Dollars and $ense

May 2014

A STRATEGY FOR ALL SEASONS

Managing a portfolio in up and down markets

We get asked some very interesting questions: Why have the STYLUS funds been able to perform so well versus other funds? Does STYLUS take more risk? Do we have some sort of magic or secret formula? Here are a few key ingredients to our disciplined approach that has helped us achieve success in varying market conditions over the years.

In a perfect world, risk would not exist. In such a world – let's call it Investopia - investments would be highly rewarding *and* completely risk free. In Investopia, there is no "downside". Every day is a positive day. We can just sit back and earn the exact returns that match our specific goals and objectives. Unfortunately Investopia exists only as a figment of every investor's (and portfolio manager's!) imagination. The reality is that most investments are not risk-free and no one can exactly predict the future. In the real world, tradeoffs must be made between risk and reward: the less risk you are willing to take, the lower your likely return.

A proper evaluation of one's tolerance for risk is essential to an effective investment program. Of equal importance is knowing that market conditions are in a constant state of flux, with an unending variety of factors pressuring stock prices to go higher or lower. Investor sentiment can shift rapidly between fear and greed. We've written extensively on the pitfalls of trying to "time" when these unpredictable events and shifts will occur. We've also debunked several well known market timing strategies that try to use past performance to predict future prices (see the STYLUS website for the latest update to our report titled "Sell in May and Go Away – Does it Pay"). If it's not possible to predict shifts in investor sentiment and one cannot use past performance to time the market, *what is an investor to do?*

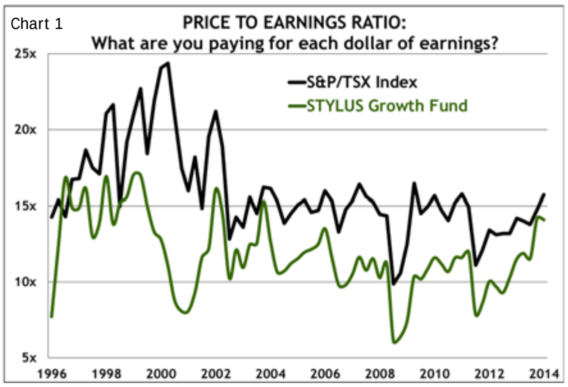
The answer begins with a realization that we don't live in Investopia. We know that in the real world, there is no magical investment strategy that will work ALL the time. Certainly our strategies do not produce constant positive returns every day. But they have proven to be highly rewarding in the long-run because they share a set of common sense rules which we follow with exacting precision.

STYLUS believes that one of the most important criteria in implementing any successful investment strategy is the willingness and ability to be an "active" manager. The term "active" can be misconstrued. It doesn't mean you are a day-trader or high-frequency trader. It means you have the knowledge and experience to adjust your holdings when new information becomes known. STYLUS plays the role of watch dog for it's clients– we make sure we are alert for any signs of trouble. The information contained in our database of over 3,000 stocks is updated and scoured every day by our investment team. Our disciplined and quantitative approach ensures that our funds will react and reflect any meaningfull changes to vital data including changes to stock prices, corporate earnings or analysts' forecasts.

Being active requires not only a *willingness* to make changes to your portfolio but also the *ability* to do so. Ability relates to being skilled at buying and selling shares relatively quickly and quietly, without significantly impacting stock prices. Before we purchase a stock, we examine its "liquidity" (i.e. the number of shares that trade each day). Liquidity is certainly important when you are buying a stock, and even more important when you are selling or trying to escape from a stock. Active management contrasts with the "buy-and-hold" method of investing, an approach where stocks are purchased and held for years, sometimes decades, regardless of the stock's underlying fundamental strength or weakness. In many cases, the buy-and-hold approach is used out of necessity. Some funds are so **BIG** that each holding is a significant portion of all the shares publically available to trade. This means there is only a limited number of stocks that some large funds can even consider buying. As difficult as it can be to buy a relatively illiquid stock, it can be even more difficult to sell. The STYLUS funds remain relatively SMALL, so liquidity is not really an issue. In addition, we plan on capping our funds once they approach a size that would impact our ability to be nimble and agile and trade on favourable terms. Capping our funds gives us a larger pool of stocks from which to chose and a lower risk of impacting stock prices when we transact.

Another important rule we use when managing our funds is to avoid stocks with poor earnings. We define "poor earnings" in several ways: 1) lower earnings in the most recent quarter than last year; 2) an earnings report that fell below our expectations; and 3) recent negative cuts to expected earnings. Common sense and history tells us that these stocks do not perform well. We used our real-time Backtest database to travel back in time and prove that a portfolio of stocks with poor earnings defined as above has generated an annual loss of over 19% per year since 1985 vs. a gain of 8.5% per year for the S&P/TSX Index. Avoiding buying a stock that already has poor earnings is relatively easy. But what if there is no warning and a stock we own suddenly has an unexpected "accident" and reports disappointing earnings? Our discipline causes us to sell, even though selling such a stock might entail realizing a loss. The reason we accept this loss is something we call the "cockroach theory". Just as there is never just one cockroach, bad earnings reports typically come in bunches, one following another. We have proven it is better to act on the first poor earnings report, and move on.

BUY LOW…SELL HIGH. Quoted by many but followed by few. Sometimes people get emotional and will pay ridiculous prices for such things as Cabbage Patch dolls and new versions of video games….and even stocks. Buying an expensive stock may not seem like a bad idea when it is HOT and looks perfect (Nortel is a perfect example). But having a set of objective rules that ask two very important questions "what am I paying" and "what am I getting in return" saves us from taking on unnecessary risks by letting our emotions cloud our judgement. For this reason, we evaluate a stock's value using such ratios as Price-to-Earnings, Price-to-Book, Price-to-Cash Flow or Price-to-Sales ratio (to name a few) not only on an absolute basis but also relative to a stock's own history. The lower the ratio, the better the value. We offer



The STYLUS Growth Fund has consistently owned stocks with lower Price-to-Earnings ratios than the average stock in the index!

Chart 1 as an example and more importantly PROOF that, just like we promised, we like to BUY LOW.

Each one of our funds has a specific personality. That means the rules we use to buy and sell stocks for each fund are different. But all STYLUS funds share a rule that helps ensure their personalities remain consistent: active trimming. Our funds are "equally weighted". So, in a 30 stock portfolio, each stock has a 3.33% weight. When one stock performs extremely well and its weight in the portfolio rises sufficiently, the gardening shears come out and we take profits. Trimming our winners is an effective way of preventing one stock from having too large of an influence on the portfolio, and helps to limit the fundamental and price risk of each fund.

We owe much of our success to following the investment rules we have outlined in this article. Following the rules takes much of the "emotional element" out of the equation and reduces the chances that personal biases are introduced. But following the rules is the easy part. Knowing when to introduce new rules or tweek existing rules is much more difficult. Technological innovation is relentless. Information that used to take weeks to deliver to the masses now takes seconds. We are constantly monitoring these changes and how they impact market and stock performance. Investment rules that were developed decades ago require updating to keep them relevant and profitable. We determine whether our rules need to be tweeked and adjusted so that we can take on as little additional risk to the management style of each fund. As an example….when market valuations become elevated and investors become nervous and fearful, our sell discipline is heightened. Like a gun fighter with an itchy trigger finger, our fingers are on the sell button, poised to act at the first sign of any fundamental weakness exhibited by one of our holdings. Likewise, when a market looks expensive, we stay selective buyers, preferring to wait until we can find a stock that meets all of our strict requirements and not overpay.

Table 1

% of all Qtrs Each Fund Outperformed the Index 1985 to 2014		
STYLUS Fund	Qtrly Success Ratios vs. the Index[1]	
	Up Markets	Down Markets
U.S. Blended Equity	63%	56%
Momentum	62%	56%
Growth	57%	62%
Value with Income	53%	62%
Wealth Protection	37%	91%

[1] used S&P 500 Index for U.S Blended Equity Fund and S&P/TSX Index for other funds. Includes backtested results prior to fund inceptions.

One should always measure success by how well an investment performs in different types of markets. The above table shows how often each of our funds has outperformed the index in both UP and DOWN markets. Each fund has it's own personality and as a result behaves differently. The U.S. Blended Equity and Momentum funds are designed with offense in mind. They tend to own stocks with high expectations that are like free swinging home-run hitters: performance will be terrific when they connect, but strike outs are a possibility when companies don't meet expectations. Not surprisingly, these two funds have higher success ratios in up markets than in down markets and would therefore appeal to investors who have a positive outlook for the market or those with a sufficiently long investment time horizon to withstand short term volatility. By contrast, the Wealth Protection Fund is designed with defense in mind. It tends to own stocks that will not likely be big winners OR big losers. As a result, it has a much higher success ratio in down markets than in up markets and should therefore appeal to investors who desire capital preservation over all else or who have a shorter investment time horizon. The above table does reveal a surprising result: all STYLUS funds add value in *down* markets, outperforming the index more than half the time. Regardless of an investor's outlook, the message is clear. The STYLUS funds are successful because they add value not only in up markets but also in down markets. It may not be Investopia, but our discipline has helped create funds that are suitable for all seasons.