INVESTORS' JOURNAL

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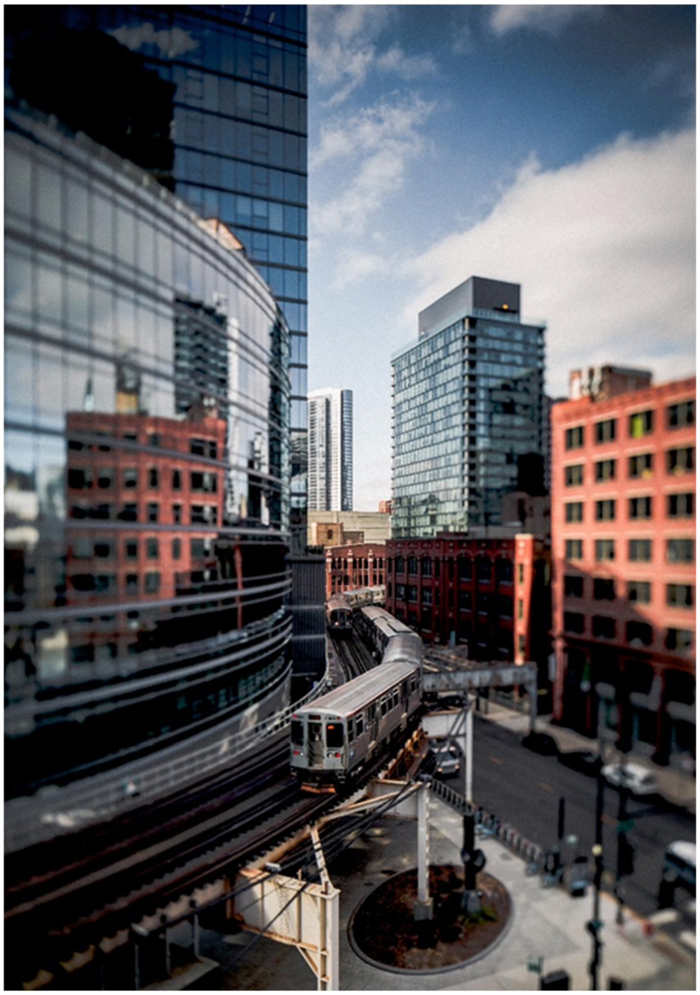
CAPSTONE
ASSET MANAGEMENT™

ECONOMIC UPDATE

2019 has come and gone and we are well entrenched into the busyness of a new year. But as they say, hindsight is 20/20, and there are many newsworthy headlines worth reviewing to prepare us for the next quarter.



The political and economic implications for market conditions have been numerous – a trade-war with China, interest rates, inverted yield curves, a slowdown in global growth expectations, Brexit, protests, and an unpredictable US president under impeachment. Despite the many investment risks, North American stock and bond markets did exceptionally well in 2019 and rewarded those who had the patience to see the year through.

US and Canadian Fixed Income markets began the year under pressure from regulators with a strong mandate to increase interest rates as quickly as possible and move out of emergency rate territory. This perspective rapidly reversed course as global market weakness incentivized the US Fed to drop rates 75bpts by year-end, while Canada cautiously held its rates steady. The drop in US interest rates caused bond prices to rise and many fixed income indices subsequently provided investors with strong returns. In Canada, although interest rates held steady this year, the market appears to have factored in a rate cut, demonstrated by benchmarks such as the iShares Core Canadian Universe Bond Index ETF (XBB) returning 7.3% in 2019.

Bond Yield inversions (when short term bonds have higher interest rates than longer term bonds) were also a theme for this year. This phenomenon is a clear sign that investors are feeling pessimistic about the future. Historically, it has been a reliable indicator of a recession 12-18 months down the road. However, other trends in 2019 have not yet supported the recession fears, and we continue to see stability in leading indicators such as employment, wages, and the housing market.

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A new year means new opportunities to invest in your registered accounts. If you would like to contribute to your TFSA, RRSP or RESP, please email us at privatewealth@capstoneassets.ca

ECONOMIC UPDATE

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On the geopolitical front, trade tensions between the US and China have remained high this past year, but investors sighed in relief when both parties agreed to begin working on a deal to avoid tariff deadlines by December 15th. The trade-war victims of 2019 were North American farmers and the manufacturing sector, while the winners could arguably be investors in the technology sector, which surged forward when a resolution appeared on the horizon. While a deal has not yet been signed, both parties appear to be motivated to resolve the dispute for the sake of their own economy.

While 2018 saw the introduction of various policies to cool the over-heated housing market, the real estate market across Canada showed its resilience in 2019. While certain policies, such as the mortgage stress test, are still working their way through the system, housing sales and market values strengthened during the year.

A significant percentage of Capstone's real estate exposure is located in the Greater Toronto Area and housing demand regained strength in this region in 2019. Condos and other housing projects that facilitate densification were the most popular, and the most affordable units sold quickly, due to restrictions added by the stress test. All of Capstone's mortgage funds exceeded 2019 return targets.

While the traditional stock markets in North America provided double digit returns this calendar year, it was not without some volatile moments. Furthermore, it is worth noting that the calendar year started during a period of steep decline due to trade wars and fears of a global slowdown. Although the equity markets quickly recovered and subsequently strengthened to even higher heights, investors should expect that volatility will be significant within the traditional markets going forward.

Many of the market concerns of 2019 have not been resolved (trade-wars, Brexit, elections, US impeachment issues, political protests and surges in national protectionism, etc.) These geopolitical factors, or something completely new, could pull on the hair-trigger of the stock market and investors should be aware of that possibility. Implementing strong global and sector diversification tactics while looking for value opportunities are good ways to help mitigate risks. Additionally, if investors have quality investments that are well diversified, employing the virtue of patience during a season of uncertainty is sometimes the best way to deal with a crisis.

Further diversification within Capstone portfolios is available to investors in the non-traditional or alternatives markets. The Capstone non-traditional portfolios achieved their target returns this year and we continue to see strength in both US and Canadian opportunities. While these investments often contain high barriers of entry, such as limited liquidity and high minimum investment amounts, providing them to investors within a pooled structure has allowed them to participate in this market while overcoming many of these barriers. Throughout 2019, Capstone has further built out the sectors that have historically formed our portfolios (real estate, private equity, private debt, infrastructure, etc.), while also expanding options to include difficult-to-access sectors such as farming and aviation leasing.

As of January 1, 2020, the total cumulative contribution room for a TFSA is $69,500 for those who have been 18 years or older and residents of Canada for all eligible years.

OUR FIRST FARM VENTURE

If you hold the Capstone Fixed Income Pool within your portfolio, you are now a part farm owner! As of early December, we have invested five million USD into this new partnership. Read on to find out more about this exciting new addition.

What type of farming are we talking about?

We are currently invested in farms across three business units: viticulture, horticulture and row crops. All of these investments are in the United States. In the viticulture arena, we have invested in four wineries, which represent permanent crops. We have also invested in horticulture, with the addition of walnut and almond seed farms. Horticulture could also include pistachios, avocados and table grapes. This diversification between different types of crops helps to smooth out the overall returns.

What is the difference between permanent and row crops and why is this difference important?

Permanent crops include fruits and nuts, such as wine, grapes, pistachios, apples, avocados, and citrus, among others. Even though some permanent crops are indeed seasonal, it can take years for some of these trees to mature and bear fruit. Furthermore, the initial investment in the trees or vines is considerable and they are not normally taken down at the end of each harvest.

Although permanent crops require a larger up-front investment, a larger labour force during harvest season and more patience, permanent crops produce good long-term yields and do not deplete the soil as quickly as row crops. Row crops, on the other hand, yield seasonal results and can be revised or displaced from one year to the next, making them an immediate cash generating crop.

Isn’t it costly to buy and operate a farm?

Yes, there are large upfront costs involved in purchasing suitable farm land and investing in depreciating assets, such as the plants themselves, the irrigation system, as well as the machinery needed for row crops. Within the vineyards, we do not own the equipment. A cost is assigned for the work done, while the maintenance of machinery/equipment and the hiring of labourers is done by the vineyard managers. Despite the various operational costs involved, we believe a stable return will be delivered.

Are there any other details that are relevant?

This particular strategy has implemented Environmental, Social and Governance (ESG) standards which we are evaluating more closely. This investment also has crop insurance, which pays 60-65% if there is a crop disaster such as fire or smoke-stains, etc. Lastly, although the investment is in USD, any currency exposure is hedged.

What is the expected yield?

The fund targets to distribute a real cash flow yield of 3-4% and another 2% of capital/land appreciation each year. Viticulture tends to be the higher yield and lower risk, since it includes land appreciation and relies less on yearly crop yield than horticulture. However, horticulture provides diversification that lowers the overall risk of the investment. Income or cash flow from viticulture is meant to smooth the income of the portfolio due to its high cash yield.

If you are interested in hearing more or potentially investing in the CFIP Fund, please contact your Portfolio Manager directly.

As tax season approaches, Capstone clients can expect to receive tax reporting and T-slips via mail and online. Please make sure to save these documents for your tax filing, due April 30th, 2020.

CAPSTONE'S POOLED FUNDS SUMMARY

Performance figures are those of Class F units as of December 31, 2019

Capstone Mortgage Pool
Diversified pool of construction and development mortgages (Launched November 30, 2012)

3 Month:	3.05%
1 Year:	9.12%
Inception:	8.12%*

Capstone Fixed Income Pool
Conservative, traditional and non-traditional income (Launched December 6, 2013)

3 Month:	4.09%
1 Year:	5.84%
Inception:	3.67%*

MarshallZehr Mortgage Opportunities Fund
Diversified pool of construction and development mortgages (Launched July 15, 2014)

3 Month:	2.54%
1 Year:	8.83%
Inception:	8.30%*

Capstone Non-Traditional Equity Pool
Diversified portfolio of non-traditional equity investment opportunities (Launched June 6, 2014)

3 Month:	3.73%
1 Year:	7.31%
Inception:	5.41%*

Capstone Traditional Equity Pool
Value-based approach to investing in traditional markets (Launched December 12, 2014)

3 Month:	5.10%
1 Year:	10.02%
Inception:	3.57%*

MarshallZehr First Mortgage Fund
Diversified pool of construction and development mortgages (Launched July 31, 2016)

3 Month:	1.55%
1 Year:	6.04%
Inception:	5.57%*

*Performance is annualized for periods longer than one year.

HAPPY NEW YEAR, FROM THE STAFF AT CAPSTONE!

We ended the year with many things to celebrate. During 2019, we launched a new fund, the Capstone Private High Income Pool. Our Non-Traditional Equity Pool was the winner in two categories at the 2019 Canadian Hedge Fund Awards. We welcomed new members to our team and enjoyed building relationships with all of our clients.

We wish you all a happy 2020 and look forward to connecting with you throughout this new year!

Front (left to right): Stephen, Heather, Denise, Leanne, and Suzi. Back (left to right): Maria, Janet, Colleen, Roger, Mikal, Brooke, Dora, Glenn, and John.

E INFO@CAPSTONEASSETS.CA T 604 546 1500 TF 1 855 437 7103 F 604 546 1501
218 – 20353 64 AVENUE, LANGLEY BC V2Y 1N5