BCV Asset Management Inc.

The Blue Chip Report
October 2017

Investors Are Selling Uncertainty- They Should Be Buying It

Tony Demarin, MBA, CFA, CIM, FCSI
President & Chief Investment Officer

Investors desire control, but there is very little that they can control. The price that is paid for a security and the decision to sell a security are within the investor's control. Management fees and related investment expenses are also within an investor's control. After that, an investor can only focus on buying quality companies. Everything else is uncertain. Investors get paid a return for this uncertainty, so it should be bought, not sold.

This summer has been a poor one for Canadian equity investors. In Toronto, the benchmark Standard & Poor's/TSX Composite Index spent most of the summer in a slow, steady downward march, before strengthening after Labour Day. In all, the index has risen by a modest 2.3 percent over the first three quarters of the year. In New York, the Standard & Poor's 500 Index has risen by 12.5 percent over the same three quarters, but the strengthening of the Canadian dollar has trimmed that return to 4.4 percent in Canadian dollar terms. Investors could not find shelter in bonds, a traditional safe haven, as the fear of rising interest rates led to falling bond prices.

Investors are frustrated that the economy is doing well, but their portfolios have not. The equity markets do not always perfectly track what is happening the real economy, but there is still much to be positive about:

- Corporate earnings are set to grow by double digit rates in 2017 and, for the first time in many years, there is revenue growth across many industries.
- Canada's economy continues to grow, in spite of a recovering energy sector and concerns about a slowdown in home prices.
- United States multinational companies are experiencing a lift-off in offshore earnings, powered by the weakening of the United States dollar against most major currencies.
- Industrial metal prices have risen by approximately 60 percent since January 2016. Copper, often seen as a proxy for industrial growth, has been strong.
- Manufacturers in the United States are seeing strong overseas demand for their products and Eurozone manufacturers have also experienced a significant improvement in demand.
- Economic growth has accelerated in all of the major economies.

So, if the economic future looks so bright, why do some investors feel so anxious? We believe that investors are too hyper-focused on daily events. Current topics of nervous conversation have centred around issues like North Korea, President Trump, sky high stock prices in the United States, and a market correction that is long overdue and seemingly right around the corner. We also hear from investors who are concerned that 'these times are the most uncertain they have ever seen'.

We believe that investors must accept that the only certainty about investing is that the future will always be uncertain. Buy that uncertainty, rather than sell it.

We want investors to understand that just because so much information is readily available, it does not necessarily mean that the information is relevant or actionable nor does it help to predict the future. Once we have accepted that the future is both uncertain and unknowable, only then can we focus on what really matters for long-term investors.

What really matters in investing is the things that an investor can control. At BCV Asset Management, we focus on investing in quality companies with pricing power, good balance sheets, and hard to duplicate products and services. We buy these companies at reasonable valuations. We sell them when we have a better investment idea, we realize that we have made a mistake in our assessment, or the business fundamentals are declining. We believe that our management fees are fair for the service that we provide and we only execute trades when it is appropriate for the investor.

Investing can be frustrating, but short-term thinking can hurt an investor's portfolio. Even as professionals, we deal with the same short-term uncertainty that plagues investors. For us, it is only through discipline that we can improve.

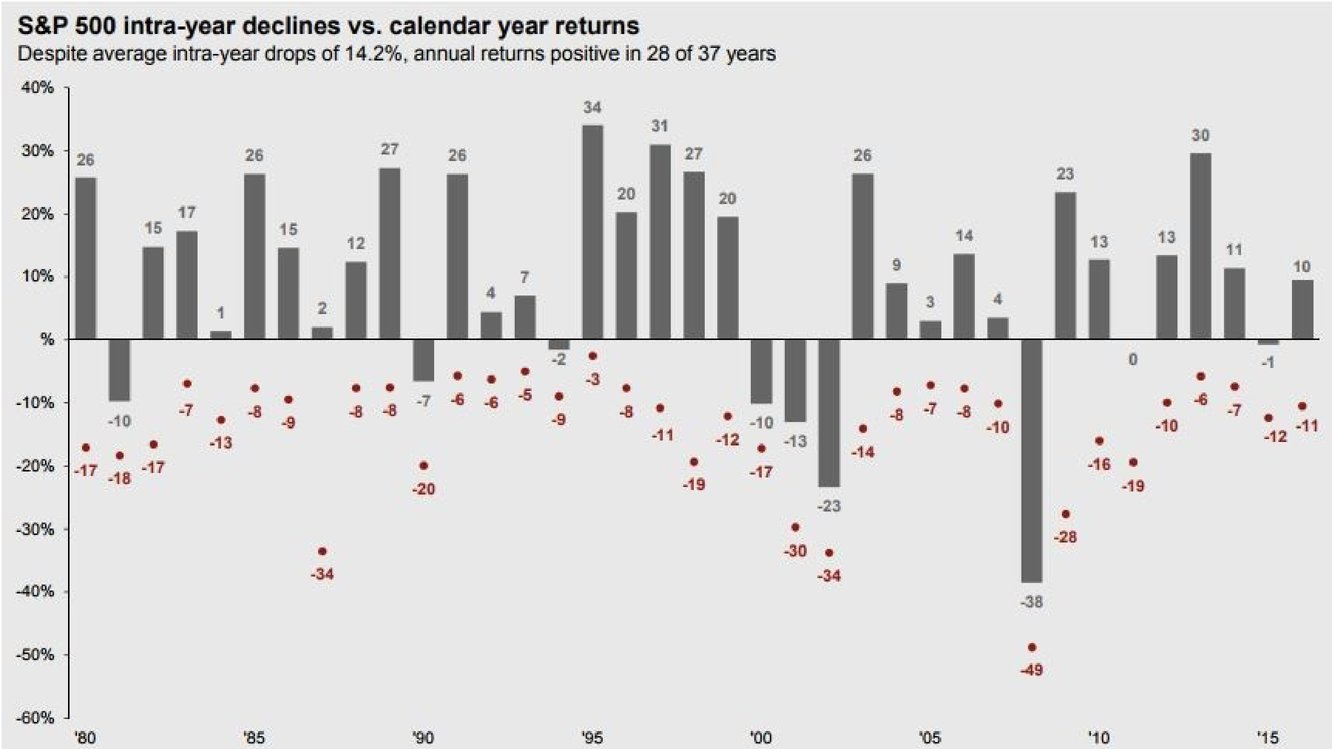
Investing- A Marathon, Not a Sprint

Chris Richard, BA, CFA
Portfolio Manager

At BCV Asset Management, we view investing as a marathon and not a sprint.

This well-worn cliché is simply another way of saying that if you buy and hold great companies, you will prosper over the long term. However, we also know that when you buy shares that are priced every second of every business day, there can be some apprehension that comes from watching financial news networks and seeing that the markets and the price of the companies that you have invested in are declining. We are fortunate to be enjoying the second-longest bull market ever recorded, with record highs being reached on a regular basis in the United States. If a client only looks at their portfolio statement on a quarterly basis, it can be easy to think that the performance has been a straight line upwards. This is not the case.

In the United States, the average return on the Standard & Poor's 500 Index between 1980 and 2016, excluding dividends, was 8.5 percent. Of course, the problem with averages is that they often provide a headline, but overlook the details. Below is a bar chart showing the annual performance of the S&P 500 with the annual returns above the bars and the largest annual drawdown in that year below the bar in red. Within those thirty seven years, the index had twenty eight years with positive returns, eight years of negative returns and one flat year. However, as the chart below shows, each of the thirty seven years had a drawdown of some significance. These drawdowns, which refer to the largest market drop from peak to trough within a year, averaged 14 percent during that period.



Source: FactSet, Standard & Poor's

Although we are the midst of a long-running bull market, drawdowns are still both significant and frequent. The chart below, which looks at drawdowns from peak to trough since 2010, shows a drawdown in every year, with many of them being 10 percent or worse.

Source: FactSet, Standard & Poor's

Twenty Year Returns by Asset Class United States (1997-2016)	
Asset Class	Return
Domestic Equity	7.7%
Gold	5.9%
Fixed Income	5.3%
International Equity	4.2%
Crude Oil	3.7%
Real Estate (Homes)	3.2%
Average Investor	**2.3%**
Inflation	2.1%

Source: Blackrock Inc.

Blackrock Inc., the world's largest asset management company, looked at returns earned by the average investor over the past twenty years and found those returns to be pretty dismal. For every major asset class- stocks, bonds, international stocks, gold, oil and real estate- the market outperformed the average investor. The average investor barely managed a return that was greater than the rate of inflation.

These results lead to the question of why the average investor has underperformed by such a large amount. The answer comes back to behavioral finance, a fancy way of saying that investors tend to sell at the wrong time, often selling only when the market has declined and then failing to reinvest to participate in the subsequent rebound. As the performance of the Standard & Poor's 500 Index shows, events that test an investor's fortitude occur frequently and the size of the reversal is often large. We firmly believe that it is impossible to time the market with anything other than luck and that when the market corrects, this should be viewed as an opportunity to outperform. While it never feels good to participate in a down market, the worst thing that an investor can do is to exit the market.

Diversification- When Less is More

Michelle Smith, B.Comm (Honours), CFA
Portfolio Manager

Diversification is a term used frequently in the financial industry. We have all heard it, but what exactly does diversification mean? In the investment world, diversification is defined as the reduction of non-systematic risk by investing in a variety of assets. In other words, by investing across various assets, the risk associated with any one single asset is greatly reduced. When one investment is underperforming, the portfolio is insulated by the performance of the other, uncorrelated investments.

To achieve ultimate diversification, an investor would have to own everything. However, owning everything is unworkable, but some degree of diversification is undoubtedly a good thing. Like most things in excess, there is a point where you can have too much of a good thing. Peter Lynch, famous for producing an annual return of 29.2 percent over 13 years while managing the Fidelity Magellan Fund, coined the phrase 'diworsification'. It is the concept of diminishing marginal returns, where adding another investment to a portfolio to diversify away risk also minimizes and dilutes the best-performing investments.

At BCV Asset Management, we believe that some level of diversification is crucial to constructing a portfolio, but it is not the driving concern. To us, it does not make good investment sense to over-diversify and be similar to the broad markets, which inherently include mediocre stocks, simply to reduce risk. Instead, we believe that the best way to reduce risk is to thoroughly and intimately understand the companies in which we invest. It takes time and dedication to perform a deep analysis on a company, which is why we manage concentrated portfolios comprised of a limited number of companies. By narrowing our focus to our best investment ideas, we develop strong conviction and comfort investing in these companies.

Warren Buffett, an eminently successful long-term investor, is a big proponent of portfolio concentration. He has said, 'it is okay to put all of your eggs in one basket, as long as you watch that basket very carefully'. We do exactly that. We believe in some diversification, but by focusing on the limited number of companies in which we invest, we are making only the most compelling investments. We only invest in high quality companies with strong fundamentals and because we truly understand the company, we are confident that it will generate growth of income over the long term. We follow these companies closely to maintain our deep understanding and to ensure that our original investment thesis remains intact. By doing so, we see to minimize risk, while maximizing long-term returns.

Recent Dividend Increases

Canada

Third Quarter 2017
Bank of Montreal: 90 cents (88 cents)
Canadian Western Bank: 24 cents (23 cents)
National Bank of Canada: 58 cents (56 cents)
Saputo Inc.: 16 cents (15 cents)
TELUS Corporation: 49.25 cents (48 cents)

Fourth Quarter 2017 (Pending)
Canadian Imperial Bank of Commerce: 130 cents (127 cents)

United States

Third Quarter 2017
Bank of America Corporation: 12 cents (7.5 cents)
Bank of New York Mellon Corporation: 24 cents (19 cents)
FedEx Corporation: 50 cents (40 cents)
Medtronic Inc.: 46 cents (43 cents)
United Technologies Corporation: 70 cents (66 cents)
Wells Fargo & Company: 39 cents (38 cents)

Fourth Quarter 2017 (Pending)
None

Dividend Increases reported in domestic currency of common shares, except where noted.
* Dividend paid in USD.
Source: Bloomberg LP