Don't Get Trumped

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The question top of mind these days is, "What does Trump mean for portfolios and investment strategy?"

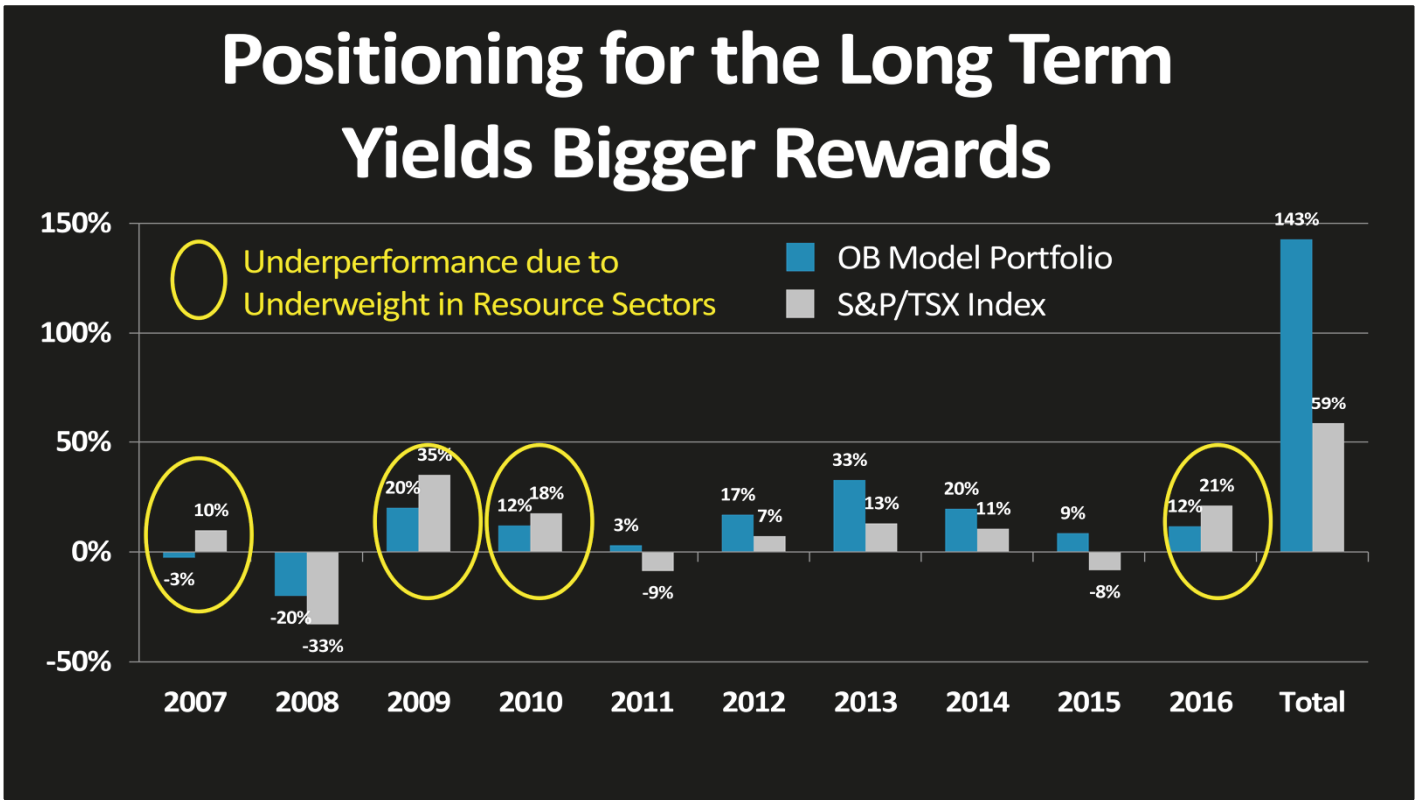
The quick answer is: not much.

That might be a surprise given all of the controversy around Trump, but let me reiterate what we've said from the get-go: Trump's popularity is a symptom of a challenged, slow-growth world.

Slow growth was a reality long before Trump decided to run for office, and we positioned the Odlum Brown Model Portfolio for a slower-growth world more than a decade ago. In fact, in 2005 we started to make a major shift from cyclical Canadian resource companies to high-quality U.S. blue chip businesses. It's a bias that we have maintained.

Owning great, high-quality businesses is a good idea at any time, but it is particularly appropriate in a challenged, slow-growth world for two reasons:
(1) they have the profits, and therefore the means, to get ahead in a sluggish environment; and
(2) they can survive a storm.

Having a bias toward high-quality companies has served us very well over the last decade, with performance that has handily beaten the Canadian stock market.



Source: Odlum Brown, Bloomberg

We haven't done better than the general market every year, as our underweight in Resource stocks has caused us to underperform in years when the economy picks up and commodity prices perform well. The point is illustrated in the chart above that highlights annual returns for our Model[1] and the S&P/TSX Index. Circled in yellow are the four years we didn't keep pace with the broad market – 2007, 2009, 2010 and 2016. Still, over the 10-year period, our Model was up 143% versus 59%, as highlighted by the bars on the far right.

We still don't think it makes sense to have a major, benchmark-like commitment to cyclical resource stocks because we don't believe Trump, or any administration, can change the slow-growth reality.

[1] *The Odlum Brown Model Portfolio was established by the Research Department in December 1994, with a hypothetical investment of $250,000. These are gross figures before fees. Past performance is not indicative of future performance. Trades are made using the closing price on the day a change is announced.*

Slow-Growth Reality

- Too Much Debt
- Demographics

Growth is slow because the world has too much debt and fewer workers entering the workforce, and those are not issues that can be solved overnight.

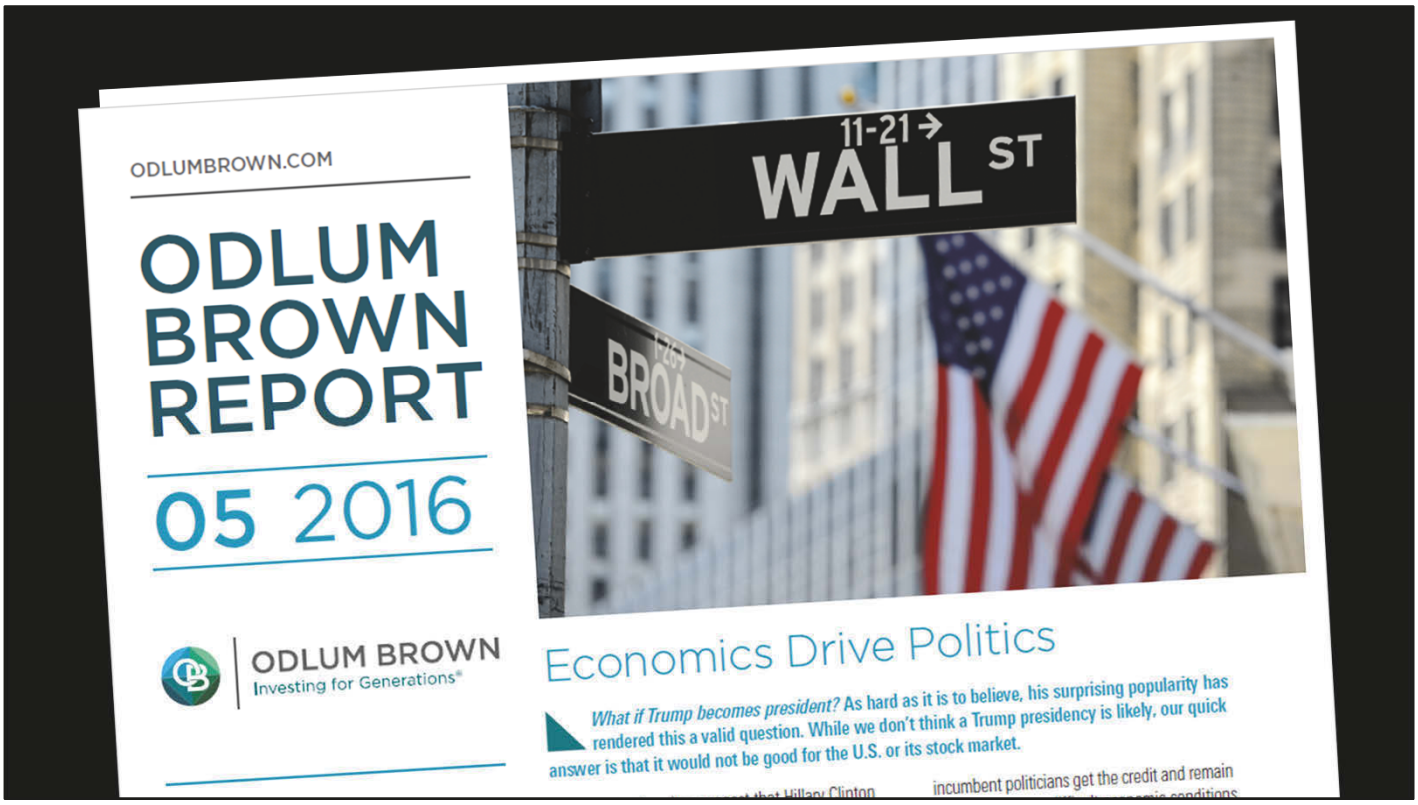
Social unrest and political upheaval are symptoms of the hangover from the unprecedented debt binge that caused the 2008/09 financial crisis.

Although significant improvements have been made to the health of the global banking system, the unfortunate reality is that global debt leverage is higher today than it was before the crisis. Collectively, citizens and governments around the world have borrowed too much and brought consumption and investment forward, and all of that has put, and will continue to put, a damper on global growth. The situation is no different than an individual who has to live within their means after maxing out their credit card.

Demographics are the other major reason why growth is slow. The world's population is aging, and the workforce is growing much slower than it used to, in all parts of the world. In fact, it will shrink in advanced economies and China over the next five years, according to the IMF's recent World Economic Outlook. That is simply a demographic fact, and it's not going to change for at least two decades.

There is a lot of debate about whether Trump will help or hurt the economy.

Currently, investors are focused on Trump's "Make America Great Again" pro-business agenda, which includes lower taxes, less regulation and infrastructure spending. There are worrisome headlines about protectionism, specifically around trade and immigration, but right now investors have a glass-half-full perspective and are focusing on the positives.



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Economics Drive Politics

What if Trump becomes president? As hard as it is to believe, his surprising popularity has rendered this a valid question. While we don't think a Trump presidency is likely, our quick answer is that it would not be good for the U.S. or its stock market.

incumbent politicians get the credit and remain

We've always said that economics drive politics, and not the other way around. In fact, that was the title of our May 2016 *Odlum Brown Report*. While the media champions the idea that the so-called "Trump rally" is all about politics and policies, there are economic fundamentals that explain the strength in the stock market.

Source: Bloomberg

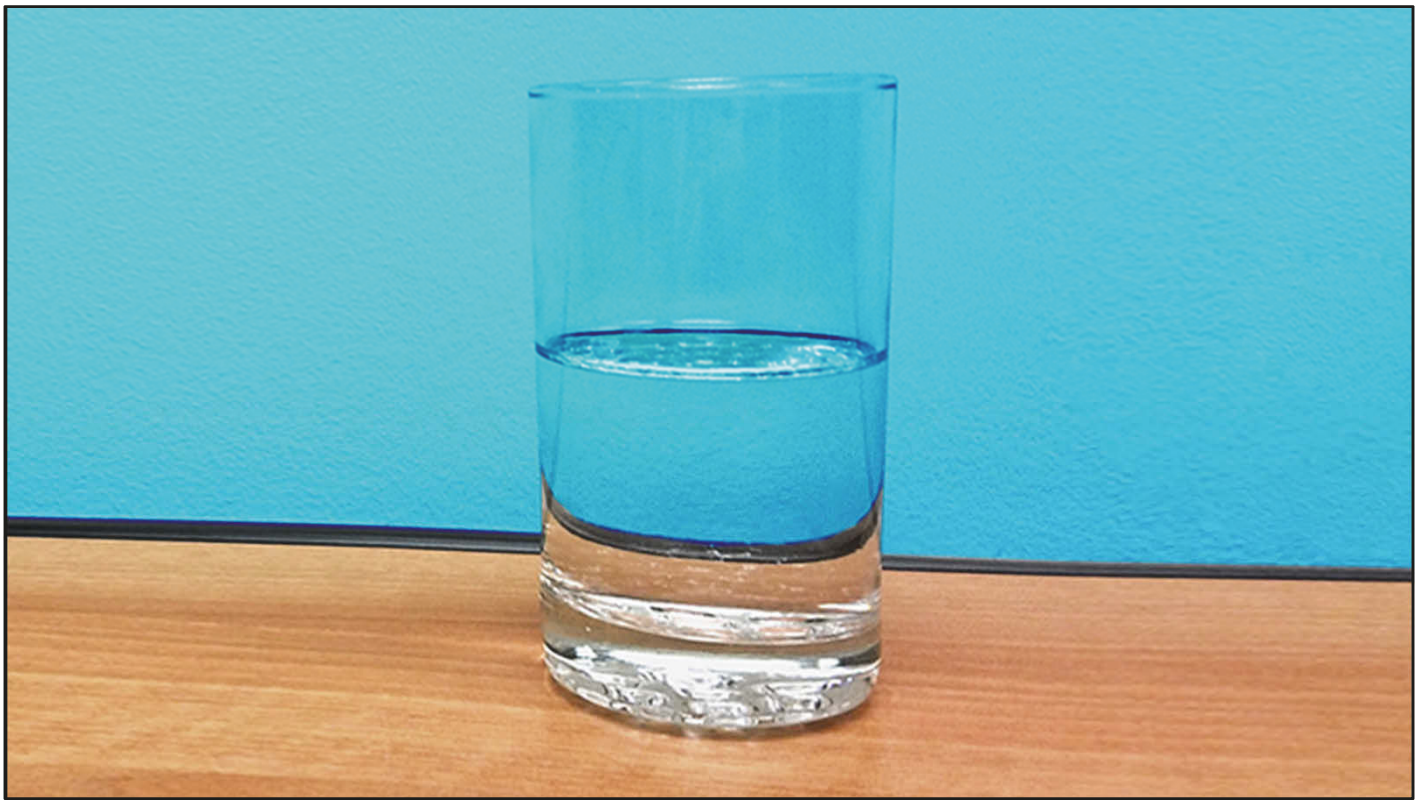
As highlighted in the chart, the 2016 performance of the U.S. stock market closely mirrored the trend in the Citigroup Global Economic Surprise Index. Stocks fell early in the year when the economic news was disappointing and rallied later in the year when the economic news was decidedly positive.

Economic conditions are still reasonably good. They might get a bit better or a bit worse, but we don't see any big changes on the horizon.

Ever since the financial crisis, the economy's ebb and flow has been driven by changes in interest rates and commodity prices. When they go up, the economy tends to soften six to 12 months later. When they go down, the economy tends to strengthen within a similar time frame.

A year ago, the economy hit a slow patch – stock and commodity prices were depressed and, consequently, investors feared a recession. We said that the drop in interest rates and commodity prices would cause things to get better, and that's what happened as the year progressed. In our opinion, the improvement in economic conditions is a better explanation for the stock market rally than Trump's presidential win.

The more recent rise in interest rates and commodity prices will likely take some wind out of the economy's sails. However, consumers and businesses are very optimistic following the Trump victory, and sentiment can be self-fulfilling. Hence, we don't have a strong feeling one way or another. The most likely course for the economy is a continuation of the slow, muddle-through growth that has been the norm since the financial crisis.



Still, we know that Trump is scary to some and that not everyone has a glass-half-full perspective. Not a day seems to go by without a client wondering if it would be prudent to take some money off the table.

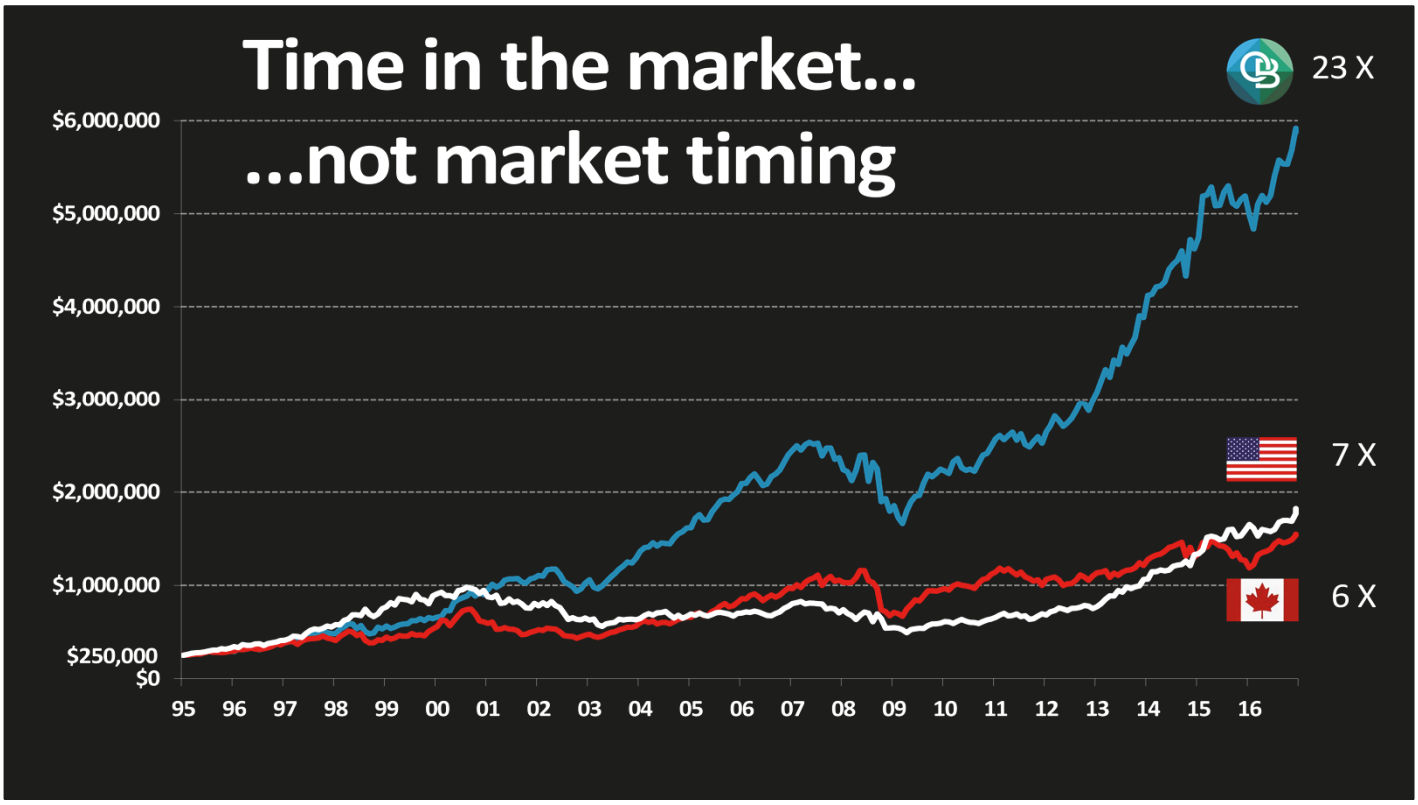
That's a question of market timing, which is not something that we believe in as it is extremely difficult to be consistently right about short-term moves in the market. To make the point, consider what happened last year.

We didn't predict that Trump would be president a year ago, but if we had we would have expected a negative market reaction. With a perfect crystal ball on the presidential race, we might have been inclined to tell investors to sell, and in doing so would have left nearly 20 percentage points of return on the table.

At the worst point in February last year, our Model Portfolio was down as much as 8%. It was up about 5.5% just prior to the election and 12% by year end.

Missing 20% sitting on the sidelines isn't just an immediate loss; it hurts every year after because it's money that isn't working for you and compounding over time.

People succeed in the market by having a good batting average. If six or seven stocks out of 10 do well, investors can afford to have a couple of lemons because the winners more than offset the losers. But when it comes to market timing, you can't afford mistakes because the strikeouts cost dearly over time.



Source: Odlum Brown, Bloomberg

Our all-equity Model Portfolio has gone up 23-fold in 22 years in large part because we have stayed invested.

Markets are volatile and there will be corrections from time to time. The next time the markets correct due to some negative event, there is a decent chance that the media will blame it on Trump. In fact, it's probably a safe assumption that Trump will regularly stimulate market volatility and get credit or blame for short-term movements whether he deserves it or not.

One of the things I've learned in my 25-plus years in the business is that those who accept market volatility and stick to a long-term plan invariably do better than those who try to anticipate short-term movements.

Imagine if there was a housing exchange where homeowners could realize the value of their homes and not have to move out. Many people in BC would have sold a long time ago, and they'd be kicking themselves today. Luckily, there isn't such an exchange, and most people have huge gains because they stayed invested in their homes for a long time. Investors should treat their stocks the same way.

It's easier to stay the course during the inevitable ups and downs when you own great businesses that will be bigger, stronger and more valuable in the future.

For the Model's first 10 years, we employed a deeper value strategy. We bought average companies when they were troubled and cheap, and we traded a lot. The strategy worked very well, and we had a compound annual return of 20% during that time. But, we learnt that theory and human nature don't always mix. That's because investors have a hard time holding companies with warts through a storm.

Like Warren Buffett, we came to appreciate that there was value in paying up for quality. We also realized that excessive trading is not the best way to generate wealth. Frequent trading triggers a lot of capital gains tax along the way, which leaves less capital to grow. It's much more tax efficient and financially rewarding to let good businesses grow and compound over time.

I'm sure there will be times over the course of Trump's presidency when the economy slows or other negative events move the markets.

The question is not "if," but "what?" What will you do when the inevitable drop in stock prices occurs and the headlines turn ugly?

If you think you might sell, then you should adjust your asset mix today.

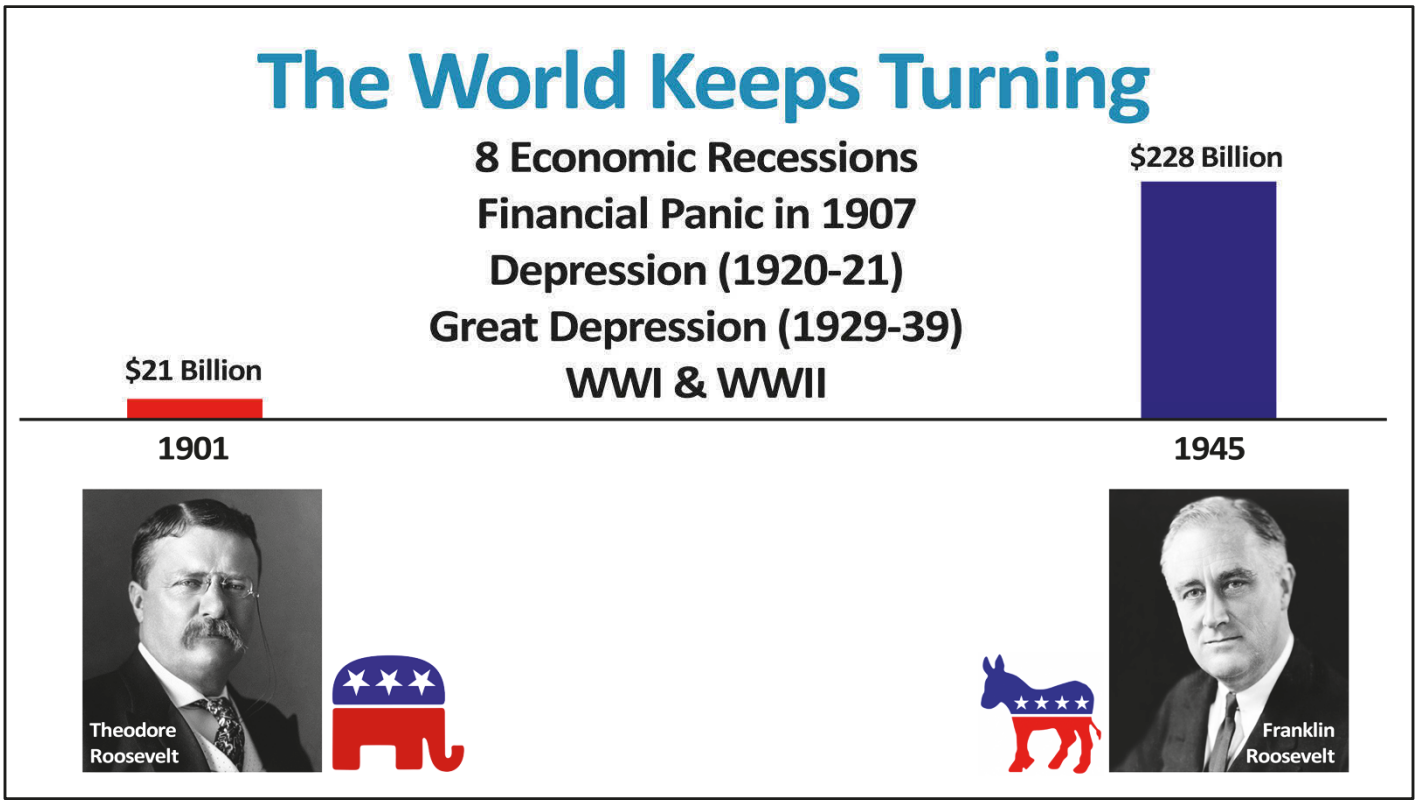


Image Source: Library of Congress, Wikimedia Commons

But before you do, consider a tale of two Roosevelts. Theodore Roosevelt – a Republican – was sworn into office after the assassination of President William McKinley in 1901. A few decades later, Franklin D. Roosevelt – a Democrat who governed much differently than Teddy – died in office in 1945. During that 44-year period, in which Republicans governed for 24 years and Democrats the other 20, the American economy grew from $21 billion to $228 billion, an 11-fold increase. What is even more remarkable is that the impressive growth occurred despite eight economic recessions, the Financial Panic in 1907, a depression in 1920/21, the Great Depression and two World Wars.

The point is, the world keeps moving forward despite the bad things that happen.

There is always something to worry about, and the internet and the 24/7 news cycle make it difficult to stay focused on the long term.

It's easiest to stay the course with high-quality businesses that will be bigger, better and more valuable three, five and 10 years down the road.

In that vein, our team of analysts are going share their insights on some of their favourite companies and elaborate on the three key ingredients that make a high-quality business great:

1) Sustainable competitive advantages, or "economic moats," as Warren Buffett calls them;
2) Great management; and
3) Long growth runways

Two years ago at the Annual Address, we focused on the importance of management. Last year, we highlighted the sustainable competitive advantages in a number of businesses that we own.

This year, the emphasis will be on businesses with long growth runways.

It's wonderful to own businesses that generate above-average profits and have great managers, but what really makes a business produce superior investment returns over the long term is the opportunity to reinvest and expand the business.

Having strong conviction that a business will grow over time is key to being able to hold in the face of market turbulence, and each of the businesses we will highlight today have simple and clear catalysts that will drive that growth.

Let me briefly highlight one of the businesses that I cover that has a very long growth runway.

Image Source: CarMax

That company is CarMax.

They are the largest retailer of used cars in the United States. They were spun out of Circuit City 23 years ago and have a very profitable and expandable business model.

They have gone from one store in 1994 to 170 today. With that expansion, sales and earnings have followed suit.

Customers love the company's approach because they take the hassle out of the car buying experience.

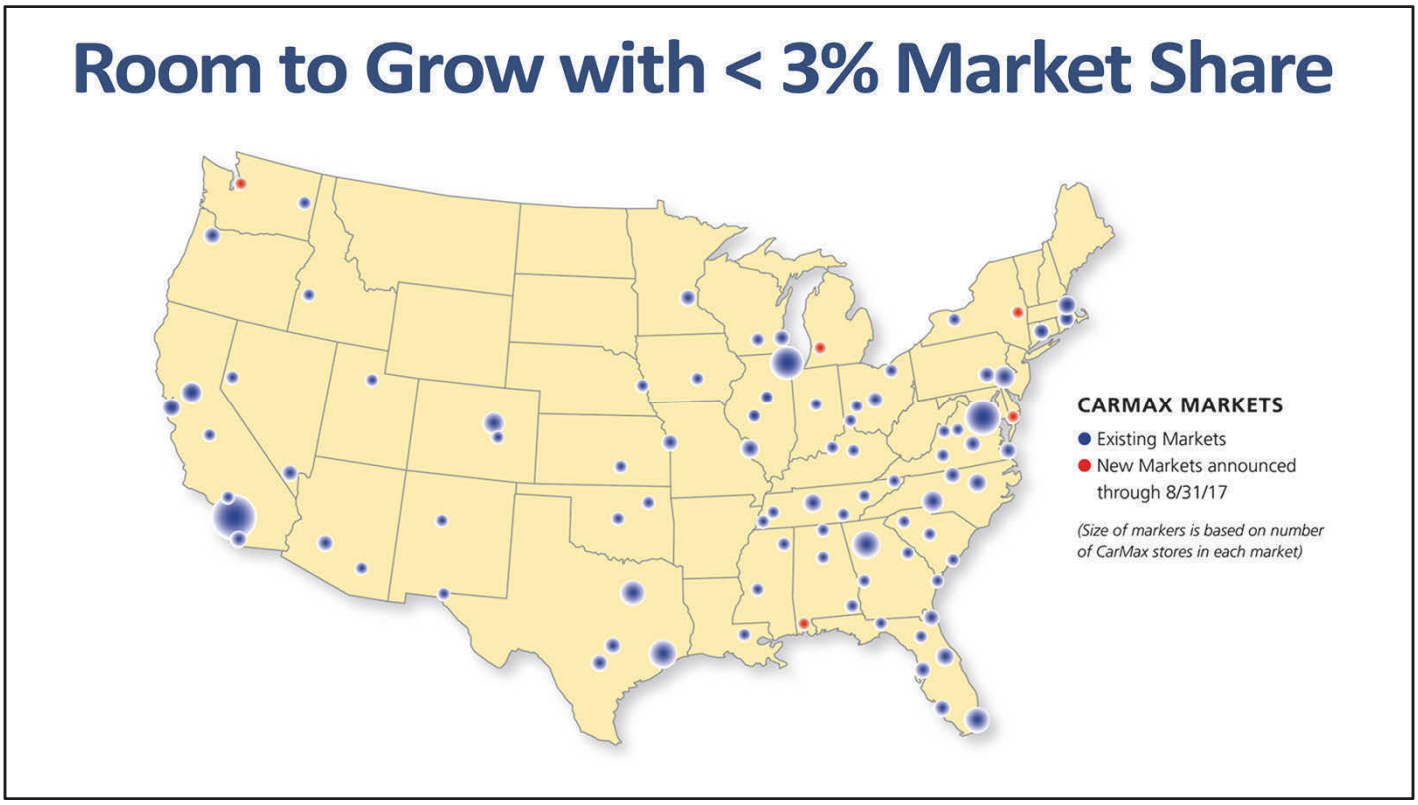


Image Source: CarMax

The growth story is simple. Today, CarMax has 170 stores and less than 3% market share. In markets where they have been for a while, they have 10% market share, and in new markets they have less than 1%. There is tons of opportunity to grow in existing markets, and also to expand in new markets. It's not hard to imagine the company being 2 or 3 times bigger in 5 to 10 years.

The thing about the stock, however, is that it can be quite volatile. The business is cyclical and sentiment can be even more erratic.

The analyst community is often worrying about some short-term factor, and potentially missing the forest for the trees.

A few weeks ago, an analyst at a big Wall Street firm suggested that there could be pressure on profit margins because a flood of leased cars is coming onto the market. I don't know if he is right or not, but if we react and are wrong about such short-term factors, we run the risk of missing out on holding a company that has the potential to double or triple in size.

Don't get trumped by market timing.

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