

# ODLUM BROWN REPORT

## 09 2019



**ODLUM BROWN**  
Investing for Generations®

## Managing Risk in a Volatile World

**All is not well in the world. As media headlines reflect global struggles, risk is on investors' minds, which in turn is fueling amplified stock market volatility.**

Income inequality is driving increased social unrest. Citizens are protesting in Hong Kong, and China is flexing its muscle and threatening to use force. The U.S. trade war with China continues to heat up and there is new leadership in the United Kingdom, which has raised the possibility of an economically debilitating hard-Brexit.

Global growth has slowed in the face of elevated economic policy uncertainty. Investors have legitimate reasons to fret about the possibility of an economic recession. The manufacturing sectors in three-quarters of the world's countries are experiencing weakness. Moreover, recent declines in the price of oil and other industrial commodities add credence to the argument that the health of the global economy is at risk.

Currently, government bond yields in much of Europe and elsewhere overseas are negative, a bizarre phenomenon that suggests economic prospects are bleak in those countries. In the U.S., not only have interest rates plummeted in the face of weaker economic reports, but long-term interest rates have also dipped below short-term interest rates. Such an inversion in the normally upward-sloping yield curve often foreshadows economic distress.

But, the news is not all bad. Corporate profits remain strong. The global services sector, which is much bigger than the manufacturing sector, continues to expand. According to the latest J.P. Morgan update on the service sector, "Output rose at the fastest pace in three months, as growth strengthened in the U.S., the U.K. and Italy and returned to expansion in India, Brazil and Russia."

We have mixed feelings regarding the economic outlook and the appropriate portfolio strategy.

Markets are normally very efficient (and accurate) at discounting the future, and as such, we consider the risk of an economic recession to be very real. Nonetheless, markets are not always right. Many central banks around the world, including the very powerful U.S. Federal Reserve, have shifted from tightening mode to accommodation. There has been a significant decline in global interest rates, which could produce enough economic adrenaline to stimulate global growth and extinguish fears of a recession.

If you are confused and uneasy, it is understandable. With so many mixed signals, it's hard to know what to do. With North American stocks and bonds still near record highs despite the challenges in the world, we can appreciate why some clients are increasing the cash and bond allocations in their portfolios.

What makes navigating markets even more complicated is the fact that many stocks are discounting different economic outlooks – some are behaving as if the economic skies will remain sunny, while others are acting as if an economic storm is coming. Moreover, the performance spread between the winners and losers has

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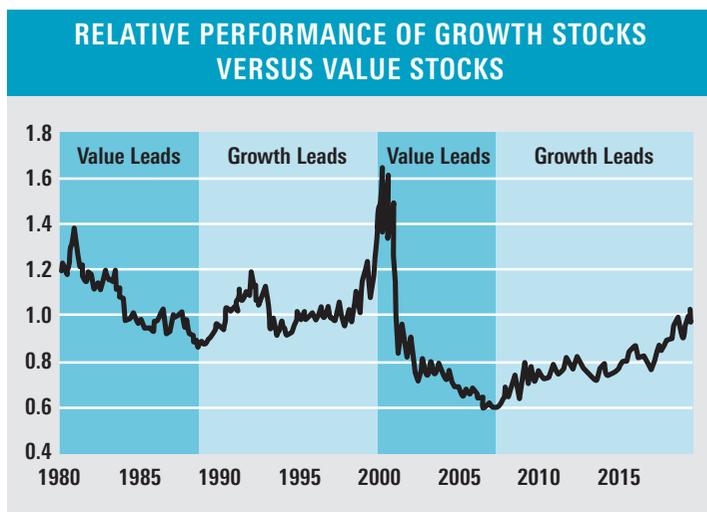


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widened. This is typical later in economic cycles when growth slows. It also powers an increased desire to dump underperforming stocks and replace them with those that are doing well. While that is human nature and understandable, it is often the wrong thing to do from a long-term risk and reward perspective.

In times of increased uncertainty, it is more important than ever to be diversified and hedge one's portfolio risks. Investors overly concentrated in the popular stocks that are doing well no doubt feel good, but their portfolios probably carry excessive risk. If you don't own some underperforming stocks, you are likely not appropriately diversified. History and experience have taught us the wisdom of not having all of our eggs in one basket. What's popular and doing well today will likely change at some point in the future.

Perhaps the easiest way to reinforce the forgoing point is to highlight the historic oscillation in the performance and popularity of growth and value stocks. Value-type stocks, and Canadian resource stocks in particular, have underperformed their growth counterparts for many years, and their recent poor performance has further reinforced the notion that contrarian value-investing is a dangerous affair. The chart below shows that growth has outperformed value since 2007.



Source: Bloomberg (Russell 1000 Value Index® and Russell 1000 Growth Index®)

Growth stocks like Starbucks, Visa and Amazon have attractive attributes: sustainable competitive advantages, less cyclical earnings, strong balance sheets and long growth runways. They are called growth stocks because they are expected to grow at a faster rate than the average business. Value stocks, on the other hand, typically have lower growth, operate in more cyclical industries and are often experiencing some challenges. Growth stocks are generally considered better businesses than their value counterparts. Other things equal, we prefer to own the best businesses.

While it might seem intuitive to believe that the growth stocks – the best businesses – will always outshine value stocks, that instinct is wrong. Value stocks outperformed growth stocks for most of the 1980s and also during the 2000s, prior to the 2008/09 Financial Crisis.

However, other things aren't *always* equal.

Price is an important differentiator, and there is a trade-off between price and growth. If the price of growth stocks is too high, growth will underperform value. The challenge is ascertaining when the price-to-growth differential between growth and value stocks is extreme enough to warrant a shift in strategy. This is

an enormously difficult undertaking, as it is human nature to extrapolate trends, chase performance and ultimately overdo a good thing. That means trends can, and do, run much longer than justified by fundamental factors.

Growth stocks were particularly hot in the late 1990s. It wasn't just dot.com companies that were popular and expensive at the time; America's biggest and best blue chip companies were also highly sought after and pricy. Between late 1998 and early 2000, the valuations of growth stocks went from silly to ridiculous. The love affair with growth stocks was so overdone that it took the Russell 1000 Growth Index® 14 years to recover after falling from its peak in 2000.

Value stocks took over market leadership in the 2000s after the dot.com companies crashed and big American blue chip stock valuations started a long, downward retrenchment to reasonable levels. Resource stocks were among the market darlings during the resurgence of the value investment style in the 2000s, but like the dot.com mania before it, the resource craze ended badly.

The Odlum Brown Model Portfolio\* has done considerably better than both the Canadian and U.S. equity benchmarks over the last 20 years because we didn't get carried away with the crowd and chase the hot stocks during the growth stock mania in the late 1990s or the value stock craze prior to the 2008/09 Financial Crisis. During that time period, the Model produced 13% compound annual growth versus 7% for the S&P/TSX Total Return Index and 5% for the S&P 500 Total Return Index (\$CAD).

While we are proud of our long-term track record, it is extremely important to remind investors that we experienced underperformance late in each of those cycles. Indeed, the Model's return was 13 percentage points below the Canadian equity benchmark in 1999 (19% versus 32%) and 2007 (-3% versus 10%). When you are not keeping up in a hot market, it really tries people's patience. Being different is difficult.

Our base case expectation is that global economic growth will continue at a moderate pace. With the dramatic decline in global interest rates in recent months, we do not believe a recession is imminent. It's most likely that growth stocks will continue to outperform value stocks. Still, we believe it is important to diversify and hedge one's risks with some value-oriented investments. Although value stocks have tried our patience, the long-term risk and reward attributes of the group are increasingly attractive relative to growth stocks.



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\*The Odlum Brown Model Portfolio is an all-equity portfolio that was established by the Odlum Brown Equity Research Department on December 15, 1994, with a hypothetical investment of \$250,000. It showcases how we believe individual security recommendations may be used within the context of a client portfolio. The Model also provides a basis with which to measure the quality of our advice and the effectiveness of our disciplined investment strategy. Trades are made using the closing price on the day a change is announced. Performance figures do not include any allowance for fees. Past performance is not indicative of future performance.

# Spending RESPs

As the school year begins, many families with children or grandchildren obtaining a post-secondary education may have questions about how and when to access Registered Education Savings Plan (RESP) funds.

Since RESP withdrawal rules are complex, here are a few quick reminders:

- Unless approved as an Education Assistance Payment (EAP) or as a Post-Secondary Education Payment (PSE), an RESP withdrawal may trigger repayment of grants or bonds to the government.
- Before requesting an RESP withdrawal, subscribers should have proof of the student's enrollment in a qualifying education program.<sup>1</sup>
- Clients with Odium Brown RESPs can usually request whether they prefer to receive an EAP, PSE or a blended payment from both portions of a child's RESP, when making RESP withdrawals.

The table below briefly compares EAPs and PSEs:



EDUCATION ASSISTANCE PAYMENT (EAP)	POST-SECONDARY EDUCATION PAYMENT (PSE)
Must be in enrolled in a qualifying education program at an EAP recognized post-secondary institution.	
Paid from government grants, bonds, accumulated capital gains and income in the RESP.	Paid from subscriber's contributions.
Taxable (to the student).	Non-taxable.
Limited to \$5,000 in first 13 consecutive weeks of enrollment (full-time) or \$2,500 per 13 weeks of enrollment (part-time), unless a special request is approved. <sup>2</sup>	Unlimited, while eligible for EAPs.
Receipts may be required if EAPs exceed \$23,976 per beneficiary, per year (2019 limit; indexed to Consumer Price Index thereafter).	

## What costs are eligible for EAPs?

Education Assistance Payments can be used for "reasonable costs" while enrolled in a qualifying education program, which may include:

- tuition;
- books;
- accommodation; and
- some transportation and general living expenses.

## Tips:

EAPs are taxable as part of the student's income. A student may pay little to no tax on an EAP, depending on their other taxable income, tax credits and deductions. PSEs are non-taxable and can therefore be withdrawn without impacting income tax.

While personalized advice is necessary to properly assess all individual factors, some families may prefer to withdraw taxable EAPs initially to reduce the risk of repaying grants and bonds to the government later if any unused funds remain in the RESP after the plan beneficiary(ies) end enrollment in an eligible post-secondary program. For example, families with children who receive generous scholarships or who might discontinue their studies may find this sequence of withdrawals attractive. A subscriber's contributions to an RESP can still be withdrawn, tax-free, after all EAPs are withdrawn, even if no beneficiary is enrolled in an eligible program.

For additional student tax tips, visit [getsmarteraboutmoney.ca](https://getsmarteraboutmoney.ca).<sup>3</sup>

There are also several budgeting tools available from the Government of Canada to help students plan responsibly, including "Budgeting for Student Life"<sup>4</sup> and the "Student Budget Worksheet."<sup>5</sup>

For more information about RESPs, please contact your Odium Brown Investment Advisor or Portfolio Manager.



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<sup>1</sup> A qualifying education program can be at a designated institution in Canada, or outside of Canada at a university, college or other educational institution providing courses at a post-secondary level. For Canadian programs, a minimum of 10 hours per week of instruction or work per week is required for full-time programs, or at least 12 hours per month if part-time.

<sup>2</sup> This limit reapplies if the student does not re-enroll for 12 months.

<sup>3</sup> [getsmarteraboutmoney.ca/plan-manage/planning-basics/understanding-tax/students-and-tax/](https://getsmarteraboutmoney.ca/plan-manage/planning-basics/understanding-tax/students-and-tax/)

<sup>4</sup> [canada.ca/en/financial-consumer-agency/services/budget-student-life.html](https://canada.ca/en/financial-consumer-agency/services/budget-student-life.html)

<sup>5</sup> [canada.ca/en/financial-consumer-agency/services/budget-student-life/student-budget-worksheet.html](https://canada.ca/en/financial-consumer-agency/services/budget-student-life/student-budget-worksheet.html)

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# Odlum Brown in the Community

We are committed to supporting initiatives that are meaningful and beneficial to our communities. As our summer sponsorships come to a close, we are proud to be a part of the following events this fall:

## Ovarian Cancer Canada Walk of Hope September 8, Throughout BC

For the sixth consecutive year, Odlum Brown is proud to be the Provincial Sponsor of the Ovarian Cancer Canada Walk of Hope. The Ovarian Cancer Canada Walk of Hope brings together thousands of Canadians in over 35 communities nationwide to raise funds toward seeing more women with ovarian cancer live fuller, better, longer lives. **For more information, visit [ovariancanada.org](http://ovariancanada.org).**



## Easter Seals BC & Yukon Drop Zone Vancouver September 12, Vancouver, BC

For more than 67 years, Easter Seals has encouraged Canadians living with disabilities to live life actively, pushing boundaries to contribute to the well-being of themselves and their communities. The Easter Seals Drop Zone challenges participants to do just that. Rappelling from the top of one

of Vancouver's tallest high-rise buildings, fundraisers are becoming superheroes for a day as they challenge themselves and change lives. Odlum Brown is proud to support the Vancouver Drop Zone event, and four team members from the Senior Leadership Team and Executive Committee will be participating. **For more information, visit [thedropzone.ca/locations/Vancouver](http://thedropzone.ca/locations/Vancouver).**

## Vancouver Public Library Foundation Gala September 12, Vancouver, BC

Odlum Brown is delighted to return as the Presenting Sponsor of the second annual Vancouver Public Library Foundation's "Beyond the Book" Gala. The event raises funds to expand and enhance the spaces and programs for children and teens, ensuring that all children have access to spaces, programming and tools to support their lifelong learning and literacy needs. We are proud to support the Vancouver Public Library's efforts to make information and knowledge accessible for everyone.

**For more information, visit [vplf.ca/2019-gala](http://vplf.ca/2019-gala).**



## BC Culture Days September 27-29, Throughout BC

Odlum Brown is pleased to support BC Culture Days as the Provincial Sponsor. As Canada's largest public participation campaign for the arts, Culture Days celebrates art, culture and heritage in communities across the country. Explore free, interactive events, in cities across British Columbia, perfect for the whole family. **For more information, visit [culturedays.ca/bc](http://culturedays.ca/bc).**

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