perceptible slowdown in major economic regions such as the EU and China in the second half of 2018, the International Monetary Fund (IMF) recently lowered its global growth forecast for 2019 by 0.2 percentage point to 3.5%, compared with an estimated 3.7% in 2018. The IMF noted that risks to global growth are skewed to the downside, with an escalation of trade tensions, a "no-deal" Brexit, and a greater-than-expected slowdown in China identified as key risks. At the present time, however, investors seem to be reveling in the month-long equity rebound. By January 18, the TSX had rallied for 11 straight days and was up 7% YTD for its best start to a year since 1980[7], while a global equity benchmark had rallied 9.1% from Boxing Day to mid-January[8]. Although earnings growth is expected to slow down this year – to 7.8% for the TSX (from 10.8% in 2018), and 6.2% for the S&P 500 (from 2018's tax-cut fueled 21.7%) – strategists' median forecasts for the TSX and S&P 500 imply new record highs for the indices in 2019 (source: FactSet). In our opinion, that level of optimism is unjustified by current fundamentals and based on the fact that this is a late-cycle rally, we continue to advocate a defensive tilt for investment portfolios. Figure 3 furnishes compelling evidence of the virtues of asset allocation and diversification; by focusing on these core concepts, we believe our diversified model portfolios (Figure 2) should continue to perform well during turbulent times.

Figure 2: Model Portfolios – Asset Allocation as of December 31, 2017 (Source: Luft Financial)

Asset Class	Asset Category	Pursuit	Pension	Protection	Preservation
Equity	CAD Top Stocks	22.75	16.25	9.75	0.00
	CAD Broad Mkt. ETFs	3.75	3.00	2.00	0.00
	CAD Sector ETFS	4.50	4.00	4.00	0.00
	US Top Stocks	15.00	11.25	6.75	0.00
	US Sector ETFs	0.00	0.00	0.00	0.00
	US Broad Mkt. ETFs	5.83	4.50	2.66	0.00
	US Sm-Mid Cap	0.00	0.00	0.00	0.00
	International Equity	11.67	9.00	5.34	0.00
	Emerging Markets	3.00	2.50	1.50	0.00
	Global Infrastructure	2.00	3.00	3.00	0.00
	Real Estate	3.00	5.00	5.00	0.00
Fixed Income	Fixed	15.50	23.75	43.00	83.00
	Mortgage	3.00	3.50	4.00	5.00
	Preferred	3.00	5.00	6.00	0.00
Alternative	Alternative	5.00	7.00	5.00	0.00
Other	Miscellaneous	0.00	0.00	0.00	10.00
Cash	Cash	2.00	2.25	2.00	2.00
Total		100.00	100.00	100.00	100.00

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Figure 3: Total Returns of Major Asset Classes – 2008 to 2018*

(*2018 returns to December 25, 2018)

2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018*
US Treasuries 14.0%	MSCI EM 79.0%	Gold 29.2%	US Treasuries 9.8%	REITS 23.8%	S&P 500 32.4%	S&P 500 13.7%	S&P 500 1.4%	Global HY 14.8%	MSCI EM 37.8%	Cash 1.8%
Gold 4.3%	Global HY 62.0%	MSCI EM 19.2%	Gold 8.9%	Global HY 19.3%	MSCI EAFE 23.3%	REITS 11.7%	US Treasuries 0.8%	S&P 500 12.0%	MSCI EAFE 25.9%	US Treasuries 0.3%
Cash 2.1%	MSCI EAFE 32.5%	Commodities 16.8%	Global IG 4.5%	MSCI EM 18.6%	Global HY 8.0%	US Treasuries 6.0%	Cash 0.1%	Commodities 11.8%	S&P 500 22.0%	REITS -1.1%
Global IG -8.3%	REITS 31.7%	REITS 15.9%	Global HY 2.6%	MSCI EAFE 17.9%	REITS 0.7%	Global IG 3.2%	MSCI EAFE -0.8%	MSCI EM 11.2%	Gold 12.9%	Global HY -2.6%
Global HY -27.9%	S&P 500 26.5%	S&P 500 15.1%	S&P 500 2.1%	S&P 500 16.0%	Global IG 0.1%	Gold 0.1%	REITS -3.4%	Gold 8.6%	REITS 11.5%	Global IG -3.4%
Commodities -35.6%	Gold 25.0%	Global HY 13.9%	Cash 0.1%	Global IG 11.1%	Cash 0.1%	Cash 0.0%	Global IG -3.8%	Global IG 4.3%	Global HY 10.2%	Gold -3.7%
S&P 500 -37.0%	Global IG 19.2%	MSCI EAFE 8.2%	REITS -9.4%	Gold 8.3%	MSCI EM -2.3%	Global HY -0.1%	Global HY -4.2%	REITS 1.3%	Global IG 9.3%	S&P 500 -6.1%
MSCI EAFE -43.1%	Commodities 18.9%	Global IG 6.0%	MSCI EAFE -11.7%	US Treasuries 2.2%	US Treasuries -3.3%	MSCI EM -1.8%	Gold -10.4%	US Treasuries 1.1%	Commodities 7.6%	Commodities -11.6%
REITS -50.2%	Cash 0.2%	US Treasuries 5.9%	Commodities -13.3%	Cash 0.1%	Commodities -9.5%	MSCI EAFE -4.5%	MSCI EM -14.9%	MSCI EAFE 1.0%	US Treasuries 2.4%	MSCI EAFE -12.6%
MSCI EM -53.2%	US Treasuries -3.7%	Cash 0.1%	MSCI EM -18.2%	Commodities -1.1%	Gold -27.3%	Commodities -17.0%	Commodities -24.7%	Cash 0.3%	Cash 0.8%	MSCI EM -14.7%

Source: BofA Merrill Lynch Global Investment Strategy, Bloomberg. *YTD annualized returns

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