VERITAS

Spring 2014

DID YOU KNOW...

- The World Bank raised its 2014 global economic growth forecast and predicts that growth in world trade will double from 2012.
- In March, GM shareholders received their first dividend from the company since its bankruptcy six years ago.
- 24% of Canadians plan on using their homes as their main source of retirement income.
- 2014 Winter Olympians received $20,000, $15,000 and $10,000 for each gold, silver and bronze medal they earned, all taxable.
- For the first time in almost a century, Canada is a creditor nation, with more assets held abroad than foreigners have here.
- Chewing gum sales in the US have fallen by over 11% in the last four years.
- In 2013, Americans spent over $58 billion (yes, billion) on their pets, a figure that is expected to rise to $60 billion this year. $21 billion, the *total* spent in 1996, was on food alone.
- Sweden has the world's safest roads (or most cautious drivers?) with only three road related deaths per 100,000 people in 2013, compared to the US at 11.4.

CURRENT SITUATION

North American equity markets extended prior year gains through the first quarter of this year. Canada's TSX posted a surprisingly healthy 6.10% return to March 31, handily outperforming its US counterpart, the S&P 500, which gained 1.80% in the same period. If the S&P return is converted to Canadian dollars however, and accounts for the 4% drop in our currency since January, the gain in the S&P jumps to 5.90%, narrowing the gap significantly.

March 2014 marked the fifth anniversary of the bottom, or trough, in Canadian and US stock markets that was brought about by the freezing of credit markets in 2008. Although we look back on this experience with absolutely no fondness, because of the incredible market movement that investors experienced during the last five years, and especially in 2008 and 2009, we thought it would be interesting to see where we are today relative to before the market meltdown. In 2007, the S&P 500 peaked at approximately 1,560, bottomed at 683 in 2009, and is at 1,865 today. That is a peak to trough to peak movement of 2,059 points, creating a gain of 173% from the bottom, and a gain of 19.5% from the pre-crisis peak. Gyrations in the TSX have been equally dramatic, but with a notably different outcome. The TSX had a 2008 peak level of just below 15,000, a 2009 trough value of 7,592, and a current level of 14,400. This is a peak to trough to peak movement of 14,216 points, and a gain of 90% from trough levels. The big difference between the performance of the TSX and the S&P in the same period is that while the S&P is 20% above its peak, the TSX is still approximately one-half percentage point below its 2008 peak. The implication is that if an investor had purchased the index at its 2008 peak, and held it to today, that investor would still be in a loss position five years on, excluding the effects of dividends. Please note that the actual points movement is somewhat misleading because of the relative levels of the two markets, but it is the percentage moves that are striking.

Some would argue that the disparity between the performance of the US and Canadian indices suggests that the TSX has yet to close the valuation gap with its US counterpart. We, however, believe that the gap is reflective of the difference in the composition of the Canadian and US economies and will not close completely. The US economy is larger and more diverse than ours, and it is less reliant on exports than we are. What it does export are generally what are known as value-added goods, such as manufactured or engineered items. On the other hand, our economy has become increasingly concentrated

in the extraction industries, such as energy and mining. These industries are almost exclusively export focussed, and based on their weighting in the TSX, make up close to 40% of our economy. But because we are exporting raw materials as opposed to finished goods, of which we are importers, the robustness of our exports and economic activity is heavily dependant on the fortunes of the rest of the world.

The nature of our economy impacts our currency in an interesting and oft times volatile manner. If foreign investors perceive that Canada's economy will do well based on strong commodity pricing and demand lifting the value of our exports, these investors will purchase Canadian assets, and to do so will need to buy Canadian dollars. It was this type of demand, coupled with our dollar's post crisis "safe haven" status that took its value quickly above par with the US dollar for much of the last five years. The same influences in reverse have a swift and negative impact. We are witnessing moderating rates of economic growth in emerging markets, typically the largest consumers of raw materials and energy, resulting in a softening in commodity prices, and leading to a potential decline in the value of our exports. Consequently, foreign investors, becoming less enchanted with our prospects, have reduced their purchases of Canadian assets. The resultant decreased demand for Canadian dollars has caused it to fall some 15 US cents from its recent peak. The decline has been exacerbated by improvements in the US economy, especially the banking sector, which is drawing investors back to that country, thereby reducing the demand for a safe haven currency that is not the US dollar.

OUTLOOK

Given that the majority of our expected 2014 annual equity returns in Canada were delivered in the first quarter, our broad market outlook for the balance of the year is more muted than it was three months ago. On a stock by stock basis however, we remain positive. We have been seeing sustained individual stock performance that is not completely explained by or tied to moves in the market, and expect this type of behaviour to continue as the global economy continues to improve and mature. In short, we believe that although Canadian market fundamentals remain good, Canadian equity investors will not be rewarded by buying the market. The principal reason for this belief is that we see resource leadership waning, and as it does, it will result in price softness in a material portion of the TSX, negatively affecting the returns of index and commodity focussed investors. Adding to overall market pressures will be the inevitable tightening of monetary policy in the US, and sooner or later in Canada. Tightening translates to rising rates, which tend to reduce the overall attractiveness of equity investments as investors price in slower growth due to higher costs of borrowing, and seek the higher yields of fixed income investments.

STRATEGY

In keeping with the theme presented in our Outlook, the strategy we employ in the management of our clients' portfolios continues to avoid buying the Canadian "market". That is not to say that we do not invest in Canadian companies, which we do. In fact, Canadian companies represent 80—85% of the equity investments in every one of our client's portfolios. When we construct a portfolio for our clients, the strategic goal is to generate returns that do not mimic the broader market. To put this another way, our clients' portfolios are not just smaller versions of the TSX. In avoiding what is referred to as closet indexing, we tend to miss the biggest swings in the market. This can be a negative when the TSX is powering ahead on what is often short term commodity price strength, but the strategy generally provides comparatively less volatile portfolio returns, and acts as a hedge against the inevitable weakness in resource stocks that follows a strong run. Although this does create great trading opportunities, we have emphasised before that we are investors, not traders.
Please do not hesitate to call with questions or for discussion.

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