INNOVA
Market Insights

EQUITY Associates Inc.

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July 2015

Issue #37 - "Grexit, China & Investment Update"

Interesting Links from Around the Web

Greece : Crisis explained in under 3 minutes : Vox
China : China's Stock Market Crash Explained : Vox
Travel : Unique Places to Stay at Great Prices! : AirBNB

"Be Fearful When Others Are Greedy and Greedy When Others Are Fearful" The Oracle of Omaha, Warren Buffett

With fears of a Greek exit ("Grexit") from the European Union, a stock market crash in China and a precipitous drop in the price of oil, the markets are finally undergoing the initial stages of the price correction we've been anticipating for some time. As you are likely aware, we've been anxiously awaiting this pullback but unfortunately for us, we've not yet seen the panic selling on Canadian and US markets that leads to great deals, and so we are not quite ready to re-enter the markets. Our re-entry will likely happen in the midst of the starkest drop in the market and so we'd like to take some time to address the two largest economic concerns dominating the headlines and how these will not impact our plan to purchase shares at a discount, should a further price correction occur on our target markets.

Greece & The EuroZone

For all the fan-fare, politicizing and media-buzz, we view a potential Greek exit as periphery to our investment strategy for a number of reasons. Firstly, our exposure to European stocks and their banks in particular, which would be most affected by a Greek default, is very limited and would have little to no material impact on our overall performance. Any spill-over into other industries would likely be prompted by emotional investing and thus provide the opportunity to pick up great companies at a discount.

We feel that Greece simply cannot compete with the economic powerhouses of the Eurozone without the flexibility of a depreciating currency and so, should be allowed to leave the Euro, despite the short-term pain that will accompany it.

Moreover, representing less than 2%[1] of the Eurozone economy , this will have limited impact on the area as a whole in the near term, while we believe that it will create a disincentive for member nations to underperform and over-borrow – a harsh lesson that Greece will soon learn – and ultimately make the Eurozone a stronger economic alliance.

The Euro-zone is a collection of countries with vastly different economic engines. Given the strength of German exports, any declines in the value of the Euro that might occur due to the Greece fallout would immediately bolster the competitiveness and profitability of the types of company we do hold in the Eurozone.

China

Since June 12th, 2015 the Shanghai Composite, an index of mainland Chinese companies, has lost more than 30% of its value - a substantial crash in a very short period of time. When you dig a little deeper, the cause of this correction is easy to spot, but not easy to reverse as the leaders in Beijing are learning.

On average, a Chinese citizen has more than double the savings rate of a Canadian or American[2] . Due to capital controls imposed by Beijing, the average Chinese citizens' ability to invest this growing nest egg is very limited. Distrustful of the poor accounting standards notorious to mainland companies, many Chinese sought to buy up real estate in fast growing cities. As one of their only attractive options, this ultimately led to a real estate bubble as developers jumped at the prospect of putting those dollars in their own pockets.

In an attempt to thwart this problem, Beijing reacted with further controls limiting the number of properties that can be purchased by Chinese citizens, leading the wealthy to shop overseas for property. With real estate investment controls in place, investors with an appetite for return started piling into the next investment option, stocks.

Thanks once again to capital controls, the average Chinese citizen's participation in the stock market is in large part limited to the Shanghai composite index, and so cannot diversify their portfolios across borders expect through a special agreement with the Hong Kong stock exchange.

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As can be expected, this led to the initial gust of air into the 'stock bubble' of the Shanghai composite. Fresh with inexpensive capital and a mandate to put it into the hands of consumers from Beijing, Chinese banks began to lend to Chinese investors in margin and leveraged investment accounts. This led to one of the most impressive stock market rallies in recent history which saw the market double, effectively rising by more than 100% in less than 1 year from mid-2014 to June 2015.

In large part, this irrational rise and eventual popping of the stock bubble can be attributed to the investors themselves. Unlike developed economies where pension funds and professionally managed mutual funds make up the overwhelming majority of investment dollars, over 80%[3] of all shareholders in China are ordinary "retail" investors who have little to no experience with the stock market. As we've discussed in the past, humans on the stock market are driven largely by fear and greed, and so in an unsophisticated market, the effects of bulls and bears are exacerbated by short-term investors. We expect things to get worse there before they get any better. Given its meteoric rise, it still has a long way to go before it gets back to fair market value.

The real fear here is that this stock market collapse seeps into the psyche of an already weakening Chinese economy. This would have material impacts on the Canadian economy and dollar as commodity prices would certainly take a beating from the prospect of the world's second biggest economy slowing down.

Though this would have an important effect on the economy as a whole, we feel that the impact on our portfolio would be short-term and limited. Ultimately, our US exposure, wherein we remain overweight, would benefit from a drop in commodity prices while the Canadian dollars' drop would give us additional returns on currency on our international holdings. Given that we remain underweight on Canadian stocks in general and have limited exposure to commodity stocks in particular, we feel that we are well prepared to weather this potential storm, and possibly even profit from it.

We continue to expect, and perhaps even hope for, a broad market sell-off that would allow us to purchase quality investments at discounted prices. Should that happen in the next few weeks or months, please check your inboxes as we will solicit trades by email.

In the meantime, here is an update on our largest mutual fund holdings and their performance figures.

1 - KIRKEGAARD, Jacob F. "The Global Impact of a Greek Default". June 25th, 2015. Testimony to US Senate http://www.banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=b31d6b2d-dd48-4a68-aae9-63cbc441c037
2- WORLD BANK, The. "Gross Savings as a % of GDP" – 2010 to 2014 ; http://data.worldbank.org/indicator/NY.GNS.ICTR.ZS
3- WILLIAMS-GRUT, Oscar. "Why Chinese Markets are in Free Fall". July 8th, 2015. BusinessInsider.com http://www.businessinsider.com/why-chinese-stock-markets-are-crashing-2015-7

Individual Accounts

Performance figures As at July 6th, 2015

Fund Name	Category	Risk Level	Year to date	2014	1-Month	3-Month	6-Month	3-Year	5-Year	10-Year	Inception
TD Monthly Income	Cdn Balanced	Low-Medium	-0.89%	9.93%	-1.58%	-1.99%	-0.89%	7.92%	7.74%	6.10%	8.38%
CI Signature High Income/Diver. Yield	Diversified	Low-Medium	2.51%	8.57%	-1.71%	-1.59%	2.51%	8.71%	9.87%	6.89%	9.56%
CI Global Leaders Balanced	Global Balanced	Medium	12.42%	2.68%	-1.15%	2.32%	12.42%	18.63%	12.72%	No data	6.26%
TD Global Low Volatility	Global Balanced	Medium	7.08%	14.01%	-2.07%	-3.33%	7.08%	15.65%	No data	No data	16.04%
CI Select Income Fund	Cdn Bond	Low	2.18%	5.65%	-1.07%	-1.39%	2.18%	4.76%	No data	No data	4.56%
Edgepoint Global Growth & Income	Global Growth	Medium-High	11.16%	13.91%	-0.40%	1.73%	11.16%	19.95%	15.42%	No data	16.07%

Group Plans

Fund Name	Category	Risk Level	Year to date	2014	1-Month	3-Month	6-Month	3-Year	5-Year	10-Year	Inception
DynamicEdge Balanced	Global Balanced	Low-Medium	6.22%	6.19%	-0.78%	-0.36%	6.22%	9.78%	7.53%	No data	5.47%
Mackenzie Symmetry Balanced	Global Balanced	Low-Medium	3.15%	6.92%	-1.34%	-1.81%	3.15%	8.92%	7.48%	No data	8.57%