Groupe Conseil Wermenlinger
Investment Advisors

Strategic Outlook, January 2019

All good things come to an end

After the market collapse in October 2008, a golden era for investors began in 2009. With a few exceptions, these were years of abundance; volatility was low, and the equity and real estate sectors generated real returns (nominal returns on investment, less the inflation rate) that were well above average.

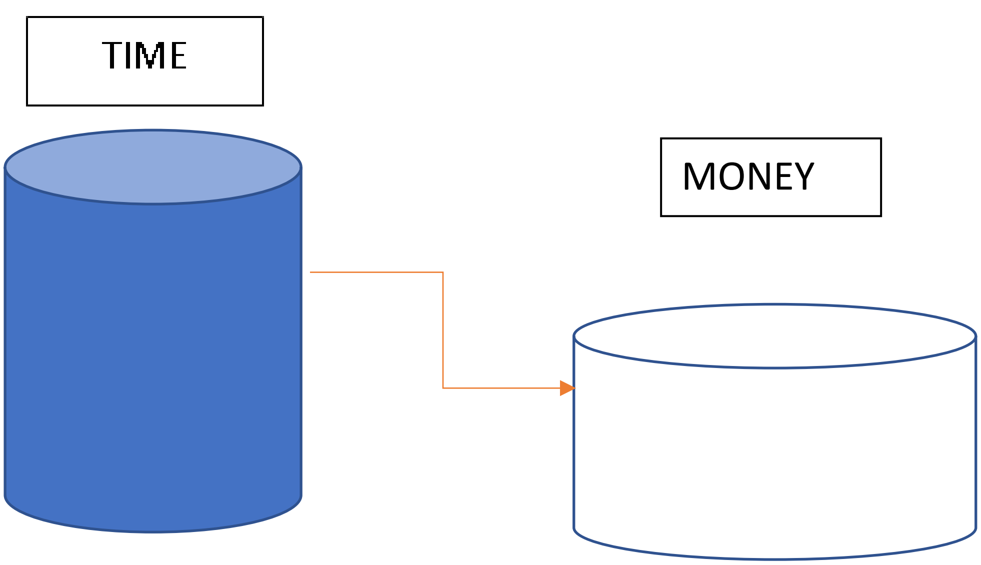
At the same time, the bond sector yielded only mediocre returns—with real returns sinking into negative territory from time to time Prudent or conservative investors watched the purchasing power of their capital dwindle while bolder decisions were rewarded.

But all good things come to an end, and in October 2018, the bell rang tolled for stock market investors. By late December, the S&P 500 Index had dropped by 19.5% from its peak in September 2018. Stock price volatility nearly doubled. Few investors managed positive returns in 2018.

What is an appropriate strategy in these circumstances? That largely depends on your ability to save capital while earning a salary. Let's call that "savings potential." If you save a percentage of your salary (approximately **15**% of your gross pay), chances are that you will build plenty of capital. You will be able to retire and live off this capital, instead of having to keep earning a salary.

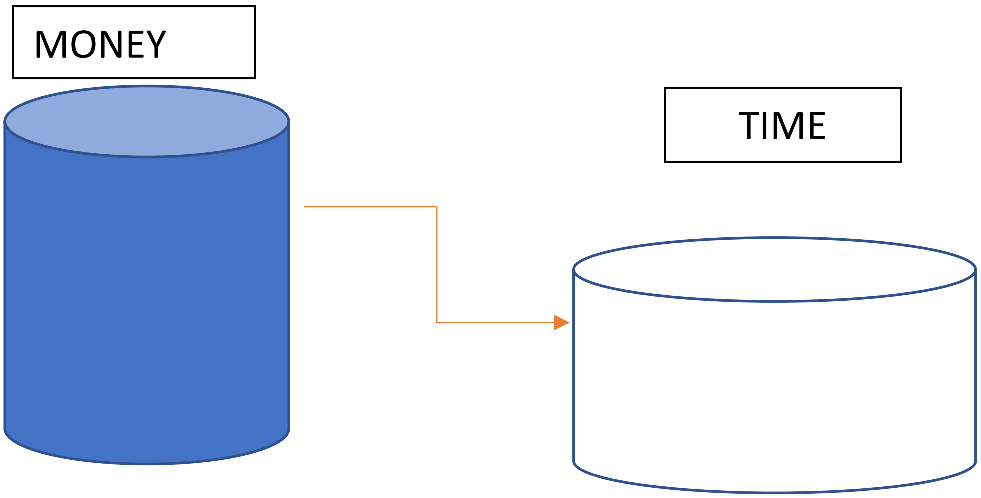
We call this period the capital accumulation phase, and many of our clients are at this stage of life. They're currently working and saving with discipline. Each month, they systematically put aside a percentage of their salary. I have no worries about their future. Here is a diagram illustrating this concept:

Savings potential at the beginning of a career: Plenty of time to save, but not much money saved yet



However, when the time comes to scale back on your paid work or retire completely, you'll have to rely on the capital you've already accumulated to meet your financial needs. This is where things become more complicated. What happens if your financial needs exceed the income generated by your capital? This can happen due to a lack of capital, weak or negative returns, or an inflation rate that is higher than expected.

Savings potential at the end of a career: Plenty of money saved, but no time left to save more



Studies have shown that the withdrawal rate—the amount that you can withdraw from your portfolio without exhausting its capacity to generate income—is around **4%.** As an example, this means that if you plan to spend $80,000 per year after taxes, excluding your private and public pensions, you'll need to have around $2 million saved.

What does this mean?

- If you don't have sufficient capital when you retire, you'll either have to reduce your financial needs or take on more investment risk in hopes of generating higher returns.

- It's easier to avoid this situation by saving early. *<u>This is why young people need to be taught about the importance of saving as soon as possible.</u>*

When you retire, you're hoping to put your worries and stress behind you—it doesn't make sense to take on any more risk than is strictly necessary. And given the current circumstances, a certain level of risk will already be required to achieve a 4% return.

It's true that if returns do not materialize, you will have to adjust your financial needs. And if returns are higher than expected, it's wisest to reinvest the surplus return, building up your capital to prevent unforeseen developments from threatening your retirement.

Having a solid, carefully designed financial plan is an absolute must for our clients. This plan will allow them to regularly track their financial progress of their finances, without ignoring their unique set of past, present and future circumstances. I firmly believe that this is the only meaningful way to maintain control over the situation.

The financial markets have reached the end of a bull market cycle. A recession is quite probable in the coming years. How should you prepare for this possibility?

There is no "one-size-fits-all" solution. I urge you to read your policy once again, as it will help inform the decisions you make. And of course, your specific circumstances will influence your strategies as well:

- For our clients in the capital accumulation phase, a period of slowdown or stagnation may lead to opportunities. You can purchase securities at depreciated prices and wait for the markets to change.

- For our clients are in the preretirement phase, it's a good idea to check your calculations twice, using conservative assumptions. And if you're able to save during periods of market turmoil, you'll increase your chances of generating higher-than-expected returns.

- And as for our retired clients, make sure that your withdrawal rate is no higher than 4% of your capital. Adjust your budget accordingly.

For all of our clients, rereading your investment policy will remind you that you have granted us discretionary latitude within each of the major asset classes, allowing us to adjust your portfolio to capitalize on present and future conditions. This is an integral part of our mandate.

Here is an overview of our actions over the last twelve months:

1. We have increased cash holdings (immediate liquidity).
2. We have selected bonds that are less sensitive to interest rate hikes.
3. We have included real return bond funds as a hedge against higher inflation in Canada and the United States.
4. We have maintained the geographical diversification of your bonds.
5. We have reduced our holdings in Canadian equity, more specifically in the Canadian financial services sector.
6. As a defensive measure, we have increased our holdings in the U.S. financial services sector and in the life sciences sector.

7. We held a slightly more substantial position in the emerging markets at a time when they were rather unpopular with investors. Now, this asset class shows the potential for favourable returns over the coming years, compared to U.S. equities, for example. We will not hesitate to increase our holdings on a sequential and opportunistic basis.

Remember: the financial markets have consistently adapted to changes in the political, geopolitical, economic and financial landscapes. We are currently faced with a number of situations that appear dire at times: commercial and political tensions between China and the United States, the rise of populism worldwide, the wide economic disparities between the poor and the ultra-rich, and countless others.

However, the most urgent challenge facing humankind is global warming. For several years now, we have been researching how our investment philosophy and strategies could be adapted to take this critical issue into account.

Over the coming months, we will share our progress with you. In the meantime, I wish to thank you, both personally and on behalf of all my colleagues, for your continued trust. We sincerely appreciate your business.

Sincerely,

Laurent Wermenlinger, FCSI® (Fellow Canadian Securities Institute)
Vice President and Portfolio Manager

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