



NICOLA WEALTH QUARTERLY PORTFOLIO REVIEW: Q1 2018

Phil Tippetts-Aylmer, CFP, CIM

V is for VOLATILITY

Q1 of 2018 saw an unwelcomed visitor return to markets, one that we hadn't seen in quite some time and one that can play havoc with investors, their behavior and (as a consequence) their results. Volatility made a return in a fairly big way having been strangely absent throughout 2017.

We saw our first official correction (an official correction is a drop of 10% or more from a market high, while a drop of 20% constitutes an official bear market) in just over two years (the last official correction was late 2015/early 2016), when between January 26th and the close of trading on February 8th, the S&P 500 fell 10.2%. Many other major markets saw significant pull backs in early February without getting to the dubious 10% mark. The MSCIAC World Index dropped 9%, while the S&P/TSX dropped 8.5% from its January 26th high.

This drop was soon followed by a rebound of sorts, with most major markets rising and closing out February above their year-to-date lows. This was simply the first salvo of this early 2018 volatility barrage. Following the 10% drop in the S&P, we saw a number of sharp climbs and falls:

Gains

1. Over 7% between Feb 8th and Feb 26th
2. Over 4% between March 1st and March 9th
3. Almost 3% between March 23rd and March 27th

Declines

1. Over 3.5% between Feb 26th and March 1st
2. Over 7% between March 9th and March 23rd
3. Over 2.5% between March 26th and April 2nd

This type of volatility occurred in most major North American markets and some major world markets as well.

In this day and age we closely measure and track volatility and, in fact, we (investors) also invest in it; essentially, betting for or against volatility on a daily basis. One of the key measurements of volatility in the markets is referred to as the VIX Index. VIX is the ticker symbol for the Chicago Board Options Exchange Volatility Index. This index tracks the market's future expectation for 30-day volatility. The VIX is built by measuring the implied volatilities of a broad basket of S&P

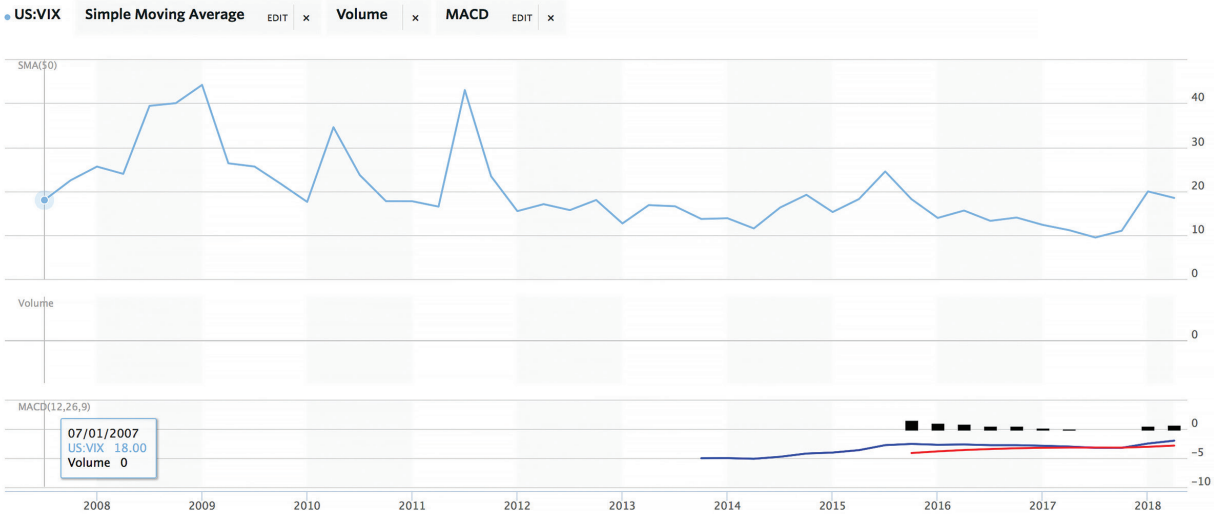


Hedgeye: Cartoon of the Day: \$VIX Fireworks 7/7/14

500 Index options. It measures future market volatility and is calculated using data relative to options, calls and puts. The idea behind the VIX is that it can give investors an idea of what to expect in terms of future market volatility.

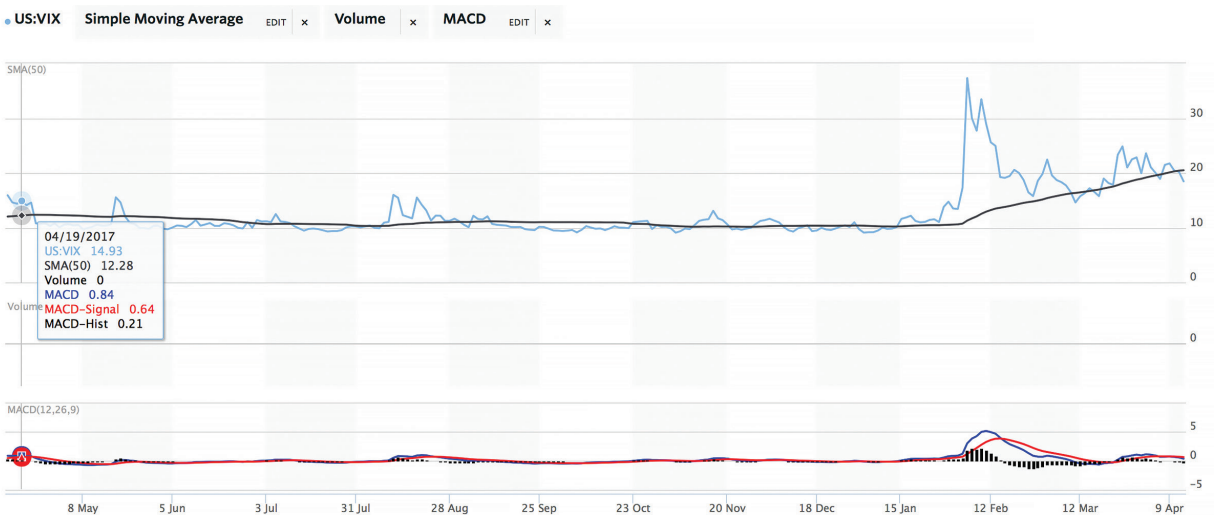
2017 saw the VIX at its lowest level since before 2008, with 2017 being one of the, if not the least volatile years since the VIX was introduced in 1993.

VIX 2008 – 2018



This graph (above) shows the VIX since 2008 and illustrates how low the index remained through 2017 in relation to previous years.

VIX May 2017 to March 2018



This second graph shows the VIX from May of 2017 and clearly shows the significant surge in the index in early 2018.

Source: www.marketwatch.com

Why is this significant? We have discussed the impact of investor behavior on results in the past; suffice it to say that investors all too often act emotionally and make investment decisions based on those emotions and not on rational analysis. At Nicola Wealth Management, we construct portfolios that are designed specifically to reduce volatility, allowing investors to weather the volatility storms that inevitably come, and to achieve a more consistent result over the long term.

At times like this, and when the next official bear market eventually comes (which is also inevitable), the Nicola Wealth Management philosophy of broad diversification utilizing alternative asset classes such as commercial real estate, private equity and private debt, alongside a firm focus on cash flow, will be as valuable as it has ever been in the past. We are confident that our clients will reap the benefits of that approach when the bear comes out of hibernation. Just like being at the start of the *Guardians of the Galaxy* ride (formerly the Tower of Terror) at Disneyland, it looks like there will be some ups and downs in our near future, so it's time to strap in and trust that at the end of it, albeit after a few screams, we'll have smiles on our faces and be none the worse for the experience.

Related to volatility, the next bear market and when it will arrive is a hot topic of conversation in the investing world with Bulls and Bears grappling for dominance of their points of view. Along with a few of my Nicola Wealth colleagues, I was lucky enough to attend the Strategic Investment Conference (run by Economist John Mauldin) in early March. This conference brings together many economists and investment experts from around the world. Presenters at John Mauldin's annual conference have historically been a bit on the bearish side, and this year was no different. Notable names such as Niall Ferguson, Grant Williams, and David Rosenberg echoed what many felt, that the end of the bull market was **probably** nigh but they just weren't sure exactly when.

It seemed that there were many who felt that the markets were due to correct within the next two years; however, there was both economic data and market analytics data that also pointed to there being some runway left in the current bull market. All of the prognostication and the analysis left me with reinforcement of a long held view that market timing is impossible to consistently predict accurately and that we are well served to maintain our investment philosophy of not relying on getting the timing right. In fact, I was pleasantly surprised to hear more than one presenter talk about diversification as being an effective shield against future negative volatility. I left the conference with a sense that we should be as committed as we ever have been to the Nicola Wealth Management approach.

MARKET HIGH(LOW)LIGHTS

So with all that said and the reappearance of volatility, how did markets actually perform when the first quarter of 2018 came to its close?

As we usually do, we can provide some data on how public markets have fared over this past quarter, in Canadian dollars and in local currency. The following table illustrates the returns of some key stock and fixed income indices and commodity prices for the first quarter of 2018.

	QTD 2018 ⁺ (CAD)	QTD 2018 ⁺ (Local Currency)
S&P/TSX Composite (CDN stocks)	-4.52%	-4.52%
S&P 500 (U.S. stocks)	2.21%	-0.76%
MSCI World (Global stocks)	1.74%	-1.21%
FTSE TMX Canada Universe Bond	0.10%	0.10%
S&P/TSX Preferred Share Index	-0.15%	-0.15%
S&P/TSX REIT (CDN real estate)	1.34%	1.34%
Gold Bullion NY	4.28%	1.74%
Crude Oil WTI	9.97%	7.29%

* Year-to-date March 31st, 2018. All indices are total return composites which include dividends, interest and distributions where applicable. Source: Bloomberg & Morningstar

As can be seen from the above data, the major North American market returns are negative for this first quarter, and while the MSCI World Index is showing as positive when measured in Canadian dollars, it is also negative when measured in the local currency.

Speaking of currency, we have previously addressed the matter of the influence that the U.S. dollar has on Nicola Wealth Management portfolios, either directly or indirectly. As such, it is prudent to note that the U.S. dollar strengthened against the Loonie in the first quarter of 2018 by around 2.5%.

NICOLA WEALTH MANAGEMENT PORTFOLIO PERFORMANCE

The **NWM Core Portfolio Fund** is one of the NWM pooled funds that is managed essentially by mirroring the asset class weights of our model portfolio, as represented by the performance metric of our NWM Core Composite which had a performance of 0.83% YTD as of March 31, 2018. It utilizes most of the NWM Investment Pools and Limited Partnerships, and has realized an annualized rate of return of 8.9% from July 2013 to December 31st, 2017. In the first quarter of 2018, this fund returned 1%.

Other positive performing funds included: NWM Global Bond Fund (3.6%), NWM High Yield Bond Fund (1.3% in CAD), the NWM Balanced Mortgage Fund and the NWM Primary Mortgage Fund (1.2% & 1%), NWM Private Debt Fund (1.2%), NWM Private Equity LP (2.5%), Real Estate including the NWM Real Estate Fund (0.3%) and SPIRE Real Estate LP (1.19% as of Feb 28, 2018), SPIRE US LP (1.31% as of Feb 28, 2018), and SPIRE Value Add LP (3.29% as of Feb 28, 2018), NWM Global Equity Fund (1.5%), and NWM Alternative Strategies Fund (1.6% as of February 28, 2018). (These returns are *before* the applicable NWM portfolio management fee, and individual client returns will vary based on a number of factors including unique risk tolerance, personal asset allocation, and timing of deposits and withdrawals.)

The negatively performing funds in Q1 included NWM Preferred Share Fund (-0.5%), NWM Precious Metals Fund (-3%) and the Canadian equities (-5.2% for the NWM Canadian Equity Income Fund and -2.0% for the NWM Canadian Tactical High Income Fund).

Note: Other than the NWM Global Bond Fund and SPIRE U.S. LP, the U.S.-denominated funds were also in negative territory.

PORTFOLIO TACTICS

With an emphasis on the overall Nicola Wealth Management approach as something of a focus in this edition of the QPR, I thought it would be relevant to make note of an imminent (minor) adjustment being made to the NWM Core Portfolio Fund weightings. These adjustments can occur at any time and are made strategically to take advantage of opportunities or to protect against threats. In recent years within the NWM Core Portfolio we have seen a reduction in the target for Canadian equities and a rotation into more U.S. and global equities. Over the same time, we have also changed our allocation in real estate by moving some funds from Canadian-focused into U.S.-focused pools, as well as incorporated SPIRE Value Add LP to the model portfolio in 2016. In 2017, we also introduced a new asset class, private debt.

With the evolution and ongoing funding of the new NWM Private Debt Fund, we are in the process of increasing the target weight for private debt from 2% to 4% (this should be completed within the next few months). The assets classes being trimmed to make room for this are: high yield bonds reducing by 1%, moving the target from 6% to 5%, primary mortgages dropping by 0.5%, moving the target from 3.5% to 3%, and balanced mortgages dropping by 0.5%, moving the target from 7% to 6.5%.

If you have any questions regarding this issue of the **Nicola Wealth Quarterly Portfolio Review**, or would like to arrange a meeting to discuss your personal portfolio results to see how this might affect your long-term financial plan, please do not hesitate to contact your Nicola Wealth Advisory Team.

IMPORTANT INFORMATION

1. *This material contains the current opinions of the author and such opinions are subject to change without notice. This material is distributed for informational purposes only. Forecasts, estimates, and certain information contained herein are based upon proprietary research and should not be considered as investment advice or a recommendation of any particular security, strategy or investment product. NWM is registered as a Portfolio Manager, Exempt Market Dealer and Investment Fund Manager with the required provincial securities' commissions. Please speak to your NWM Advisor regarding your unique situation.*
2. *Past performance is not indicative of future results. Returns are net of fund expenses charged to date. All investments contain risk and may gain or lose value. All investments contain risk and may gain or lose value. Please speak to your NWM advisor for advice based on your unique circumstances.*
3. *These investments are intended for sale to tax residents of Canada who are accredited. Please read NWM's account agreements, any purchase agreements and disclosure documents for additional details and important disclosure information, including terms of redemption and limited liquidity.*
4. *SPIRE Real Estate LP is an investment portfolio comprised of retail, industrial, office, hotel, seniors living and self-storage properties totaling 3.7 million square feet located primarily in major Canadian markets. SPIRE U.S. LP is an investment portfolio comprised of office, retail and industrial properties located in Seattle, and office properties in Denver, San Francisco, Houston and Chicago. The portfolio also includes interests in over 13,000 multi-family apartment units located in the South and South-east U.S. SPIRE Value Add LP is a new addition to the SPIRE and SPIRE U.S. investment portfolios and focuses on generating returns through re-sale of investments in multiple projects using "value-add strategies."*
5. *All values sourced through Bloomberg and Morningstar.*
6. *The NWM Core Composite returns represent the total returns of Cdn. dollar denominated accounts of all fee-paying portfolios with a NWM Core mandate. The composite includes clients who are both fully discretionary and nondiscretionary. Historical net of fee composite performance returns are calculated using individual realized time-weighted client returns net of fees and is presented before tax. The NWM inclusion policy is based on clients' weights at calendar month end. The composite returns are asset-weighted based upon ending monthly market value. The NWM Core mandate may change throughout time. Additional information regarding policies for calculating and reporting returns is available upon request. The composite returns presented represent past performance and is not a reliable indicator of future results, which may vary. NWM Core Portfolio past performance is not indicative of future results. Returns are net of fund expenses. Please refer to the NWM Funds disclosure document for additional details and important disclosure information. The NWM Core Portfolio Fund Asset Mix takes into consideration only the primary asset class of the aggregated funds but does not take into consideration the underlying fund's holdings of other asset classes. For example, the NWM Primary Mortgage Fund is allocated in its entirety to "Mortgages" even though it holds some "Cash." NWM is registered as a Portfolio Manager, Exempt Market Dealer and Investment Fund Manager with the required provincial securities' commissions. Client returns are net of NWM portfolio management fees.*