The Internet Wealth Builder

Volume 23, Number 38 **Issue #21838** **October 29, 2018**

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BUILDING WEALTH
The Internet Wealth Builder

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No issues next week.
Next issue:
November 12

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THE RISE OF MACHINES

By Richard N. Croft, Associate Publisher

You have probably heard a lot about artificial intelligence or "A.I." if you have tech savvy friends. There was news this week that Canada was bidding on a new A.I. space arm for the unmanned moon orbiter that the U.S. is planning to launch in the next few years. The space arm needs to be able to learn simple tasks so that ground personnel can manage the orbiter by telling it to execute this or that rather than manipulating the arm through a complex series of movements. The IBM Watson project is another A.I. example where learning software tools optimize data collection and dissemination.

I raise this issue because A.I. software is driving many of the investment decisions for Wall Street hedge funds. A.I. software digests new information and makes trading decisions based on sophisticated algorithms. The problem is that it can have a major impact on your portfolio and the fallout can occur in a matter of minutes.

We have seen this play out over the past couple of weeks. Notable was the activity on Oct. 10 when the Dow Jones Industrial Average fell 800 points in one day. Much of the move occurred in the afternoon, when stocks appeared to fall off a cliff.

As expected, there was "insightful" spin on financial networks advancing reasonable cause and effect explanations. Market rotation was at the top of the list as analysts opined that managers were shifting focus from momentum (e.g. FANG) to value stocks (e.g. banks and utilities). Economists also weighed in, citing higher interest rates, trade tensions causing a sharp sell-off in Chinese markets, and, more recently, concerns around the Italian budget deficit.

These are all reasonable arguments that, longer-term, will influence market trends. But the sell-off on Oct. 10 was more about A.I. then with any single motivating factor. You could see it during the day. Trades were triggered when the yield on the US ten-year Treasury note crossed 3.25%. There was a clear rotation away from FANG stocks (Facebook Amazon, Netflix and Alphabet (i.e. Google) and small caps with high debt to equity ratios into banks that benefit from higher rates.

The quick and sharp sell-off caused widespread angst, which carried over into virtually all sectors. At one point there were ten stocks down for every one that was up. For some perspective, the March 2009 post financial crisis bottom occurred at a point when there was a nine to one ratio of down to up stocks.

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What makes me believe this was based on an algorithm was the fact that despite the Oct. 10 across the board sell-off we did not see significant capital movement away from stocks as an asset class into bonds and gold. To that point, I draw your attention to the accompanying chart showing the Dow Jones Industrial Average (the black bars) relative to the TLT (20-year Treasury bond ETF) and GLD (Gold bullion ETF). Notice when the Dow fell 800 points on Oct. 10, TLT and GLD barely moved. As the Dow fell another 400 points on Oct. 11, TLT moved higher by 0.8% and GLD was up about 2.5%. TLT and GLD have for the most part, remained at Oct. 11 levels.

I suspect the reaction on Oct. 11 was caused by the follow through in price action on the Dow. Investors were taking Wednesday's move more seriously and wanted to shift some assets into safer havens. We saw a rebound on Friday, October 12, which, based on the action this week, seems to have been a bear market bounce.

This preamble sets the stage for the importance of staying focused through market turmoil. A.I. has simply shortened the time line of seismic shifts. It used to take weeks for traders to transition from bullish to bearish. It now happens in days and hours.

I'm not a big fan of money management via algorithms. It is not new and previous iterations have not benefitted investors. For example, the 1987 stock market crash was exacerbated by program trading, where algorithms systematically raised cash when specific price points were breeched. As the market fell through pre-determined levels, selling picked up. That caused further downside movement. The speed of the October 1987 sell-off caused wide spread panic and in the end did not protect investors in the way it was originally intended. Program trading went down as a failure and was pushed to the sidelines through much of the 1990s.

But in Wall Street, what goes around comes around. As a result, algorithms now account for as much as 30% of the trading activity on any given day. And this at a time when there are fewer shares to trade because of significant stock buybacks and institutional investors who follow a buy and hold approach (think Warren Buffett).

Make no mistake. NYSE and Nasdaq market makers who are charged with providing liquidity are keenly aware when they are taking the other side of a trade triggered by an algorithm. They also know that a machine is acting on electronic impulses and market makers will take advantage of that by shifting the bid and ask prices in accordance with the direction being taken by the algorithm. For the rest of us, that creates a trading pattern where we get sporadic volatility spikes interspersed with longer periods of narrow price swings.

It is virtually impossible to trade within these variables. I only hope that by understanding what is happening behind the scenes provides some comfort that will allow you to stick with an investment plan through turbulent times.

Longer-term focus

If you believe, as I do, that intraday gyrations are more noise than substance, then you can focus on the factors that have real long-term implications. If institutional investors are shifting strategies from momentum to value, banks should benefit and FANG stocks should weaken.

It's the same with the interest rate scenario. Higher rates should benefit banks, insurance companies, and large cap tech companies with sizeable cash hordes. Higher rates will be detrimental to small cap stocks because borrowing costs will rise. They will be particularly harmful to companies with significant leverage. I'm not sure that the current rate environment will have any major repercussions, but clearly the 3.25% rate on U.S. ten-year Treasury Notes is the current demarcation line.

But here's the rub! Suppose we are correct about what is driving investment decisions. The point of our A.I. preamble is that much of what we think will happen has probably been priced into the market. The reaction time is simply too short to make moves after the fact, which means it is better to hedge your risks with a portfolio that can function within a multitude of detrimental scenarios.

For example, given the current macro economic overlay, think about a portfolio that has some high-quality Canadian banks that pay above market dividends. Perhaps hold some momentum stocks via a technology ETF like the Invesco Nasdaq Internet ETF (NDQ: PNQI), which has about 40% of its assets invested in the FANG stocks.

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Add some value stocks with the iShares Russell 1000 Value ETF (NDQ: IWD). IWD seeks to track the investment returns results of an index composed of large and mid-capitalization U.S. equities that exhibit value characteristics.

Bottom line: Build an all-weather portfolio within your risk profile. Trying to trade the current environment will harm your pocketbook.

Richard Croft has been in the investment business for more than 40 years and is the founder of R.N. Croft Financial Group. As a global portfolio manager and option specialist, his focus is helping investors clarify their goals and risk tolerances, leading to an appropriate risk-adjusted portfolio. He can be contacted at rcroft@croftgroup.com.

RICHARD CROFT'S UPDATES

iShares Russell 2000 ETF (NYSE: IWM)

Originally recommended on Jan. 15/18 (#21803) at $158.16. Closed Friday at $147.43. (All figures in U.S. dollars.)

Background: IWM is an exchange-traded fund that tracks the U.S. small cap market.

Performance: The units hit an all-time high of $173.39 at the end of August but has been retreating since, reflecting the broad sell-off in the small-cap sector.

Key metrics: This is a very large ETF, with almost $44 billion in assets. It represents almost the entire U.S. small cap universe, with 2,029 holdings. The p/e ratio of the portfolio is 17.52 and the annual distribution yield is 1.17%. The management expense ratio is a low 0.19%.

Comments: This is an excellent core holding for small cap exposure within a portfolio. Daily trading volume of this ETF makes it easy to move in and out. IWM will be more volatile than ETFs that hold a broader collection of large cap stocks but having some exposure to small caps will provide some longer-term oomph to your portfolio.

Action now: Hold.

O'Shares FTSE Russell Small Cap Quality Dividend ETF (NDQ: OUSM)

Originally recommended on June 25/18 (#21824) at $27.62. Closed Friday at $25.28. (All figures in U.S. dollars.)

Background: This ETF seeks to track the performance (before fees and expenses) of its target index, which bears the awkward name of FTSE USA Small Cap ex Real Estate 2Qual/Vol/Yield 3% Capped Factor Index. So what we have here is another small cap ETF, but in this case all of the companies are profitable and will benefit from the lower tax regime that was set in motion earlier this year.

Performance: The pattern is similar to IWN. This ETF hit an all-time high of $29.16 in mid-September but then went into a dive.

Key metrics: OUSM holds about 125 positions and does not own any real estate companies, which tend to be highly leveraged. According to the marketing material; "the quality and low volatility factors are designed to reduce exposure to high dividend equities that have experienced large price declines, as may occur with some dividend investing strategies."

The fund is quite new, having been launched at the end of December in 2016. It has $127 million in assets and an expense ratio of 0.48%.

Comments: I would not hold both OUSM and IWM. Choose the one that best suits your circumstances and risk tolerance. And, with either IWM or OUSM, think in terms of less than 10% exposure.

Action now: Hold.

H&E Equipment Services (NDQ: HEES)

Originally recommended on Jan. 15/18 (#21803) at $40.82. Closed Friday at $20.12. (All figures in U.S. dollars.)

Background: H&E operates an integrated equipment services company, renting, selling, and servicing hi-lift or aerial work platform equipment, cranes, earthmoving equipment, and industrial lift trucks.

Performance: The stock recovered to approach $40 in early October but then went into a deep slide that brought it down to the current level.

Recent developments: The stock rebounded a little following release of third-quarter results on Thursday but then fell $2.78 on Friday. Revenue for the quarter was up

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Richard Croft's updates – continued from page 3…

24% year-over-year, to $156 million. Net income was $21.3 million ($0.59 per share, fully diluted), compared to $8.5 million ($0.24 a share) the year before.

Outlook: This company was initially recommended as an infrastructure play. But as President Trump's self-absorbed personality quirks stifle his ability to work with the Democrats on any level, new infrastructure projects are unlikely to occur. For certain they will not happen should the Democrats control Congress after the November mid-term elections. Given the initial thesis, we need to cut bait on this stock.

Action now: Sell.

LOW-RISK PORTFOLIO SLIPS

By Gordon Pape, Editor and Publisher

Everyone wants to be in the stock market when share prices are booming. But when things get rough, as they are right now, investors become much more concerned with safety. Fear overtakes greed.

I created a Low-Risk Portfolio last year at this time. The goal is to minimize any stock market losses while providing a return that is at least a point and a half better than the top GIC rate. Right now that is 3.75% at FirstOntario Credit Union so our current target is 5.625%.

The portfolio is comprised of the following securities. Here is an update on their performance with prices as of the afternoon of Oct. 25.

iShares Core Canadian Universe Bond Index ETF (TSX: XBB). This ETF tracks the performance of the broad Canadian bond market, including both government and corporate bonds. Bonds continue to be under pressure as interest rates rise and the fund dropped $0.40 per unit in the latest period. However, we received almost as much in distributions (a total of $0.368) so the loss was fractional.

PIMCO Monthly Income Fund (TSX: PMIF). This ETF invests in non-Canadian fixed income securities from around the world. It too has been hit by rising rates, although the decline in unit value was a modest $0.12 since the last review in May. Distributions of about $0.18 a unit offset that and left us with a small gain for the period.

First Asset Enhanced Short Duration Bond ETF (TSX: FSB). This ETF invests in a portfolio that is divided between short duration high-yield securities and investment grade corporate bonds. It held its ground over the latest period, losing only $0.01 per unit. We received monthly distributions totaling $0.10 ($0.02 per month) so we ended up marginally ahead.

Canadian Utilities Rate Reset Preferred Shares (TSX: CU.PR.I). This is a rate reset from a leading utility company. It is down $0.31 since May when we added it to the portfolio. However, that was virtually offset by a dividend of $0.28.

Royal Bank (TSX, NYSE: RY). This is very unusual. Banks typically profit in a time of rising rates. But despite good earnings, Royal's price is down $4.34 since March. We received one dividend of $0.94.

Dream Global REIT (TSX: DRG.UN). The REITs focuses on business properties in Europe. It was a strong performer in the early part of the year but the pressure of rising interest rates and the stock market sell-off knocked back the share price by $1.24 in the latest period. The distributions of about $0.33 per unit could not offset that.

Sun Life Financial (TSX, NYSE: SLF). Insurance companies should fare well in a rising interest rate environment but, as with Royal Bank, this is not proving to be the case so far. The stock is down $7.14 since we added it to the portfolio in May. We received two dividend payments during the period, for a total of $0.95.

Apple (NDQ: AAPL). Technology stocks took a beating in the market sell-off. Apple stock traded as high as US$233.47 in early October before investors decided tech had gone too far, too fast. But even with the pull back, we are still ahead by $31.73 a share since we added the stock to the portfolio in May. Also, we received one dividend of US$0.73.

Cash. We received interest of $7.31from the $762.71 held in our on-line account at EQ Bank.

Here is a summary of the portfolio. Commissions are not included and the Canadian and U.S. dollars are treated at par for ease of calculation.

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Low-risk portfolio – continued from page 4…

IWB Low-Risk Portfolio (a/o Oct. 25/18)

Security	Weight %	Number Held	Average Price	Book Value	Market Price	Market Value	Retained Income	Gain/ Loss %
XBB	15.7	250	$30.86	$7,715.00	$29.95	$7,487.50	$241.00	+0.2
PMIF	14.7	360	$19.60	$7,056.00	$19.48	$7,012.80	$64.28	+0.3
FSB	12.4	600	$10.01	$6,006.00	$9.87	$5,922.00	$162.00	+1.3
CU.PR.I	14.8	275	$26.03	$7,158.25	$25.72	$7,073.00	$77.33	+0.9
RY	13.9	70	$100.82	$7,057.40	$94.88	$6,641.60	$259.00	-2.2
DRG.UN	8.5	300	$14.80	$4,440.00	$13.56	$4,068.00	$100.01	-6.1
SLF	10.1	100	$55.20	$5,520.00	$48.06	$4,806.00	$95.00	-11.2
AAPL	9.2	20	$188.07	$3,761.40	$219.80	$4,396.00	$14.60	+17.3
Cash	0.7			$318.51		$325.82		
Total	100.0			$48,972.56		$47,732.72	$1,013.22	-0.5
Inception				$50,000.00				-2.5

Comments: The GIC won the first round as the portfolio incurred a small loss of 0.8% during the latest period. Our bond ETF and preferred share holdings held their ground (including distributions) and Apple performed well. But we were hit by unexpected declines in the shares of Royal Bank and Sun Life, which were primarily responsible for the loss.

In the year since the portfolio was launched, we are down 2.5%. The S&P/TSX Composite is down 5.9% over the same period so we're better on that score. But we're well short of achieving our target goal, which is a point and a half better than the best five-year GIC rate.

The asset mix is quite conservative. Just over 58% of the portfolio is invested in bonds, preferred shares, and cash. Another 24% is in banks and insurance companies, which should rally as rates move higher.

Changes: The portfolio offers a good combination of modest growth potential with relatively low risk. It has not done well in its first year, but I expect it to improve going forward so I am not changing any of the basic components.

We will use a little of the accumulated cash to add to our position in FSB by spending $98.70 to buy another 10 units. That will bring our total to 610. Accumulated cash will drop to $63.30.

We are left with cash and retained earnings of $1,240.34, which we will keep in our EQ Bank account at 2.3%.

Here is the revised portfolio. I will revisit it in April.

IWB Low-Risk Portfolio (revised Oct. 25/18)

Security	Weight %	Number Held	Average Price	Book Value	Market Price	Market Value	Retained Income
XBB	15.6	250	$30.86	$7,715.00	$29.95	$7,487.50	$241.00
PMIF	14.7	360	$19.60	$7,056.00	$19.48	$7,012.80	$64.28
FSB	12.6	610	$10.01	$6,104.70	$9.87	$6,020.70	$63.30
CU.PR.I	14.8	275	$26.03	$7,158.25	$25.72	$7,073.00	$77.33
RY	13.9	70	$100.82	$7,057.40	$94.88	$6,641.60	$259.00
DRG.UN	8.5	300	$14.80	$4,440.00	$13.56	$4,068.00	$100.01
SLF	10.0	100	$55.20	$5,520.00	$48.06	$4,806.00	$95.00
AAPL	9.2	20	$188.07	$3,761.40	$219.80	$4,396.00	$14.60
Cash	0.7			$325.82		$325.82	
Total	100.0			$49,138.57		$47,831.42	$914.52
Inception				$50,000.00			

GORDON PAPE'S UPDATES

NFI Group (TSX: NFI, OTC: NFYEF)

Originally recommended by Tom Slee on March 4/13 (#21309) at C$10.30, US$10.04. Closed Friday at C$45.25, US$34.64.

Background: NFI is the leading manufacturer of heavy-duty transit buses in the United States and Canada. The company, which is based in Winnipeg, offers a broad product line including drive systems powered by clean diesel, natural gas, diesel-electric hybrid, electric trolley, and battery-electric. The company also operates an aftermarket parts organization, sourcing parts from hundreds of different suppliers and providing support for all types of transit buses. NFI employs about 6,000 people with manufacturing, fabrication, parts distribution, and service centres in both Canada and the U.S.

Performance: The stock has been in a slide for most of this month, touching a 52-week low last week.

Recent developments: The company reported a drop in order backlog at the end of the third quarter. At that point, the order book stood at 11,110 units valued at $5.51 billion. That was down from 11,685 units (valued at $5.8 billion) at the end of the second quarter. However, it was an improvement over 10,537 units (valued at $5.39 billion) at the end of the same period in 2017. The majority of the backlog relates to transit buses for public clients.

Over the past 12 months, NFI has delivered 4,255 units, up 502 from the previous one-year period. Management now expects to deliver 4,390 units in fiscal 2018, an increase of 562 over 2017 and an increase of 40 from previously reported expected deliveries.

So why has the stock taken such a beating? Several factors appear to be at work. Some investors may be concerned that the drop in the backlog is a sign that business is slowing down. There has also been some profit taking as the stock had been on a strong run – when the shares hit an all time high of $61.25 in March they had tripled in value over the previous two and a half years. Rising interest rates have also weighed on the stock.

Dividend: NFI raised its quarterly dividend by 15.4% to $0.375 ($1.50 annually), effective with the June 29 payment. With the drop in the share price, the yield on the stock has moved up to a more attractive 3.3%.

Action now: Hold. The company will release its third-quarter results on Nov. 6. Don't take any action until we see what they reveal.

Mawer Balanced Fund Series A (MAW104)

Originally recommended on Feb. 13/12 (#21206) at $16.72. Closed Thursday at $27.85.

Background: This is a fund of funds – the portfolio consists of seven other funds from the Mawer organization.

Performance: Very good. The fund has outperformed its peer group over all time frames from three months to 20 years. The five-year average annual compound rate of return to Sept. 30 was 9.4% compared to a category average of 5.8%.

Key metrics: As of the end of September, the portfolio was about 60% in stocks, 40% in bonds. The management expense ratio is a very reasonable 0.92%. The minimum initial investment is $5,000.
Distributions are paid monthly but are very minimal.

Outlook: The 40% bond rating provides this fund with a cushion in case the market sell-off persists.

Action now: Buy. The Mawer organization has a long history of above average performance combined with below average fees.

TFI International Inc. (TSX: TFII, OTC: TFIFF)

Originally recommended by Tom Slee on June 11/12 (#21220) at C$17.49, US$17.06. Closed Friday at C$42.46, US$32.24.

Background: The company is a North American leader in the transportation and logistics industry. It operates across Canada, the United States, and Mexico offering package and courier service, truckload and less than truckload haulage, logistics, and other services.

Performance: The shares hit a high of $49 in mid-September but had been in a downtrend since, reflecting the retreat in the broad market. However, they rallied on Friday, gaining $1.17 on the day.

Recent developments: The company beat analysts' estimates with strong third-quarter results. Total revenue for the quarter came in at just under $2.3 billion, up about $110 million from the year before. For the first nine month of the 2018 fiscal, revenue was $3.8 billion, compared to about $3.6 billion in 2017.

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Gordon Pape's updates – continued from page 6…

Adjusted net income for the quarter was $94.5 million ($1.04 per share, fully diluted) compared to $48.8 million ($0.53 per share) in the prior year period. For the first nine months, adjusted earnings were $235 million ($2.58 per share), up from $137.9 million ($1.48 per share) in 2017.

Dividends and buybacks: The directors approved a 14% increase in the quarterly dividend, to $0.24 per share from $0.21 previously. The shares yield 3.5% at the current price.

The company has been actively repurchasing its stock in the open market. The weighted average number of shares outstanding was about 87.7 million at the end of the third quarter compared to 89.9 million at the same time last year.

Action now: Sell half. We have a capital gain of 142% to this point. This stock is economically sensitive so if the economy slows next year (which the market is suggesting it will) we could see a further retreat in the share price.

By taking half profits now you'll recover your original investment with a nice gain. That ensures you won't lose money on this position, no matter what happens down the road.

Horizons Marijuana Life Sciences Index ETF (TSX: HMMJ)

Originally recommended on Jan. 15/18 (#21803) at $19.90. Closed Friday at $19.01.

Background: This ETF invests in a portfolio of cannabis stocks, with the heaviest weightings in Tilray (11.35%), Canopy (11.27%), and Aurora (10.52%). Combined, these three companies make up more than a third of the portfolio.

Performance: Cannabis stocks sold off after legalization on Oct. 17 and the fund's value plunged. The market price went from $24.82 on the day before pot became legal to $18.66 on Oct. 24, before staging a modest rally. Investors have been pulling money out of the fund as the value dropped. Trading volumes topped two million a day twice last week, more than twice the normal rate.

Key metrics: The management fee is high for an ETF at 0.75%. Distributions are paid quarterly, with the September payment coming in at about $0.20 per unit. Net assets as of Oct. 24 were $777 million.

Outlook: I have consistently warned about the volatility of cannabis shares and said they are only suited for very aggressive investors. Last week's sell-off proves my point yet again. To underline the point, Dominion Bond Rating Services issued a report that concluded the industry is overcrowded and that some companies are going to fail.

Action now: If you are a die-hard cannabis believer, buy this dip. But only do so if you have a strong stomach.

YOUR QUESTIONS

Bond funds

Q – Our financial advisor at one of the big banks has placed a large portion of my RRSP into a bond fund. That bond fund over the past 2-3 years has consistently lost money. I am currently down about $3,500. Why do financial advisors place investor money in these bond funds? After the MER, he is earning about 2.5% with the three other funds in my portfolio. The three other funds are invested in equities. What is your view of the investment of our money in the bond fund? – Richard C.

A – Fixed income (bond) funds are typically part of a balanced portfolio. They provide stability in the event of a major pullback in the stock markets, such as we're seeing now. The downside is that bond values fall as interest rates rise and that's also the environment we are in right now. It's the direct opposite to the profits bond funds produced when interest rates declined sharply after the crash of 2008.

That said, you should check to see what type of bond fund you are holding. The average annual three-year return for a Canadian fixed income fund to Sept. 30 was 0.87%. Global fixed income funds did a little better, at 1.31%. That's not a lot, but it's not a loss either. Did you count the distributions you received when calculating your loss?

If you don't want to keep holding the bond funds, tell your advisor to switch. He would probably gladly accommodate you; he gets a higher trailer commission from an equity fund than from a fixed income fund. But keep in mind that, if you may the move, you are exposing yourself to greater losses if the stock market continues to break down. – G.P.