Cidel

Our Key Themes for 2018

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As we begin 2018, here are the themes and issues at the forefront of our Investment Team's thinking.

Equity Valuations and how they influence rebalancing

Given the impressive stock market returns around the world in 2017, it is worth turning one's attention to current valuation levels. While share prices are certainly high on most metrics relative to historical norms, implying modest returns going forward, a few points are worth bearing in mind. Longer term measures such as the Shiller P/E are still reflecting dramatic financial sector losses in the 2008/9 timeframe and will improve as those years drop out of the denominator; US tax reform will provide a high single digit boost to profits (provided companies do not compete it away), compressing forward looking valuation multiples; and the current low inflation levels underpin low interest rates and boost earnings quality, both of which justify higher than average valuation levels. As such, current multiples aren't in and of themselves an impediment to further upside, particularly if sentiment around the sustainability of current economic fundamentals continues to improve *provided that does in fact turn out to be the case.*

Given the significance of the italicized words, it's important to remember, in terms of achieving longer term goals, the importance of regular portfolio rebalancing - mechanically selling assets that have run ahead of the desired portfolio allocation and buying laggards, to benefit from the inevitable mean reversion at some point in the future and avoiding the peril of bad judgement on the sustainability of current trends. Chart 1 shows the significant cumulative benefit of regular annual rebalancing to a 60:40 equity/bond mix over the last 20 years- a period spanning the tech and financial bubbles and their subsequent bursting. The same philosophy holds true for portfolios that include other asset classes, including real estate.

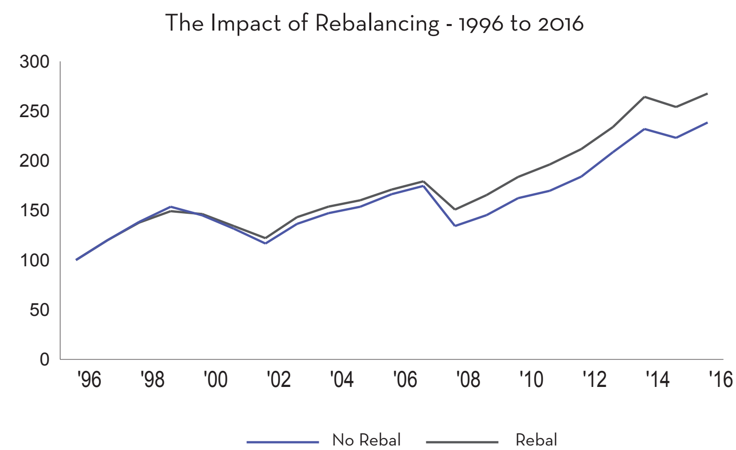


Chart 1
Source: Barclays, Cidel

Bottom line – Regular rebalancing, regardless of how tempting it may be to stick with current strong performers, is an important constituent of the disciplined investor's toolbox.

The Search for Yield

One of the natural consequences of a low interest rate environment is that investors seek ways in which to increase the income they used to receive from their traditional bond allocations. This has led to increased investment flows over the last number of years into all manner of credit strategies (investment grade, high yield and emerging market bonds), as well as less liquid forms of private credit. It is important, however, that investors pay attention to other things they may be taking on in addition to higher yields.

Investment grade credit has not historically been an asset class with tremendous downside risk. However, the demand for incremental yield has driven down the extra return investors receive to very low levels, relative to history. The excess yield investors receive has declined to levels not seen since before the credit crisis in 2008. (Chart 2)

Looking Forward – Cont'd

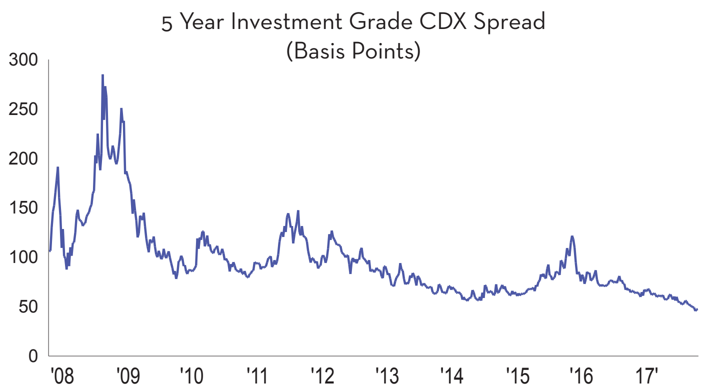


Chart 2
Source: Bloomberg

At the same time, companies have taken advantage of the low interest rate environment the last few years and borrowed to the extent that the median gross leverage of investment grade companies is now at an all-time high. Going forward, an increase in credit spreads could more than offset the extra yield investors have been receiving and investors need to keep this risk in mind.

For investors not satisfied with a small amount of extra yield, high yield and emerging market bond funds and ETFs have seen massive inflows. This has also driven down the extra yield earned in each of these asset classes to extremely low levels. Unlike investment grade credit however, high yield and emerging market bonds can see their spreads widen significantly in times of stress and each of these asset classes can experience equity-like downside.

This is not to suggest that high yield and emerging market bonds have no place in an investor's portfolio. Investors just need to be aware of the risks that they take with each of these asset classes, and that they are not a direct substitute for high quality bonds.

Lastly, an area of increasing interest to investors has been private credit. This refers to investments that are not publicly issued and traded. Examples include loans made directly to medium sized private companies, or portfolios of loans sold off by banks. Yields in this space have remained significantly above that of more liquid high yield bonds.

The trade-off for these more attractive yields is a lack of liquidity. Typically these types of investments are accessible to investors through private-equity style funds (with commitment levels, drawdowns over time and payback over a number of years). So while they can present very attractive risk-adjusted returns, they are also not a replacement for liquid government and investment grade bond allocations.

Bottom line – Investors need to be cognizant of the risk they are taking on while chasing higher yields, the effects it could have on their overall portfolio, and prudently develop portfolios that don't overexpose them to certain events like a sharp rise in credit spreads.

Hope for the Retail Apocalypse

In 2017, the US saw over 8,000 retail stores closures in a year where the economy grew and the unemployment rate continued to fall. The last time we saw a similar number was during the credit crisis of 2008. (Chart 3)

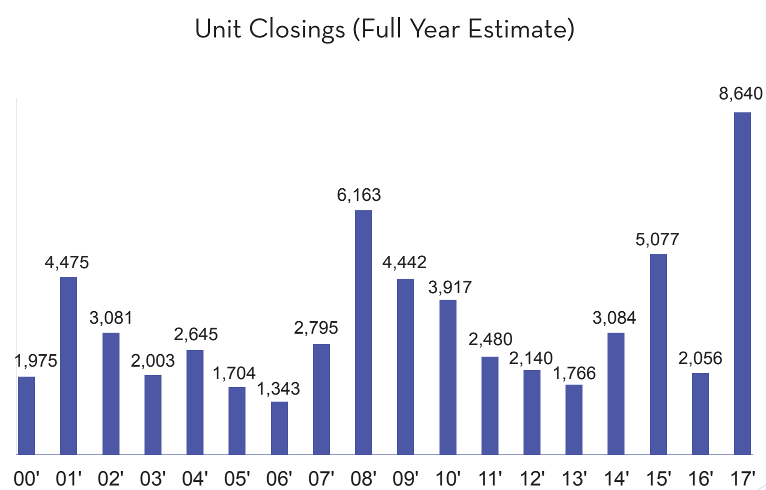


Chart 3
Source: Credit Suisse

The demise of brick and mortar ("B&M") retailers was one of the biggest investment themes of the year. There was actually acutally an ETF created to short the sector – ticker symbol: EMTY! However, although there will be B&M retailers that will fail this year, we think that 2018 will be a pivotal year in retail as the remaining players adjust their business models.

The majority of B&M retailers are facing steep declines in foot traffic, a statistic that many like to point to when arguing that retail is doomed. But traditional retailers are not going to roll over and die. We are seeing exciting experimentation in new forms of retail. For example, high-end department store Nordstrom is experimenting with Nordstrom Local – smaller footprints with no inventory, personlized stylsts and great bars and restaurants. Innovative web-based retailers like Bonobos & Warby Parker have opened multiple B&M stores that serve as showrooms for the brands, allowing consumers to touch and feel the product. In 2018, we expect to see even more experimentation as B&M retailers move away from simple price competition.

The winners will be the retailers with the right business model: a brand that aligns with consumer values coupled with a strong technology platform. This is the key forumla that investors have to keep in mind when evaluating any investment that has a retail component. Retailers that only focus on transactions and price will ultimately lose out to online stores. To compete, B&M retailers will need to focus more than ever on the buying experience rather than just the transaction.

Bottom line – The extreme doom and gloom surrounding traditional B&M retailers could create opportunites to invest in companies that take an innovative approach to technology.

US tax changes will have unintended consequences

One of the most interesting stories of 2017 was how the city of Memphis managed to get rid of two of their confederate statues that the state thought were protected by the Tennessee Historic Preservation Act. The city sold the statues to a non-profit corporation. The corporation, not subject to the Act, was able to take down and dispose of the statues. It was a neat series of transactions that allowed the city to get around state legislation. The state legislation never contemplated these types of transactions when it was drafted. In a similar vein, we believe 2018 will see a surge in structuring and tax planning that will allow individuals and corporations to circumvent, or shall we say tax optimize, many of the provisions in the hastily enacted US tax bill.

The press has focused on individuals prepaying their property taxes, but this is just a small indication of what is likely to come, particularly in the highest income brackets. The process will involve a detailed examination of all assets, liabilities, sources of income, shareholdings, and residency - all in pursuit of paying less tax. For example, people owning rental properties can restructure the holding into a pass through corporation and reduce their taxes to 20%.

From an investment analysis standpoint, it will be more important than ever to focus on cash flows from investment rather than simply looking at earnings. Moreover, investors will have to be careful to include the tax effects when looking at year-over-year comparisons. For instance, the accelerated expensing of capital expenditures for tax purposes may cause corporations to alter the timing of their expenditures. This accelerated expensing will also have a dramatic effect on the deferred tax that corporations report. Similarly, how the alternative minimum tax will be calculated may alter the forecast of effective tax rates for corporations. Analysts will need to discern what activities are related to day-to-day business and what activities are a result of a change in the tax legislation. Gaming tax rules

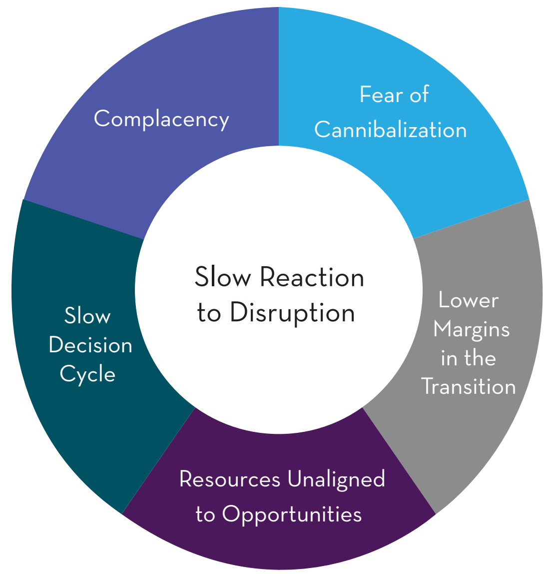
Looking Forward – Cont'd

The impact on equity markets is less than certain. It is not simply about calculating a new earnings number - it is likely to be murkier than that. The effect of higher deficits in the future and higher interest rates could offset the benefit of lower taxes. Finally, if individuals perceive these tax reductions as temporary, then the expansionary effects on the economy will be significantly reduced. In the end, we fear that the US will get higher deficits with no appreciable pick-up in growth.

Bottom line – The US tax bill is a significant development that will impact how we analyze corporate earnings, and could have unintended consequences for the US economy.

A.I and its wide-ranging impact

Artificial intelligence ("A.I."), and the multitude of ways it will continue to shape the global economy, has been a consistent theme of Cidel's investment team. A.I., broadly defined as a system's ability to analyze tremendous amounts of data while concurrently learning and improving from that data, has impacted many industries and companies. Analyzing which industries and companies are next plays a large role in our research process, security selection and asset allocation decisions. Often, looking for the second derivative of obvious targets yields better results. Autonomous driving has had a huge impact on the incumbent auto makers and will give rise to new brands like Tesla, but figuring out who else will benefit, such as chipmakers and other automation components, greatly interests us. Another example lies in the fact that many A.I. systems require massive amounts of data. Could countries with less stringent privacy regulations use this to their advantage, and could that favour certain companies? Using China as an example, could this "advantage" favour domestic internet giant Tencent over Google?



Source: Capgemini Consulting Analysis

It also impacts Cidel directly as investors. A.I. is a tool that can be of significant utility to industries that require the analysis of significant amounts of data and documents. For us, not leveraging these tools in our investment process would be a folly, and we have begun to incorporate them in our research; we also are greatly encouraged by the results that some of our external managers have had utilizing A.I. in their investment strategy. There are some who believe that the days of human stock pickers are over – that all investment decisions will shortly be ceded to robots. We believe that the complexity of global markets, and the ephemeral human emotions that move them, will provide a role for human portfolio managers for many, many years to come.

Bottom line – A.I. will impact many sectors in non-obvious ways, including our own. Embracing, not fearing, technology is of great importance.