F&A
FOSTER & ASSOCIATES

# Quarterly Report

Third Quarter Report 2020

# The Model is Broken

*The problem isn't really that bonds don't go up when the stock market goes down... the problem is more that they just don't move very much.*

Deciding how much you should own in stocks is never an easy decision, regardless of your age. Owning just stocks can make for gut-wrenching ups and downs in your portfolio, but owning just bonds won't provide enough growth. How to properly balance the two is a question that investors grapple with every day. Which is why people find simple asset allocation models appealing.

One of the most popular models is the 60/40 model, which says you should have 60% in stocks and 40% in bonds, and you should periodically rebalance. Many balanced funds that use variants of this model rebalance quarterly. So, after quarters such as the one just passed, when stocks have made small gains and bonds have been unchanged, there will be some 'rebalancing' activity in the market at the beginning of the following quarter. That means these balanced funds will sell some stocks (to get back to 60%) and reallocate that money to bonds.

But there is truly nothing magic about 60/40. In fact, investors of a certain age may remember 70/30 being considered a more appropriate target for balancing the risks of stocks and bonds.

Sadly, the last twenty years have piled regulation and complexity on top of this simple rule of thumb. Quite rightly, it's now not just a matter of figuring out what the right mix is, it's figuring out what the right mix is for the specific investor, in light of their age, health, risk appetite, among other things.

One of the earliest ways to make this model sensitive to the age of the investors was the 100-year model. You simply went 100 less the investor's age, and that was the recommended percentage you should own in stocks.So the older an investor got, the less value in stocks they would own.


*ICE BofA Move Index. Source: Bloomberg

These simplistic models have become received wisdom in the investing universe. This is a problem. No portfolio manager, or investment advisor, or estate trustee, will ever lose their job for using a model such as this to guide their decision on how much stocks to own for a particular investor. Even if it is absolutely the wrong thing to do.

| | | 2020 Q3 | 12 Month Returns |
|---|---|---|---|
| S&P/TSX* | 16121 | 3.9% | -3.2% |
| S&P 500 | 3363 | 8.5% | 13.0% |
| Dow Jones | 27782 | 7.6% | 3.2% |
| Nasdaq | 11168 | 11.0% | 39.6% |
| $CAD | $0.7507 | 1.9% | -0.6% |
| Crude Oil | $40.22 | 1.4% | -36.6% |
| Gold | $1,885.80 | 5.9% | 28.1% |

** The S&P/TSX, the S&P500, the Dow Jones and Nasdaq indices are not investable indices, and as such are not a direct comparison to any investment product available at Foster & Associates Financial Services Inc, and therefore should therefore be considered hypothetical in nature and for illustrative purposes only.*

We have already felt rumblings in the market, hinting that bonds are no longer a great counterweight to stocks. One doesn't have to look much further than the recent COVID-inspired correction. While in Q1, the total return on the TSX Index was a negative 21%, the bond market was almost exactly unchanged. True, bonds at least held their value, but an investor might as well have been in cash.

The same worrisome sign is being witnessed during the current correction, which at the September month-end has Canadian stock prices down some 4% from the August highs. Once again, bonds are steady to lower in the same period. Their much-heralded value as a buffer against the volatility of stocks has been entirely absent.

The problem isn't really that bonds don't go up when the stock market goes down. That still happens by and large. The problem is more that they just don't move very much, as shown at left. So, bottom line, on top of microscopic yields, bonds aren't doing their job of zigging when your stocks are zagging.

Back in the fourth quarter report of 2019 we referenced how we were worried about the looming obsolescence of the bond market and recommended the consideration of alternative investments as a possible replacement.

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This idea has proven to be a good one, though there were certainly some nervous moments during the February sell-off. While our favourite Private Equity investments and Multi-Strategy hedge funds did well, we were very worried that our alternative lenders, such as Mortgage Investment Companies or Private Debt funds, would buckle under the crippling dislocations caused by the near-total lockdown of the Canadian economy.

However, despite facing a sudden flurry of redemption requests from nervous investors, by and large these funds have managed to prosper through the period. One dark patch has been REITS, where work-from-home directives have punished commercial property prices, rents, occupancy levels, and ultimately the price of the REITS themselves.

A seasoned investor could be forgiven for hankering for the days when the bond market would reliably provide high single-digit yields and would equally reliably go up in value every time the stock market wobbled.

But until that time comes around again, investors need to be open to these bond market substitutes. Granted, they may bring some complexity, and they may be more difficult to buy and sell. But compared with either owning too much in stocks, or owning too many bonds that yield almost nothing, these alternative investments are quickly proving they are worth the effort to understand.

**Christopher Foster, CEO and Portfolio Manager**

## The 12-Month Market Outlook

| | |
|---|---|
| Stocks (U.S.) | ▲ |
| Stocks (Canadian) | ▲ |
| Bonds (US) | ▼ |
| Bonds (Canadian) | ▼ |
| Canadian dollar | -- |
| Crude Oil | -- |

This table represents the way the firm is leaning in particular market sectors over the next 12 months. It does not represent a trade recommendation, nor does it play a major role in our portfolio construction, which involves much more than having a view on a particular market index, currency or commodity.

# Critical Illness Insurance for Children

Critical Illness Insurance is designed to assist families in dealing with the financial impacts of being diagnosed with, and surviving, one of the covered illnesses. It's not just adult illnesses that can cause financial hardship to a family. A sick child can cause loss of family income as one parent becomes a full-time caregiver, and it can also mean significant unexpected expenses.

Children diagnosed with cancer and other child specific illnesses have been increasing year after year. According to data published by Juvenile Diabetes Researach Foundation on Type 1 Diabetes (Juvenile Diabetes) "Nationally, the average incidence rate has been growing at an estimated 5.1% per year – higher than the global average"[1].

Childhood cancer, still relatively uncommon, remains the most common disease-related cause of death, second only to injury-related deaths among Canadian children. Cancer, a disease that can involve extended and costly periods of treatment times and overwhelming emotional stress, has been increasing in children.

Too often parents are faced with the decision – do I take a leave of absence to care for my child or continue working to pay expenses, expenses that increase with a sick child, or seek help from my support network.

The financial and personal pressures of dealing with a sick child or a child diagnosed with cancer, congenital heart disease, Type 1 Diabetes, Cerebral Palsy, Cystic Fibrosis, MS or other childhood diseases, can be immense. Loss of employment, financial distress, and in extreme situations loss of home and/or family break-up, can result.

When planned and structured properly, Critical Illness coverage can protect families and ensure parents have options available to care for children diagnosed with over 26 illnesses, 5 of them specifically child-related. Once paid for, the policy can never be taken away. A Critical Illness policy can be kept in force and given to your child to form part of their financial foundation.

Foster wealth advisors work with clients to shelter them from market volatility and to create options to help deal with unplanned life events. Ask us about our various insurance options.

**Howard Schwartz, MBA, CPA, CMA,**
**Vice President, Wealth Management**

*Howard supports the Advisor Team at Foster & Associates to help customize insurance solutions for their clients.*

[1] DIAMOND Project Group. Incidence and trends of childhood Type 1 diabetes worldwide 1990- 1999. Diabetes Med. 2006;23 (8): 857-866.

# Political Intrusion

**Briar Foster**
*is a retired Portfolio Manager and remains an active investor.*

For investors, the most serious concern immediately ahead is the U.S. election on November 3rd. Unfortunately, it is unlikely the election results will be confirmed on election night as it may take several days for the mailed-in ballots to be counted. Worse, there will likely be sufficient real and imagined irregularities to delay an election result, giving us a potential replay of the litigation at the conclusion of the Bush/Gore election twenty years ago.

The problem for investors is how to formulate an investment strategy that does not simply ignore the mounting political uncertainty. Of course, uncertainty can often create opportunities. Sadly, in this case, the opportunity may occur before, immediately after, or never, depending on the result. A better approach may be to focus on the things that will remain mostly unaffected by the results of the election.

Firstly, interest rates aren't going anywhere. Absent an effective vaccine, COVID-19 will remain with us until there is a unified effort to eliminate it. Whichever party wins the election will be spending large amounts of borrowed money to support those still in need and to give a boost to those enterprises on the brink of failure. We also know that central bank interest rates will remain near zero because the central bankers are committed to supporting the recovery.

Second, banking will remain troubled. The loan losses of the banking industry may slowly recede, but the interest-rate spread is too narrow to add much to their top and bottom lines. Lingering trouble spots will haunt profitability for years to come. Commercial real estate and condos are in over-supply. Retail stores, including restaurants, are going through a transition that entails significant changes in the way they do business. Fear of travel seems slow to dissipate.

Finally, energy will remain a no-go zone for a while due to climate change concerns. Without environmental considerations, the fossil fuel industry has a long list of projects that would significantly hasten the economic recovery. But the fires on the west coast, the hurricanes on the southern and southeast coasts are grim reminders of a generally accepted commitment to reduce GHGs emissions. Intensifying the cultural divide within the United states, President Trump remains one of the most prominent climate change deniers left standing.

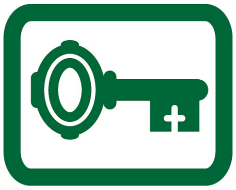
Investors could be forgiven for feeling like the election, COVID-19 and climate change are all conspiring to cripple economic activity and to further deepen the cultural divide within the United States. But a conspiracy requires a criminal purpose. The only discernible purpose here is to test the resilience of a great nation.

Bottom line, given the high level of uncertainty we are faced with, diversification may offer only limited protection. Investors need to be extremely selective in their choices as well as maintaining a strong defensive component. While this may be frustrating, we must recognize that when the ugly uncertainty of politics permeates economies, markets go from being difficult to being extremely chaotic.

*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

What defines the culture of a firm is what stays consistent no matter what's going on in markets. Politics, market trends, and the business cycle will cause us to think different about the way we invest our clients' money. However, there are a few things you can count on from us, through good markets and bad, through recessions and buoyant recoveries:



## Asset Allocation is Key.

While some individual securities will do well, and some less well, most of what will make or break your portfolio over time is asset allocation. Of course, we all remember our great buys, and mourn our missteps, but the key to how well you do in the markets will come from how much you owned of various asset classes, and when you owned them.

## We Love Canada.

But it's not where we want to put all your money. The Canadian stock market is heavy on banks and resource companies, making true diversification hard to achieve. Venturing abroad can improve returns and lower volatility. You'll also find companies where Canada isn't as strong, such as in consumer staples and biotechnology.


## Alternatives aren't that Scary.

Sure, some hedge funds can be dangerous, but there's more to the Alternatives space than hedge funds. There's private debt, real estate, infrastructure and market-neutral funds, all of which can provide a place of refuge during periods of excessive market volatility.


## Costs matter a Great Deal.

Over time, even small increases in costs can significantly lower returns. If you pay us to manage your money, we will pinch your pennies for you.

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