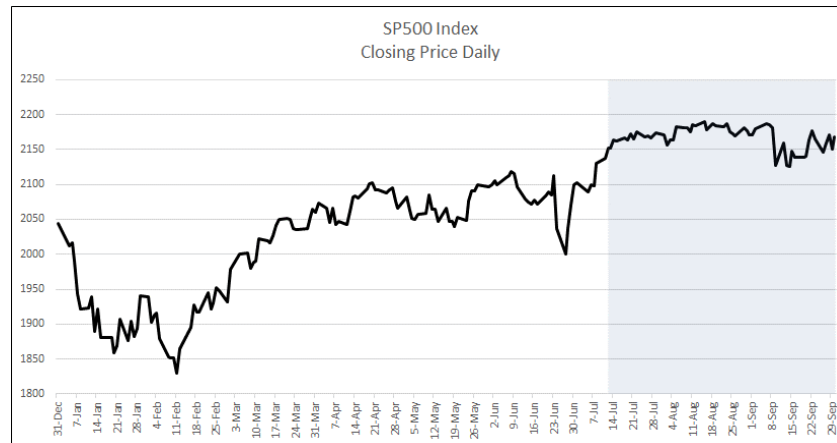


As we wave goodbye to what has been one of the best summers in memory, we also leave one of the sleepest summers in investing terms. There was very little price movement from about the middle of July through quarter end, as shown in the chart below:



There are plenty of theories on this investor complacency.

- Valuation levels are getting to extremes despite the low interest rate environment (the SP500 is currently trading at about 25x trailing earnings); or
- Underlying corporate earnings have stalled which will impede price growth if multiples cannot expand; or
- A wait and see attitude surrounding the outcome of the US Presidential election; or
- General disquiet over the lack of sustained fiscal policy as a substitute for a weak monetary policy.

Whatever the case, according to Credit Suisse daily trading volumes for the period July through September were about 20% lower than the previous seven months, a feat not seen since 2010. Interestingly, according to FactSet, the categories of exchange-traded funds whose assets grew the fastest in the past couple of months a) seek to double the daily return on telecommunications stocks, b) to earn the opposite of the daily return on energy companies, and c) to hold real estate in China.

Clearly a boring market can lead investors into an interesting quest for enhanced returns. But does action for action's sake lead to greater investment performance?

As further evidence, most discussions with the average investor typically begins with a question about performance; however, what should really be asked is "what percentage of the market upside do you pick up versus the downside?" Of course we're biased: as mentioned in our recent August commentary, one of the primary advantages of investing in high quality companies is the protection of capital in down markets.

This sounds confusing, but it's actually quite simple. To provide an illustration, we measured the SP500 Index (in USD) from December 1989 to August 2016 (almost 27 years). During that period, there were five bull periods (where the market rose) and four bear periods (where the market declined).

Over the entire period, the market rose 503.6% (a five-fold increase) or an annualized rate of 7% per year. The cumulative bull periods (summing all five periods) totalled 631.6% or an annualized rate of 9.6%. The cumulative bear periods totalled -137.8% or an annualized rate of -27.3%.

A hypothetical portfolio that achieved 100% of the bull – or upside – market performance and 100% of the bear – or downside – market obviously would provide an identical return to the market, or about 7% per annum on an annualized basis. Comparatively, a hypothetical defensive portfolio that only achieves 50% of the bull/upside market but only 50% only of the bear/downside market would generate an annualized return over the entire period of 5.6%, much lower than the market return resulting from the lower participation rate in bull periods.

Option	Upside Participation	Downside Participation	Estimated Return
1	100%	100%	7.0%
2	90.0%	90.0%	7.0%
3	80.0%	80.0%	6.9%
4	70.0%	70.0%	6.6%
5	60.0%	60.0%	6.2%
6	50.0%	50.0%	5.6%
<b>Nirvana</b>	100.0%	50.0%	11.4%
<b>Optimal</b>	<b>80.0%</b>	<b>60.0%</b>	<b>8.5%</b>

So what is the optimal portfolio? Our chart at right shows “Nirvana” could be achieved if one could participate in 100% of the bull market returns and only 50% of the bear market return. In that situation, the portfolio would have an annualized return of 11.4% - well above the overall market return. However, that would assume one only owned investments that participated in rising markets and was able to accurately shift the portfolio to participate in only 50% in the down markets. This would be extremely difficult to achieve (as proven by a variety of asset mix studies), and the trading costs immense.

However, a portfolio that achieved a reasonable balance of 80% participation in bull markets and 60% participation in bear markets, would have earned 8.5% annualized – still well above the market return. And probably a more reasonable approach to portfolio construct.

So why is all this important?

Over the past twelve months ending September 2016, the TSX Composite Index has risen 14.2% including dividends. During that period, metal & mining stocks rose 90.4% and contributed 5.7% or 40% of the overall index return for the year. Similarly, oil and gas exploration stocks rose 47.4% and contributed 4.8% or 34% of the overall index return. In short, the aggregate return of stocks outside these two sectors over the past twelve months was 3.7% (also including dividends).

Rolling back the clock and doing a similar measurement for the twelve months ending September 2015, the TSX Composite Index fell -8.4% including dividends. Over that twelve month period, metal and mining stocks fell -37%, contributing -2.8% to the overall Index retreat while oil exploration stocks fell 33% and contributed -7.5% to the overall index return. Without these two sectors, the remaining stocks posted a gain of 1.9%.

In aggregate, the two year return of the TSX Composite Index was 2.3% including dividends. If an investor had avoided investing in oil or metal stocks, the annualized return for the two year period would have been 2.8% (assuming the same investment holdings).

While very simplistic, the example bears out the concept of avoiding speculative investing and its corresponding volatility. Minimizing loss in down markets is the best solution for long term performance gains.

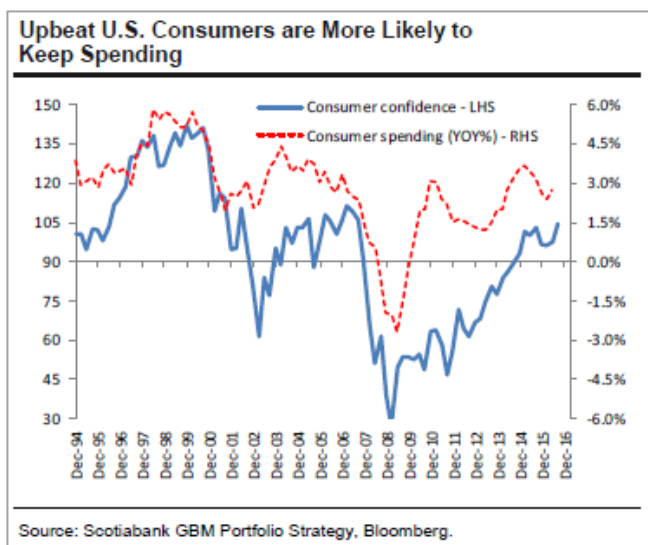
### **CURRENT MARKET CONDITIONS**

In our comment last quarter, we outlined our expectations that the previous twelve month profit contraction would begin to reverse through year end as oil prices stabilized, Fed interest rate increases would be deferred, and the US economy would continue to improve with corresponding strength in the labour market. There has been significant data released in the past three months, and we continue to be of the opinion that the macro picture remains supportive for economic – and therefore corporate profit – growth in coming quarters.

U.S. stocks wrapped up their best quarter of the year, as the financial stocks finally jumped into the fray and technology stocks rallied. The S&P500 advanced 3.9 per cent (USD), though much of that gain (as mentioned earlier) was in the first 15 days of the quarter, by which time the market had risen 3%. For the remainder of the quarter, the index traded in a very narrow range between 2125 and 2190.

The S&P/TSX, aided by a recovery in the energy market and further aided by a recovery from the Alberta wildfires in May, was up 5.5 per cent. Like the S&P500 index, the TSX rose by 5.2% by August 9<sup>th</sup>, then traded in a tight pattern through the end of the quarter.

The global economy is in a fragile period; despite sluggish economic growth, central banks are perceived as having run out of room to stimulate their economies. In the US, a recent survey of CEOs showed executives remain reluctant to increase capital investment or hire at a stronger pace. However, the consumer recovery is progressing; the US unemployment rate is below 5%, median household incomes rose materially last year, and house prices have recovered. The US consumer confidence index is at its highest level in 9 years, showing that the presidential election campaign is not having detrimental effect on sentiment.



At the last Fed meeting on September 21, 2016, the Fed left rates unchanged, in line with market expectations. The next two Fed meetings are meetings are November 2nd (6 days before the US election) and December 14th. Most observers expect the Fed will raise rates in December, a foreseeable short-term negative sentiment hit to the stock market. However, beginning to close the yawning gap between the prevailing zero interest rate policy and historically normal levels is a step towards a more balanced

economy and stock market. The knee-jerk stock market response to rate hikes is offset by the better US economic data that is spurring them, especially in the labour market.

Meanwhile, supported by a healthy job market and rising consumer confidence, the increase in consumer spending appears well supported. That bodes well for improved corporate profitability in the quarters to come.

Regardless of the outcome of the November U.S. presidential election, both candidates appear poised to invest in infrastructure (similar to Canada). The new President is likely to use fiscal policy to drive growth in the economy as monetary policy has not done the trick. From 1956 to 2006, the U.S. economy grew 3.5 per cent per annum on average but slipped to an average of 1.6 per cent over the last 10 years due to the financial crisis of 2008 and general economic sluggishness. We currently have recovered to about 2 per cent, but the impact of the slowdown in China is holding back global growth. Financials, materials and industrials should benefit the most from fiscal spending.

We continue to look at equity markets favourably for the foreseeable coming quarters. While the extent of the rebound in corporate profits is difficult to predict, benign interest rates and accommodative stable economic conditions provide a reasonable backdrop. While many pundits continue to whine over low GDP growth, GDP growth is derived largely from productivity gains (historically 0.5% to 1%), population growth, and inflation. With inflation negligible, and US population growth lagging (a result of the aging “boomer” population), the days of 3-4% GDP growth may be behind us, at least for the next few years.

Yours truly,

THE LAURUS INVESTMENT TEAM