Heathbridge Capital Management Ltd.

Checkmark Investing™

COMMENTARY
Third Quarter of 2017

A KEY WAY TO MANAGE MARKET RISK–

A MATTER OF REBALANCING

Peppa Pig as a Weeble

Investment portfolios can get knocked around but if they are well constructed and well balanced, they will bounce back. It reminds us of the Hasbro toy the Weeble, whose slogan many years ago was "Weebles wobble but they don't fall down."

Weebles are still around. Peppa Pig, the beloved children's character controlled by one of our shareholdings, Entertainment One, has one.

The Holy Grail of Investing is to get Higher Return with Less Risk.

This can only be achieved through Diversification and Rebalancing.

THE CONCEPT OF DIVERSIFICATION GOES BACK TO BIBLICAL TIMES

"...divide your investments among many places, for you do not know what risks might lie ahead."

—Ecclesiastes (11.2), estimated around 935 BCE

Henry Markowitz went on to win a Nobel Prize for economics for his work, which he summarized in 1952 as "*diversification: the only free lunch in finance.*"

DIVERSIFICATION DEFINED:

dĭ-vûr′sə-fĭ-kā′shən

Diversification is a risk management technique that mixes a wide variety of investments within a portfolio. The rationale behind this technique contends that a portfolio constructed of different kinds of investments will, on average, yield higher returns and pose lower risks than any individual investment found within the portfolio.

Source: Investopedia

REBALANCING DEFINED:

riːˈbæləns ĭng

Rebalancing is the process of realigning the weightings of a portfolio of assets. Rebalancing involves periodically buying or selling assets in a portfolio to maintain an original desired level of asset allocation.

Source: Investopedia

DIVERSIFICATION WORKS BEST WHEN THERE IS PERIODIC REBALANCING

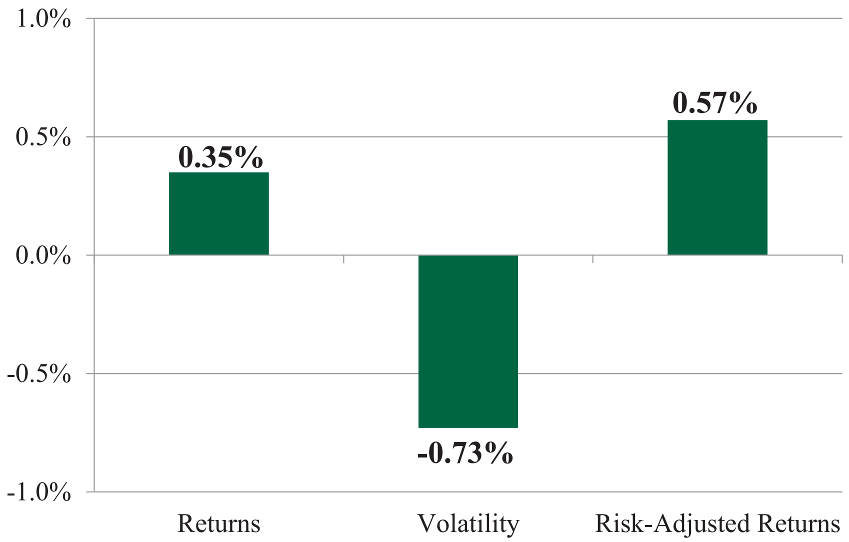
THE BENEFITS OF REBALANCING

The research below quantified the benefits of Rebalancing for Canadian, US, UK and Japanese portfolios using ten different methods of rebalancing for each country.

The results were universally the same for all four country portfolios:

- ✓ Returns were higher with Rebalancing
- ✓ Volatility (a measure of risk) was lower with Rebalancing

ADDED ANNUAL RISK-ADJUSTED RETURNS THROUGH REBALANCING CANADIAN PORTFOLIO 1980 - 2014



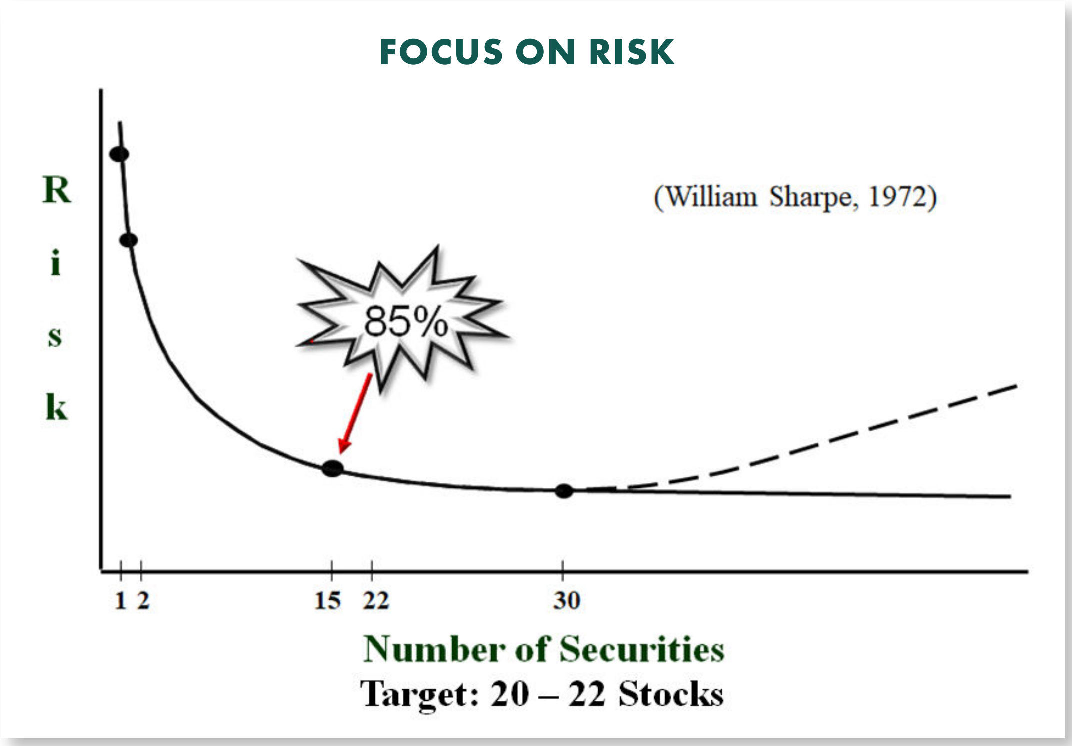
Source: "Rebalancing Act: Estimating the Value Added Through Portfolio Rebalancing," Raymond Kerzerho, Director of Research, PWL Capital Inc., July 19, 2016

With Heathbridge's Checkmark Investing™ rebalancing takes place in three ways:

1. **Rebalancing between Individual Stocks**
2. **Rebalancing between Stocks and Bonds or Cash**
3. **Rebalancing Geographically**

1 REBALANCING BETWEEN INDIVIDUAL STOCKS

First, a refresher on why we build portfolios targeting 20 - 22 stocks.



As Dr. Sharpe quantified in 1972, adding different securities to a portfolio reduces the overall amount of risk. The declines are dramatic as a second stock is added, then a third, and so on.

However after a certain point, we at Heathbridge believe that adding more securities lacks additional benefits and over-diversification occurs. Our target number of 20 to 22 stocks in our portfolios is rationally determined – as this number of securities optimizes risk reduction and allows for greatest control over the risk variables.

The paradigm illustrated above is one of the few economic models that can be verified by empirical testing.

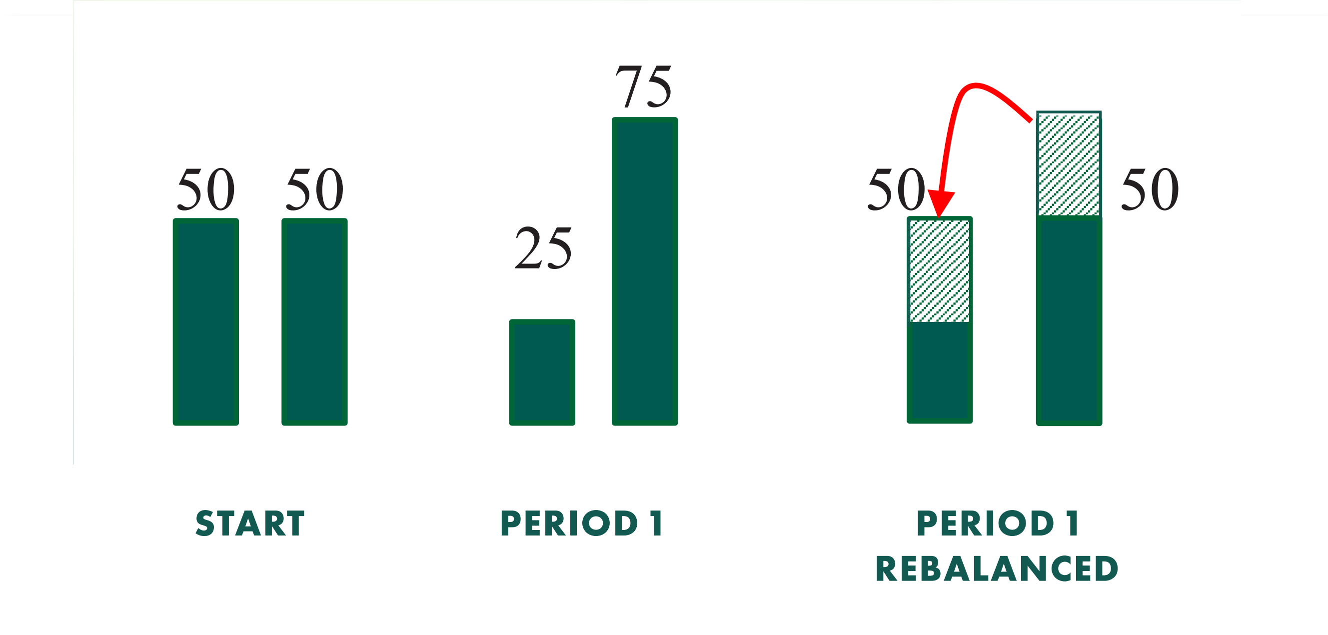
Implicit in the Sharpe model are two critical principles, which are:

a. **An Equal-Weighted Portfolio is Safer**

B. **Differentiation Optimizes Diversification**

1a AN EQUAL-WEIGHTED PORTFOLIO IS SAFER

The Sharpe model shows that if each investment is equal-weighted, the portfolio will maximize the impact of each stock's differentiating variables. In other words, any ratio other than equal-weighting is suboptimal. To illustrate, see the two stock portfolio below.



If after a year, one stock has increased by half and the other declined by half, the risk characteristics of the portfolio are dominated by the appreciated stock. Selling part of the larger-weighted security to buy the lesser achieves two important outcomes:

1. It rebalances and restores maximum diversification, thereby reducing risk
2. It adds to returns by selling high and buying low

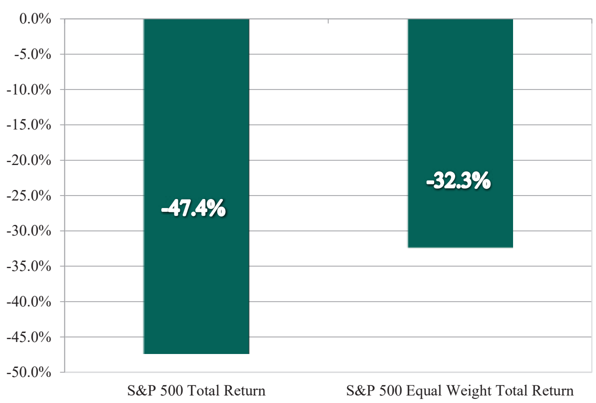
This rebalancing takes the emotion out of investing and serves investors well. Heathbridge portfolio managers review each portfolio in our care at least once per quarter to identify securities for rebalancing. This process is unique to Heathbridge in that we have deterministic targets and know exactly how much to trim or to add to rebalance risk.

EQUAL-WEIGHTED PORTFOLIOS GENERATE HIGHER LONG-TERM RETURNS WITH LESS RISK

Using a real life example, consider the S&P 500 index that weights each stock by its market capitalization (i.e. total dollar value of company). Hence, a giant company such as GE or Citigroup has a much larger weighting than a mid-sized company such as Rockwell Automation.

LOWER RISK

SEPTEMBER 1, 2000 - OCTOBER 9, 2002



Source: Bloomberg

When the "hottest" sectors have grown through market appreciation to a large weighting, index investors and unbalanced portfolios are effectively making their biggest bets on the most popular stocks. When affection for these sectors dissipates, these investors typically experience a painful correction. After the collapse of technology and telecom stocks from 2000 to 2002, the S&P 500 fell more than the equal-weighted version of the same S&P 500 (each company weighted the same at 0.2% of the index). The equal-weighted S&P index alone was safer because it declined less than the traditional capitalization-weighted S&P index.

HIGHER ANNUALIZED RETURNS

JANUARY 1990 - AUGUST 2017

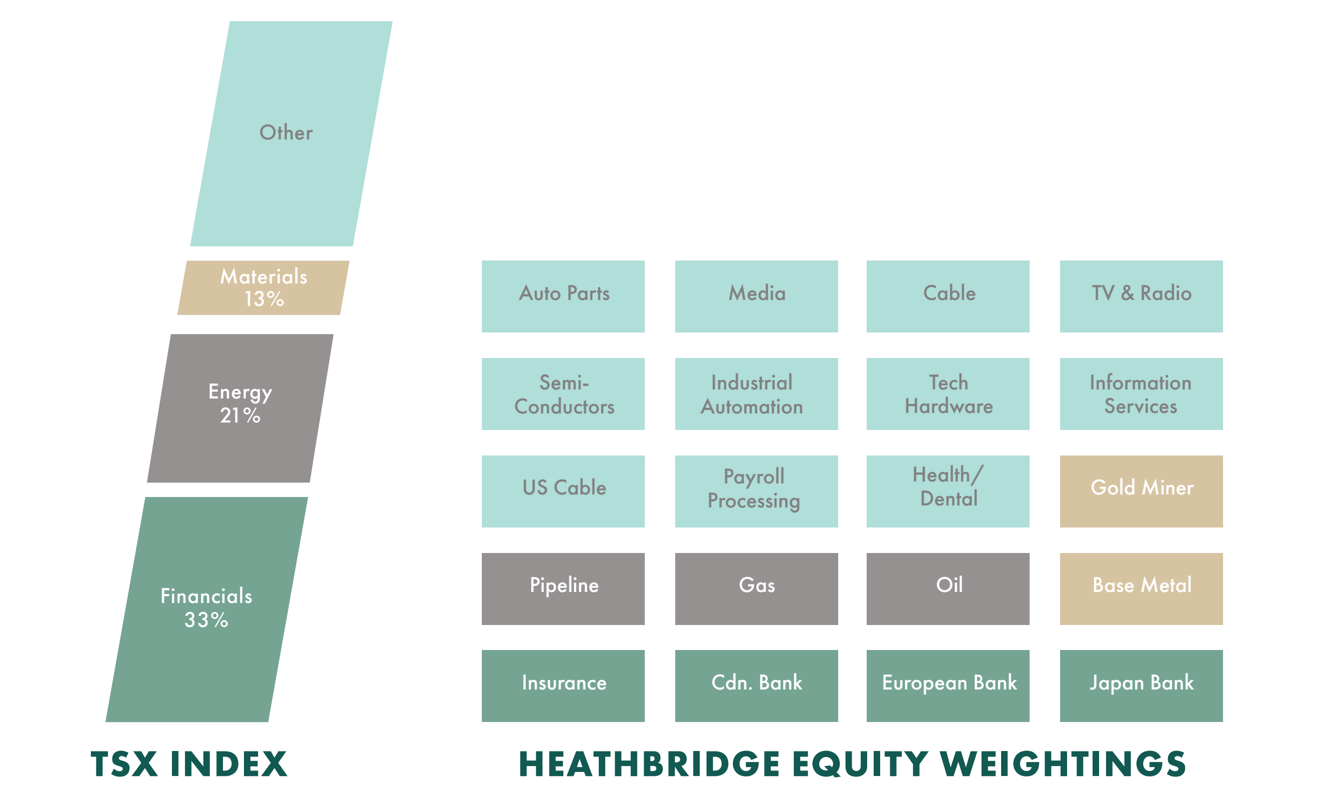
Source: Bloomberg

Over the long term, the equal-weighted S&P 500 index experienced higher returns than the market value-weighted index, as illustrated in the chart to the left.

Investors in these equal-weighted portfolios experience higher long-term returns with lower risk.

1b Differentiation Optimizes Diversification

Also implicit in the Sharpe model is the concept that each investment will be differentiated. That means, if we target 20 stocks in a portfolio, they will each be as different from each other as possible (i.e. different industries, different sectors, etc.). This helps avoid two behavioural finance pitfalls: falling in love with recently successful ideas and closet indexing.



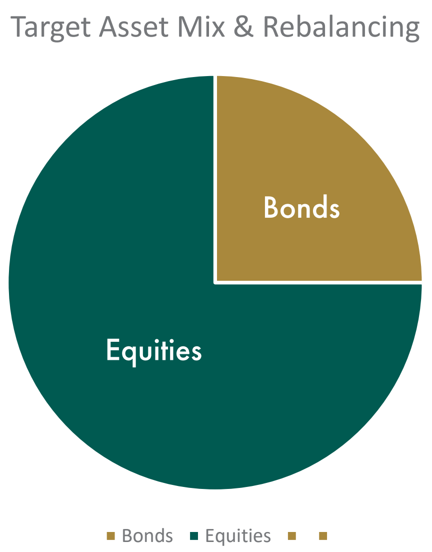
As you may have heard us say many times before, the problem with the main Canadian stock market index is that it is weighted two-thirds to three-quarters in Banks, Oils and Mines (Financials, Energy and Materials). These are cyclical industries that tend to have "blow-ups" every five to ten years. Betting two-thirds of one's wealth on these three cyclical sectors is imprudent.

Our fortress-like portfolio in contrast is far more robust.

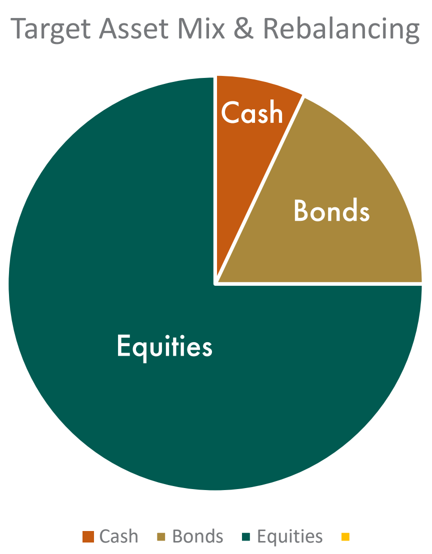
> **"It is impossible to produce a superior performance unless you do something different than the majority."**
>
> —Sir John Templeton

2 REBALANCING BETWEEN STOCKS AND BONDS

Here is a starting portfolio targeting a mix of 75% Equities (Stocks) and 25% Bonds.



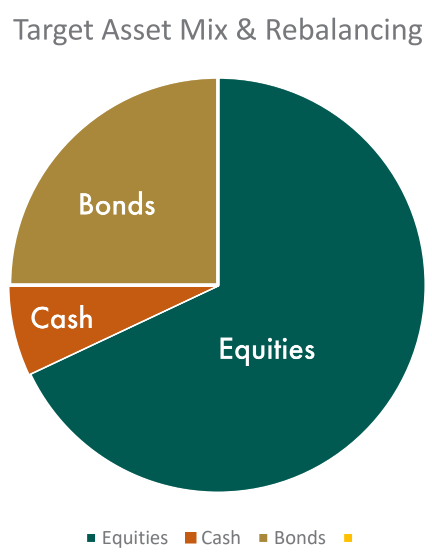
- ✓ The bond/equity asset mix is determined by long-term rate of return requirements. Asset mix should rarely change.



What happens when Stock prices RISE?

- ✓ As equity prices rise, the bond weighting will decline.
- ✓ To rebalance the portfolio, equities will be trimmed and cash will build in the total portfolio which can be re-invested in bonds.
- ✓ Net result: equities are sold at high prices.

WHEN STOCK PRICES FALL, NEW OPPORTUNITIES ARISE



What happens when Stocks prices FALL?

- ✓ As equity prices decline, the bond weighting will rise.
- ✓ To rebalance the portfolio in this case, bonds will be trimmed to generate cash to be allocated to equities.
- ✓ If potential checkmarks are identified, cash will be used.
- ✓ Net result: equities are bought at lower prices.

Portfolios that are targeting 100% Equities use the same principle, except when individual stocks are trimmed, cash levels grow to await new Checkmark™ opportunities.

3 REBALANCING GEOGRAPHICALLY BETWEEN COUNTRIES

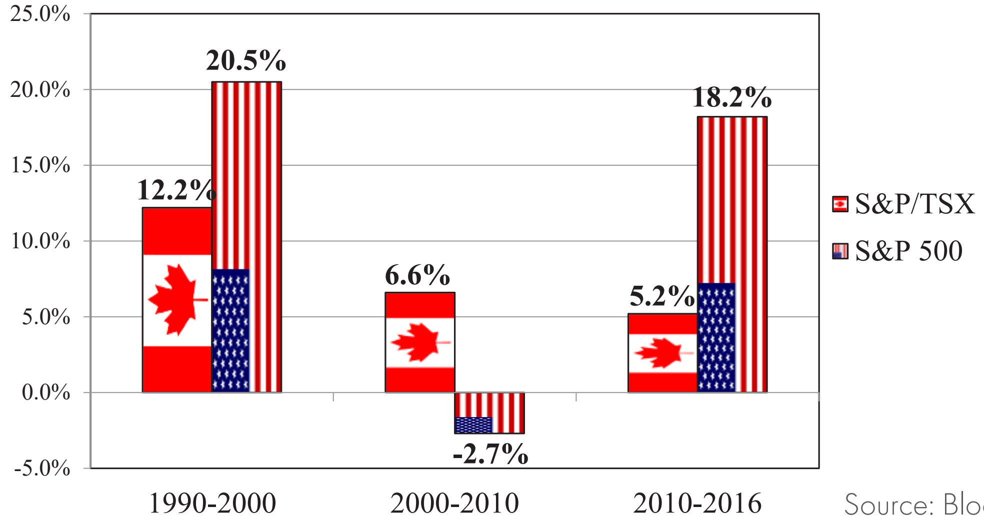
Most investors have a "home country" bias.

Canadian investors typically tend to own too many Canadian stocks, UK investors own too many UK stocks, etc. This makes sense to a certain degree since expenses are tied to the local currency and economy. Additionally, investors tend only to own stocks that they know.

However, in our Q3 2011 Commentary, we noted that 72% of Canadians had nothing invested outside of Canadian securities, which was very rash. A portfolio with both Canadian and US equities would have performed better.

We rebalance geographically, as illustrated in the chart below. Note that this simplifies the process somewhat since many of the companies that we own have global operations and the location of their head office is not particularly important.

ANNUALIZED RETURNS OF S&P/TSX AND S&P 500 (C$)
DECEMBER 31, 1990 TO DECEMBER 31, 2016



Source: Bloomberg

By the end of the 1990s, we were net buyers of Canadian stocks at a time when Canadian stocks were unpopular.

By the end of the first decade of the 2000s, we were net buyers of US stocks at a time when US stocks were unpopular.

In 2016 and 2017, we have been net buyers of Canadian stocks after several years when they were (once again) unpopular.

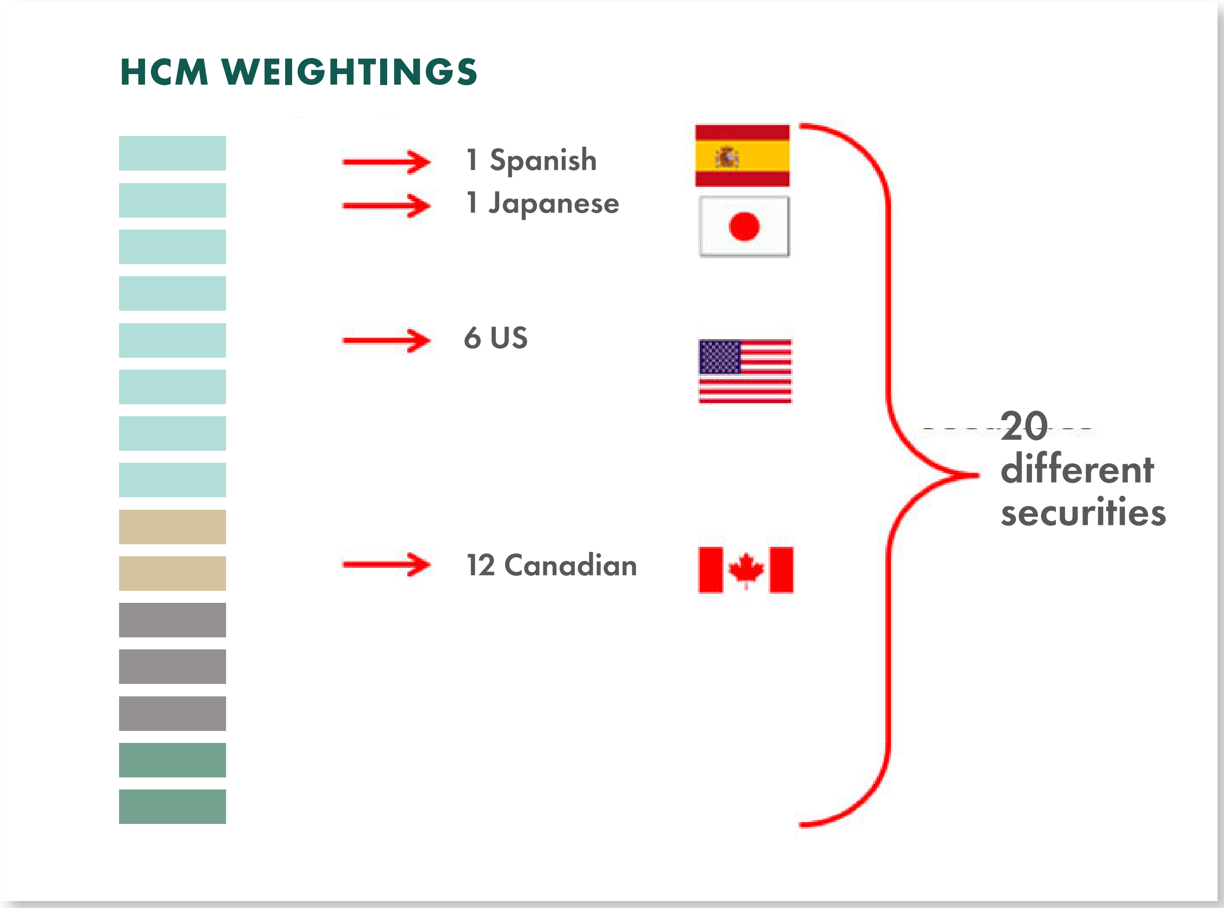
AN INTERNATIONALLY DIVERSIFIED PORTFOLIO

We have found that adding carefully selected non-North American headquartered stocks helps diversify portfolios.

The Japanese market has a low correlation with North American ones, so Japanese stocks are good diversifiers in a portfolio.

On the other hand, European stocks are not generally good diversifiers as their correlation with US stocks is actually quite high – 83% from 2000 to 2017. However, we found a quality Spanish stock that has very strong businesses in Mexico and selective parts of Latin America.

This is how we build a sound internationally diversified portfolio:



CONCLUSION

It remains true what Dr. Markowitz wrote in 1952, that *Diversification is the only free lunch in finance*.

This makes the investment principle of diversification timeless and something that will never go out of style. It is of no coincidence then that diversification is at the centre of Heathbridge's investment process and philosophy. Over the past 20 years, many things have changed in the investment world, but what has not changed is our consistency as a result of our investment discipline and rebalancing mechanics – that's why we call it Time-Tested Discipline™.

Discussing the topic of Rebalancing in this commentary provides more context on a critical mechanism that ensures our portfolios are aligned to attain maximum diversification benefits, regardless of market conditions or any other economic variables for that matter.

To recap, we Rebalance Portfolios with Checkmark Investing™ in three ways:

1. Between Individual Stocks
2. Between Stocks and Bonds (or Cash)
3. Geographically

To summarize, why did we want to talk about rebalancing and diversification this quarter?

- ✓ Because it reduces the risk.
- ✓ Because it enhances the returns.
- ✓ Because the investment process at Heathbridge is designed to ensure that we strictly execute on an investment discipline and parameters that are timeless.

All of this might sound boring, but it will allow you to sleep better at night while still being able to eat well during the day…enjoying your free lunch!