SEAMARK

THE LATEST

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39 Years in Industry

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CIO Commentary / Q3 2018

Whew! An 11th hour deal has all but replaced NAFTA with its successor the U.S. Mexico Canada Agreement (USMCA). All that remains is for the triumvirate to formalize the agreement by passing it into law in their respective countries.

In the end, Canada made some one-off concessions, most notably in dairy. It was however able to keep the all-important dispute resolution mechanism in place and settled for a 16-year term, rather than the five-year sunset clause that had been proposed. We can live with it, so said the Loonie, that moved steadily higher, touching the 78-cent level as negotiations were concluding.

If only the government could turn its attention to the domestic issues with the same vigor and success that it applied to the NAFTA talks. The elephant in the room is of course the oil patch. The revamped National Energy Board may have passed the political test, but it has been seen as a failure within the industry and by investors. All one has to look at is the state of pipeline approvals in the country, or lack thereof, and the consequent widening spread of the price between West Texas Intermediate (WTI) and Canada's heavy oil. The Canadian discount has opened to a whopping $50, a new all-time high. So, in a market that prices WTI at a recent $75 per barrel, Canadian producers are receiving only about one third of the WTI price. Such a large discount is stifling energy investment in this country. Concrete steps need to be taken at the political level to alleviate this missed economic opportunity for Canadians.

South of the border, the U.S. continues to amaze in both politics and business. The economy is humming along at a 4% clip, and unemployment, at just 3.7%, has almost reached a 50-year low. The last time workers were in such demand was 1969, just as the baby boomers were about to flood the workforce en masse.

Despite all of the good economic news, the U.S. appears more divided than ever on the political front, as midterm elections loom on November 6. And with the contentious confirmation of Justice Kavanaugh, both sides are trying to rally support. Surely, we have learned that calling election results is a mug's game, but that does not stop investors from asking 'what if' type questions.

Some observers readily concede that the Republicans will lose control of the House. It is a fairly common occurrence at midterm elections for the President's party to give up House seats –in the last 20 midterms, it has happened 90% of the time. The American people do like to have their balance in politics. Bolder predictions though, suggest that the Senate too may be about to turn Dem-blue. If that should come about, it may be more of a surprise to investors and the market would probably have to endure some initial indigestion as power and policy shifts to the left.

How the marketplace is apt to receive any of the potential outcomes, boils down to the old adage: beauty is in the eye of the beholder – perhaps this time, more than at any time in 50 years. Should the House turn over to the Democrats, with subpoena power, the stage will be set for further investigations into Trump (tax returns etc.), and even Justice Kavanaugh, given his partisan confirmation. That may bring comfort to those who are currently distressed about the state of U.S. politics, but angst to Trump supporters, or at least to those that support how he has managed the economy, and by extension, the stock market rally (which is now into its 10th year).

...CIO Commentary continued

That said, some argue that Trump has already instituted the bulk of his agenda and that in the eyes of investors, he has now reached a point of diminishing returns. The remaining gains may be small in relation to the apparent chaos permeating the White House and the potential for any geopolitical missteps. These observers may like the prospect of clipping the President's wings and having him lame-duck his way through to 2020. The market may be fine with that too. Apart from stark political divisions, things are going pretty well south of the border.

For what it is worth, U.S. markets have a long history of delivering positive returns in the year following mid-term elections. Once the uncertainty of the November 6 outcome has been resolved, investors are likely to refocus on the strength of the U.S. economy and corporate earnings, and that remains a good story as we look ahead to 2019.

Sincerely,

Robert G. McKim, CFA
Chief Investment Officer

The Weighty Subject of Benchmark Indexes

How many readers or investors are truly aware of the utility (or maybe the futility) of broad-based index benchmarks within the investment industry? Perhaps spending a day with a money manager would help shed some light on the subject.

At one time in my career, benchmarks weren't even considered by pension trustees. Rather, they subscribed to comparative return studies, populated by like-minded pension fund sponsors, who used the surveys to learn of their relative performance standing. That is, relative to other managers, not to an index return.

Benchmarks gradually came into their own as another means of examining the contribution of money managers. Initially, this phenomenon spawned a new category of managers, one that thought it better to compete against a 'dumb' index, rather than be compared to a peer group of high performing, dynamically minded investment managers. "Index +" strategies were aptly named for the effort to eke out a small gain relative to an index benchmark.

Fast forward and industry benchmarks have taken over much of the discourse on money manager returns, perhaps for better, but I would argue to the detriment of many. The mantra of the financial press, that most managers don't beat indexes, is pervasive, but not persuasive. Yet many industry players (consultants and investors alike) have run with this and changed the business irrevocably. Witness the rise of Exchange Traded Funds (ETFs), which are simply investment products designed to mimic the performance of an underlying (benchmark) index. At a compliance conference we attended recently, one active management industry participant queried why security regulators don't demand that the prospectus of every ETF include in bold print: "After fees, the investor is guaranteed to earn a return that is less than that of the underlying index". Perhaps we should label ETFs as "Index -" strategies.

The Flawed Argument

To say that money managers don't outperform indexes assumes that every investment manager sets out to beat a benchmark. There is no regard for the manager that strives to achieve attractive risk-adjusted rates of return, recognizing that not all investors can accept the volatility of often lop-sided benchmark indexes. Those with the "Index +" mandates do, by definition, attempt to better the benchmark, and so should be held accountable to variances relative to the index. But are these indexes for everyone?

Every money manager has a myriad of investor clients, all of which have individual backgrounds and circumstances. In acting in a fiduciary capacity, it is appropriate that we take each individual's particular circumstances into consideration. How then, is a broad index benchmark the best fit for all?

Consider a pension fund of a successful company, with a workforce that is middle aged, and contributions are being made to the fund. Not every plan is so lucky. Others are more likely to have an aged workforce; whose plan is cash flow negative. The same analogy can be made of two individual investors, one young and employed, the other retired and drawing upon a lifetime of savings. The ability to tolerate and recover from market corrections is vastly different for this foursome of investors. How can a fiduciary conclude that the risk-taking ability of these four be equal? But that is what would be assumed if we managed portfolios just to an index benchmark.

The Weight of the Argument

The selection of a bogey index benchmark then cannot be suitable to all, thereby limiting its utility. But even within any index there can be vastly different return outcomes, depending on how each holding in the index is weighted within the portfolio. Traditionally, the larger pension funds required that the benchmark index be capitalization weighted in order to accommodate large investments across a receptive selection of stocks. Active managers however, especially those who deem that their role is one of a risk manager, might not be swayed by a company's weight within the index, or even the sector weighting of an index. It would be hard for a risk manager to justify a commitment of 25% of a portfolio being invested in technology stocks, like the S&P 500 has been over the last year or so. Thus, the concept of a benchmark comprised of equal weighted holdings was born, to reflect a more judicious portfolio construction. Recall that there are 11 industry subgroups to select from, so when one sector takes up 25%, it tends to suck a lot of the oxygen from the remaining ten industry subgroups. As an example, shares of Apple make up 4.2% of the capitalization weighted S&P 500 Index, but less than 1/20th of that, only 0.2% of the equally weighted S&P 500 Index.

And what of the returns of these two indexes that are made up of identical stocks?

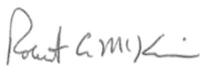
According to TD (via Webbroker), for the period ending September 30, 2018, SPY (an ETF mirroring the S&P 500 Index) has registered high relative quartile rankings for all periods including 3 and 6 months (second and first quartile, respectively) and for the longer term, 3 and 5 years (both first quartile rankings). But for 10 years, the closest we have to a complete market cycle, SPY has actually underperformed more than half of the funds sampled, recording a third quartile placement.

On the other hand, if we look at RSP (an ETF mirroring the S&P 500 Equal Weight Index), i.e., a fund comprised of the exact same companies as SPY, we see a vastly different return profile. This benchmark is solidly in the fourth quartile for 3 and 6 months, ranks in the third quartile for 3 years, and fourth quartile for 5 years. Yet, for 10 years, this benchmark registered a first quartile ranking, better than 75% of similar funds, and some 75 basis points above the SPY cap weighted benchmark, the related index that held all of the same companies throughout the period.

The significant discrepancy between these relative rates of return only speaks to the recent phenomenon that the S&P 500 Index has been driven by a very narrow group of companies, rather than the broad market that the index is expected to represent.

What then to conclude regarding the utility of benchmarks?

Don't give them more weight in the discussion than they deserve! They are paramount for those managers that specifically tout an "Index +" mindset, and their clients that can accept the level of volatility inherent in the benchmark, or the added stock selection beta (risk) necessary to better the benchmark. But they should not be the be-all-end-all for the rest of us. You will have a hard time convincing me that an index benchmark should ever be considered as a more appropriate fit for a client's circumstances, than the hand-picked, actively managed selection of stocks determined by the client's fiduciary. The best a benchmark can offer, is context, as to how markets perform and an insight perhaps into the DNA of the make-up of those returns. They can go a long way in the discussion with the client as to how his or her portfolio is positioned differently from the index and can help the manager explain all of the risk mitigating strategies that have been used in the construction of the client's portfolio. Variances from index returns are probably better explained by the risk-taking ability of the client, then by an under/over performance by the manager. An index benchmark return is just like the onion, waiting to have its layers peeled away to see what lies inside.



Robert G. McKim, CFA | Chief Investment Officer

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2017 Pooled Fund Capital Gains Tax Deferrals

	Tax Loss Carry Forwards*
SEAMARK Pooled U.S. Equity Fund	$ 21,834,243
SEAMARK Pooled Total Equity Fund	$ 17,788,240
SEAMARK Pooled Low Volatility Equity Fund	$ 4,946,610
SEAMARK Pooled Canadian Equity Fund	$ 4,962,722

*Audited Financial Statements, as at December 31, 2017

Some of these tax loss deferrals are significant compared to the assets in the respective Pools.

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Composite Performance Update

As at September 30, 2018

	One Quarter	Six Months	Nine Months	One Year	Two Years	Five Years	Since Inception	Inception Date
SEAMARK Balanced Composite (%)	**-1.46**	**1.59**	**-0.55**	**2.41**	**3.62**	**5.92**	**5.64**	12/31/2009
Balanced Benchmark* (%)	0.62	3.89	3.21	6.92	5.76	6.94	6.05	
SEAMARK Low Volatility Equity Composite (%)	**0.82**	**4.26**	**0.26**	**3.32**	**3.93**	**8.04**	**7.62**	12/31/2010
S&P/TSX Composite Index (%)	-0.57	6.16	1.36	5.87	7.52	9.70	4.87	
SEAMARK Canadian Equity Composite (%)	**-3.80**	**1.50**	**-4.85**	**-1.52**	**2.61**	**6.48**	**3.28**	01/31/2011
S&P/TSX Composite Index (%)	-0.57	6.16	1.36	5.87	7.52	9.70	4.87	
SEAMARK Total Equity Composite (%)	**0.31**	**4.60**	**1.44**	**5.11**	**6.12**	**8.82**	**7.46**	09/30/2011
Total Equity Benchmark** (%)	1.71	7.34	5.87	11.68	11.48	11.83	9.64	
SEAMARK Fixed Income Composite (%)	**-0.39**	**0.09**	**0.39**	**2.11**	**-0.12**	**1.82**	**2.75**	04/30/2012
FTSE Canada Universe Bond Index (%)	-0.96	-0.45	-0.35	1.66	-0.68	1.60	2.51	
SEAMARK U.S. Equity Composite (%)	**6.15**	**9.43**	**10.40**	**15.25**	**11.95**	**12.80**	**12.01**	04/30/2012
S&P 500 Index (CAD) (%)	5.88	11.86	14.08	22.31	17.50	15.98	16.67	

*Effective 01 Jan 2018, the SEAMARK Balanced Composite Benchmark is 5% FTSE Canada 91 Day TBill Index, 40% FTSE Canada Universe Bond Index, 27% S&P/TSX Composite Index, 20% S&P 500 Index, 8% MSCI EAFE Index; from inception to 31 Dec 2017 the benchmark is 5% FTSE Canada 91 Day TBill Index, 40% FTSE Canada Universe Bond Index, 30% S&P/TSX Composite Index, 25% MSCI World (ex-Canada) Index.
**50% S&P/TSX Composite Index, 35% S&P 500 Index, 15% MSCI EAFE Index

Links to Q3 2018 Pooled Fund Profiles

Balanced | Canadian Equity | Low Volatility Equity | Canadian Bond | U.S. Equity | Total Equity

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