VERITAS

Winter 2014

DID YOU KNOW...

- 50 years ago, the average stock was held for eight years, but by 2010 the average holding period had dropped to five days.
- 15 years ago, S&P listed companies spent over 40% of available cash on capital investments: today it is barely 20%.
- 2% of China's 1.36 billion people consume one third of the world's luxury goods.
- The OECD ranks Canada as the world's most educated country with over half of our adult population possessing tertiary education.
- In good news for old school audiophiles, vinyl (yes, vinyl) record sales in the UK are at their highest in over a decade.
- You now can use your Aeroplan points to pay for tuition at select post-secondary institutions.
- Accounting for 45% of alcoholic beverage sales, beer is the most popular alcoholic product sold in Canada. It also makes up 1 out of every 100 Canadian jobs.
- The US is expected to become the world's top oil producer by 2015, ahead of Saudi Arabia and Russia, and will be close to energy self-sufficiency by 2033.

CURRENT SITUATION

North American equity markets ended the quarter, and the year, strongly. The broader US S&P 500 pushed through a succession of record highs, posting a 2013 total return of 32.4%, with approximately 12 points of that gain recorded in the fourth quarter. Canada's TSX finished the year with a lesser but still respectable 13% total return, more than doubling its return as at September 30th. While the heavyweight energy and materials sectors mirrored the market return, and financials outperformed significantly, what we find encouraging in this year's market performance is that virtually all of the smaller sectors that comprise the balance of the TSX outperformed the market. Over the past several quarters, we have commented that as the commodity cycle matured, overall Canadian market index performance would be overshadowed by individual stock performance, defining a new stock-pickers market where fundamentals will have more of an impact on asset returns than overall market direction. It appears that such an environment is developing.

With global economic conditions improving, bond yields continuing to rise, and equity markets advancing strongly, the flow of capital into equity related securities has been increasing. Data confirms that 2013 not only marked the first year since 2007 that US equity mutual funds recorded positive net contributions (contributions less redemptions), but also marked the best year for overall contributions since 2004. 2013's "return of the retail equity investor" phenomenon is expected to continue into 2014 as the Fed removes economic stimulus throughout the year, and interest bearing products experience further price declines. Assuming the shift in capital flow is evidence of the "Great Rotation" (from bonds to stocks) that has been trumpeted in the press, it should continue to provide support to equity markets, but not without risk.

Investors have chronically short memories, and also are prone to selection bias where they remember only that which they want to remember. These traits likely are beginning to manifest themselves now in the context of many investors not considering that as they make a wholesale shift from their safe haven assets, for which they overpaid in this ultra low rate environment, into equities, investors are not only locking in losses as they sell their bond funds (forgetting that prices do decline on even safe haven assets), but they are buying the risky assets at historically high prices. As a result, investors engaging in this asset shift are assuming a far less attractive risk/return trade-off than they would have even one year ago. The implication is

that while the capital flow indeed might support equity markets, the support has the risk of coming at the expense of uninformed investors who can least afford it, and who are taking on far too much risk already in search of recouping the returns they gave up by purchasing "safety". Chasing returns always is a risky proposition, and it rarely ends well for those who engage in it blindly.

This all having been said, it is far from doom and gloom. There is no question that almost anywhere you choose to look, conditions are significantly improved from even one year ago. In fact, as recently as at the time of writing, the US unemployment rate has fallen below 7% for the first time since before the insanity of 2008/09. Granted, part of this drop was as a result of a lower participation rate (fewer people actively looking for work), but with the increased activity in the US manufacturing sector, in part spurred by the "re-shoring" of jobs, and a generally robust housing and home construction market, it is evident that there are more jobs out there to be filled. Perhaps more importantly, European economic data has been more reassuring of late, especially relating to manufacturing which has experienced growth for the first time in years. This has led to a relatively stable, albeit still high, unemployment level but as business and consumer confidence continues to improve, it is not unreasonable to expect the European jobless rate to come down as well. And to top it off, Ireland is set to exit its financial bailout programme with no conditions, a first for the region. In short, to paraphrase the New York Times, "*Europe's single-currency zone...is spasmodically emerging from its near-death experience*".

OUTLOOK

Financial market commentators now are advocating an increased emphasis on fundamental analysis and security selection for returns, as opposed to relying on market direction. If equity investors respond to this, and move away from index related products, we would expect the result to be relatively flat markets in Canada. In the US, because markets there are seen to be fully valued, it would not surprise us to see a market pullback fuelled by valuation concerns and rising yields. But because of the improving economic conditions mentioned above, and assuming corporate earnings grow as a result, in turn tempering valuation concerns, a pullback is not expected to become a full blown correction. In the face of rising rates, we expect that interest sensitive assets on both sides of the border will be again the worst performers this year. We do sound like a broken record on this topic, but the Fed has confirmed that tapering, or the reduction of stimulus measures, will begin this month, and bond yields have already moved higher in anticipation. They will continue to rise, putting further pressure on asset prices, as the extent of the reduction becomes more precise. 2013 was the first year since 1999 that bond investors experienced negative returns, and we suspect that 2014 will be the second.

STRATEGY

With the financial media now calling for the same care and attention to investing that we have always applied to our clients' portfolios, it is refreshing to have our discipline validated, if even only for the short term. Short term because experience tells us that market focus ultimately will move away from fundamentals and to a new theme of the day. The shift will be a distraction, but we will not chase the trends of the day to fulfill our responsibilities to our clients for the management of their portfolios. The companies, or at least the types of companies, that our clients own today will be the same when the market experiences its next "paradigm shift", a term that was coined during the tech bubble to explain why fundamentals no longer mattered. They also will be the same when the shift reverses, and fundamentals come back to the fore. Most market trends do reverse, and because they do, we are just as happy to miss them. Constant, consistent and conservative are not bad traits to be accused of having when investing on behalf of others.

We wish all our readers a very happy and healthy 2014.

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