The Blue Chip Report
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What If The Markets Decline?

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The investment managers at BCV Asset Management do not spend their business days worrying about a market correction. They know that it will eventually come, as will a bear market.

Long-term investors will not be permanently impaired by a market correction. Market timers, momentum investors and active traders, believing that they can sell at the top and buy at the bottom despite quantitative evidence to the contrary, will almost always fail with this strategy. A well-constructed portfolio consisting of a properly-diversified group of high-quality, dividend-paying stocks and interest-bearing bonds will certainly fall in value during a correction or a bear market, but will also rebound as the capital markets recover.

It is hard to underestimate the importance of dividends to a long-term investor. Our Canadian stock portfolios have a dividend yield of just over 3 percent and our American stock portfolios yield just over 2 percent. This dividend income is recurring; moreover, those dividends tend to increase over time. If history is our guide, the amount of dividend income earned by our portfolios should double every eight to ten years. Even during the 2008-09 credit crisis, the worst recession in almost eighty years, only one company in our Canadian portfolio (Manulife Financial Corporation) reduced its dividend, while the other companies maintained or even increased their dividends. We expect dividends to provide between one-third and one-half of the total investment return over time.

Investors in Canada are now faced with high levels of personal income tax, with the highest marginal rate reaching 54 percent in several provinces. With realized capital gains subject to a tax rate of close to 27 percent, selling positions with capital gains and paying a meaningful part of that gain to the government not only results in forfeiting future dividend income, it also results in a permanent loss of capital from which future dividends might be earned.

Will there be a stock market correction? We have little doubt. Do we know when it might happen? Unfortunately, we do not. Having said that, neither does anyone else, despite what is printed in newspapers or heard on the television.

Will we sell our high-quality stocks in anticipation of the next correction? No, we will not. BCV Asset Management has been in business for ten years and many of our investment managers have been part of the industry for longer than that and we have never seen the wisdom of that course of action. Not only would we not know when to sell out of the market, we would not know when to buy back into it either. That does not mean that we abandon our focus on the fundamentals or valuations of the companies in which we invest. Those are the factors that are important to our decision to buy or sell the shares of a company.

The chart that follows looks at the S&P 500 Index since it reached it low point on March 9th 2009. While there seems to be numerous catalysts to sell during those eight years and several of these catalysts were followed by corrections, the S&P 500 Index has risen by close to 250 percent over those eight years.

Source: Michael Batnick (theirrelevantinvestor.com)

Our strategy avoids making the these most difficult decisions, either of which could be very wrong, as well as ensuring that our investment portfolios continue to earn growing dividends while avoiding the payment of investment income taxes.

We know that during the next correction our clients will be unhappy while the market declines. The short-term pain is unavoidable, but it is far better than the permanent loss of capital that so often results from abandoning a proven investment philosophy.

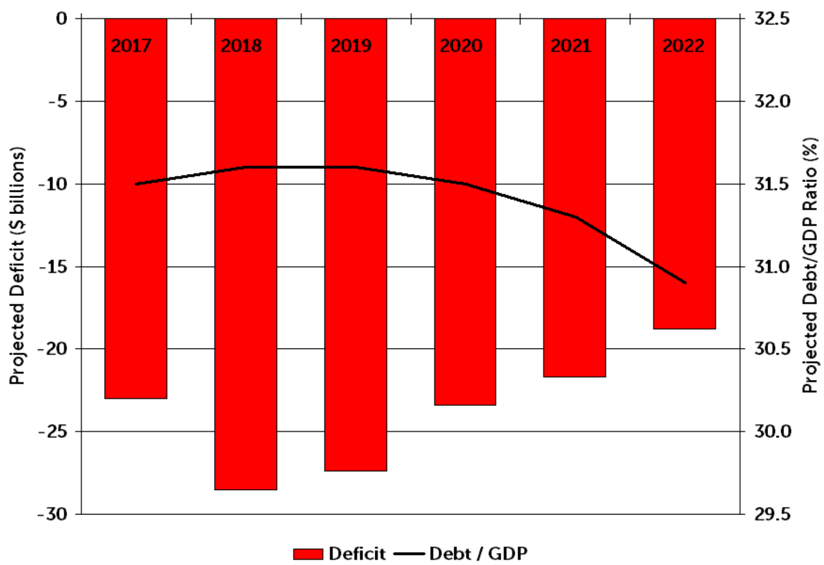
The 2017 Federal Budget

Chris Richard, BA, CFA

The most recent federal budget, unveiled in late March, came with far less excitement than was promised by the financial media. The lead up to Budget Day was full of promises of income tax changes and new spending initiatives, but when the budget was unveiled in the House of Commons, there was little of what was expected. While no public official will admit it, it appears that Canada is waiting to see what changes the Trump administration will make to the budget and tax code in the United States before Canada introduces large changes of its own. This was a continuation budget, with no significant changes from 2016, but the underlying assumptions are something that we review as we update our investment thesis for Canada.

One of the underlying assumptions is that Gross Domestic Product will experience real growth of over 2 percent only in 2018, before retreating to 1.7 to 1.8 percent until 2021. While this level of growth is not spectacular, in a low interest environment it is not reasonable to expect super-sized economic growth. One of the other assumptions, which is linked to the low economic growth assumptions, is that the price of oil is not expected to increase much beyond 50 dollars per barrel until 2021. The spot price for oil has moved up since the last budget, but the long-term futures price remains stuck near the 50 dollar mark. The budget shares that view of oil prices, but is of the view that the contraction of investment in the oil and gas extraction industries has bottomed.

The Trudeau government has made no attempt to bring the federal budget back into balance for the foreseeable future and has offered no reasons or excuses for this. They view the fiscal world through the lens of the Debt to Gross Domestic Product ratio. If that ratio remains within their predetermined acceptable limits, they will be fine with never returning to a surplus. The problem with this view is that GDP growth is anything but linear. The growth is vulnerable to change from outside forces that can cause that Debt to GDP ratio to spike in a recession, leaving little room for the government to deploy its fiscal levers in a recession.



Source: Department of Finance, 2017 Budget

One of the most-discussed items leading into the budget was the possibility of changes to the inclusion rate for capital gains and changes to the dividend tax credit. As it turned out, both items were left unchanged. In media reports after the budget release, the Minister of Finance (Bill Morneau) tried to put investor's minds at ease that changing the rules for capital gains is not an issue. In an interview with The Globe and Mail, Mr. Morneau stated that "I don't want people speculating on tax. It's most appropriate for me to say: We didn't put something in our budget and there's no value in speculating on tax measures". He further went on to emphasize the point that "by not talking about those things [capital-gains tax-rate changes], we're not talking about them… I think it's clear enough that we didn't put it in the budget after all that speculation."

The main item that could impact some investors was that the government has indicated its concern with certain tax reduction strategies employed by high-income earners and their corporations. They view the splitting of income and other benefits as being unjust and will be releasing a document in the coming months stating the nature of their concerns along with proposed changes to government policy aimed at restricting the use of certain tax planning strategies.

While the Canadian budget has been released with little or no change, we still view the Canadian economy on the mend from the shock of oil prices falling by half. We are undeterred in our view that focusing on the big picture and the long term is the true way to manage client assets. We continue to focus on the long-term fundamentals of companies with growing business and growing dividends.

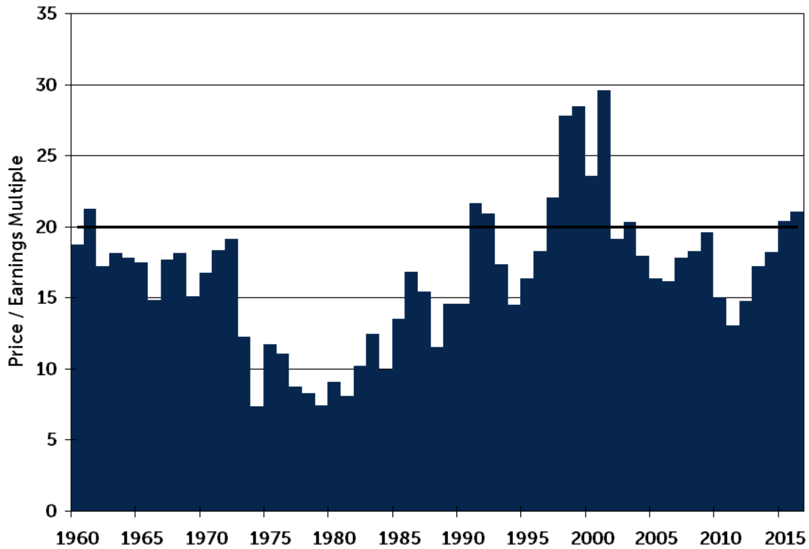
Rising Interest Rates: The Case for Stock Bull Market to Charge Ahead

Michelle Smith, B.Comm (Honours), CFA

On March 15th, the United States Federal Reserve raised the overnight interest rate, the so-called Fed Funds Rate, by 25 basis points to 0.75 percent. This decision was driven by encouraging economic growth, strong job gains, and increasing confidence that inflation is rising, albeit slowly. This marks the second 25 basis point increase in three months and the Fed shows no sign of slowing down. In fact, the Fed reconfirmed its outlook for two more rate increases in 2017 and three more in 2018. While increasing interest rates signal of economic recovery in the United States, what does it mean for investors? Contrary to conventional thinking, rising interest rates are not necessarily bad for the equity markets.

A bull market is a period of generally-rising prices and confidence in the stock market. There is two types of bull markets- interest rate-driven and earnings-driven. An interest rate-driven market is characterized by falling interest rates and expanding price-to-earnings multiples. Alternatively, an earnings-driven market sees rising interest rates and falling to stable price-to-earnings multiples, as increasing earnings drive the multiple downward. (The price-to-earnings ratio (P/E) is a valuation measure that assesses how much investors are willing to pay for a company's earnings.) Investors have become very familiar with the former, as the United States is now nine years into an interest rate-driven bull market, the second-longest in history. For most of the past nine years, until only recently, the Fed has cut interest rates and held them near zero in an attempt to stimulate economic growth. Low interest rates allow companies and consumers to borrow inexpensively, which in turn encourages spending and investing. Many companies have taken advantage of the this low cost of borrowing to raise debt and to buy back shares, driving up share prices and, in turn, driving up P/E valuations to above average-levels.

Standard & Poor's 500 Index
Price / Earnings Ratio (1960-2016)



Source: Standard and Poor's

The price-to-earnings ratio tends to exist within a range. At times, the P/E multiple will trade above where it should be and, at other times, will trade at a discount. However, over time, it will generally revert to its long-term average. In today's market, P/E valuations are rich because stock prices have gotten ahead of themselves. This means that earnings will need to catch up to the higher stock higher prices so that P/E valuations come down to the long-term average. The current environment of rising interest rates and above average valuations suggest that the market may transition into an earnings-driven bull market. That transition may be more bumpy and volatile compared to interest rate-driven markets. An active investment strategy is well-suited for the anticipated earnings-driven environment, particularly when the strategy is supported by a bottom-up analysis. Bottom-up analysis involves starting the investment evaluation process at the company-specific level, rather than the macroeconomic level employed by top-down analysis. It consists of looking for good companies with strong financials, good management teams and the ability to grow future earnings.

BCV Asset Management is a bottom-up, research-driven firm, performing fundamental analysis on the companies in which we invest. We focus on investing in high-quality companies that have a history of consistent earnings growth, strong balance sheets and a track record of paying a growing dividend. While we always consider a company's ability to generate organic revenue and earnings growth, it is especially important in an environment where the price-to-earnings multiple is likely to contract. We also focus on dividend-growing companies to ensure that investors can expect a predictable and rising dividend from their portfolio, regardless of the prevailing economic conditions.

Recent Dividend Increases

Canada

First Quarter 2017:
Bank of Montreal: 88 cents (86 cents)
Brookfield Asset Management Inc.: 14 cents (13 cents)*
Brookfield Property Partners LP: 29.5 cents (28 cents)*
Canadian Imperial Bank of Commerce: 124 cents (121 cents)
Canadian Natural Resources Ltd.: 25 cents (23 cents)
Canadian National Railway Company: 41.25 cents (37.5 cents)
Intact Financial Corporation: 64 cents (58 cents)
Manulife Financial Corporation: 20.5 cents (18.5 cents)
Magna International Inc.: 27.5 cents (25 cents)*
National Bank of Canada: 56 cents (55 cents)
Suncor Energy Inc.: 32 cents (29 cents)
TELUS Corporation: 48 cents (46 cents)

Second Quarter 2017 (Pending):
BCE Inc.: 71.75 cents (68.25 cents)
Canadian Imperial Bank of Commerce: 127 cents (124 cents)
Canadian Natural Resources Ltd.: 27.5 cents (25 cents)

United States

First Quarter 2017:
Analog Devices Inc.: 45 cents (42 cents)
AT&T Inc.: 49 cents (48 cents)
CVS Health Corporation: 50 cents (42.5 cents)
Home Depot Inc.: 89 cents (69 cents)

Second Quarter 2017 (Pending):
None

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