ODLUM BROWN REPORT

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ODLUM BROWN
Investing for Generations®

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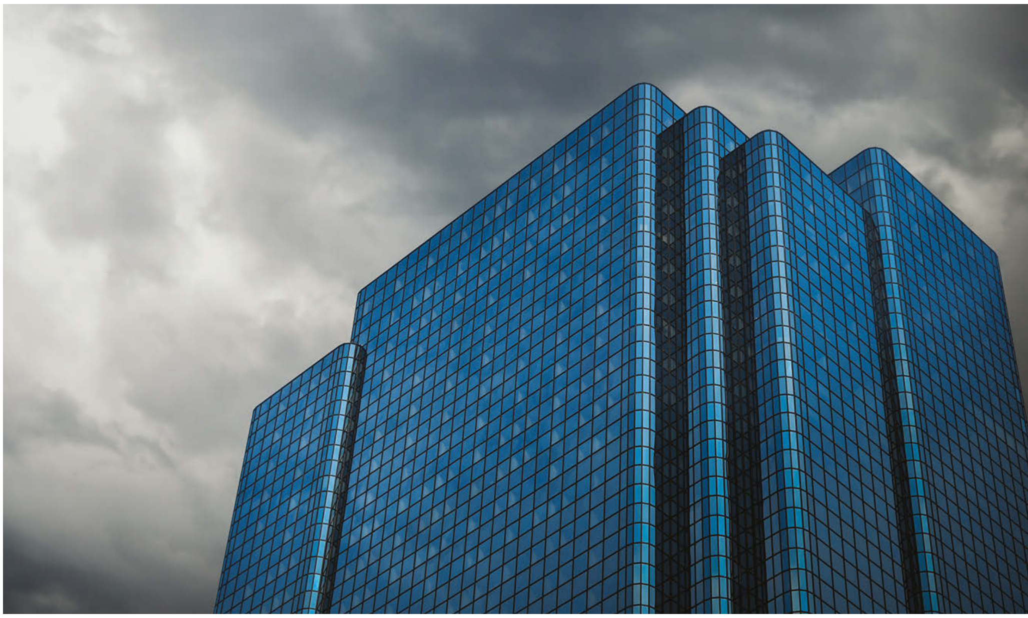
Odlum Brown Limited
Suite 1100 - 250 Howe Street
Vancouver BC V6C 3S9

Main 604 669 1600
Toll Free 1 888 886 3586

Kelowna 250 861 5700
Victoria 250 952 7777
Chilliwack 604 858 2455
Courtenay 250 703 0637

Email information@odlumbrown.com

Odlum Brown Limited
@Odlum_Brown
Odlum Brown Community



Home Capital - A Shot Across the Bow

Home Capital is not a stock that we cover, but we are closely following the company's fall from grace as there are lessons to be learned. In the face of a run on deposits, the company saw its share price fall as much as 90% from its 2014 high.

The good news is that the situation has stabilized and there doesn't appear to be an immediate reason to be overly concerned about our country's broader financial system. Indeed, Bank of Canada governor Stephen Poloz recently declared the situation at Home Capital "idiosyncratic." In other words, the central bank believes that the issues are company specific.

While it is doubtful that any of Home Capital's creditors will lose money, or that depositor insurance will even need to be tapped, it's unclear whether the business will survive long term. Regardless, the company's recent troubles provide an important reminder of how quickly things can change in the banking world. They also lead us to ponder how the outcome could have been worse under different circumstances.

Until recently, Home Capital was a Canadian success story and a respected institution. As the country's largest non-bank lender, assets, revenues and earnings had grown at double-digit annual rates for two decades, and the stock price followed suit. The quality of the loan portfolio has been excellent in recent years, with relatively low levels of problem loans. Consequently, the business has been very profitable.

So what went wrong, and why did the company's fortunes change so quickly and dramatically? The short answers are a lack of trust, leverage and an asset-liability mismatch.

Banking is a trust-based business. Survival depends on depositors and other providers of capital having faith that they'll get their money back. Home Capital simply lost the public's trust, and that caused people to pull their money out of the company.

There has been considerable media coverage on what caused this lapse in trust. As such, we won't delve into the details other than to say that the reaction seemed outsized relative to the facts. It's true that the company had unresolved disclosure issues with the Ontario Securities Commission, but those were related to events that happened more than two years ago. Although Home Capital's growth and profitability had weakened somewhat over the last two years, the company's financial reports were no cause for alarm, nor did they warrant a run on deposits. But trust is trust, and in the banking business, when it's gone, it's deadly.

The reason a shift in trust affects a bank so quickly is that banks use leverage. Their basic business is to borrow money at one rate and lend it out at a higher rate to earn a positive spread. For example,

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While the Home Capital storm has subsided, investors should consider it a warning shot across the bow. The economic consequences could be broader and more painful the next time there is a storm, especially if it happens at a time when the economy isn't as healthy as it is today.

Home Capital can earn a 3% net interest margin by paying a saver 2% on a GIC while earning 5% on a borrower's mortgage. Banks turn relatively thin interest margins into attractive returns on shareholders' equity by using leverage. Leverage, however, is a double-edged sword – it magnifies shareholder returns during good times and heightens the pain when banks get into trouble and trust erodes.

What is interesting and noteworthy is that Home Capital wasn't using excessive leverage. At year end, its assets were less than 13x its equity base. That is meaningfully less than Royal Bank's asset-to-equity ratio of about 16x, and considerably less than respective leverage ratios of roughly 20x and 30x at Citigroup and Lehman Brothers prior to the 2008 financial crisis. Indeed, Home Capital is very well capitalized relative to its banking peer group. Still, even leverage that is considerably less than the peer group can be harmful when sentiment turns.

The primary cause of Home Capital's undoing was not concerns over the company's solvency. It was a lack of liquidity stemming from an asset-liability mismatch. The company was using money from high-interest savings accounts, which could be liquidated on demand, to fund longer-term mortgages. Because of this, the company faced a liquidity crisis when depositors asked for their money back. They didn't have the cash on hand to meet the surge in demand for repayment and had to make alternative borrowing arrangements that turned out to be very expensive. The good news for creditors is that the new $2 billion line of credit alleviated the near-term asset-liability mismatch. Longer term, maturing mortgages will adequately cover maturing deposits.

What is somewhat perplexing is that the breakdown in trust and run on deposits occurred against the backdrop of a healthy global economy, positive investor sentiment, a strong stock market and a robust domestic housing market. It makes one wonder if there's something else going on. Perhaps Canadians were quick to run at the first sign of trouble because deep down we suspect that our country has problems with excessive debt and expensive real estate.

Our biggest worry is the risk of contagion. Indeed, shares of other big alternative lenders like Equitable Group were hit hard when the Home Capital crisis erupted. Fortunately, the big Canadian banks were quick to support Equitable with backstop credit facilities at reasonable interest rates to assuage investor concerns and contain the panic. Had that not been the case, the consequences could have been more significant, as credit, house prices and the economy are interconnected in ways that most don't appreciate.

A reduction in the availability of alternative non-prime loans in the Canadian market could reduce demand for starter homes. If people can't sell their starter homes, they can't move up market into bigger homes. Thus a reduction in credit availability could have ripple effects, impacting housing prices and the economy at large.

It has been a long time since Canada has experienced a meaningful credit cycle, and it is quite likely that credit lending standards have deteriorated. Stability ultimately breeds instability as it creates a false sense of security. Financial institutions regularly point to low delinquency and default rates on mortgage loans as reasons to believe that credit quality is excellent, but such is always the case when house prices are rising. After all, people tend not to default on a loan when it's easy to go down the road and get another at a different institution.

While the Home Capital storm has subsided, investors should consider it a warning shot across the bow. The economic consequences could be broader and more painful the next time there is a storm, especially if it happens at a time when the economy isn't as healthy as it is today.

The big Canadian banks have diverse operations, higher lending standards, and more stable and diverse sources of funding than alternative lenders like Home Capital. Consequently, investors shouldn't bargain hunt in the alternative-lending arena. It's best to stick to the higher quality of the big Canadian banks. Investors would also be wise to make sure that they are appropriately diversified beyond the financial and housing-related sectors, and outside of Canada. Quality remains paramount in a leveraged world.

MURRAY LEITH, CFA
Executive Vice President and Director, Investment Research
@murrayleith

Beyond Baby Proofing: Have You Taken All the Steps to Protect Your Little Ones?

We recently celebrated my newest nephew's first birthday, much to the joy of family and close friends. I could not help but notice how his parents' house had changed in subtle ways since his arrival. There are bumpers on the corners of the coffee table, baby gates on the stairs, plug covers on the electrical outlets – nothing dangerous within reach of his cute little hands now that he is walking.

This got me thinking about the lengths to which parents go to protect their little ones, and all of the families we have helped protect over the years with insurance policies purchased through Odlum Brown Financial Services Limited. It also brought to mind a few recent situations I have seen in the media where tragedy has struck and, following the death of a loved one, crowdfunding was used to raise funds for surviving family members. There is nothing wrong with crowdfunding, but having your own insurance plans in place allows your family to avoid the added burden of financial stress in the event of a tragedy. Planning ahead guarantees that the right amount of insurance coverage will be available for your dependents if and when needed.

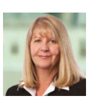
Reviewing your insurance coverage needs whenever there is a major change in your life, such as having children, is an essential step in safeguarding your loved ones. If you have been delaying this important task, you are not alone. A recent study noted that 51% of Canadians surveyed were concerned about the financial well-being of their family if they were to suddenly pass away. In addition, several confessed that they simply did not know enough about insurance or the options available and considered the whole process overwhelming.[1]

Many Canadians have misconceptions about insurance that prevent them from getting the proper coverage to protect themselves and their families. For example, individuals may count on coverage provided through work, when in fact an employer can change a benefit plan at any time. In addition, this coverage would be lost if the person changed employers. There is also a misbelief that insurance is too expensive, when in fact industry competition and longer life spans have helped to lower costs for many products that provide valuable protection. Another misconception is that insurance is not important for young, healthy people. Unfortunately, unforeseen events such as an illness or accident resulting in death can happen to anyone at any time, even those who are young and healthy. Further, once someone's health history changes, they may not qualify to purchase any insurance despite needing and wanting to have the coverage in place.

Clients are often surprised by how affordable the right amount of protection can be and how simple the process is to put coverage in place. For example, a young couple with children, aged 35, non-smokers, could each obtain $500,000 of term life insurance with guaranteed level rates for 20 years, for a total monthly premium of approximately $65.[2] This would ensure that, for less than the cost of many monthly cell phone plans, both parents have life insurance over the period when their children are the most dependent upon them for financial support.

Today's families can be complex, with blended families uniting and a variety of other circumstances. Proper insurance planning is a very important aspect of family life that should not be overlooked and need not be overwhelming or complicated.

If you are not sure whether you have the right amount or type of protection for your family, please feel free to contact me through your Odlum Brown Investment Advisor or Portfolio Manager.



RITA AGER, CFP, CLU, CHS, CPCA, FEA
Insurance Specialist
Odlum Brown Financial Services Limited

[1] Survey conducted by ValidateIt™ for the BMO Wealth Institute from June 2-10, 2015, with a sample size of 1,005 Canadians.

[2] CompuOffice Software -- Life Guide rate survey May 2017. Standard non-smoker rates. Individual rates may be higher or lower depending on individual medical history and healthstyles.

"Today's families can be complex, with blended families uniting and a variety of other circumstances. Proper insurance planning is a very important aspect of family life that should not be overlooked and need not be overwhelming or complicated."

Odlum Brown Financial Services Limited is a wholly-owned subsidiary of Odlum Brown Limited, offering life insurance products, retirement, estate and financial planning exclusively to Odlum Brown clients.

Odlum Brown in the Community

We are committed to supporting initiatives that matter to our communities. With the arrival of summer, we are excited to sponsor these upcoming events:

Bard on the Beach
June 1 – September 23
Vancouver, BC

We are pleased to be the Presenting Sponsor of Family Nights for the 28th season of Bard on the Beach Shakespeare Festival. Bard is Western Canada's largest not-for-profit professional Shakespeare festival, presenting Shakespeare plays, related dramas and special events in the magnificent waterfront setting of Vancouver's Vanier Park. This year, Family Nights will take place on July 11, August 8 and August 22 and feature Shakespeare's great comedy *Much Ado About Nothing,* along with family-friendly activities and an exclusive pre-show talk designed just for kids.

For more information, visit bardonthebeach.org.

Canucks Junior Golf Week
July 2 – 9
Throughout BC

We are proud to once again partner with the PGA of BC as the Presenting Sponsor of Canucks Junior Golf Week. Now entering its fourth year, this week-long event is open to children and youth aged 5-18 at 30 golf facilities throughout BC. Participants will learn the fundamentals of the sport and the benefits of staying active while making new friends and developing important life skills such as honesty, sportsmanship, responsibility, integrity and respect. Single-day certified PGA of BC-instructed golf camps are open to golfers of all skill levels in their respective communities.

Visit canucks.com/golfweek for more information.

Harmony Arts Festival
August 4 – 13
West Vancouver, BC

This summer marks our 16th year as Presenting Sponsor of the Harmony Arts Festival, one of the North Shore's best-loved community events. There is something for everyone at this annual celebration of the arts: visual art exhibits, an art market, free outdoor concerts and licensed beachside dining venues, along with drop-in art activities for both kids and adults. The festival turns West Vancouver's stunning Ambleside waterfront and John Lawson Park into a lively outdoor spectacle. Most events are free to the public. **Visit harmonyarts.ca for more information.**