F&A Managed Accounts

QUARTERLY REPORT

Third Quarter Highlights

Our portfolios had a solid quarter in Q3, as we were rewarded again for not being overly cautious.

Without a good client relationship, it's hard to stay on track when the waters get rough.

The rising Canadian dollar created a bit of a headwind, as it devalued our non-Canadian investments, while another headwind was the relatively soft Canadian stock market. However, the buoyant US stock market saved the day, with health care stocks leading the way.

You will hear us talk a fair bit about our decisions on how much we should or shouldn't be in the US stock market. That's because we think it's one of the big decisions that we, as your portfolio managers, have to make. If we buy the wrong technology stock, the damage to our client accounts will be minimal. If we get the Canada/US decision wrong, it could amount to a serious setback.

For now, we still think it's okay to be slightly overweight the Canadian stock market. We don't think the Canadian dollar is going to go much lower, we are positive on commodity prices, and we don't think the global economy is on the verge of a crisis.

One area where we are quite cautious is bonds. While the march higher in interest rates hasn't been fast, it has been persistent, with 10-year US rates more than doubling since mid-2016. If we're right about this, it will put pressure on bonds, which is normally a meaningful holding in most portfolios.

	2018 Q3	12 Month Returns
Portfolio**	0.95%	6.82%
S&P/500*	-1.26%	2.80%
XBB	-1.69%	-1.31%
MSCI	2.74%	12.99%

*The S&P500 Index (SPX) is a capitalization-weighted index of large-cap U.S. equities; the IShares Core Canadian Universe Bond ETF (XBB) is an open-ended mutual fund trust; the MSCI World Index is a free-float weighted equity index. These are not investable indices and as such are not a direct comparison to an investment in the Foster Managed Account program, and should therefore be considered hypothetical in nature and for illustrative purposes only.

So, one of our challenges ahead will be to find instruments that provide a solid income stream, like bonds do, without losing us money as can happen to bonds when interest rates rise. That has made us consider some bond-substitutes, such as alternative lenders, arbitrage funds, and Floating Rate Notes (see page 4 for a quick primer on these out-of-favour instruments). These products will allow us to be fully invested without risking the farm by being 100% in the stock market.

UNDER NEW MANAGEMENT

You may have already noticed the new format and the new logo. What you may not be aware of is that our Managed Accounts division is under new management. Ron Riley is our new Managing Director responsible for all managed portfolios at the firm as well as being the new Team Leader.

Even more important than the experience that he brings from a number of distinguished Bay Street firms, Ron brings with him strong views on how to build wealth for clients. Readers who continue to watch this space will quickly gain an appreciation for his buoyant optimism about investing for the long haul, his impatience with over-diversification, and his strongly held belief that relationships matter – not just because they are good for business, but because without a good client relationship, it's hard to stay on track when the waters get rough.

RON RILEY MANAGING DIRECTOR, PORTFOLIO MANAGER

*** DISCLAIMER: Net returns are stated in Canadian dollars and are the actual returns of the first portfolios in our F&A Managed Account Program (the Model Accounts). The current quarter and 12 month return percentage for our FMAC (Foster Managed Account Composite) represents the composite performance of all accounts managed under the program formerly known as FIQ, which forms the basis for the new Foster Managed Account Program. These accounts are charged a 1% per year management fee, accrued monthly (standard on investments over C$ 1.0 mil). Different portfolios' performance in this program will be higher or lower than the above reported performance of the program depending on several factors, such as fee levels, starting point, investment amount, asset allocation, government taxes (if any).*

What's Next?

Briar Foster
is the founder and former CEO/Chairman of Foster & Associates Financial Services Inc (Foster), and remains a Board Member of FAFS Holding Corporation, the parent company of Foster.

The financial markets are clearly in a transition phase. Interest rates are rising. Oil prices have rallied. The FANG stocks have shed more than a few of their nervous holders. In general, equities are down 10%. Mercifully, we are no longer suffering daily updates on USMCA (originally the NAFTA) negotiations, but President Trump's bullying strategies have turned to the trade negotiations with China. It now appears that U.S-China trade issues are likely to hover over the next phase of the financial markets. Maybe longer.

Looming are the midterm election in the United States. The polls indicate the Democrats will take back control of the House of Representatives, and just maybe the Senate, creating a likelihood of gridlock between the White House and Congress. Perhaps not such a bad thing, but this could prove a distraction over the next month.

More certain is Canada's coast-to-coast-to-coast legalization of marijuana on October 17th. According to a recent study by The C.D. Howe institute, at the outset of legalization there will be a shortage of weed, leaving the illegal market dominant and a significant shortfall in the anticipated tax revenue for the provincial and federal governments. If the weed launch is somewhat disappointing, the investors in cannabis stocks may feel pain. But not to worry. Once oils and edibles are added to the menu sometime in 2019, the industry will be on track to rival alcohol and tobacco, and to be taxed accordingly. Obviously, the prime unspoken reason for weed legalization is the addition of a third robust source of sin tax revenue.

The next phase of the equity markets will crave new leadership. The FANG stocks plus Tesla have shown serious signs of fatigue. In the weeks ahead, some new names, or old names with new faces, will emerge. A prime source of industries providing new names is the needs of seniors. In healthcare, there is an acute shortage of residences for ailing seniors and a growing demand for over-the-counter health products. The ageing population also wants travel, entertainment, and dining at medium-priced restaurants.

As urban centers morph into virtual no-parking zones, the demand will grow for environmentally pristine public transportation and the noisy, polluting trucks of the past will run on batteries or hydrogen fuel cells rather than diesel.

Banks, automobile companies and department stores are no longer growth stories. On the other hand, insurance companies, hardware stores and pharmacies have brighter futures. While rising interest rates aid bank earnings, the need for all those branches has shrunk. Years past many people went into their bank quite often, maybe just to fill their fountain pens. They got to know some of the staff and would someday buy traveler's cheques, take out a car loan or open an account for their daughter. For most millennials, their credit card and smart phone are their bank, so I anticipate some discomfort as banks deal with the death of their branch networks.

Department stores have had serious trouble surviving against the likes of Amazon. Shopping from home is a new form of recreation. As to automobiles, while it's popular to trash-talk those lazy millennials, they are smarter than I was way back when. They realize a car is a terrible liability. Most would rather rent, use Uber or take the bus.

For investor in pursuit of greater potential for their capital, there are the emerging economies. India seems to have exciting growth potential, based on a rapidly growing middle class within an enormously creative culture. Add to that a social cauldron of great complexity and a political administration that it seems is only sometimes is charge, you have a dynamic culture that could one day rival the most vibrant economies on the planet. I have never been to India and have no plans to travel there. However, from what I hear and read, the investment potential there is an unusual opportunity.

Bottom line, as I peer into the misty future, I continue to see lots of opportunities. Yet I am confident that investors would be well served by showing some skepticism about some ageing trends, and to start thinking about some new stories. *October 2018*

The views as articulated in this article are those of Briar Foster alone and do not necessarily reflect the opinion of Foster, and do not constitute a solicitation to engage in any specific investment or strategy.

Our core beliefs

As your fiduciary, we have a deep sense of responsibility, act with good faith and loyalty and provide full and fair disclosure of all material facts.

Relationship First

Your portfolio begins with the professional relationship we have with you. To construct a portfolio consistent with your values, goals and objectives, we need to understand what makes your relationship with us unique. To do that, we specialize in thoughtful discussion with you; we are available to answer questions, provide input and discuss options. Our job is to guide you through the investment planning process as often as you need.

As your fiduciary, we have a deep sense of responsibility, act with good faith and loyalty and provide full and fair disclosure of all material facts. You will hear from us regularly, on an ongoing basis, to help you understand what is going on in your portfolio, and why, so that you feel comfortable with it. As your situation changes over time, your portfolio may also need to change – so we periodically reassess your needs.

Portfolio Engineering

Using a top-down asset allocation model first, with economic, political and sentiment drivers, tailored to your personal objectives, we dynamically adjust your asset allocation based on our forward-looking market views. We believe the vast majority of long-term portfolio returns are attributable to allocating between the Foster Four asset classes and when to shift between them.

> **Canadian Stocks** – Canada makes up less than 5% of the global stock market and is not very well diversified – that said, we are asked to measure the performance of your portfolio in $CAD, so when considering individual companies for your portfolio will always look to Canada first to eliminate currency risk.
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> **US Stocks** – the largest, best diversified stock market in the world with great liquidity and the largest companies in the world with global diversification. To get appropriate sector diversification we include US stocks in your portfolio.
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> **Fixed Income** – traditionally the lower risk asset class that provides predictable fixed dollar returns and protection in the event of market selloffs.
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> **Alternative Results** – particularly in low risk interest environments, these generate stable, non-correlated returns for your portfolio similar to large scale, institutional investment management firms.

For both Canadian and US stocks, we use a proprietary, largely quatitative, multi-factor selection model to screen for stocks that are likely to outperform in your portfolio. This provides a disciplined system to avoid common behavioural pitfalls and help identify successful companies. For Fixed Income and Alternatives we use both exchange traded funds and outside managers to get appropriate diversification and thematic overlays to dampen the overall volitility of your portfolio and enhance real returns in excess of inflation.

At the core, we believe an active, disciplined, balanced approach built on a professional relationship will deliver long-term outperformance.

Float Away

If you think that interest rates are heading higher, but you DON'T think the economy is perched on a precipice, then FRNs may be just the ticket.

It's been a very long time since we have seen much point in talking about Floating Rate Notes (FRNs), but we think the time has come to think about them more seriously. But first, a quick primer:

- FRNs are a kind of bond but unlike regular bonds the interest rate that they pay goes up and down with short-term interest rates (that's the 'floating' part).
- FRNs are usually issued by companies, not governments, so if the economy goes into crisis, the price of these notes can go into crisis too, if it looks like the company may not be able to pay them back.
- The big appeal of FRNs is that they don't plunge in price when interest rates rise, which can happen with bonds or notes that have fixed (not 'floating') interest rates.

So, if you're like us and you think that interest rates are heading higher, but you DON'T think the economy is perched on a precipice, then FRNs may be just the ticket.

Individual FRNs can have complex terms to them. They can have a maximum or minimum interest rate they pay, they can be callable by the issuer, and they can be irregular in the way they reset the interest rate they pay.

For these reasons, we prefer to buy FRNs through an ETF, and at the moment our favorite is from BMO, the High Yield Floating Rate ETF (ZFH on the TSX).

F&A MANAGED ACCOUNTS

Ron Riley
Portfolio Manager
416.369.3194
rriley@fostergroup.ca

Helen Altimari
Investment Representative
416.369.3204
haltimari@fostergroup.ca

Frankie Liu
Quantitative Analyst
416.363.2962 ext 2006
fliu@fostergroup.ca

Foster & Associates Financial Services Inc.
372 Bay Street, Suite 1100, Toronto, Ontario, M5H 2W9 Main:416.369.1980 TF 1-800.559.8853 www.fostergroup.ca