WEALTH

April 14, 2015

A monthly commentary on personal finance and investments, by Randal van Eijnsbergen

March Monthly Returns:			CAD		0.7893	0.3%	Cdn 30-yr	1.98%	3.13%
TSX Comp	14,902	-2.2%	Gold	$	1,184	-2.3%	US 30-yr	2.54%	-1.6%
S&P 500	2,068	-1.8%	Oil	$	47.47	-3.7%	VIX	15.28	11.0%

Personal Wealth Management

Time to Switch the Shotgun for the Sniper Rifle

There has been much written about the power of Exchange Traded Funds (ETFs) and other forms of passive investing recently. The result has been massive asset outflows from managed mutual and hedge funds into index-following ETFs. The recent trend towards robo-brokers even takes that one step further.

It has been argued by those more learned than I, that when the masses latch onto an idea, it is usually time to do the opposite. Barry Schwartz, one of my favourite PMs just said: *"As the popularity of indexing grows, the correlation risk increases as everyone owns the same. Active management becomes less risky."* Indeed, the U.S. stock market indices have enjoyed a persistent, steady upward trend over the last few years and have outperformed many actively-managed portfolios. According to an article in the Wall Street Journal, in 2014 investors yanked $99 billion out of U.S. stock mutual funds and put $71 billion into passive, index-tracking investments. With lower costs, passive investments do outperform many more-expensive active ones in a broad bull market. Some articles suggest ETFs beat as many as 90% of mutual funds. However, an article by Rob Isbitts in MarketWatch studied numerous time periods and found that during the 15 years prior to 2014, indices outperformed 71.5% of its peers on average during bull markets but only 36% of its peers on average during bear markets.

One look at relative valuations and it becomes obvious that index constituents, on average, demand higher multiples than those not included in any index. This is especially true in a well followed one such as the S&P 500. Considering many EFT investors are what the market rudely refers to as "dumb money," or investors who will be easily influenced by their emotions, how do you think they will fare in a bear market? Poorly.

There are a few things I would take away from these pertinent observations:

1. Do your research to know what you are invested in.
2. ETFs are better for offence (bull markets) than defense (bear markets.)
3. Favour ETFs that bring unique investment strategies that will not simply lump their holdings in with an index, but add a proprietary angle or strategy. (See Top Pick below.)

4. Don't follow the herd for too long, and if you do, don't be greedy.

Me? I'll give my broad-based conservative money to John Thiessen, Matt Shandro, Andrew McCreath or the fellas at Connor Clark & Lunn any day. For individual ideas, I am bringing out a 12-foot long Remington with a scope nicknamed Hubble!

Markets

This sideways-trading year so far, is experiencing another up-leg post-March. Commodities also remain range-bound while the USD remains strong and interest rates low. There is modest deflation in Europe and modest inflation in North America due to strong job numbers.

Strategy:

I thought I would share excerpts from a speech made by Stanley Druckenmiller, an ex-Soros sidekick and one of the best investors of all time. From a speech in January 2015:

"The first thing I heard when I got in the business, not from my mentor, was that bulls make money, bears make money and pigs get slaughtered. I'm here to tell you I was a pig, and I strongly believe the only way to make long-term returns in our business that are superior is by being a pig. I think diversification and the stuff they're teaching at business school today is probably the most misguided concept everywhere.

"And if you look at all the great investors that are as different as Warren Buffett, Carl Icahn, Ken Langone, they tend to be very, very concentrated bets. They see something, they bet it, and they bet the ranch on it. And that's kind of the way my philosophy evolved, which was if you see – only maybe one or two times a year do you see something that really, really excites you.

And if you look at what excites you and you look down the road, your record on those particular transactions is far superior to everything else, but the mistake I'd say 98% of money managers and individuals make is they feel like they have got to be playing in a bunch of stuff. And if you really see I, put all your eggs in one basket and then watch the basket very carefully."

"…Never, ever invest in the present. It doesn't matter what a company's earning, what they have earned. You have to

visualize the situation 18 months from now and whatever that is, that's where the price will be, not where it is today. … If you invest in the present, you're going to get run over."

"… Earnings don't move the overall market; it's the Federal Reserve Board. And whatever I do, focus on the central banks and focus on the movement of liquidity, while most people in the market are looking for earnings and conventional measures, it's liquidity that moves markets."

"… I learned something incredibly valuable from George Soros and that is when you see it, to bet big. … He was running his personal account and focusing on philanthropy. I was running Quantum and I'd say 90% of the ideas we were using came from me and it was very insightful and I'm a competitive person, frankly embarrassing, that in his personal account working about 10% of the time he continued to beat Quantum while I was managing the money. And again, it's because he was taking my ideas and he just had more guts. He was betting more money with my ideas than I was."

Stanley goes on to describe how after unification in 1992, Germany really did not want inflation again and was raising rates, while at the same time Britain's economy was looking weak. So he went short the British Pound with $1.5B of Quantum's $7B… A month later the head of the Bundesbank confirmed his bias by denouncing the Pound.

"… So I go into the office at 4:00 and I said, "George, I'm going to sell $5.5B worth of British Pounds tonight and buy Deutsche Marks. Here's why I'm doing it, that means we'll have 100% of the fund in this one trade." And as I'm talking, he starts wincing like what is wrong with this kid, and I think he's about to blow away my thesis and he says, "That is the most ridiculous use of money management I' ever heard. What you described is an incredible one-way bet. We should have 200% of our net worth in this trade, not 100%. Do you know how often something like this comes around? Like once every 20 years. What is wrong with you?" So, we started shorting the British Pound that night. We didn't get the whole $15B on, but we got enough that I'm sure some people in the room have read about it in the financial press."

To add to the arguably wise and wild stories of an investing legend, let me mention, that among those I am fortunate to work with – a couple of whom might be considered Canadian legends – those with the greatest success have done just this. They have been highly exposed to those ideas they have very high conviction in and deep knowledge of. It did not always work out the first, or even second, time, but it did work out and when it did, it was a game changer.

Taking this perspective one step closer to implementation, what high-confidence trades, backed by central bank liquidity, appear worthy of consideration now? To support one of my principal theses, here is a Stanley Druckenmiller quote from a March 2nd Bloomberg article:

(Bloomberg) -- Stan Druckenmiller, who boasts one of the best investor track records over the past three decades, said that he expects stocks in Europe and Japan to outpace U.S. shares this year.

"I'm not all that excited by the U.S., but I do have large exposure in Japan and Europe," Druckenmiller said in an interview on CNBC. His individual European picks include carmakers Volkswagen AG and Bayerische Motoren Werke AG and Airbus Group NV, which will benefit from a weaker euro.

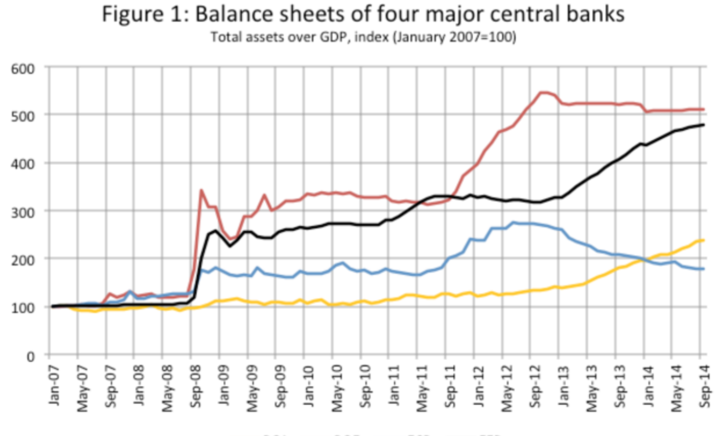
Druckenmiller, who produced average annual returns of 30 percent from 1986 through 2010 at his Duquesne Capital Management, said that Japan and Europe will get a boost from increased monetary stimulus, just as U.S. shares rallied after the Fed started buying bonds after the 2008 financial crisis. Since hitting a low on March 9, 2009, the Standard & Poor's 500 Index has more than tripled in value. Druckenmiller said U.S. equities are fairly priced.

Other money managers who expect Europe and Japan to outperform include George Soros's family office and Leon Cooperman. The head of Omega Advisors said in a letter to investors this year that anticipation of more stimulus from the European Central Bank, along with a weaker euro and expectations of solid earnings, has had an effect on sending money overseas.

So far in 2015, the wager has been a money-maker, with the Japanese Nikkei Index returning about 8 percent and Europe's Stoxx 600 Index climbing 14 percent, compared with a 2.8 percent gain in the U.S. benchmark.

From my observations Europe has been written off as a falling currency region handcuffed by major challenges such as Greece, Ukraine, a fragmented central bank, high energy costs, deflation etc… Enter the European Central Bank, which, until recently, was reducing money supply. (See blue line in Figure 1.) As they start QE and reverse that flow significantly, watch asset values increase disproportionately starting with those of the banks – which, of note, have also scared investors with recent "stress tests." With Europe being more fragmented and diverse than the U.S. or Japan – the two most recent case studies – I am not yet confident their QE will adequately stimulate their economy. However, at very least their

Figure 1: Balance sheets of four major central banks



banks should stand to benefit as the conduits of QE and immediate depositories. Therefore, I am comfortable and even excited about making an investment in European banks and positioning myself to profit from increased central bank liquidity in Europe.

Top Picks:

First Asset Hamilton Capital European Bank ETF (FHB:T $10.85) is possibly the best way to invest in European banks. Proven manager, Rob Wessel, a former #1 ranked Canadian bank analyst, has selected – and will continue to manage – 25 of Europe's banks with the best reward-to-risk profiles (see list below.) The price-to-tangible book value of the FHB portfolio is around 1X vs. 1.3X for the sector, 1.6X for U.S. banks and 2.9X for Canadian banks. This basket approach allows Rob to choose a few of the more leveraged banks for greater upside torque, while their incremental risk is offset through diversification. As a matter of fact, his largest weighting is in Italy, followed by France, Britain, Spain and then Germany. The fund is CAD hedged meaning it should be unaffected by further weakness in the Euro.

FHB % Holdings at 09/30/2014:

UniCredit SpA	6.11	DNB ASA	3.15
Barclays PLC	6.10	Credit Suisse Group AG	2.99
Societe Generale SA	5.99	Banco Santander SA	2.95
Commerzbank AG	5.17	Raiffeisen Bank International	2.91
Bank of Ireland	5.00	Danske Bank A/S	2.81
BNP Paribas SA	4.97	UBS AG	2.80
HSBC Holdings PLC	4.95	Jyske Bank A/S	2.78
Deutsche Bank AG	4.83	Alpha Bank AE	2.76
Banco Bilbao Vizcaya Argenta	4.79	Swedbank AB	2.48
Credit Agricole SA	4.43	Lloyds Banking Group PLC	2.13
Banco Popular Espanol SA	4.02	Royal Bank of Scotland Group	2.13
Banco Popolare SC	3.91	Cash and Equivalents	1.61
UBI Banca SCpA	3.66	**Total:**	**100**
Intesa Sanpaolo SpA	3.55		

Previous Top Picks:

February 2015: Avigilon, Sun Life, Manulife, Rio Alto Mining.
March 2015: AGT Food & Ingredients, Parex Resources.

Last But Not Least:

No sooner has Zinc been identified as the metal du jour** and Robert Friedland's Ivanhoe Mines pulls a staggering hole from their Kipushi mine in the Congo grading 49% Zn over 50 meters in length. Apparently an extension of their known Big Zinc zone, it demonstrates why Kipushi has been called the richest zinc copper deposit in the world. (Now if he can just get 2km deep in the Congo?!) This should make China's Zijin Mining happy. They recently bought 9.9% of Ivanhoe at $1.36 per share. (It has since retreated and can currently be bought under $0.90.)

** A recent Bloomberg article stated: "…From Africa to Ireland, zinc mines that have produced the metal for decades are now tapped out. Morgan Stanley estimates that by 2017 more than 1.2 million metric tons of annual mined supply will be taken out of production. That's more than the U.S. uses in an entire year. …"

All the best. Cheers,

Randal

Randal van Eijnsbergen
Investment Advisor and Portfolio Manager
HAYWOOD SECURITIES INC.
Direct: 604 697-7429
Cell: 604 616-9598
rvaneijnsbergen@haywood.com