VERITAS

Spring 2013

DID YOU KNOW...

- One percentage point of GST is now worth approximately $7 billion in government revenue.
- Despite prodigious Oktoberfest consumption, German beer consumption fell in 2012 to the lowest level since reunification.
- Free roaming cats, including outdoor domestic pets, kill as many as 3.7 billion birds and seven times that in small mammals each year in the US, making cats more dangerous to wildlife than cars and buildings.
- Canada is one of only 11 countries in the world that still has "triple-A" (the highest) rated debt, down from 16 prior to the credit crisis.
- The original Batmobile, a modified one of a kind 1955 Lincoln Futura concept car used in the 1960s TV series, recently sold at auction for $4.2 million.
- 15% of traffic fines issued in Dubai are for driving at speeds over 200 km/h.
- The owner of Muzak has retired the name of the often ridiculed music provider, but the "music" will live on under the Mood brand.
- The Cyprus stock market has lost 98% of its value in the last 5 years.

CURRENT SITUATION

Equity markets in North America extended their 2012 gains into the first quarter of 2013. In fact, not only did the two main US indices, the Dow Jones Industrial Index and the broader S&P 500, extend their gains, but both posted new record highs, surpassing levels from prior to the 2008 credit crisis. Toronto, while still grinding out a small gain for the quarter, is still far from making new highs, an event that would require a more than 2,000 point advance from current levels. An advance of this magnitude is unlikely given the current pressures under which commodity prices find themselves, and that commodity stocks still represent over 50% of the index.

The disparity in performance between the Canadian and US equity markets is a reminder that the composition of the indices plays a significant role in influencing their direction. It is also worth noting that broader index movements are not necessarily indicative of the performance of all underlying constituents, or of those that are not part of the index, but that are still widely owned. In short, under normal conditions, just because a market is doing well or poorly does not mean that the same is happening to all individual stocks.

Closer examination of the drivers of Canadian and US market performance reveals that conditions that favour one market over the other do not last forever. One example of this, and perhaps the most obvious, is the impact on our equity markets of a change in commodity prices. Because of Canada's increasing economic reliance on raw commodity exports, and the weighting of this sector in our market, when commodity prices are strong, it is almost certain that the TSX will do well. But when prices are weak, whether because of economic or political reasons, so too will be the TSX. We have seen this cycle repeat itself time and time again, with increasing impact on the TSX as it becomes more resource based. As a consequence of their significantly lower exposure to commodities, and because the US is a commodity importer, US markets will lag Canada during a commodity boom, but will generally outperform during a bust. Another example, and one we found particularly interesting, is found in the financial sector. A significant portion of recent US equity outperformance relative to Canada has been the result of a very strong run up in US bank stocks, which have been weak since getting crushed during the 2008—2009 credit crisis. What is happening now is that US banks that survived the crisis are experiencing a long delayed business expansion, and with the expansion, a dramatic share price recovery from 2009 lows. Because share prices fell so far and have taken so

long to recover, the price appreciation has been virtually a straight line up, eclipsing the recent performance of our banks, which never had the same gap to make up. Our banks, after an initial dip and recovery, have been slow and steady since 2009. It is inappropriate, however, to focus on the recent US bank share gains in isolation because it ignores the initial price collapse and the duration of depressed prices, both of which factor significantly in longer term returns. Adjusting for this, performance data for Canadian banks in the same period has been more favourable, and much less volatile, an investment characteristic favoured by long-term investors, like us.

There is another point of which we are reminded when examining these cycles, and it is that cycles are just that: cycles. Sooner or later, all cycles end. In the example of the US banks, business expansion ultimately will slow, their share prices will reach what markets will consider fair value, and share price performance will revert to "normal". This will open the door for a new cycle to emerge in a different industry as business and economic conditions evolve. Perhaps it will be a new manufacturing boom as the trend to "re-shoring" jobs continues in response to higher transportation costs, and increasingly abundant and accessible sources of domestic energy, another sector that has been exhibiting growth recently.

OUTLOOK

Despite the headlines that Cyprus is certain to be the next nail in the coffin of the collapse of the Eurozone, or that China's economy is slowing, a sure sign that the global economy will soon follow suit, we still see real global economic conditions as being better than the headlines would suggest. US labour and housing markets continue to evidence growth, good news for confidence. Europe has seen a decline in negative trade against the Euro, and a concurrent modest recovery in manufacturing. Inflation remains in check in developed economies, and interest rates are low in almost all regions, a condition that is allowing businesses and individuals to continue cleaning up their balance sheets. We have long acknowledged that there are risks to keeping interest rates too low for too long, but central banks finally seem to be taking this seriously and are hinting that they are prepared to take some of the stimulus out of the system. In the last edition of *Veritas*, we commented that we expect to see a continuing normalisation of stock and bond markets, and this remains the case. Despite the record high levels of US markets, valuations are not stretched, suggesting further room to move up, but more modestly. And although Canada's market likely will continue to struggle because of commodity price pressures, there are still many opportunities to profit on a stock by stock basis. Risk/reward analysis still favours equities over bonds, and will continue to do so absent a significant run up in interest rates.

STRATEGY

As we were calculating portfolio performance for the last quarter, we were reminded of the impact on performance of the axiom that what contributes more to long term returns is time *in* the market as opposed to *timing* the market. Critical to this is the importance of focussing on quality, well run companies for inclusion in our clients' portfolios, the holding of which reduces the need and temptation to perpetually trade accounts, which would otherwise take away from the time in the market.
Our goal in portfolio construction is to provide consistent returns over the long term with a minimum of volatility. In keeping with this goal, we deliberately avoid investing in sectors that react overnight to a change in sentiment (gold, for example), or sectors that are deeply rooted in economic cycles. The result is that our clients' portfolios look very little like the market, and generally they do not behave like the market. Our long-term readers will recognise this as just another way for us to say boring, conservative investing is good investing, at least for our clients.
Please call for further discussion of how boring can be good.

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