February 2014

2013 Review
Stories Behind the Numbers

Chris has a BA in Economics from UBC, and a business degree from Western (now Ivey MBA). Before joining Assante in 1992 he was Treasury Manager for a Fortune 50 firm where one of his responsibilities was Chair of the Investment Committee of the $65 million pension fund.

Chris provides financial planning, investment planning and full implementation services to about 100 families.

We are pleased to welcome new clients.

For more information, please call (416) 216-6532 or email at choran@assante.com

As your December statements showed, 2013 was a great year. The returns were a surprise to everyone that I am aware of, which demonstrates once again that forecasting short-term returns is not possible. Even your advisor, who has been optimistic that the credit crisis and its aftermath are drawing (slowly) to a close, didn't expect a +30% gain in US stock prices (S&P500).

Even sweeter was the fact that all but one of your main US managers all posted returns north of 40%, (the laggard was still 36%, handily trouncing the index by at least 10 full points).[1] Your Canadian managers similarly bested the Canadian index by posting returns north of 20% vs. the TSX at 13%.[2]

Today my goal is to go into the numbers, and show you some of the most interesting stories that the numbers tell.

[1] CI US Equity, CI American Value, CI American Small Companies and Cundill American, all posted returns of 40% or more. Mackenzie US Mid-Cap posted at return of 36%.
[2] CI Canadian, CI Small/Mid Cap, Mackenzie Canadian Growth, and Cundill Canadian Security all had returns of at least 20%.

130 Adelaide Street West
Suite #3401
Toronto, ON M5H 3P5

Phone: (416) 216-6532
Fax: (416) 216-6512
Email: choran@assante.com
Website: www.chrishoran.ca

First Story

Your advisor is one of the few that has a track record of over 15 years verified by an independent third-party consulting firm. A $2.6 million pension fund has followed my recommendations exclusively for 15 years now. The portfolio is very similar to many clients' portfolios, and my own, so while no two portfolios are exactly alike, the results are quite representative of my thinking over the last 15 years.

Annual Returns to December 2013

	1yr	3yr	5yr	10yr	15yr
Pension Fund[3]	22.4%	8.0%	12.2%	6.3%	6.4%
Balanced Fund Peers	17.4%	6.4%	9.1%	4.1%	3.2%

First, a note of caution: our marketing people say I should use my newsletter to tell people what a great job I've done, but I must remind my readers that I do not invest with the goal of 'outperforming' anything.

It may sound lame, or at least counterintuitive, but the investment gods show no mercy to people who set out with the goal of 'outperformance'; I have seen too many performance chaser's fortunes thrashed on the rocks of unforeseen events. It's why experienced investment professionals know the adage: 'pigs get slaughtered'. Humility is the antidote.

In any case, the Fund returns compare very well with relevant benchmarks, handily outperforming its peers.

Notes to the returns:

The 10 and 15 year returns of 6% are decent, but they are actually far better than they look: they hide the two great bear market declines from 2000-03 and 2007-09 where the US market (S&P500) fell 45% and a stunning 57% respectively[4].

The low peer group and index returns over 15 years reflect the Nortel/tech stock craze that peaked in March 2000. The Fund had no Nortel or tech stocks, and very little in US stocks at the end of the 1990s, so it missed the crash completely.

The strong Fund returns over 15 years also reflect a significant weighting in resources and Canadian stocks, which did very well through the decade to 2011.

The recent returns result from the heavy exposure to US stocks and the low weighting in bonds in 2012 and 2013. Bonds had negative returns in 2013 as interest rates rose (they move in opposite directions).

[3] Fund returns from The Recordkeeper Inc.; Global Equity Balanced Fund Peer Group from Globefund.
[4] S&P500 Index, peak to trough decline

The 3% annual improvement in the Fund return over the benchmark adds 50% to the value of the Plan Members' accounts over the 15 years.

These changes in asset mix are made maybe once or twice in a decade. The shifts are strategic adjustments, made in recognition of changes in valuations in broad markets over time. Strategic shifts are very different from shorter term forecast-based market timing. It's a subtle but critical distinction. Forecasting is difficult, as Mark Twain said, 'Especially about the future', and changing your portfolio around based on the latest short term forecast is likely to lead to big mistakes (called a 'whipsaw' in investment parlance).

On the other hand, the analysis of underlying or intrinsic value, combined with the study of history is much more likely to yield insights. I will expand on this in a future newsletter.

Second Story

Where we look at the Great Mistake.

The numbers camouflage a very important point: the returns of a great many individuals have been much much worse. It is not possible to prove, but industry data as well as my own observations clearly indicate a great many investors have lost 30% to 50% *or more* of their capital over the last 15 years. (One I know of has lost 90% of an opening value of almost $1 million.)

How? By succumbing to the temptation to capture gains or avoid losses by making major shifts in their investment strategies at inopportune times. I personally know several people (not clients) that sold out close to the bottom in 2009 to 'sit in cash until things looked better'. Unfortunately, since nobody rings a bell when it's time to invest, they remained in cash while the markets recovered.

Industry data[5] shows that money flowed strongly into tech stocks at the peak, and strongly out at the bottom; and money has been flowing strongly (i.e. hundreds of billions) *out* of equities from the bottom in 2009 to mid-2013 *even as the market doubled* off its lows.

These moves crystallized large losses, while sitting in cash or bonds prevented the portfolios from recovering. The losses will never be recovered.

So a 6% return for 10 or 15 years may not look it, but it is – let's just say – good.

Third Story

Where we look at the Canadian markets in more detail.

The Canadian market (TSX) was more muted at 13% for 2013. The numbers hold some interesting and important lessons. Below are the returns from the Canadian equity market and a number of the subcomponents that comprise the index.

Canadian Equities 12 Month returns
December 2013

Index:	
S&P TSX Composite	13%
TSX Small Cap	4%
Subindexes:	
Consumer Discretionary	43%
Industrials	38%
Financials	27%
Consumer Staples	24%
Materials	-29%
Mining	-20%
Real Estate Trusts	- 6%
Utilities	- 4%

Source: Globefund

[5] Investment Funds Institute, and Cambridge Investment Advisors, a unit of CI Investments, approximately US$800 billion flowed into tech stocks before 2000, and the same amount has flowed out of equities and into bonds since 2009.

You can see the significant variation in the returns from the various subindexes: Consumer Discretionary stocks (e.g. Canadian Tire, Cineplex) as a group were up 43%, Consumer Staples (e.g. Loblaws, Shoppers Drug) up 24%, and Industrials were up 38%.

On the losing side, Mining and Materials lost 20% and 29% respectively, led by the gold subindex down 48% as gold itself had the biggest decline in 32 years since 1981, according to Danny Bubis of Tetrem Capital Management. Real Estate Trusts (REITs) and Utilities lost 5.5% and 4.4% respectively, and bonds, the traditionally safe asset class, lost 2.3% in 2013.

Here's what the numbers tell us: the Consumer, Financial, and Industrial stocks largely represent the broad Canadian economy: people going about their daily business. Their stock prices, up as a group by a third, are the market telling us that the economic recovery is taking hold, and the broad economy is working fine.

Mining and metals companies are sensitive to inflation and global growth. Their decline from 2011 tells us that the strong, infrastructure-heavy growth phase of China's early development is probably slowing down as the Chinese shift gears to cars and phones from cement and steel. The Materials subindex includes gold, which ran to record prices in 2012 on fears of catastrophic currency collapse; the decline tells us that a major monetary inflation is not in the cards.

Real Estate Trusts (REITs) and Utilities are very similar to bonds in that they produce reliable income. The decline in those sectors reflects the increase in bond yields (interest rates) that occurred in mid-2013, driving bond prices lower. Bonds go down as rates go up, and rising interest rates will drag bond-like sectors like real estate and utilities down with them.

When you wrap these observations together, they tell us:

1. The world economy is growing, at least slowly. This is good.
2. Runaway inflation is not in the cards. Also good.

What about valuations? Valuations are the bridge between a company's earnings and what its stock sells for. Books can be written on the subject, but here is my take: earnings for the S&P500 are expected to be around $121 for 2013, and are projected to grow 13% in 2014, according to Investors IQ, a research firm[6]. This would put earnings at about $137 for 2014; applying the long-term average Price Earnings multiple of 15 gives us S&P500 at 2055, a 13% increase from today's level of 1800.

With inflation at only 2%, earnings are worth more, so a higher multiple could easily be justified (a 20x multiple equates to a 5% earnings yield, and with bonds earning 2 or 3%, stocks are still better value). But let's just take today's valuation of 17 on earnings of $137 – that takes us to S&P500 2329 – a 29% increase on today's level.

A more moderate scenario of 10% earnings growth and a 15x multiple gives us S&P500 at almost 2000, an 11% increase from today.

I am certainly not predicting these returns – I am not so foolish as to predict the future, and I did say in my last newsletter that I wouldn't be surprised to see a correction of some magnitude in 2014 – I am saying here that as long as global growth continues, and it seems to be, the shares of great companies continue to be the best value and hold the best prospects for future appreciation in value.

Heck, after 2013, even with a zero return this year I'm still a lot farther ahead than I thought I'd be just a year ago!

That's where my money is.

[6] Published in Investment Executive January 2014

(Technical note, in case you need ammo for a cocktail party or a golf course conversation: critics often refer to the overvalued US market based on the Case-Schiller price-earnings ratio (P/E). Schiller gained fame calling the US housing market overvalued; his P/E ratio for US stocks uses an earnings number which is an average earnings over the past 10 years, to smooth it out. All fine, except the effect of a 10-year average in a data series that is growing causes you to get a number that is a lot lower than the current number.

With 2 recessions in the last 12 years, including the serious decline of 2009, it seems quite reasonable to see earnings growing as we go forward, so I think the argument of smoothing earnings is incorrectly applied here. US companies are well-positioned to do well as the global economy expands, by supplying the world's markets with the things they need, from jet aircraft to computer systems to iPhones.)

Final Story

The numbers on page 6 are your main managers in the Canadian and US equity segments of your portfolio. They have done very well against their index benchmarks.

Particularly noteworthy is the Mackenzie Canadian Small Cap Value (formerly Saxon Small Cap) which many of you have held for many years. The fund demonstrates one of my main messages – that active portfolio managers add tremendous value. Scott Carscallen was able to outperform the Small Cap Index by 32 points: 36% return vs. the index at 4%. Scott was able to do this by avoiding the half of the Canadian market that declined.

The TSX looks good in the 10-year return, but that is lucky for the TSX: 10 years ago was 2003, the bottom of the Nortel-led decline, so it is measuring from a low point. Going back just 2 more years, the TSX return drops from 8.0% to 5.8%, and most of the managers in the list have done better. (Especially since the managers' returns are after fees and expenses, and the indexes are theoretical returns with no fees or expenses.)

Similarly the 5 year return at 11.9%/yr. is from almost the bottom of the financial crisis, so it is starting at a very low point. Measured from 2007, before the crisis, the TSX is just 3.7%/yr. When your 5 year return is almost 12%/yr., and your 7-yr. return is only 3.7/yr., you know something big happened in year 6.

The point here is that the published returns, required by industry regulators to be 1,3,5 and 10 years, hide some important and interesting messages. In this case the very rough ride of the last 7 and 12 years are camouflaged. Nice to be looking at them in the rearview mirror.

Main Managers Performance 2013

	31-Dec-13				
	1 Year	3 Year	5 Year	7 Year*	10 Year
American					
CI American Small Cap	44.9%	16.6%	15.9%	5.1%	5.7%
CI American Value	40.0%	14.6%	11.7%	3.5%	5.3%
Cundill US	44.0%	14.4%	17.4%	3.2%	4.0%
Mackenzie US Mid Cap Growth	38.5%	15.8%	14.1%	9.7%	9.4%
S&P 500	29.6%	13.7%	15.4%	4.8%	5.2%
Dow Jones	26.5%	12.7%	13.6%	5.6%	4.7%
Canadian					
CI Cdn. Investment	25.8%	5.6%	11.2%	3.3%	7.2%
CI Cdn. Small/Mid Cap	22.0%	6.8%	16.4%	4.8%	6.7%
Cundill Cdn. Security	26.0%	10.7%	15.5%	5.4%	7.0%
Mackenzie Cdn. Growth	21.2%	6.7%	8.4%	3.4%	5.9%
Mackenzie Cdn. Small Cap Value	37.7%	8.6%	21.2%	4.1%	7.7%
TSX	13.0%	3.4%	11.9%	3.7%	8.0%
TSX Small Cap	4.4%	-6.8%	10.7%	n/a	0.3%
Bonds					
Broad Index	-2.3%	3.1%	2.7%	4.3%	4.8%
Long Bonds	-6.8%	4.4%	5.9%	n/a	5.8%

Source: GlobeAdvisor.com

* Data from Morningstar PALTrak