INVESTORS' JOURNAL
June 2018
CAPSTONE
ASSET MANAGEMENT™

MARKET & INVESTMENT UPDATE

It is hard to believe that the first half of 2018 has come and gone. While the past six months have been fairly unremarkable on the economic front, there are still many large issues at play which could affect things for months or even years to come. Most notably, the protectionist policies of the U.S. have shaken trade treaties and economic relationships around the globe. By the end of this past quarter, the U.S. had implemented new tariffs on some international goods and this has prompted counter-tariff measures by their trading partners; the most prominent of which being China. While our neighbors to the south are working hard to protect their borders and promote their own products, history has shown that trade wars can weigh heavily on economic growth. So far this year, the U.S. economy has grown faster than usual, but the impacts of these major changes are likely to still play out.

On the Canadian front, the re-negotiation of NAFTA remains a very real threat and we continue to watch this closely. If significant changes do unfold, at a minimum, they could negatively impact Canada's manufacturing industry and these repercussions would have a serious ripple effect throughout the entire economy.

June saw the U.S. hike interest rates once again to the range 1.75 to 2% as their labor market continues to strengthen and inflation nears its target of 2%. Meanwhile, Canada has held interest rates steady at 1.25% since January. Expectations are high that the U.S. will continue to raise rates this year, while Canada will likely raise in July and then hold until data indicates additional movement is necessary.

Toward the end of this past quarter on the housing front, we have seen a bit of a divergence between the western and eastern markets. While the west is still gently correcting, the east, particularly the GTA, has slowly seen a stabilization in prices after a slowdown during the first part of 2018. New mortgage financing rules combined with the implementation of various provincial housing regulations, have sought to cool overheated markets and, combined with interest rate increases, buyers have shown more caution as they observe how the market will absorb the changes.

As Capstone considers the current economic environment, we are once again reminded how important it is to construct portfolios that can both optimize investment opportunities, while mitigating risks that could jeopardize successes. At present, a good example of this is in the fixed income market. While interest rates rise, bond prices have been going down and many investors are seeing little to no growth on this side of their portfolios. Capstone's Fixed Income Pool has sought to incorporate an overweight of non-traditional fixed income investments to help buffer the volatility seen within the traditional bonds holdings. Over the past year, Capstone's Fixed Income Pool has returned 3.78% compared with the 0.79% of the iShares XBB Index Fund (a good proxy for the Canadian bond market).

Continued on page 2

IN THIS ISSUE

"Make as much as you can, save as much as you can, and give as much as you can." John Wesley

WHAT ABOUT RISK?

Investing involves risk and too often investors are unsure what risks are associated with their portfolio and if they do know, they are unsure how to measure them. This is likely because for many people, risk factors can sometimes feel nebulous, subjective and even emotionally charged.

And so, where do we start? To begin with, the definition of investment risk is the chance you have of losing part or all of your investment. Yes, it is that simple. The factors that play into this potential loss and how to evaluate this chance, is where it can get complicated.

Why is risk so important to understand? Although it might seem obvious that a person should know the risks they are subjecting their hard-earned money to, the other side of the answer is that an investor should also know how much they are being compensated for these risks. If you have a good understanding of the risks in your portfolio, then you will likely know if your reward is suitable.

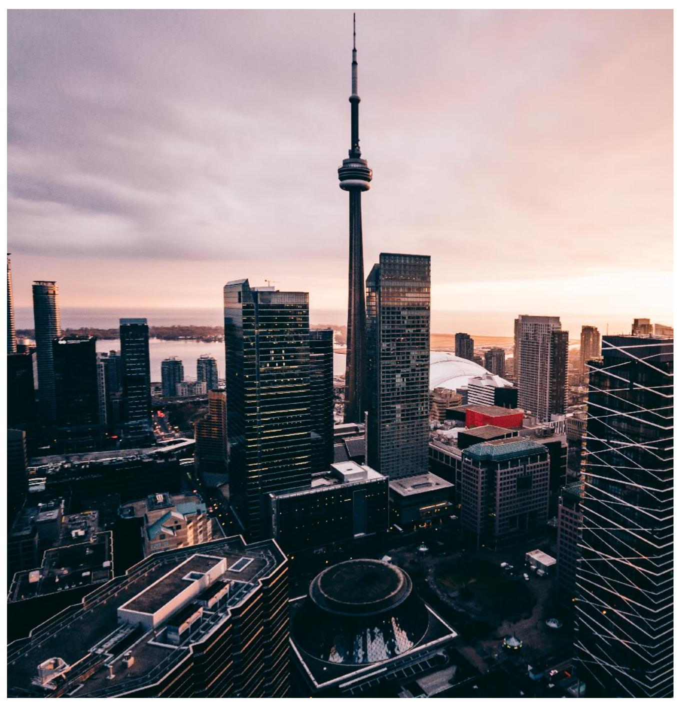
Measuring the amount of investment risk you *should* be taking is another important process that too often investors neglect. Why take a lot of risk if it is not necessary? To better understand your risk profile, you can start by determining the following:

- How much risk do you *need* to take to achieve your objectives?
- What is your financial *capacity* to take the risk (how much can you afford to lose)?
- What is your emotional *tolerance* to the risk you are exposing yourself to (how much of this risk can you emotionally handle before you start losing sleep)?

When you understand your risk profile from the perspective of your goals, financial situation and emotional capacity, you can better devise an investment portfolio that is suitable to your situation.

But what are the various types of risks that investors are frequently exposed to? By far, the most common portfolio risk is price volatility, or how dramatically and frequently the price of a security fluctuates. The risk with price volatility is the chance that you will need to cash out of the investment before it recovers from a decline, if it does at all. A really good way to evaluate portfolio volatility is by calculating the Standard Deviation. Although the formula can be complicated, many software packages can help you calculate this easily, and most funds will publish this information. For example, the 1-year standard deviation of the Canadian bond market is 3.8% versus the much more volatile stock market at 11.4%. Statistics tell us that almost all returns for investments are most likely to fall within 3 standard deviations of the average. You can see then, that the higher standard deviation gives you the higher chance of bigger losses, or bigger gains. This greater likelihood of loss increases the risk of the investment.

Another common risk is liquidity risk. This risk is most obvious for some non-traditional investments like real estate or items like art, precious metals or luxury cars. These investments often take time and extra expense to sell and many investors do not always factor in this lack of liquidity when evaluating the return they desire.



"The plans of the diligent lead surely to advantage, but everyone who is hasty comes surely to poverty." Proverbs 21:5

WHAT ABOUT RISK CONT…

At Capstone, a good example of investments containing liquidity risk is our various mortgage funds. These investments contain a diversified portfolio of mortgages, and since they naturally have a term to maturity, the funds cannot arbitrarily cash out the mortgage. For this reason, some of the funds trade monthly while others only permit sell transactions twice a year. Our investors should expect to receive a return that compensates them for this lack of liquidity.

Credit risk, which is the chance that a borrower will default on a loan, is another common risk. This can be found in fixed income portfolios since they contain debt instruments such as bonds, private debt or mortgages. Ensuring appropriate compensation for credit risk is critical and is reflected in the interest rate. The Capstone Mortgage Pool (CMP) has higher credit rate risk than the MarshallZehr Mortgage First Mortgage Fund (MZFMF). While both invest in mortgages, the MZFMF targets a 5% return with very low risk bank grade debt, while the CMP targets an 8% return and has a higher risk profile overall. When investors are looking for mortgage exposure and considering their options, they might simply look at the higher historical return of the CMP and choose that option, without recognizing perhaps that they are choosing a higher risk exposure compared to the MZFMF.

Currency risk is another factor Canadians are routinely exposed to as currency changes can quickly enhance or erode investment return. In fact, currency adjustments have a multiplicative (vs additive) effect on return calculations. This means that if currency has appreciated, the resulting profit/loss will be greater than simply adding currency and investment returns together. That said, adding the gain (or loss) from the investment to the gain (or loss) from the currency can give you a pretty good idea of the range of return you are dealing with and it is easier to see how big currency adjustments, particularly in the short-term, can dramatically impact performance.

Other risks include interest rate changes, political moves, fluctuation in markets such as manufacturing or housing, trade wars, geographic hurdles, and the list goes on. Each risk that is introduced to the portfolio must be fully understood so that a suitable investment return can be expected.

There are often ways to mitigate risk, but these can sometimes be expensive or difficult to access. The easiest way an investor can protect their portfolio against excessive loss is to diversify. Avoiding an over-concentration in any one risk category can help buffer the overall portfolio against unexpected sharp declines. At Capstone, the concept of diversification is one that we take very seriously, and our investment solutions incorporate this approach at both the investor's portfolio level as well as at the fund level.

"Life involves risks. Some risks are necessary, reasonable, and well worth taking. Others are not." - Randy Alcorn

CAPSTONE'S POOLED FUNDS SUMMARY

Performance figures are those of Class F units as of June 30, 2018

Capstone Mortgage Pool
Diversified pool of construction and development mortgages (Launched November 30, 2012)
3 Month: 1.87%
1 Year: 5.15%
Inception: 7.98%

Capstone Fixed Income Pool
Conservative, traditional and non-traditional income (Launched December 6, 2013)
3 Month: 0.77%
1 Year: 3.78%
Inception: 3.37%

MarshallZehr Mortgage Opportunities Fund
Diversified pool of construction and development mortgages (Launched July 31, 2014)
3 Month: 1.92%
1 Year: 5.48%
Inception: 8.22%

Capstone Non-Traditional Equity Pool
Diversified portfolio of non-traditional equity investment opportunities (Launched June 6, 2014)
3 Month: -0.57%
1 Year: 5.83%
Inception: 5.67%

Capstone Traditional Equity Pool
Value-based approach to investing in traditional markets (Launched December 12, 2014)
3 Month: 4.50%
1 Year: 12.14%
Inception: 5.06%

MarshallZehr First Mortgage Fund
Diversified pool of construction and development mortgages (Launched July 31, 2016)
3 Month: 1.41%
1 Year: 5.67
Inception: 5.25%

Class F Performance is net of all Management fees and expenses. Performance is annualized for periods longer than one year.

STAFF UPDATES

Over this past quarter we welcomed Cory Gaston to the Capstone team, taking the role of Compliance Administrator. Cory comes with vast experience in implementing policies and overseeing procedures and will provide valuable support to the Compliance and Operations team.

On a sad note, Elyse Vroom will be leaving the team at the end of July. She has been with Capstone for eight years and began her time as Stephen Smith's Executive Assistant on the Operation/Compliance team. More recently she has been working with the Business Development team. Her depth of experience, attention to detail and good sense of humor will be greatly missed by everyone. Elyse will be spending time with family in PEI and then travelling for a few months before focusing on the next steps in her career.

If you would like to review your investments with a portfolio manager, please contact our team at wealthmanagement@capstoneassets.ca