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Strategy Update – December 2003

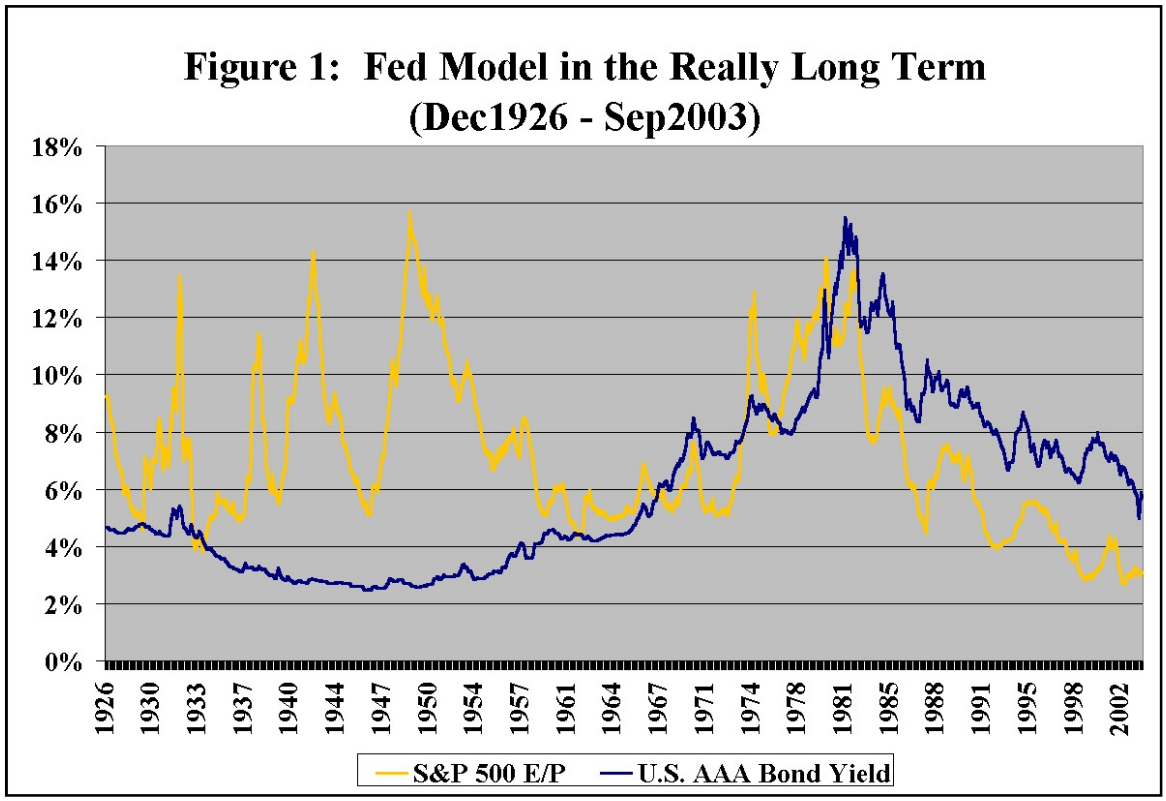
This is an annual instalment focussing on a fundamental review of broad asset classes and selected sub-classes. What follows are over-, under-, or normal- weight suggestions in the respective classes based on expectations for the future along with product recommendations. I cannot provide this type of advice and not call it market timing. That's what it is on some level but I'll only recommend a shift if something seems truly "out of whack" with fundamentals. Otherwise, I will simply recommend "normal weight" and provide a few thoughts and product recommendations.

Stocks vs. Bonds

The Fed Model is an often-used simple methodology for judging the relative attractiveness of stocks vs. bonds. It gets a lot of press because the model has intuitive appeal, but I'm not sure I buy into its merit. Dr. Cliff Asness, Managing Principal of AQR Capital in New York, has a working paper questioning both the theoretical and empirical support for this model. A truly long-term examination of this model shows an unreliable record of predicting returns. Plus, the relationship between market valuations and bond yields hasn't held up in the very long term anyway.

Figure 1 charts the S&P 500 earnings yield (i.e. inverse of the P/E ratio) based on most recent twelve months of GAAP net income, alongside the yield on AAA-rated corporate bonds. As the chart illustrates, the correlation between these "yields" is quite strong and positive (0.71) during the past 37 years. But the correlation during the previous 40 years shows a very different picture – a correlation of negative 0.49. The correlation over the entire 77-year period is 0.06 – which doesn't lend much support for a meaningful relationship. At best, this indicates an extremely weak relationship. This is particularly interesting since, in the early part of the last century, stocks traded on dividend yield (much like income trusts do today) – an environment during which I'd expect a stronger

link between the two "yields". The impact over shorter and intermediate time periods will be whatever most market participants think it will be.



It may simply be that market participants didn't see stocks and bonds as competing assets back then. Another possibility is that reported earnings figures may not be reliable – though I'm not sure that explains the graph since it looks very similar if replacing earnings yield with the more concrete dividend yield figure. Since interest rates tend to fall in slower economic (i.e. lower inflation) times, nominal earnings growth would rise and fall with inflation – with real earnings growth being more stable. In other words, it's not the market's earnings yield that changes directly but rather nominal earnings growth. If this is the case (which I'm inclined to believe it is), the Fed Model has little merit.

Equities

Stocks remain expensive, even in the context of today's real interest rates. For some context, let's look at the worst decade for U.S. stocks (i.e. the dirty thirties) shown in **Table I** on the next page. If the first decade of this century is witness to real stock returns

equal to that of the 1930s, the next six years will hold annualized returns of more than 10% per year above inflation.

That's encouraging until I go through some basic math to estimate the real earnings growth rate that will be needed to just match the worst decade on record. If real returns are to equal 2.4% per year from 2000 through 2009, earnings growth for the next six years must average more than 8% per year above inflation[1]. However, the median profit growth for the S&P 500 companies is just 1.5% per year in real terms. Hence, the first decade of the 21st century may snag the dubious honour of "out-doing" the dirty thirties.

Table I – U.S. Economic and Financial Fundamental Information

Decade	Starting E/P Ratio*	Starting Dividend Yield	Starting AAA Bond Yield	CPI**	Real Earnings Growth**	Real Returns**
1930s	6.0%	4.5%	4.7%	-2.0%	-4.5%	2.4%
1940s	7.4%	5.0%	2.9%	5.4%	6.2%	3.9%
1950s	11.3%	6.9%	2.6%	2.2%	1.1%	17.4%
1960s	5.6%	3.1%	4.6%	2.5%	3.3%	5.5%
1970s	6.2%	3.5%	7.7%	7.4%	1.7%	-1.6%
1980s	10.8%	5.2%	10.7%	5.1%	0.5%	11.9%
1990s	6.0%	3.2%	8.9%	2.9%	2.6%	15.1%
2000s***	2.9%	1.2%	7.6%	2.6%	-10.9%	-9.6%
Next 6yrs	3.1%	1.9%	5.7%	?	?	?

**E/P is the reciprocal of P/E (price-earnings ratio) for the S&P 500. An average of trailing three years of earnings is used for this ratio to smooth out cyclical extremes.*

***Annualized for each time frame. Earnings Growth and Real Returns are for the S&P 500 US$.*

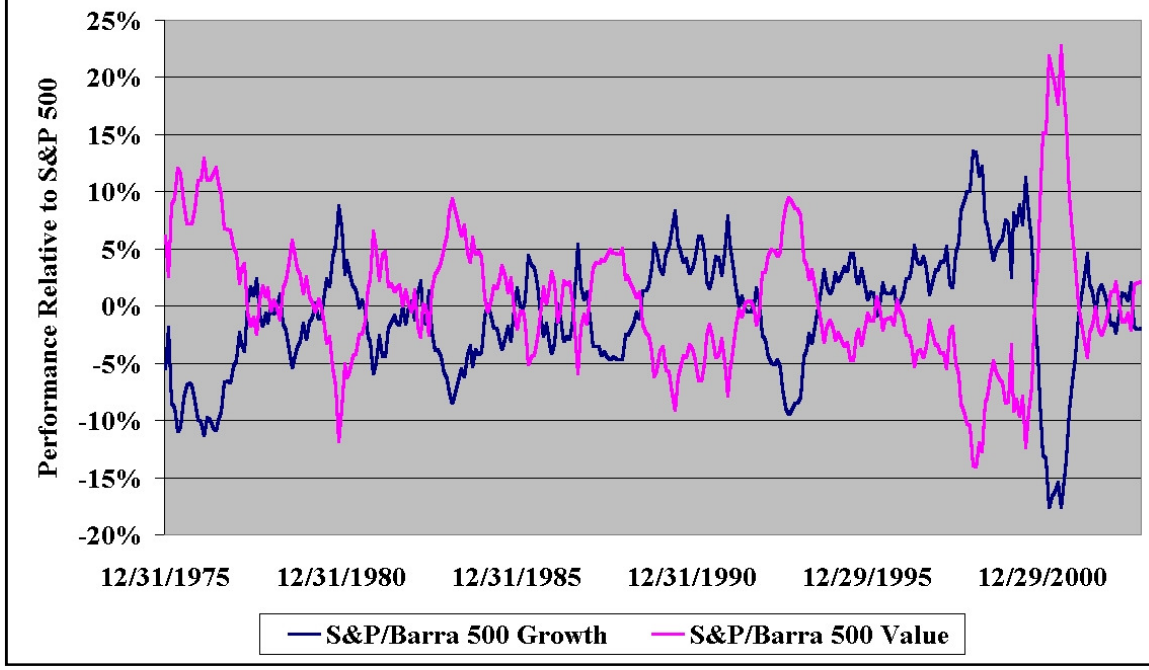
****Covers the period of January 1, 2000 through September 30, 2003 (45 months).*

[1] Expected return = (dividend payout ratio) x (E/P ratio) + real earnings growth

Style (overweight value)

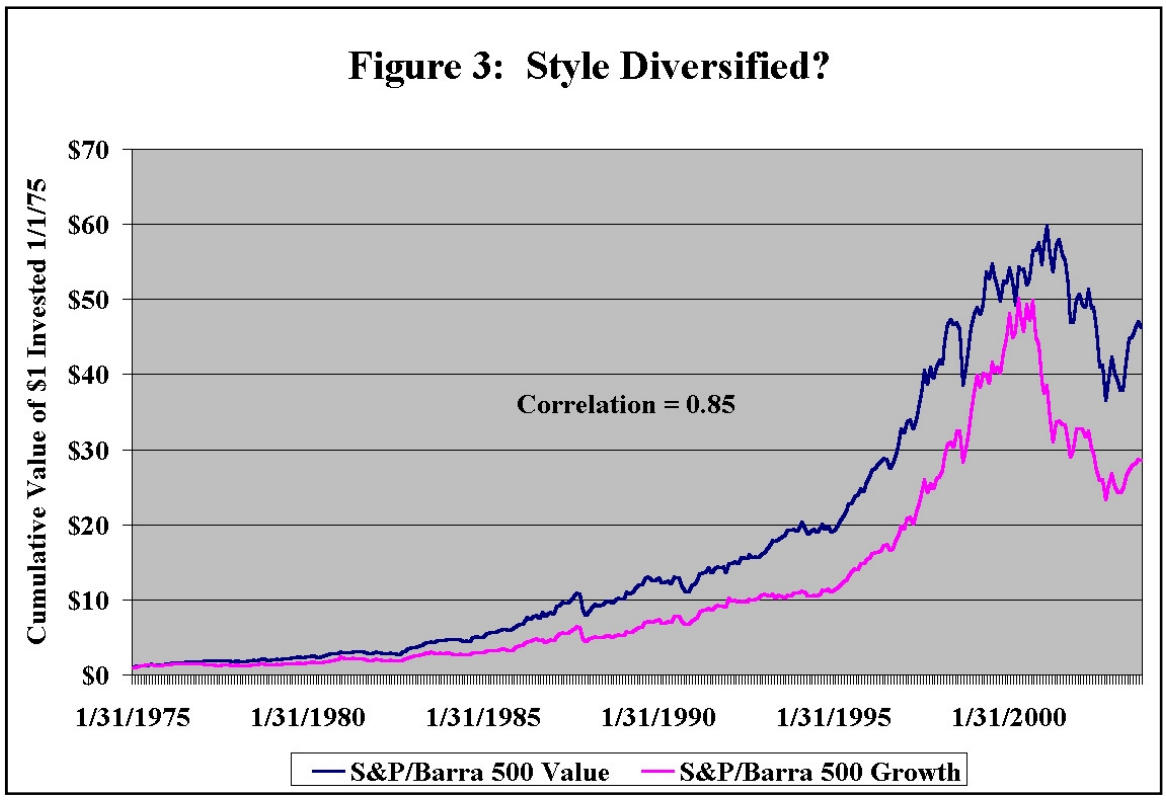
Let me say from the get-go that I have a bias in favour of value investing. That said, many fund companies hand out charts like **Figure 2** to make a case style diversification and/or to make the case that one style is poised to outperform. The chart appears to show a perfectly negative correlation between value and growth, which again has some intuitive appeal but there are reasons why this is a silly and misleading chart.

Figure 2: S&P/Barra 500 Growth vs. Value



Read the chart closely. The Y (i.e. vertical) axis is the outperformance vs. the S&P 500 by value (grey line) and growth (blue line). S&P/Barra 500 style indexes are constructed very simply by dividing the 500 stock universe by price-to-book (P/B) such that both groups have equal total market capitalizations. The S&P 500 index is a capitalization-weighted index, and the market caps of the value and growth subsets add up to the S&P 500. Hence, the returns of value and growth are, by definition the only two halves of the same pie so to speak so their returns should add up to the overall index.

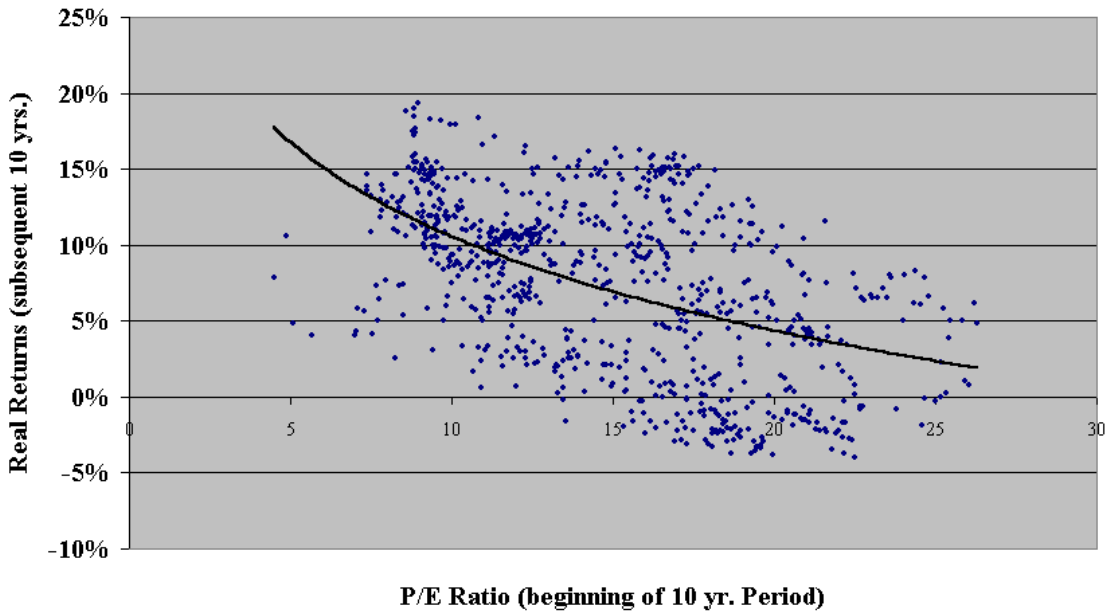
Figure 3 below shows a more realistic picture. Note the high 0.85 correlation between value and growth. It's not because the styles are that similar, but rather a reflection of the fact that these style subsets are poor representations of managers following the respective styles.



It's not the performance of value and growth that are perfectly negatively correlated, but rather the difference in their respective performance figures (vs. the index from which the style subsets are constructed) that are so highly negatively correlated. But **Figure 2** does not come close to even resembling any potential diversification benefits.

My value bias leads me to recommend that value managers in all equity segments get the lion's share of your clients' equity money. My personal preference for value managers is based in part on a study of historical data, which suggests that valuation is solely responsible for roughly 1/3rd of the variation in future returns. See **Figure 4**, which illustrates the historical relationship between valuations at the time of purchase and the returns (net of inflation) over the following ten years, on a rolling basis. The slope trending to the upper left indicates an inverse relationship (i.e. a negative correlation).

Figure 4: P/E vs. 10 Year Annualized Real Returns for the S&P 500 US$ (Jan. 1926 - Sep. 2003)



Size (overweight small caps)

In Canada, the valuation advantage that existed a couple of years ago no longer prevails as most Canadian equity managers are having a tougher time finding good value today. The likes of Irwin Michael, Kim Shannon, Vito Maida, and Gerry Coleman have all voiced concerns about market valuations and, more importantly, the sheer scarcity of new investment opportunities. While small cap stocks are not necessarily much cheaper, there are likely a greater number of opportunities given the much larger number of companies available. A slight overweight position is warranted in, in particular the following (in

order of preference): *Mawer New Canada* (no foreign content), *Standard Life Canadian Small Cap, Beutel Goodman Small Cap, Trimark Canadian Small Companies* (capped), *Saxon Small Cap (CI Canadian Small Cap is a 'load' version of this), Clarington Canadian Small Cap, Bissett Microcap* (capped), and *Talvest Small Cap Canadian Equity* are all good funds for small cap exposure.

Geography (overweight overseas)

Overseas stocks are generally cheaper (as measured by standard metrics) as compared to North America. Emerging markets are also attractively valued, though that's in part a reflection of a risk premium due to economic and political uncertainty. These are not new trends. They've been in place for some time, which means a longer-term commitment to overseas markets is needed to realize the potential benefits of their relatively lower valuations. International fund picks (in order of preference): *Mawer World Investment, Brandes International Equity, Trimark International Companies, Templeton International Stock,* and *AGF International Stock Class*. For emerging markets (in order of preference): *CI Emerging Markets* and *Templeton Emerging Markets*. It should be noted that with higher real interest rates, it's likely that the Canadian dollar will continue to strengthen against the U.S. dollar, but it should not be so significant as to influence portfolio allocations.

The lure of China is appealing and many want to tap into the growth potential. There is something of a misconception, however, that investing in China is the way to do it. But that's not the case. Investing in China is impractical because there remain money flow restrictions and limited availability of shares. It's also risky because current valuations are high due to the great expectations of this huge economy. The more sensible (albeit more difficult) way to play this theme is to invest in companies with potential to tap China's growth. The China factor is increasingly prominent in the analysis of managers of developed market portfolios – particularly where manufacturing concerns are evaluated given the migration of labour from North America to China. Hence, this theme is ever present in many equity funds not specifically emphasizing it in their marketing material. In other words, China theme funds aren't particularly appealing, in my opinion.

Fixed Income

The following table will be referenced in the commentary to follow on various fixed income segments.

Table II – Selected U.S. and Canadian Rates and Statistics

Canadian Bond	**Yield**	**U.S. Bond**	**Yield**
90-Day T-Bill	2.68%	90-Day Treasury	0.93%
3 Year Canada	3.47%	3 Year Treasury	2.61%
5 Year Canada	4.06%	5 Year Treasury	3.42%
10 Year Canada	4.77%	10 Year Treasury	4.38%
Long-Term Canada	5.27%	Long-Term Treasury	5.24%
Mid-Term Corporate (investment grade)	5.25%	Moody's Aaa Corporates	5.70%
Long-Term Corporate (investment grade)	6.29%	Moody's Baa Corporates	6.67%
RRB	2.90%	T.I.P.S. (30 year)	2.27%
Inflation (12 months ending Oct 2003)	1.58%	Inflation (12 months ending Nov 2003)	1.98%
Bond Market's Long-Term Expected Inflation*	2.30%	Bond Market's Long-Term Expected Inflation*	2.90%

Sources: Bank of Canada, Federal Reserve Board of Governors, Bloomberg

**Inflation expectation = (1 + long term gov't bond yield) / (1 + RRB or TIPS yield) – 1*

Federal Government (overweight long & normal weight for RRBs)

Whether government bond yields are evaluated in the context of inflation or credit spreads, short/mid term yields are low by historical standards. Real yields on government bonds are 120 to 200 basis points below historical norms and they've been rising steadily February 2003. Real yields are likely to continue upward somewhat, particularly on the short/mid term maturities. Hence, among government bonds, longer-term issues are relatively more attractive. For pure government bond exposure, it's just not worth buying a fund since any value added is likely to be more than offset by relatively high fees.

With real return bonds yielding notably less than 3%, it's getting down to a level that makes buying regular long-term government or investment grade bonds more attractive. Despite the guaranteed nature of RRBs, even ten-year Canadas are yielding close to 3.5% above inflation making RRBs less attractive than just a few months ago. Generally speaking, buying RRBs at yields much below 3% annually is not advisable – particularly when other fixed income options exist without taking undue risk. That said, RRBs also have valuable diversification benefits since they benefit from rising rates, which still calls for a normal weighting. That would likely switch to an underweight recommendation if RRB yields drop below 2.75%. Since existing RRB funds have fees that eat up half of the real yield, I'm not a fan of them, except for investments of less than $5,000.

Corporate/High Yield Bonds (overweight short term)

Despite a significant narrowing of credit spreads from a year ago, corporate bonds remain relatively attractive today, particularly among shorter maturities. Along the short end of the curve, stepping outside of the guaranteed universe into corporate paper provides a larger spread than has historically been the case. The credit spread among mid-term issues sits below historical norms while shorter-term credit spreads remain historically high.

Hence, while bonds deserve a typical or normal weight overall, emphasizing corporate paper on the shorter end of the curve, while emphasizing government nominal and real return issues for longer term bonds should provide a decent yield and reasonable protection if rates should rise.

Alternative Assets

This broad category is an important long-term portfolio component. However, advisors must be careful not to go overboard. Since these segments are usually employed in an effort to diversify exposure to publicly traded stocks. Hence, the allocation rules assessed for portfolios may be best specified as a percentage of traditional equities. A good guideline is to limit the total of these segments to a ceiling of 20% of a portfolio's equity component, with no single segment accounting for more than 10%.

Venture Capital (overweight)

Labour Sponsored Investment Funds have their share of issues. Lack of transparency, high fees, and potential conflicts of interest make fund selection difficult. However, there are a number of funds that, in my opinion, are worth a look. My February 2004 monthly report will contain an update on this sector and the LSIF recommended list, but last year's recommended list consisted of: *Working Opportunity (BC), Working Ventures Canadian, Dynamic Venture Opportunities, Ensis (MB), VenGrowth II,* and *First Ontario*. With the IPO market having hit a brick wall and valuations falling off a cliff, this is a good time to add to this asset class.

While LSIFs are typically sold during the RRSP season, advisors would serve their clients well by buying these only in taxable accounts. Clause 53(2)(k)(i)(C) of the Income Tax Act states that, unlike most tax shelters, LSIF tax credits do not reduce the adjusted cost base a LSIF investor.

Hedge Funds (normal weight)

Fees and a lack of transparency are also concerns with hedge funds. Managers are so secretive about how they manage money that I have a really tough time to get the details I need to make a good assessment. Alternately, I simply bombard hedge fund managers with questions. Failing the desired level of transparency, a long list of detailed due diligence questions help me to get a feel for this class. It's a long process, which means that I can't cover all funds. But of those few products I have reviewed, the one with which I'm most comfortable is *Abria Diversified Arbitrage Trust* – a fund of market neutral funds with a qualitative tilt toward manager assessment and selection.

Again, many funds are structured such that the tax treatment of hedge funds and linked is favourable relative to traditional asset classes. The uncertainty and lack of transparency of these products is somewhat offset by their preferential tax treatment.

Hard Assets (normal weight)

I'm a bit surprised that no fund company has yet stepped up and created a hard asset fund – which would invest in oil and gas, forest products, base materials, precious/non-precious metals, and real estate. We have plenty of specific funds but none that packages all of these classes in one mutual fund package. Failing that, some of the following are worth considering: *Mackenzie Universal Precious Metals, Mackenzie Universal Canadian Resource, iUnits S&P/TSX Capped REIT Index, Trimark Canadian Resources, TD Resource,* and *RBC Energy*. It should be noted, however, that REIT yields are not compelling so caution is urged in this sector.

This article was originally published in December 2003 as part of our proprietary investment research.

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