Luft Financial Model Portfolios

Q2 2019 Review

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HollisWealth®

Your Vision

Our Goal

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June Rebound Caps Best First-Half in Two Decades

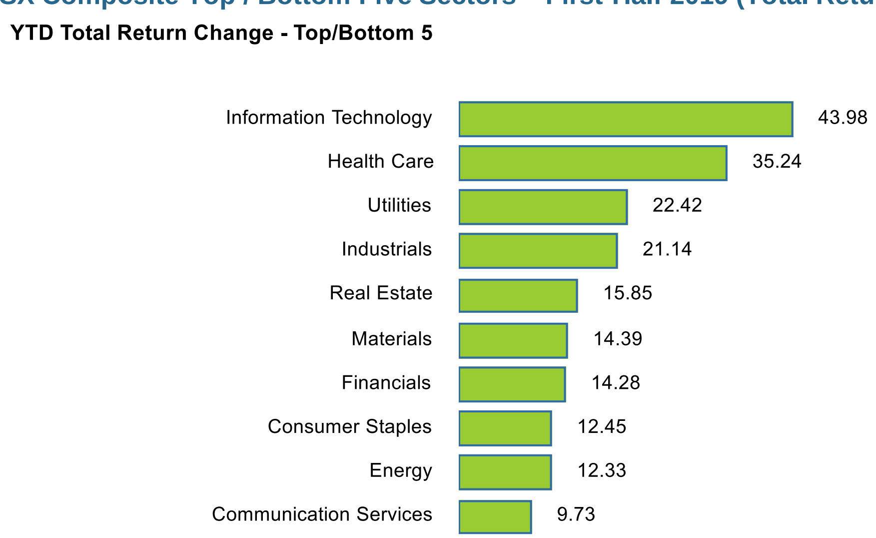
North American indices advanced to new highs in Q2, as global equities added to their stellar Q1 returns. Q2 gains were significantly lower than Q1's exceptional numbers and accompanied by higher volatility, as markets were whipsawed by the U.S.-China trade conflict and the outlook for U.S. interest rates. Equities encountered a second bout of volatility in six months in May, with indices recording their worst monthly performance of 2019, before rebounding in June as trade tensions receded and the Federal Reserve and European Central Bank signaled their commitment to support economic growth. The June rebound capped the best first-half for North American and European stocks in two decades; other asset classes also turned in strong performances in the first six months of 2019 (Figure 1).

Figure 1: Strong first-half despite headwinds (Source: Bloomberg)

Asset	Performance	Best since
S&P 500	17.3%	▲ 1997
European Stocks	14.0	▲ 1998
U.S. Corporate I-Grade	9.7	▲ Record
U.S. Corporate High Yield	9.8	▲ 2009
WTI Crude	27.8	▲ 2016

On a total returns basis (price change plus dividends), the TSX had a return of 2.6% in Q2, bringing its YTD returns to 16.2%. TSX gains were broad-based in the first half, with all of the index's 11 sectors posting positive returns over this period (Figure 2). (Source: FactSet).

Figure 2: TSX Composite Top / Bottom Five Sectors – First-Half 2019 (Total Returns)



Source: FactSet

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Portfolio Constituents – Major Movers

- As many as 21 of our portfolio constituents posted double-digit total returns (in Canadian dollar terms) in the first half of 2019, with nine of these recording total returns above 20%. The top five and bottom five performers for the first six months of 2019 are shown in Figure 3.

Fig. 3: Portfolio Constituents Top/Bottom Five Performers–First-Half 2019 (Total Returns in CAD)

Security	Symbol	Type	Sector	YTD Gains
General Electric	GE	Stock	Industrial	33.5%
Qualcomm	QCOM	Stock	Technology	30.9%
Restaurant Brands	QSR	Stock	Cons. Discretionary	29.4%
Visa Inc.	V	Stock	Financials (Services)	26.7%
Manulife Financial	MFC	Stock	Financials (Insurance)	25.6%
Dynamic Alpha	DYN394	Fund	Alternatives (Hedge Fund)	-1.3%
Natixis Cdn.Pref. Share Fund	NXG5338	Fund	Preferred Share Fund	-3.7%
Redwood Cdn.Pref. Share ETF	RPS	ETF	Preferred Share ETF	-4.7%
Altria Group	MO	Stock	Cons. Discretionary	-5.2%
SNC-Lavalin Group	SNC	Stock	Industrial	-42.0%

Source: SIACharts.com

- Despite the Canadian dollar's 4% appreciation versus the USD in the first half, three U.S. stocks (**GE**, **QCOM**, **V**) were among our top five performers over this period. Two of our bottom five performers were in the preferred share space, while **SNC-Lavalin** was by far the worst performer in the first half.

Q2 Portfolio Changes and Rationale

- In June, we undertook a major overhaul of our smaller model portfolios, streamlining them by consolidating positions with low weights, selling under-performers and taking profits in some positions.
- Subsequent to quarter-end, we extended this overhaul to our large models. In the second week of July, with the TSX trading above 16,500 and U.S. indices at all-time highs, we dialed down the risk profiles of our portfolios by taking profits in some long-standing positions and using the proceeds of these sales to initiate positions in lower-beta (less volatile) securities.
- A number of these changes involved the fixed-income sleeve of our portfolios, where we extended duration by more than 50% (from 2.67 years to over 4), based on our view that interest rates could trend lower in the months ahead. Specifically, we sold two short-term ETFs and the **BMO Emerging Market Sovereign Bond ETF (TSX: ZEF)**, replacing them with the **TD Fixed Income Pool (TDB3474)** and the **Pender Corporate Bond Fund (PGF510)**. The TD Fixed Income Pool is an institutional-quality, competitively priced product that is actively managed by TD Asset Management, the largest fixed income manager in Canada. Pender Corporate Bond Fund is a top-quartile fund and consistent performer managed by Vancouver-based PenderFund Capital Management.
- Another notable change was made in the Infrastructure sleeve, where we replaced the **Sentry Global Infrastructure Fund (CIG54230)** with the **Russell Investments Global Infrastructure Pool (FRC108)**, which is managed by three leading infrastructure sub-advisers.

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Security Discussion: SNC-Lavalin Group

- On July 23, we added to positions in **SNC-Lavalin Group**. SNC was the worst performer in our portfolios for the second successive quarter, plunging 23% for a YTD decline of 42%, and single-handedly reducing the average gain of the 13 Canadian stocks in our large models by 4.5 percentage points (12.16% average gain YTD versus 16.67% for 12 stocks ex. SNC). Since the obvious question given this dismal backdrop is "why buy more?," we set out below a few key reasons for our investment decision.
  - SNC's corporate reorganization, announced on July 22, has been acknowledged by some analysts as the "right decision" and a "necessary first step." The reorganization will enable the company to focus on its high-performing and growth businesses – Engineering Design & Project Management, Nuclear, and Infrastructure Services.
  - SNC is also exiting its lump-sum turnkey (LSTK) contracting business that has been the root cause of the company's performance issues. As a result, SNC's management expects to see a material improvement in the predictability and clarity of its results.
  - The sale of SNC's 10.01% stake in the Highway 407 ETR for $3 billion will strengthen the company's balance sheet and enhance its financial flexibility. SNC also trades at a deep discount to its Sum-of-the-Parts valuation. National Bank estimates SNC's Net Asset Value at $37.74, which indicates a 45% discount to NAV, based on the stock's July 31 price of $20.88.
  - In our opinion, although political risk will continue to hinder SNC in the near term, substantially lower debt has de-risked the business (although investors are in no mood to give the company the benefit of the doubt). Upside catalysts include any potential steps that could resolve SNC's legal issues or measures to jettison its troubled businesses (Resources and Infrastructure EPC Projects), in our view. However, "re-rating" of the shares that could result in higher valuations may take many months, and investors will have to exercise continued patience as SNC works its way through its challenges.

Looking Ahead – Growing Divergence Warrants Caution (Part II)

In our Q1 Portfolio Review, we had noted that the growing divergence between surging equity markets and tepid economic data warranted caution, and supported a continued defensive stance with regard to portfolio positioning. For another aspect of divergence, consider the conflicting signals emanating from the equity and bond markets. Although equity indices at or near all-time highs may suggest that the good times could continue for a while yet, bond yields at record lows (with $13 trillion in debt globally having negative yields) indicate that a period of sustained low growth may lie ahead. The Federal Reserve's 25 basis-point rate cut on July 31 – its first since the 2008 financial crisis – cements the "dovish" policy pivot by major central banks in Q1. While low bond yields have provided a tailwind to global equities so far this year, it is becoming increasingly difficult to ignore downside risks such as slowing global growth and earnings momentum, and rising trade protectionism and geopolitical risk. Citing some of these factors, the International Monetary Fund (IMF) earlier this month again reduced its global growth forecasts for this year and next by 0.1 percentage point to 3.2% and 3.5% respectively. We fear that more downgrades to economic forecasts and earnings estimates may be in store, capping upside for equities and tilting the near-term outlook to the downside.

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