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The importance of risk management in a late investment cycle

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Happy new year to all of our readers. We wish you a healthy, joyful and prosperous 2018.

We had another solid year in 2017. Equity markets were very generous; fixed income – not so much. The U.S. dollar depreciated significantly against the Canadian dollar and cut into U.S. market gains experienced by Canadian investors. Our decision to invest more in foreign markets and hedge a portion of foreign currencies added value. In terms of stock selection, growth stocks outperformed value stocks significantly. Using the MSCI World Index as a benchmark, growth-style stocks outperformed value by 10%. Within the growth style, growth at *any prices* (for example, Bitcoin, Tesla, Amazon) outperformed growth at *reasonable prices* (Alphabet, Apple). Markets grew without a meaningful correction during the year.

Those who have held investments since the market bottom in 2009 may have earned outsized returns. The S&P/TSX Composite Index gained 139% from March 2009 to December 2017 while the S&P 500 Index rallied 299% over the same period (in Canadian dollars). At the entry point in March 2009, markets were trading at significant discounts as global economies were suffering a recession. Today, almost nine years later, the U.S. and Canada are thriving with full employment and economic growth. Valuations are at premiums as investors are optimistic and markets are flooded with buyers who do not want to miss out.

We do not expect this "high return, low volatility" trend to continue forever and we are both constructive and cautious at the same time. We are constructive because we believe our investors will earn positive returns during their holding periods, albeit at lower rates to reflect the reality of above-normal valuations. We are cautious because there are "land mines" to avoid. Investors with a fear of missing out are pouring their money into virtually any idea without due diligence. Among the most extreme is bitcoin – a virtual currency derived from intangible software and far from mainstream use – which rallied 1330% (in U.S. dollar terms) in 2017 alone. At current prices, the outstanding 16,779,725 bitcoins are worth over $250 billion.

Our portfolio management teams continue to find value opportunities and we will remain patient while value is recognized. We expect higher inflation to return, at least temporarily, and are monitoring our fixed-income exposure frequently. Our risk management process is not limited to holding cash. We may, from time to time, use options to manage our equity market downside exposure. Our portfolio positioning evolves as market conditions change and that keeps us constructive as we look forward.

Combined top 15 equity holdings as of December 31, 2017 of the Evolution 40i60e Standard portfolio with Alpha-style exposure:

1. Canadian Natural Resources	6. Alphabet Class A	11. SNC-Lavalin
2. Microsoft	7. Atco	12. AltaGas
3. Athene Holding	8. UnitedHealth	13. Praxair
4. Apple	9. Gilead Sciences	14. Middleby
5. Walgreens Boots Alliance	10. Suncor Energy	15. Broadcom