VALUE CONTRARIAN
ASSET MANAGEMENT

May 1, 2017

Can We Talk???

Confidence – Confidence – Confidence

(It's the "Oxygen" of Our Banking System)

In real estate, a key fundamental has always been; Location – Location – Location. In stock market investing it's: Price paid – Price paid – Price paid, at the heart of a good investment.

In the banking and financial services sectors, a key ingredient is, Confidence, Confidence, Confidence.

The moment the markets lose confidence in a bank, mortgage company or investment fund, investors often start a mad stampede for the exits.
In short, investors want their cash back – Now!

This usually takes the form of deposit holders withdrawing money from high-interest accounts, investors not renewing a maturing GIC, banker's acceptance note, or fund investors simply asking to redeem fund units.

In the case of Home Capital, more than $1 billion has been taken out of Home Trust's high-interest accounts in recent weeks.
This run has occurred despite the fact that Home Trust, Home Bank and Oaken Financial, are all Canada Deposit Insurance Corp covered (CDIC) up to $100,000 dollars. And, despite the fact that Canada Mortgage and Housing Corporation (CMHC- which insures the mortgages of Home Capital) stated publicly: **"We have no significant concerns about the quality of mortgages in the Home Capital portfolio."**

Home Capital and its banking peers manage their business based on the unwritten rule of maintaining depositor/investor "Confidence". Clients entrust their cash to high-interest savings accounts and GICs issued by these institutions. This GIC money is then lent as mortgages to home buyers. For this business to work, depositors have to believe they will get their money back.

Today, the "trust" factor is breaking down at the country's largest alternative lender, Home Capital. This bond of confidence appears to have been seriously broken when Ontario Securities regulators alleged the company did not properly disclose in a timely manner flaws in its mortgage underwriting process to investors.

For mortgage lenders, surviving a crisis of confidence means finding new sources of funding. Not an easy task.

6 Investment Lessons Learned From The Home Capital Run On Assets:

1) The fact that a financial institution is covered by CDIC insurance is no guarantee that prevents a "run" on a banks deposits/GICs.

2) Often there are advance warning signs of a potential loss of confidence (or financial stress) months prior to any "run" on the bank's deposits.
   With regards to Home Capital, the "canary in the coal mine" moment was perhaps in November 2016, when brokerage firm Canaccord instructed its brokers to stop recommending Home's high interest savings account. A further sign occurred last month, when some of the big Canadian chartered banks introduced a cap of $100,000 dollars per client on Home Capital GIC products. ($100,000 is the maximum level covered by Canada's deposit insurer.)

   The lesson is simple. When a financial institution, such as Home Capital, has its GIC investment/deposit products boycotted or curtailed by the big Canadian banks… a huge yellow warning caution is in effect.

3) Home Capital and the ABC paper fiasco of 2008 are a reminder of the risks of reaching for higher interest rates compared to similar investment products offered by the chartered banks. Is it worth the extra 0.5 per cent?

4) The fact that the underlying business or assets of a financial institution are sound, doesn't necessarily ensure the bank's survival or prevent a "run". No one has proven there are any major issues with the **credit quality** behind Home Capitals Mortgage portfolio. Nonetheless, a run on a bank's assets can still occur.

5) Watch out for the risks of "contagion". Investors tend to see things as being correlated. This brings to mind "the cockroach theory", where if there is one cockroach, more must also be present.

   Thus, Equitable Group, another player in the Canadian mortgage sector also saw its shares plummet. This was due to the uncertainty created by Home Capital and general concerns about the overheated Canadian residential housing market. The risks of contagion have clearly gripped Canadian investors.

6) Finally, pay attention to short sellers. They usually conduct in-depth research and don't have the same conflicts of interests as the mainstream brokerage or analyst communities. Where there is smoke, the is often a fire burning somewhere. Nonetheless, short-sellers, who profit when stock prices decline, often employ bluster to overstate their cases.

Ben Horwood

Fund Manager
Value Contrarian Equity Fund
May 1, 2017

Value Contrarian Fund: March 31/2017 – **YTD Returns: + 1.55%**

Next purchase date Value Contrarian Equity Fund: May 31, 2017
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