Q1 2018 MARKET REVIEW & COMMENTARY

April 17, 2018

Applying Chaos Theory to the Financial Markets

President Trump likes chaos. Financial markets do not. Those facts became abundantly clear for the equity markets in general, and Amazon shareholders in particular, during the last week of March. As investors, the trick is to keep focus on the longer term while dodging the shorter-term darts hurled from a reckless twitter feed. To do that we need to have a rudimentary understanding about what makes President Trump tick.

On the surface it appears that we are dealing with a man who has a narcissistic personality disorder and is quite willing to engage in self-indulgent payback, even if it means slamming mega-companies like Amazon. In this case, the payback is aimed at Jeff Bezos, the billionaire president of Amazon. Mr. Bezos just happens to own the Washington Post, which editorially has been one of the harshest critics of the Trump Presidency.

But Trump's mastery of the *get-even* psyche only scratches the surface – and it may not be all bad because, underneath it all, Trump is not a politician. His outside voice has no filter and it aligns perfectly with his inside voice. That's unique because most politicians' outside and inside voices have never even had a first date.

We also know that Trump's approach to negotiating is based on a stick and carrot approach. We have witnessed this *throw-a-hand-grenade-into-a-room-and-walk-away-strategy* play out in the US refusal to endorse the Trans Pacific Partnership (TPP), clashes with NATO about cost sharing arrangements, the tumultuous NAFTA negotiations and, more recently, pressuring North Korea to bend under the weight of sanctions.

The steel tariffs were the most recent volley in this chaotic approach to negotiating. The very notion of such tariffs was enough to send fearful shivers of an all-out trade war through financial markets. That doomsday scenario, however, was never a likely outcome because there is a vast chasm between Trump bluster and *realpolitik* economic reality.

Hence, the threatened imposition of large steel and aluminum tariffs is clearly a political move and there is no chance that an all-out trade war would ensue.

Trump gains nothing from a trade war especially if the other side targets his base. Notice I said Trump and not the US. Make no mistake – everything we have witnessed is about Trump and has little to do with American domestic interests. That's important because with his personality, the President is not about to engage in a trade war that provides no political upside.

So why do this at all? In this case, the steel and aluminum tariffs were floated to prop up the chances that the Republican candidate would win a Congressional seat up for grabs in Pennsylvania (America's steel capital). More to the point, this Congressional seat is in a solid Republican District that Trump had won by more than 20 points during the previous election. With all the pomp and ceremony of a reality show Trump signed the Tariff order surrounded by steel workers at the White House.

The Democrats ultimately won that seat and, as for the 25% tariffs on steel and aluminum, almost every major trading partner except for China, which was always the primary target, has been granted an exemption effectively rendering the penalties moot.

China has already responded tit for tat with countervailing duties on pork and other agricultural products intended to apply maximum pressure on, you guessed it, States that form Trump's base. But to me this is likely the opening salvos in trade negotiations that will begin in earnest later this year. The end game will see the US standing firm on the transfer of intellectual property with the quid pro quo likely to be more favorable treatment for Chinese imports. As both sides play to the gallery, likely causing additional volatility in the financial markets, the trick is wading through the mid-game.

There are positives to Trump's approach. When he came into office he threatened to leave NATO. His rationale was that most of the NATO partners were not carrying their fair share of the costs. Within months the other NATO countries started upping their contributions. Clearly his threat worked.

With regards to NAFTA, frequent threats of cancellation have culminated with invocation of the "nuclear option" (whatever that may mean) with regards to Mexico and immigration. Yet, at the same time, there is word of real progress and even an eagerness to conclude a deal – on the President's own politically-shortened timelines.

He also got North Korea to the bargaining table – something that no other President has been able to do. In the lead up to negotiations with North Korea, Trump has maintained the maximum pressure campaign and for good measure appointed two hard line staffers (Bolton as the new National Security Advisor and Pompeo as Tillerson's replacement for Secretary of State) to act as his supporting cast. I suspect Trump sees a successful North Korea summit as the best chance to turn around his numbers. Because of its importance he likely will get a favorable outcome, which could be good *and* bad.

Shorter-term, a clear victory would be a positive for the financial markets as it would provide stability in a region that is strategically and economically important. On the downside, it will support Trump's position that his negotiating approach is spot-on, meaning we are likely to see more of the same in the coming months.

The challenge is to maintain a well-thought-out investment strategy that takes advantage of Trump's bluster while managing the risk that his altered universe may become reality. Bluster creates buying opportunities in financial markets while an altered reality could traumatize global trade and investment values longer-term.

And there's the rub! Weighing the probability of taking a simple long or short position based on potential outcomes that are Presidential-personality dependent is almost impossible. But if we enhance buy and sell decisions with options we can exponentially increase the chance of a positive outcome. At a minimum, we get paid to assume the additional risk.

To that point in the current environment many of our portfolios are benefiting from option contract premiums that are about double what we were collecting at the end of last year. Higher premiums provide cash flow for investors seeking tax advantaged income (option premiums are taxed as a capital gain in Canada) and provides a hedge against downside movements, which should benefit investors notably in the second and third quarter of 2018.

Think of this as our strategy to reduce the chaotic fallout from President Trump's future "nuclear option" threats.

Richard N Croft
Portfolio Manager

Q1 2018 MARKET REVIEW & COMMENTARY

April 17, 2018

TCG534 Income Pool

In the first quarter of 2018 we increased equity exposure and reduced the allocation to preferred shares the Income Pool, resulting in a significant 24% shift in asset allocation. This shift was in response to the early February market sell off, which brought equities' valuations back in line with reasonable levels, and to an 80% increase in implied volatility, which made equity option writing (selling) very attractive.

The pool's overall equities allocation now over-weights the Information Technology and Financial Sectors. The Information Technology sector has strong fundamentals and free-cash-flow valuations are competitive. The Financial Sector is expected to experience EPS growth of 30% due to higher interest rates and improved credit performance.

As of January 1, 2018, we initiated a 5% annual distribution in the pool, paid monthly, which is funded by income derived from interest, dividends, and option premiums. To that end in Q1 2018 we employed the increased equities allocation in a covered call strategy, which capitalizes on the expensive option market and depressed equity prices.

To reduce volatility within the pool, we also increased allocation to gold through select resource companies. Gold typically exhibits a negative correlation to the overall equities market and acts as a hedge against equity risk. To increase cash flow in the pool and reduce the cost of hedging, we are also selling calls on the gold exposure, and we expect to maintain this strategy until the valuation of gold companies exceeds reasonable levels.

The correction and increased volatility during Q1 also provided us with an opportunity to unwind a hedge that we had put in place early in 2017. To address concerns of heightened equity valuations we purchased long-duration SPY (S&P 500 index) puts. Since most of 2017 was a period of extraordinarily low volatility, these puts were trading at historic lows. After equity markets sold off and volatility spiked In the first week of February 2018, we sold these puts at a significant profit.

Mark McAdam, CFA
Portfolio Manager

TCG531 Equity Growth Pool

After an uncommonly comfortable and profitable 2017, Q1 2018 yielded the first US equity market correction since Donald Trump took office. While most investors view such corrections negatively, in some ways we welcome the event as both a healthy adjustment and a new investment opportunity. Through January 2018, US markets got a bit ahead of themselves as tax reform materialized and price-earnings multiples became quite stretched. While multiple expansion is a sign of a healthy economy, valuations must be reasonable if we are to continue to invest.

That's not to say we were unprepared. By design, the Equity Pool contains companies with favourable growth prospects, healthy balance sheets and stable price behavior, with which we aim to build and maintain a portfolio that will go down less when markets get rough. So far in Q1 2018 we have been able to achieve this goal.
However, the volatility that returned to the market in February marked our entry into a new investment regime. With US tax cuts behind us, many market participants lost their focus and investors started paying attention to other things such as uncertainty surrounding global trade.

Higher volatility also means opportunities to write (sell) options and collect greater premiums for bearing the risk of the underlying stock. The question most people ask at this point is: if markets are getting riskier why continue to bear that risk and write options? Fundamentally, it is because we are comfortable pricing that risk (with options) and we don't think markets will drop much further in the near term.

While there are reasons to believe we are in the mature phase of the macroeconomic cycle, we probably still have a couple of more years to go. Unemployment is low and wage inflation is on the rise. Further, tax cut savings are supporting a new business investment cycle. Any money companies have left over is invested into employee compensation and share buyback programs, which are both good for markets and the economy.

Looking out to the rest of 2018, we see broadly-based sales and EPS growth across all sectors, which suggests that bottom-line earnings growth is moving beyond mere tax cuts and is now supported by top-line sales growth as well. While the recent era of steady growth with low volatility is unlikely to resume, we are optimistic about the year in general and stand ready with the necessary tools to navigate what comes ahead.

Alex Brandolini, CFA
Portfolio Manager

TCG539 Option Writing Pool

A Tale of Two Periods

Like the great Dickens novel, *A Tale of Two Cities*, it is both the best and worst of times for the Option Writing Pool, which experienced in Q1 2018 its first quarterly loss since it was launched in February 2016. The Option Writing Pool is designed to provide consistent, tax advantaged income to investors and as such now forms an important component of our new Enhanced mandates. The strategy is to manage risk within the pool by writing (selling) options that expire at different times, benefiting from the time value erosion.

The tale of most of the period since the pools inception was one of low market price volatility, which is the main variable in how options are priced. Higher volatility translates into higher premiums for longer periods – we get more when we sell the option – while a low volatility market has the opposite effect. In a low volatility scenario, the objective is to sell options close to maturity – sometimes within a week of their expiry – to benefit more frequently from the maximum decay of smaller premiums. This best/worst scenario remained broadly in place through January 2018.

Times have changed since the beginning of the year, introducing us to the second financial market tale. Volatility has increased exponentially, which means this an excellent period for selling options as we are now getting much greater premiums for the options we sell.

In this scenario, as long as volatility remains above the historical norm we tend to sell longer-dated options because we can capture the higher volatility and the resulting higher premium. This works well for managing the income within the pool. However, due to the further out expiration date the time value of the larger premiums erodes at a much slower pace. So, what we will likely experience through the second quarter is a slower uptick on the value of the pool, but at the same time we have banked significant capital to deliver the monthly income, which is critical to our investors.

Q1 2018 MARKET REVIEW & COMMENTARY

April 17, 2018

Based on the current size of the pool we need approximately $2 million dollars to meet the monthly income requirement. We collect about $1.3 million from dividends on the stocks we hold in the portfolio while the remainder is delivered through the sale of call and put options. Altogether, we have already captured the additional cash flow from the sale of the options to meet our income needs. However, as mentioned, we will not likely see that benefit the pool's price until the late second or early third quarter of this year.

Richard N Croft
Portfolio Manager

R N Croft Financial Group Investment Committee

Richard Croft	PM	CIO & CEO	rcroft@croftgroup.com
Kenneth Mulders, CFA	PM	CCO & COO	kmulders@croftgroup.com
Christopher Croft, CFA	PM	CFO	ccroft@croftgroup.com
Alex Brandolini, CFA	PM		abrandolini@croftgroup.com
Mark McAdam, CFA	PM		mmcadam@croftgroup.com
Jack Morris	PM		jmorris@croftgroup.com
Paul Fettes, CFA	PM		pfettes@croftgroup.com
David Burnie, CIM	PM		dburnie@croftgroup.com
Christopher Heaman, CIM	PM		cheaman@croftgroup.com
Bo Chew, CIM	PM		bchew@croftgroup.com
Marc Lamontagne, CIM	APM		mlamontagne@croftgroup.com
Robyn Thompson, CIM	APM		rthompson@croftgroup.com
Jason Ayres, DMS	Derivatives Strategist	Director	jayres@croftgroup.com