Come writers and critics, who prophesize with your pen
And keep your eyes wide, the chance won't come again
And don't speak too soon, for the wheel's still in spin
And there's no telling who that it's naming,
for the loser now will be later to win
Cause the times they are a-changing Bob Dylan, 1964

Given events over the past year, it seemed appropriate to begin this year's letter with a quote from one of the most influential voices of the 60's protest movement. Like most years in history, the past twelve months have passed with the inevitable ups and downs consummated by two historic events, both stunning in their conclusion.

It has been more than six months since Bluewater and Laurus started talking, three months since we formally combined businesses, and more than a month since we moved into our new office together. We have not learned anything that makes us feel differently about one another or our process, we get along very well, think similarly, and we have maintained our sense of humour. Just as important, we have achieved our primary goal – we are better today at what we do than we were at this time last year.

Over the twelve months, the market provided investors with the good and the bad. The initial gold index rally (+115%) in the first six months might have brought you good cheer – if not for the 80% collapse through the latter half. Of course, similar volatility has been experienced many times – the 75% collapse in 2008 followed a 40% rise, the 45% rise through 2010/11 was followed by a 60% collapse, which was subsequently followed by a quick 25% rise only to collapse another 60% through early 2013.

Chasing commodity prices or market sentiment just isn't our style. We prefer to invest in great companies with strong future growth prospects, buying more when a pessimistic Mr. Market offers a discount and selling/reducing the position when Mr. Market becomes greedy. While there are a variety of investment managers that successfully invest in the commodity market, we prefer gains that can be made elsewhere with much less volatility.

It has been an interesting year. As Dylan wrote over fifty years ago, the times are changing, and with that change comes the inevitable questions on which path to be taken in the future. As we've said many times before, our focus is NOT on the macro… but it's prudent to understand that, whenever economics change, the road ahead changes.

The Vote

Clearly the biggest events of the past year have been Brexit – the decision last June on whether the United Kingdom should leave the European Union – and the "shocking" victory of Donald Trump in the US Presidential election.

The consequences of Brexit are virtually impossible to assess given the time it will take to unwind current economic realities. However, it was the first indication of voter displeasure – and the reality that political status quo is in flux.

David Cameron's 2013 election promise to bring the issue of European Union membership to a popular vote was, at first, seen as the typical politician promise to put off potential consequences until tomorrow. Moreover, as the referendum was debated and, eventually, decided (with 37% of the electorate holding sway as only 72% of the registered voters actually went to the polls), there was no clear understanding of the consequences of the decision. As Thomas Friedman of The New York Times put it:

> *The politicians assume that the dog will never catch the car and they will have the best of both worlds – opposing something unpopular but not having to deal with the implications of the public actually voting to get rid of it. But they so dumb down the debate with lies, fear-mongering and misdirection, and with only a simple majority required to win, that the leave-the-EU crowd carries the day by a small margin. The dog catches the car. And, of course, it has no idea what to do this this car. There is no plan. There is just barking.*

Original estimates had the actual exit taking up to six years to negotiate. However, a lower court challenge to trigger Britain's Article 50 - the agreement which gives Britain and the European Union two years to agree to the terms of the split - has been initially successful with the High Court appeal to be heard in January 2017. So six years might be optimistic.

The UK economy appears to have weathered the initial shock of the Brexit vote, although the value of the pound remains near a 30-year low of 1.228 versus the USD (the peak in November 2007: 2.1064 USD). Opinion is sharply divided over the long-term effects of leaving the EU with a number of major firms purchasing input goods from outside the country pointing out that the slump in sterling has increased their costs. Of course, those that generate most of their revenues outside the country have benefited.

Britain also lost its top AAA credit rating from S&P, meaning the cost of government borrowing will be higher. But share prices have recovered from an initial dramatic slump in value, with more British-based businesses trading higher than before the referendum.

While there has been little impact to the investment markets there will, however, be considerable effect should the transition actually transpire; the "voting machine" Ben Graham referred to suggests the market does not believe the event to be an immediate issue.

The Vote 2

Not so the ascension of Donald Trump from self-aggrandized business person to President-elect.

During the race to the White House, news media were fixated on Donald Trump and Bernie Sanders – both outsiders to the traditional parties – with their large, vocal constituencies and decried by pollsters as zealots with little opportunity to win. The pollsters clearly misunderstood the millions of voters that were unhappy with the historic political arrangement and its direction.

The United States now heads into 2017 with a President-elect who espouses tax reform, protectionism, and spending cuts. A pro-business President with promises of renegotiating free trade agreements and “making America great again.”

On the back of Trump’s win, the market has experienced a strong rally based on the expectation that tax reform and a roll-back in regulatory reform will stimulate corporate earnings in the coming months. Just a few months ago, market prognosticators were pointing to the earnings “recession” the markets had recently experienced and the extremely high valuations (highest since 2001) that resulted, with predictions that returns in the coming year would be benign. By year end, the market was discounting fairly significant growth in 2017.

The recent boom reflects Mr. Market getting greedy once again. Based on historical norms, this excessive rally (almost 10% in a five week period) is unsustainable. Public equities are inherently long-term instruments that generate their cash flows over decades. The Presidency is a coalescing series of short terms, whose existence cannot be properly judged within the time frames we apply to it. We like to attribute events to certain Presidents because it makes for convenient political narratives, but when viewed through the less ideological lens it becomes clear that one can’t easily separate any event from one Presidential term to the next.

Leadership

In the case of Brexit and Trump’s election, leadership was lacking. Cameron shrugged responsibility for managing their membership in the EU, preferring to let the popular vote make the decision. Trump took advantage of a disconsolate voting population to propagate a series of untruths on how his election will “make America great again”.

These two situations are simply representative of a lack of leadership in today’s politics. Strong leadership is based on trust, which must be established before anyone will make the decision to follow. Trust is a feeling that emerges when believe that another person is driven by things other than their own self-gain. Correspondingly, that belief is gained by being consistent in everything done and said – ergo, lack of consistency will lead people to question your beliefs, which erodes trust. So political leadership, with its constant bias to waffle and tilt to the voting populace, fundamentally breeds a lack of trust.

We have often said that our goal is to uncover great companies for our investors. These companies are typically led by great leaders. But what makes a great leader?

Great leaders clearly define why their organizations exist…what pulls everyone out of bed in the morning and why anyone should care. Simon Sinek calls this the “Why” – why they do what they do; their purpose or belief. It’s not to make a profit as that’s simply a result of providing something of value. It’s not “How” the organization does it, though that may be what separates them from their peers. And it’s certainly not the “What” the organization does, as that’s simply a description of the business function.

Sinek believes people don’t buy what you do, that businesses thrive by selling why they do it. His key example, as one of the most innovative and successful companies, is Apple. He frames it this way:

If Apple were like everyone else, they would say, “We make great computers, they’re beautifully designed, simple to use, and user friendly. Want to buy one?”

Instead Apple says, "In everything we do, we believe in challenging the status quo. We believe in thinking differently. The way we challenge the status quo is by making our products beautifully designed, simple to use, and user friendly. We just happen to make great computers. Want to buy one?"

Apple is one of the most valued brands in the world. They have used the same strategy to sell mp3 players, touchpads, beautiful accessories, and now even a watch; something smart phones had almost made obsolete when all it did was tell time.

This is a terrific example of a great company. Most of us realized Apple was a market leader – a market capitalization growing from $5 billion in 1996 to over $833 billion in twenty years is strong evidence of their leadership. Few investors clearly understand why.

Finding great business leadership – with clarity of purpose and underlying discipline to avoid veering from that purpose – will almost always lead to uncovering a great company and, therefore, a great long term investment.

The Road Ahead

With the possible exception of the inverting demographic pyramid (as the boomers age), climate change will likely be the dominant investment challenge and opportunity in the years ahead. It won't play out quickly which means the investment market will likely miss its implications – after all, the "street" plays on actionable items to be undertaken immediately with near term results. However, the evidence overwhelmingly supports the fact the climate changes will have to be dealt with sooner or later. And for investors with a very long term investment horizon, the risks and opportunities of climate change have to be considered:

1. more frequent and severe weather events with possible implications to shipping or structural decay;
2. technological advances in batteries, electric vehicles or energy efficiency;
3. increased regulatory implications such as increased taxes or rules on energy efficiency; and,
4. changing consumer and corporate preferences and demand.

Another challenge and corresponding opportunity exists in changing technology within the financial industry itself. While this is not a new trend – companies like Jack Henry, First National, Gartner and Altus Group have graced our portfolios for some time – the pace of change is quickening. A report issued by PricewaterhouseCoopers in March 2016, suggests up to 28% of the banking and payments business is at risk of disruption by 2020 from new digital technologies.

Close behind is the disruption to the asset management and insurance industries, with venture capitalists closely watching start-ups reinventing the way we invest money. Most evident today is the "robo-advisor" whose ideology is based on the so-called efficient market theory. Briefly, they sell the idea that nobody can beat the market, so an investor should invest passively (i.e. exchange-traded funds), diversify his/her portfolio, and save on management fees.

Since many investment managers fail over short terms (particularly in turbulent markets), the efficient market hypothesis seems plausible. Yet others disagree. "*I'd be a bum on the street with a tin cup if the markets were always efficient*", quips Warren Buffett. Perhaps a correct interpretation of the efficient market theory should be: the market is usually efficient but sometimes provides an opportunity.

Robo-advisors are probably the easiest but not necessarily the best way to invest. They offer a low-cost investment alternative to be sure, but will not satisfy many of the investing public. Similar to the defined contribution pension products that have replaced traditional pension (where the end benefit is defined), they lack personal advice –

which leaves the investor flapping in the wind during turbulent periods. Further, Canadian markets lack diversification, so participation in Canadian exchange-traded products will combine both good and bad investments equally.

The robo-advisor will likely work for small account investing as an alternative to mutual funds but, like anything in the investment marketplace, buyer beware.

Despite regular challenges, the asset management business has continued to thrive through the years. The market environment since the early 1980s has been relatively benign, with a secular trend of disinflation leading to the low interest rates and the generally high equity valuations that we "enjoy" today. Globalization, favorable demographic changes, the democratization of investing, the information revolution, and the adoption of modern financial theories and practices have all provided tailwinds for the markets and for those managing other people's money.

Like any industry, the asset management business is filled with firms that run the gamut from low-cost providers (passive portfolios) to avant-garde product management (factor investing or smart beta). We have become generally more sophisticated in our methodology, yet are challenged to provide clients with the consistency, transparency, and asset protection they deserve. In response, the environment is changing as pricing pressure and volatility in assets under management take their toll.

The coming years will not be kind to traditional asset managers as the industry narrows. The largest asset managers are becoming commoditized – a result of shadowing indices and not providing customers with value net of fees. Hedge fund managers are not living up to the hype – proving once again that good marketing may provide short term asset gains but not a strong, long term business base. And the entrepreneurial spirit that gave rise to our industry fifty years ago is beginning to wane in the face of increased regulation, increasingly volatile markets, and a progressively more circumspect consumer.

The market we all face day-to-day is becoming increasingly challenging. The complexity of the global economy has been increased by monetary and fiscal government interventions everywhere. There is simply no historical example on which to draw comparison. When was the last time every major global economy was this over-levered and over-stimulated? I believe, other than going back to the Second World War, the answer is never. What is going to happen when governments like the US Federal Reserve begin to unwind their leverage? I simply don't know…but I do know that investors will need a trusted advisor in times like these.

The times they are a-changing. Or perhaps to paraphrase, the times will continue to change. And we must remain vigilant and willing to adapt to change accordingly. With the understanding, according to the old axiom, that this is a marathon and not a sprint.

At this time, we would like to thank our clients and their advisors for the continued confidence you've shown Laurus over the past year. As I've said in prior notes, every year end also marks a new beginning. All of us at Laurus wish you the courage, faith, and strength of spirit to walk the difficult road ahead - along with the tenacity and patience to achieve everything you desire.

Christopher (Chris) Page
President & CIO