The Market in Review

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This week's articles and insights

1. *The 80/20 Rule*
2. *Another One Bites the Dust*
3. *Uphill Battle for Canada*

"Never tell your problems to anyone. 20% don't care and the other 80% are glad you have them."

Your Index Report

	Current	Last Week	Year-to-Date
Dow Jones Ind. Avg.	20,941	+1.91%	+ 5.96%
S&P 500	2,384	+1.51%	+ 6.49% (+8.06% in $CDN)
TSX	15,586	-0.18%	+ 1.95%

The 80/20 Rule

In 1906, the Italian economist Vilfredo Pareto observed that about 80% of the peas in his garden came from about 20% of the peapods. He then took this concept into the financial world and saw that approximately 80% of the land in Italy was owned by 20% of the population, a ratio that applied to almost every country. It has become known today as the Pareto Principle, or the 80/20 Rule. It shows up in a variety of places.

For example, most companies will admit that 80% of their sales often come from 20% of their clients, and 80% of sales come from 20% of products. As well, 80% of complaints come from 20% of customers, and in most projects, 20% of the work takes 80% of the time.

In health care, 20% of patients use 80% of hospital resources, and in the home, 20% of your carpet gets 80% of the wear. We wear 20% of our clothes 80% of the time.

In the income tax world, Canada derives 82% of its taxes from its top 25% of income earners (source: CRA 2013). In the US, 86% of income taxes are paid by the top 25% of income earners (source: IRS, 2013).

Following this pattern, it should not surprise us that from 1989 through 2015, just 20% of stocks accounted for ALL of the market's gains while the other 80% contributed nothing (source: Longboard Funds). It is rather depressing to think that 80% of common stocks delivered essentially nothing in those years, but forewarned is forearmed. It obviously pays to find the top 20% and concentrate there.

It doesn’t always apply, because some aspects of society lend themselves to even more concentration.

For example, 1.3% of new movies account for 80% of box office revenues. This increase may also be happening in the financial world. For example, the percentage of profits accruing to the largest companies. A recent Wall Street Journal article showed that 84% of all profits in the US market accrue to the top 100 companies. Since there are over 3,000 publicly-traded companies, this is a very concentrated number. The top 100 companies earned 53% of profits in 1995 and just 49% in 1975, compared to 84% today. The most profitable companies keep taking a bigger and bigger chunk of the earnings pie.

Why is this? The story in the next section offers one perspective.

We are all chasing those companies that will outperform in the years ahead. Of course, we all want to find the next Alphabet (**NASDAQ GOOGL**) or Amazon (**NASDAQ AMZN**). The data suggests we are better off to buy the current winners rather than look for the next ones.

Food for thought.

Another One Bites the Dust

Even as some companies are soaring, there is always another in utter misery. That company this week was Home Capital Group (**TSX HCG**), a company that offers mortgages to people turned down by the banks. These are not deadbeats or poor credit risks. Often, they are self-employed people whom the banks reject because they do not have regular salaries. Home Capital charges them a slightly higher interest rate for the added risk. There are even people Home Capital declines who then borrow at higher rates from smaller, private lenders. Some call these “sub-prime lenders” but this is not really true. Any company lending to this less-than-AAA group has to do their homework. In fact, Home Capital’s default rate is very low.

So why did the stock drop from $20 to $6 inside of a week? Unlike a mining company whose assets remain in the ground or a software company protected by patents, mortgage companies live and die by their daily cash balances. They take in $100,000 and then lend it out for years at a time. If the deposit term matches the loan term (five years, for example), all is good. But when the deposits are daily savings accounts and the loans are tied up for years, this can be a recipe for trouble. Home Capital had issues several years ago with mortgage brokers fudging income data on clients in order to get mortgages through. The company downplayed this and kept the information from shareholders longer than they should have.

They were fined, but no one lost money.

However, when regulators charged several of the officers this month, depositors began to bolt from their High Yield Savings accounts, even though they are CDIC guaranteed up to $100,000 per person. We were part of the rush, because we have learned that he who panics first, wins. Home Capital found its funding source vanishing by the day and they could not recall the mortgage money they had lent out. They were forced to arrange a punishing 10% loan for up to $2 billion. Home Capital has now put itself up for sale.

On the surface, it makes one wonder about the state of mortgage lending in Canada because of the sharp rise in property values. If those values were to fall even 10%, many new homeowners would be underwater. Lower-tier lenders like Home Capital could be in trouble, but so could the Big Six banks. Is this the first straw to break in Canada’s overheated real estate bubble?

For now, credit standards have been tightened and the banks have passed all stress tests that simulate worsening conditions. And our banks have weathered many downturns in the past, including 1990 and 2008.

But what is likely to happen is this: increased concentration once again.

The lower-tier mortgage market is quite lucrative. It has been off-limits to Canada's banks, who lend only to the best borrowers. They would like to take a bite of this juicy apple, and so it will be interesting to see if Home Capital ends up being sold to one of the banks. Canada's banking industry successfully absorbed our brokerage industry when it stumbled after 1987, and Canada's trust companies after they collapsed in 1991. It would not be a surprise to see them quietly scoop up the second-tier mortgage market as well.

Which leads us back to the issue of concentration. In the interest of client safety, regulators have now helped Canada's banks grow even larger, even as they already control over 90% of deposits in our country. So when we are asked why fewer and fewer large companies are capturing more and more of both Canada's and the USA's profits, a good part of the reason is because of the load of new rules and regulations forcing small companies into the arms of their larger competitors.

Bank stocks fell during the Home Capital decline. They remain core holdings for us.

Uphill Battle for Canada

Despite all the issues facing the world, from North Korean tensions to upcoming elections in France and South Korea, US earnings in the first quarter were +9.2% over those last year. This is the best earnings growth since 2011.

Canada is a bit less rosy. Oil prices have declined due to poor discipline in the OPEC nations and the ongoing success of shale drilling technology. The breakeven costs of shale wells used to be close to US $100 per barrel, but have now fallen to under $50. Any production cuts in the rest of the world have been met with increases in US production. Energy is 23% of Canada's S&P/TSX Index, so our market follows oil closely.

Oddly, wood stocks have been the exception. Under assault by President Trump, Canada's unique trade relationship is in jeopardy if the NAFTA trade agreement is cancelled. Canadian softwood exports were slapped with a 20% duty, but since it was less than expected, the stocks rallied.

The truth is, the US has been building far fewer homes than needed since 2008, so a building boom is in full swing. They need every stick we can send them, in other words. They'll just pay more for them now. US homebuilding stocks remain some of the best values in the market today, we believe.

We want to say thanks to our clients for introducing their friends and family members to us throughout the year. It's a tremendous compliment and a huge responsibility, and something we never take lightly.

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