ODLUM BROWN REPORT

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ODLUM BROWN
Investing for Generations®

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Too Much Easy Credit Could Be Harmful

Stocks have staged an impressive rally this year, thanks to a stimulative shift in monetary policy. From its low last December, the Canadian S&P/TSX Total Return Index has appreciated roughly 25%. The broadly based U.S. S&P 500 Total Return Index is up a similar amount, in Canadian dollar terms.

While North American stocks are near all-time highs, they are not as high as you might think. Much of this year's rally has merely recouped losses from the latter part of last year. Stocks had a horrible fourth quarter in 2018, as investors started to worry that the U.S. Federal Reserve and other central banks would kill the economic expansion by raising interest rates too much. The major North America stock benchmarks experienced peak-to-trough declines of roughly 15% in the fourth quarter of 2018, and bottomed on Christmas Eve.

Investors have grown accustomed to central banks coming to their rescue, and so far they haven't been disappointed. The U.S. Federal Reserve signalled early in the year that they would shift back to monetary accommodation. They lowered interest rates in July and September, and further reductions are expected. The world's other major central banks have also transitioned to more stimulative policies, lowering interest rates and stepping up bond-buying programs. The Bank of Japan is even buying stocks to help stimulate their economy.

The worldwide shift in monetary policy has fuelled a significant drop in global interest rates. In fact, interest rates are negative in a number of countries.

In the near term, the meaningful decline in interest rates will likely provide the necessary economic adrenaline to keep the world economy on a muddle-through, growth path and stocks will probably continue to do well against that backdrop. As President Trump gears up for re-election, some resolution on the U.S./China trade war could also brighten the near-term economic outlook and buoy stocks even further.

Nonetheless, we are worried about the medium-term consequences of overly stimulative monetary policies and ultra-low interest rates. In particular, we are concerned about the build-up of debt in the world, and the seeming lack of a long-term plan – by central banks and governments alike – to move the world toward a healthier state.

Increased government debt and deficits, and extremely accommodative monetary policies (ultra-low interest rates), were absolutely necessary to stabilize the banking system and global economy during the 2008/2009 Financial Crisis. However, we believe authorities have over-used these stimulative policy levers during the recovery and have failed to learn from the past.

The Financial Crisis was caused by excessive debt and a poorly regulated and undercapitalized banking system. Since then, we have learned some important lessons about the banking system. The risk of a banking crisis has been reduced considerably, because regulation is now much tougher and these institutions are very well capitalized. Unfortunately, we have learned very little about the consequences of too much debt. The world has increased leverage significantly since 2008/2009.

Continued on next page

The U.S. consumer is in much better shape financially, but government and corporations have increased leverage considerably.

Debt is one of the major factors contributing to slower economic growth. Demographics (a slower growing, working age population) and divisiveness (caused by growing income inequality) are the other significant factors that have restrained the pace of the economic recovery this cycle.

Debt is not bad per se, but too much debt can be deflationary, as debt used for excessive consumption today reduces society's capacity to consume in the future. Ever since the Financial Crisis, central banks have endeavoured to keep deflationary forces at bay and stimulate economic growth by encouraging debt accumulation via ultra-low interest rates. But, if excessive debt is deflationary, and one of the major factors that is hampering global growth, aren't we treating the patient with medicine that will ultimately make the patient sicker? We think so.

With US$17 trillion of global debt trading with negative yields and interest rates on the rest of the world's debt otherwise extremely low, the central banks will have less ability to stimulate economic growth by lowering interest rates during the next inevitable economic downturn. As such, the authorities will likely have to rely on bigger government deficits, and turn to money printing to finance the larger deficits. Unfortunately, doing so will likely be controversial and challenging. As such, the recovery following the next global slowdown/recession could be weak and weigh heavily on investor sentiment.

Governments have expanded deficits and increased debt during the good times, and as a result, they will enter the next downturn in a weaker condition. Deficits naturally increase during downturns, as tax revenues decline and spending on social entitlements increase (i.e. unemployment insurance). In addition to these natural cyclical pressures, there is ongoing secular pressure on government finances due to the rising cost of providing entitlements to an aging population. Consequently, we believe governments will struggle to justify and finance discretionary deficits when the economy needs them most. If governments weren't spending the rainy day funds during the good times, they would be in a better position.

Not only have ultra-low interest rates fueled an undesirable increase in global debt, but there are other very troubling consequences as well. Low interest rates have exacerbated income inequality, as the wealthy disproportionately own the assets that have risen in price as interest rates have fallen. Income inequality, in turn, is fueling social unrest and polarized politics. The situation is not likely to get better if ultra-low interest rates continue to drive asset prices higher. This is another important consideration, as social unrest increases the risk of policy mistakes.

Given that we see the world heading towards a challenging juncture in the medium term, we believe a more conservative balance between stocks and fixed income is warranted. There isn't a universal asset mix that is appropriate for everyone, as investors' goals, risk tolerance, time horizon and tax considerations vary considerably. For example, if you were comfortable with a 70/30 mix of stocks and bonds, you might want to consider shifting to 60/40.

Despite our medium-term concerns and regardless of the state of the economic environment, good businesses will continue to survive and thrive. Owning pieces of these businesses will remain a key pillar of preserving and growing wealth. In the long run, we have faith in the human race's ability to leverage science and technology to improve our collective standard of living. Things that aren't sustainable won't be sustained. We believe adjustments will be made along the way, and that the world will ultimately find a sustainable path forward.

COMPOUND ANNUAL RETURNS[1]
(Including reinvested dividends, as of September 15, 2019)

	YTD	1 YEAR	3 YEAR	5 YEAR	10 YEAR	20 YEAR	INCEPTION[2]
Odlum Brown Model Portfolio	18.8%	6.1%	9.4%	9.5%	12.7%	12.9%	14.6%
S&P/TSX Total Return Index	19.0%	7.6%	8.0%	4.6%	6.9%	7.0%	8.4%
S&P 500 Total Return Index ($CDN)	18.5%	7.5%	14.5%	15.1%	15.8%	5.7%	9.8%

[1] Except for YTD period. [2] December 15, 1994.

OB Model Portfolio – Raising Cash

We have reduced our equity exposure and raised the cash position in the hypothetical, all-equity Odlum Brown Model Portfolio,* as we are cautious regarding the medium-term economic outlook and less enthusiastic regarding the risk and return attributes of the stocks in our investment universe. The shift in strategy reflects our view that investors should have a more conservative overall asset mix at this time.

This economic/stock market cycle is unusual in that we are having trouble finding high-quality investment opportunities at attractive prices. The biggest and best businesses are understandably popular and unfortunately pricey.

In the latter stages of the last two major cycles experienced during the Model's 25-year history (the late 1990s and the period prior to the 2008/09 Financial Crisis) we had the opportunity to own high-quality businesses at attractive prices. In the late 1990s, high-quality Canadian businesses were out of favour and very attractively priced. In the lead-up to the Financial Crisis, high-quality blue chip American stocks were unloved and favourably priced. There isn't an enticingly priced, high-quality alternative in this cycle.

Investors are worried about social unrest, trade wars, negative interest rates and the possibility of an economic recession, and yet the major North American stock benchmarks and the value of the Odlum Brown Model Portfolio are all near record highs. In this uncertain environment, the shares of higher-growth businesses and those with greater earnings and financial stability have been bid up in price. That has rendered the risk and reward attributes of these stocks less appealing. Unfortunately, stocks with these attributes dominate the market and our portfolio.

We also own some value-type stocks, which are unloved and cheap, and yet it is hard to be super enthusiastic about this group when we are cautious regarding the medium-term economic outlook. It normally takes a stronger economy for value stocks to outperform. While some exposure is warranted for diversification purposes, we believe it is too soon to place an increased emphasis on out-of-favour securities.

Consequently, we decided to increase our cash position from 1% to 13.5%.

We executed several trades to increase the cash position in the Model, which are explained and summarized in the table on the following page.

We trimmed our holdings of several great businesses, and pared our weights back to moderate levels, as some stocks are close to our near-term price targets. Specifically, we reduced our weight in Amazon.com, Starbucks, Restaurant Brands International, Dollarama and Constellation Software to 2.0% each. We also reduced our Visa position to a 2.5% weight.

We reduced Howard Hughes Corporation to a 1.0% weight and used some of the proceeds to increase Weyerhaeuser Company to a 3.0% weight, as it has an attractive dividend yield of 5.2%. We also reduced XPO Logistics to a 1.0% position and increased our weight in Colfax to 2.0%. Our conviction regarding the upside on Colfax is higher than other out-of-favour stocks.

We sold our entire positions in Air Products, Stella-Jones, Shawcor, Tri Pointe Group and CarMax. All five stocks remain BUY-rated and we intend to maintain active coverage. Stella-Jones may be the exception, as the recent change in management has caused us to consider an exit strategy.

We added to Berkshire Hathaway, Enbridge, BCE and Rogers Communications.

COMPANY	PRE-TRADE SHARES	PRE-TRADE WEIGHT	BUY (SELL)	POST-TRADE SHARES	POST-TRADE WEIGHT
Berkshire Hathaway (BRK.B)	700	2.7%	350	1,050	4.0%
The Howard Hughes Corp. (HHC)	1,125	2.7%	(700)	425	1.0%
Weyerhaeuser Company (WY)	4,600	2.3%	1,375	5,975	3.0%
Air Products (APD)	325	1.4%	(325)	0	0.0%
Stella-Jones (SJ)	3,000	1.6%	(3,000)	0	0.0%
Enbridge (ENB)	2,600	1.6%	2,150	4,750	3.0%
ShawCor (SCL)	2,700	0.6%	(2,700)	0	0.0%
XPO Logistics (XPD)	1,850	2.4%	(1,075)	775	1.0%
Colfax Corporation (CFX)	2,300	1.2%	1,675	3,975	2.0%
Amazon.com Inc (AMZN)	110	3.7%	(50)	60	2.0%
CarMax (KMX)	1,000	1.6%	(1,000)	0	0.0%
Starbucks (SBUX)	2,200	4.0%	(1,100)	1,100	2.0%
Restaurant Brands International (QSR)	2,000	2.8%	(575)	1,425	2.0%
Dollarama Inc. (DOL)	3,500	2.5%	(725)	2,775	2.0%
TRI Pointe Group (TPH)	8,550	2.3%	(8,550)	0	0.0%
Visa Inc. (V)	1,200	4.1%	(475)	725	2.5%
Constellation Software (CSU)	175	3.2%	(65)	110	2.0%
BCE (BCE)	2,000	1.8%	800	2,800	2.5%
Rogers Communications (RCI.B)	1,600	1.5%	1,100	2,700	2.5%

This table does not include all of the companies held in the Odlum Brown Model Portfolio and only reflects the changes made as of September 2019.

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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.

Kay Meek Arts Centre West Vancouver, BC

Odlum Brown is pleased to return as the 2019/2020 Play Series sponsor, supporting five laugh-out-loud productions from across Canada. The Kay Meek Arts Centre has been a pillar for the performing arts in West Vancouver for 15 years. Passionate about supporting the communities where we live and work, Odlum Brown is proud to support the inspiring and inclusive space that Kay Meek has created, offering great arts experiences and cultural expression in its many forms. For more information, visit kaymeek.com.

Managing Longevity Risk

With many senior Canadians fearing that they may outlive their retirement funds, a recent focus has shifted towards managing longevity risk. Annuities have a long history of providing guaranteed lifetime income that you cannot outlive and are often used to manage the concerns regarding guaranteed income and longevity risk. With this in mind, two new annuity options have been proposed in the March 2019 Federal Budget to help consumers. If approved, the annuity options would be available for consumers starting in 2020.

Proposed New Annuity Options in the 2019 Federal Budget

Advanced Life Deferred Annuity (ALDA)

- Registered Retirement Savings Plans (RRSPs)
- Registered Retirement Income Funds (RRIFs)
- Defined Contribution Registered Pension Plans (RPPs)
- Deferred Profit Sharing Plans (DPSPs)
- Pooled Registered Pension Plans (PRPPs)

Currently, tax rules for these types of registered funds require they be converted into an income vehicle starting no later than the end of the year in which the owner/member turns age 71. The proposed option for an Advanced Life Deferred Annuity (ALDA) would allow for a further deferral of income, as the commencement of the "annuity" could be deferred up to the end of the year in which the annuitant reaches age 85.

Another benefit would be that the value of the funds used to purchase an ALDA would not be included in the calculation of the required minimum withdrawals, based on the amount held in individual RRIFs and or a member's pension funds.

The value or amount available to transfer to an ALDA will be limited to 25% of the registered account value (at the end of the previous year, plus any amounts already used to buy an ALDA in the previous year) and a comprehensive or overall lifetime limit will initially be set at $150,000 from all qualifying plans. The lifetime ALDA dollar limit will be indexed to inflation after 2020 and rounded to the nearest $10,000. Excess contributions would be subject to a 1% per month penalty tax and the annuity cannot provide other benefits such as commutation, cash surrender payments or payments under a guarantee period.

Variable Payment Life Annuity (VPLA)

This option will only be available to members of defined contribution Registered Pension Plans (RPP) and Pooled Registered Pension Plans (PRPP). The current options for members of these plans are to:

- take variable benefits from the plan;
- transfer the balance to a locked-in RRSP or RRIF; or
- purchase a life annuity from a licensed annuity provider, usually an insurance company.

The proposed changes will allow members of the pension plan (RPP or PRPP) to obtain a Variable Payment Life Annuity (VPLA) directly from the plan. As the name would suggest, income payments of the VPLA will vary depending on the investment performance of the underlying fund assets and the mortality experience of the VPLA annuitants in the plan. Plan members will only be able to acquire a VPLA by transferring money from their existing PRPP or defined contribution RPP. VPLAs are not available for purchase directly by consumers and a number of rules will apply to this type of plan.

For more information, contact your Odlum Brown Investment Advisor or Portfolio Manager.

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