2012 Review – Optimism Returns

Chris Goes Green – No more Paper Mail!

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You may have noticed an insert in your December 31st statements announcing improved online access to your accounts. This includes the ability to select electronic delivery of your statements, confirmation slips and tax receipts.

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You can still receive paper mail if you like; you don't need to do anything. If you need help going paperless, give Barb a call at (416) 646-3836.

Happy New Year to all and welcome to 2013. You will have received your December statements recently, and they will show that we finally had a decent year. Below are the returns from major world markets for 2012 as well as going back 15 years.

The US market retains its uptrend of the last 5 years, having doubled from the 2009 bottom, and is now within 5% of regaining its all-time highs of about 1550 (S&P500) reached in 2007 and previously in 2000, twelve long years ago! These all-time highs are important psychological levels, and it will be very good to be through them[1]. (See Optimism Page 5)

The big surprise is Europe, sporting a return of over 17% for 2012. Even the Greek market was up over 30%[2].

The Canadian market was up modestly at 7%, held back by resource stocks, as precious metals and industrial metals such as copper and iron ore were weak in 2012. However, Dr. Copper (so-called for copper's reputation as an economic bellwether) has recovered about 12% since the summer of 2012, and is also within spitting distance of its pre-crisis high.

These price movements indicate that the global recovery is on track, if mild. A mild recovery is fine.

[1] New highs are very good for market psychology because everyone who owns stock is sitting on a gain, and so they are less likely to become sellers; at the same time, people who don't own stock become more inclined to buy, so the supply/demand equation tilts in favor of continued price rises.

[2] Athex Compsite Index, per The Economist

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The most remarkable feature of the numbers is the low returns of the last 5, 10, and 15 years. The numbers reflect the technology crash that took the broad markets down almost 50% between March 2000 and 2003; the markets had barely regained the 2000 highs by 2007 when the US financial crisis drove them down a stunning 58% in March 2009[3].

You think your returns have been low? No kidding. We have suffered *the* two greatest bear markets since the crash of 1929[4], and both in the same decade. Many investors are shell-shocked and understandably very nervous about the future. Anxiety is the predominant emotion today.

Anxiety and frustration, being emotions, are not managed well by reason and logic. As one client said recently in a meeting, ‘I don’t care that much about the explanations. I just want my portfolio to go up!’.

Average Annual Returns

Dec-12

	1 Year	3 Year	5 Year	10 Year	15 Year
TSX	7.2%	4.8%	0.8%	9.2%	6.5%
Small Cap	-4.9%	0.6%	-3.7%	2.8%	n/a
S&P 500 (Cdn. $)	13.5%	9.0%	1.8%	2.3%	2.0%
Dow Jones 30	7.8%	9.0%	4.0%	2.7%	3.4%
MS World (Cdn. $)	14.0%	5.7%	-0.5%	3.2%	2.2%
MSCI (Cdn. $)	17.3%	2.3%	-3.5%	4.1%	2.7%

Source: Globeadvisor.com

Proof in the pudding

Most if not all of you have experienced returns better than 2% over more than 10 years, because we have been heavily weighted to the Canadian market, (including specialist resource managers), we avoided the tech stocks, and many clients had a significant weighting in bonds to moderate the downside risk.

A $2 million pension fund account that I have advised exclusively for more than 12 years, with a strategy and asset mix similar to many of yours, has had a return of 5.7% in the 10 years ended 2012, and 9.3% in 2012, as measured by a 3rd party consulting service. Very few advisors can make this claim. (See also ‘Proof in the Pudding’ www.chrishoran.ca April 2011.)

[3] The S&P 500 index in the US and the TSX in Canada fell 47% and 49% respectively in the tech crash, and in 2009 the TSX, Dow 30, and S&P 500 fell 50%, 51%, and 58% respectively, peak to trough. Data per Financial Times.

[4] The next two biggest declines were 36% in 1968 – 1970, and 45% in 1973-74; Nick Murray, *The Excellent Investment Advisor*, p331.

The far more important point: your returns will be much better than the great many investors who made 'The Big Mistake' – succumbed to the (intense) pressure during those terrible declines, sold their equity holdings managed by experienced professional money managers, and fled to bonds.

Those investors, which industry data shows represent billions and billions of dollars, locked in their losses (and surely the losses were large, because it was the price declines that motivated them to sell in the first place), and are now sitting on bonds that are guaranteed to earn interest lower than the rate of inflation ... a few months of relief, followed by a lifetime of regret.

It is to your credit that, after the two worst market declines experienced by any investor alive today, you have not lost any money. You are the envy of all those who have. Thank you for your patience. I look forward to a much better 12 years ahead …

Looking Forward

As bad as the last 12 years have been, the only thing that matters now is where we are headed.

Today, equity market valuations in the US are reasonable: not the cheapest in history but certainly not high. Compared to bonds, however, stocks have not been cheaper since the 1950's. Corporations are in excellent financial health, and economic growth should come in at about 2.2% for 2012, which is a perfectly reasonable number.

What's more important is that within the overall market, of course, are sub-markets and individual companies, and this is where the opportunities lie. Even in a modestly-growing economy, there will be sectors and individual companies that will be doing very well, and will make great investments. This is the time for your professional investment managers to identify these opportunities.

US banks, for example, are selling at about half their net asset value, and should do extremely well as the US housing market normalizes over the next few years, according to David Slater, manager of Cundill American in Vancouver.

Ford Motor is seeing excellent recovery in demand for its trucks, and has both styling and very high quality standards across the entire automobile lineup, according to my car-nut publications and Danny Bubis, manager of the CI US Equity Plus Fund. Ford stock has gone from $6 to $14 since mid-summer, still sports a rock-bottom valuation of 10x earnings, according to Bloomberg Data Service, and is a major holding in Danny's fund.

Phil Taller, manager of Universal American Growth, invests in very specifically identified smaller US companies. The profile of his portfolio bears no resemblance to the broader market - good thing since his return of 15% beat the market by about 2% in 2012. Laurence Chin, manager of the Cundill Canadian Security Fund, saw his investments in Canadian lumber producers and US banks pay off with a handsome 20% return in 2012.

Retired and nearly-retired clients will be very happy with Eric Bushell's Signature High Income and Signature Global Income & Growth funds. Eric is one of the brightest people you will meet, and his understanding of the financial crisis has been lucid from very early stages. This detailed research has paid off with 2012 returns of over 11% in each of those two portfolios.

This is the time to have professional money managers investing your money. They will identify and research the opportunities that occur within the broad markets. While we all know that past performance is not an indicator of future returns, a time of mild economic growth is the ideal time for active professional portfolio managers to be capitalizing on individual investment opportunities.

Below is a table of some of my favourite money managers.

Average Annual Returns
Dec-12

	1 Year	3 Year	5 Year	10 Year
Canadian				
CI Cdn. Investment	7.1%	1.9%	-0.4%	6.7%
Signature Cdn.	8.2%	3.0%	0.7%	8.0%
Cundill Cdn. Security	20.4%	9.0%	4.2%	6.5%
Universal Cdn. Growth	10.4%	1.1%	-0.4%	5.4%
TSX	7.2%	4.8%	0.8%	9.2%
American				
CI American Small Cap	9.1%	8.0%	1.6%	3.4%
CI American Value	7.3%	4.3%	-1.1%	3.2%
Cundill American	10.1%	5.5%	-1.1%	n/a
Universal American Growth	15.3%	9.7%	6.4%	n/a
Black Creek Global Leaders	20.0%	4.7%	2.4%	n/a
S&P 500 (Cdn. $)	13.5%	9.0%	1.8%	2.3%
Dow Jones 30	7.8%	9.0%	4.0%	4.6%
MS World (Cdn. $)	14.0%	5.7%	-0.5%	3.2%
Income				
Signature High Income	11.6%	10.5%	6.7%	9.7%
Signature Global Income & Growth	11.3%	5.1%	2.5%	n/a
Sentinel Income	4.1%	4.9%	3.4%	5.2%
Sentinel Corporate Bond	11.5%	9.0%	6.8%	7.0%
Peer Index*	4.6%	4.3%	3.1%	3.9%

* Globe Cdn. Fixed Income Balanced Peer Index

Source: GlobeAdvisor.com

Important Note: These managers look after most of my personal and family investments, as well as yours. The only exception is the “income” managers, since I don’t own any bonds.

Optimism

It is helpful to keep a few positive facts in mind, to counter the negativity of the daily news. Herewith a few optimistic observations.

One reason for optimism is that the US economy continues to recover from the financial crisis, having been growing since mid-2009, now more than 3½ years. Unemployment is coming down (slowly), and US house prices nationwide have increased 4%[5]. All 20 US cities in the Schiller index are positive in the 12 months to October, with the exceptions only of Chicago and New York which are slightly negative. Meanwhile, Detroit, Miami, Minneapolis, and San Francisco are each up 8% or more, and Phoenix is up 22%. Lumber prices are up 40% in the last year, reflecting increased demand for housing.

The US economic recovery is weaker than past recoveries, because the consumer is paying down debt (not in Canada). A lukewarm recovery means that businesses can meet demand with little new hiring, so unemployment can be expected to come down more slowly than normal. Lukewarm is fine.

The outlook for the US economy is good. In addition to the strong demographics discussed in the last newsletter, technology and computing power is beginning to pay off with incredible new possibilities. For example 3D printing (also called laser sintering), where layers of material are repeatedly printed ('sintered') on top of each other to create a 3-dimensional object, could revolutionize manufacturing.

While manufacturing is less important in an educated, science-oriented economy (called a 'service economy'), manufacturing is beginning to return to the US as companies are finding that quick turnaround, high quality, and proximity to the customer is more important than the (declining) Chinese price advantage.

The iPod, hula-hoops, and a great many things in between were invented in California for a very good reason. American ingenuity, research, and entrepreneurialism will continue to help drive us all forward.

Emerging Economies

The emerging economies, having been through their debt and currency purgatory in 1998, escaped the 2009 financial crisis unscathed[6]. The economic growth rates in 4 of the 6 largest emerging countries are 4% or more per year, with the largest two, China and India, growing at 8% and 6% respectively[7].

Three billion people, fully one half of the globe's population, are escaping poverty and entering the world economy, with clean drinking water, sanitation, electric power, hospitals, medicines, not to mention education, and on and on. These improvements are possible because people are being freed from the 'dead hand of central government control' and are allowed to pursue economic freedom. Political freedom surely has to follow (we dearly hope).

China's forecast growth of 7% would double the size of its economy in only 10 years. This alone is cause for great optimism (see Trade below). The table below shows the economic growth of the 6 largest emerging economies, ranked by population.

	Population (millions)	2012 Growth (GDP)
China	1,300	8%
India	1,200	6%
Indonesia	232	6%
Brazil	195	2%
Mexico	110	4%
Turkey	75	3%

[5] Case-Schiller 20 City Index 12 month change +4% to October 2012 per S&P
[6] William De Vijlder, Chief Investment Officer of BNP Paribas Investment, in France. He is not alone in his view.
[7] Ranked by population per The Economist World 2013 edition; 2012 GPD growth and forecast per Economist; I arbitrarily excluded the Russian kleptocracy. Turkey's population is greater than any European country except Germany

In Europe, the central bank has finally stepped in as lender of last resort and has calmed the markets. This will give the governments breathing room to bring their spending under control. The longer things remain stable in Europe, the more time the banking system will have to heal, and the greater chance of dealing with an eventual Euro problem (as there is bound to be).

And anyway, as someone said recently, 'Who cares about Europe? China is adding the equivalent of Greece to the world economy every 6 months.'

The US, Canadian, and emerging economies have been expanding for over 3 years. Time to stop thinking recession and move on.

Q&A with Chris

Q: I'm worried about our economic future. The Chinese have low costs because they pay workers peanuts, have no environmental or safety standards, and they are taking our jobs. I saw a bumper sticker that said 'Put your neighbour out of work: buy another Toyota' or something like that. Won't the Chinese just take over everything?

A: The short answer is 'no'.

The key is trade. We fear trade because we think that one more Toyota is one less Chevy and one less job here. This fear of trade is a dangerous oversimplification.

The way trade works is that for every containerload of laptops that China sells us, they import the equivalent value – of office equipment, professional and scientific instruments, industrial machinery, oil and coal[8] - from us. It's a two-way street. That's why it's called trade.

(China's biggest import partner is Japan; one of Japan's biggest import partners is the US; so trade is actually a multi-way street.)

The value of the goods we exchange with each other matches closely. If they sell us much more than they buy, the mismatch drives up the Chinese currency, the Yuan[9]. A higher Yuan makes Chinese toys more expensive for Canadian parents, so Canadians buy fewer toys. A higher Yuan also makes Canadian machinery, like farm tractors, less expensive for the Chinese farmer, so he can actually afford to buy one. This is how the exchange rate mechanism keeps things in balance.

[8] China imported about $250 billion of these top 5 categories, comprising more than half of all Chinese imports, per The Economist.

[9] This is an oversimplification [but not a dangerous one]. The Chinese can sell Yuan and buy Loonies to keep the exchange rate down; this is ultimately inflationary because the Chinese would have to print Yuan to buy the Loonies. Repatriation of foreign currency reserves [Loonies] drives the domestic currency [Yuan] higher, because you are selling foreign currency to buy domestic.

RSP Reminder

The deadline for 2012 RSP contributions is Friday, March 1st, 2013. The limit is $22,970 for the 2012 tax year and for 2013 it rises to $23,820.

Your personal limit is on your Notice of Assessment from your 2011 Tax Return; your contributions to-date are on your Assante RSP statement.

If you currently do your banking online, you can send your Assante contributions via internet banking. (Please call Barb McKenzie to find out how!)

Increase to TFSA Limit

CRA has increased the TFSA limit for 2013 to $5,500.

If you don't have a TFSA and would like to open one or if you would like to transfer an existing TFSA held elsewhere, please contact Barb.

… China, continued

It gets better. When the poor, uneducated, unskilled Chinese worker has a job sewing ski jackets for Canadians, the worker can afford a small apartment for her family, with running water, a toilet, and a refrigerator to keep food from spoiling. She will pay taxes to build schools, hire teachers, and vaccinate her children. Her children will be educated and qualified for more difficult jobs like becoming a doctor.

When the Chinese farmer owns a tractor, he is much more productive. His children can go to university and become engineers, pediatricians or airline pilots. The wealthy Chinese doctor can afford a BMW, an iPod, a Prada purse, Italian shoes, a RIM phone, and a trip to the Canadian Rockies. And maybe a Chevy truck.

To see it another way, imagine if there was no trade allowed between American states. Say Texas had to provide its own lumber and Oregon had to find its own oil. Oregon's standard of living would fall (a lot) because they would have to devote significant effort to make synthetic oil. Texans' living standards would also fall because they don't have any trees bigger than a 2x4. Trade allows Texans to do what they do well – pump oil – and Oregonians to saw lumber. Each state is far better off by not wasting time trying to produce something it doesn't do well[10].

So trade with China may take away a job stuffing toys, but it is providing an even more valuable job to a Canadian making scientific instruments, computer equipment, industrial machinery or drilling oil wells.

The emergence of China into the modern economic world is likely to be one of the most important and beneficial developments in the history of humanity. It will create a much larger global economic pie and lift the standard of living for everyone.

[10] Even if a country can produce everything cheaper than another, it will still benefit from trade because it will do some things relatively less well; it will benefit from specializing in the things it does best and trading for the other things. See David Ricardo, Paul Samuelson e.g.

Book Review – Antifragile

Antifragile is more than robust. Nassim Taleb, author of ‘The Black Swan’, and ‘Fooled by Randomness’, invented the word because he couldn’t find one to describe the idea. Something that is antifragile actually benefits from a shock or volatility, whereas something that is robust can merely withstand volatility without damage.

Taleb makes the interesting point that much of our efforts in life are spent trying to protect ourselves from volatility or stress, yet almost all natural systems (like our bodies, or banking systems) are actually improved by appropriate levels of volatility. Much as strenuous physical exertion makes our muscles and bones stronger, the experience of not making a sports team, failing an exam, or letting a company go bankrupt makes us stronger and better able to handle future adversity.

Trying to protect ourselves from adversity makes us weak, and less able to handle a rough ride when it inevitably occurs. Some people, for instance, like to protect their children from the ignominy of losing a sports game by not keeping score; others like to think society is a better place if nobody ever loses their job. I even watched a mother hovering over her daughter at the gym as the professional athletic coach showed the girl how to run on a treadmill. What is the girl learning about confidence?

Taleb’s main point is that the most important risks we face in life and society are frequently not predictable or controllable. We never know when mortgage rates will go to 21%, reliable jetliners will terminate our railroad career, or the microchip will terminate our middle management job. These are the ‘Black Swan’ events (see www.chrishoran.ca newsletter, Feb 2010).

Antifragile means we would benefit from an adverse event, not just survive it. We would be antifragile if we had no debt and were bold enough to buy a house when interest rates went to 21% and prices fell. Antifragile means we had suffered the stress of knocking on doors for jobs or customers; then when our employer suddenly went bankrupt, we would benefit by putting our experience to work getting a new job.

Antifragility requires optionality. You are fragile if you have limited options. You become antifragile by giving yourself options. You give yourself options by having different courses open to you. The concept of antifragility is not quite as clever as Taleb thinks it is, but the book is an interesting and thought-provoking read.

Antifragile
Nassim Nicholas Taleb
Random House, 2012