

Year in Review, Market Commentary

Date: January 4, 2012

“Year’s end is neither an end nor a beginning
but a going on, with all the wisdom that
experience can instill in us.” Hal Borland

I like to observe people. I find it interesting. As people go about their daily lives, I wonder what they are thinking. I see them interacting with a spouse, a child, a colleague, a service worker, people in positions of power and authority. Let me share with you two personal observations I have made of late.

Recently, one of my sons joined me at the office for “Take Your Child To Work Day”. Having four kids of the same age provides for some meaningful reflection in such situations, such as why did only one of my kids want to join me at the office? Of course, it is natural that they would not ALL want to follow dear ol’ Dad in the business, as they have their own dreams and lives after all. I soon came to realize what it was that they perceived of what I do, when my son proclaimed upon reflection of the day “your job is not as boring as I thought it would be...” Gee, thanks son!

The second observation I have made occurs when I am introduced to or introduce myself to someone, and we get to the age old question of ‘what do you do for a living’. When I respond with “Investment Management or Financial Advisor” the response is twofold. The first is pity! Their body language says it all. People feel sorry for me. “Oh, you deal the stock market every day? You poor chap... how do you deal with that every day? Pity” The second response is invariably...”what are you doing or recommending these days?” The current financial market has created much angst in the minds of investors.

2011 has been that kind of year. I cannot remember a time in which markets have seen more ups and downs (volatility) and where the bigger picture has been lost amongst the many economic and political headwinds. We remember recent history such as 2008/2009 in which the market dropped in light of the financial crisis and the failures of Lehman and Bear Stearns. The failures then could be identified both corporate and individual villains (Bernie Madoff anyone?). 2011 has been a different kind of year. There has not been one catastrophic corporate failure in which we could pin all of the blame on, but rather a series of headwinds that have pushed back on markets and economies.

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There have been two investment terms that have been used repetitively during the course of the year, headwinds and tailwinds. In investment terms, headwinds refer to those things that push back economic growth such as unemployment or political uncertainty, and tailwinds refer to those things that push forward economic growth such as demographics that increase consumption or lower tax rates.

2011 has provided a great many headwinds. To name a few:

1. Political disunity and lack of leadership in the United States
2. Fiscal and political dysfunction in Europe (Greece, Italy, Spain, Portugal...)
3. The Arab Spring (Yemen, Egypt, Tunisia, Jordan, Libya, Syria)
4. Catastrophic events leading to economic and corporate distress (the Tsunami in Japan)
5. Inflation in the BRICs (Brazil, Russia, India, China) leading to economic slow-down

In the midst of all of these events, where do we stand now? The most common questions I am asked these days are “how do you invest in light of all of these problems (a.k.a. “headwinds”), and where do you invest now?” In response, I find myself singing the familiar refrain from the song in *The Sound of Music*, “How do you solve a problem like Maria?”

How do you solve a problem like Maria?
How do you catch a cloud and pin it down?
How do you find a word that means Maria?
A flibbertijibbet! A will-o'-the wisp! A clown!

Many a thing you know you'd like to tell her
Many a thing she ought to understand
But how do you make her stay And listen to all you say
How do you keep a wave upon the sand?

Ok, so maybe I am not singing the song out loud – that could result in Lara, my new assistant, claiming poor working conditions. But the spirit of the song has come to mind often. How do you catch a cloud and pin it down, how do you keep a wave upon the sand? The headwinds mentioned above are clearly out of the control of investors – and there is no magic formula or silver bullet that could be utilized to ‘solve’ the problem faced globally today.

First, I must affirm what we do. We are investors. We are not speculators, we are not traders, and we are not market prognosticators. I have seen many investors make the right move in the short-term, only to suffer badly by making the wrong move over the long-term. Patience is one of the best traits of a successful investor, which I believe is one of the greatest strengths of Warren Buffet, arguably one of the best investors of our time.

Recently in conversations with some peers, one of whom was an arbitrage trader (think hedge fund or day trader on steroids), we commented on each other’s businesses. When I said to my arbitrage trading friend that he must be having a good year based on the volatility of the market, he guffawed almost choking on his food, and exclaimed... “it could NOT

have been worse! Every right call we made was followed by a wrong call". He thought that us "buy and holders" would be having a better time in these markets. The bond trader in the group sat quietly listening until we all turned to him for comment. His comment was that the year was an eerily good one, but that he was not looking forward to the coming years. He envisions a decade long bear market in bonds.

The observation here is that these are not easy times to be invested. When times are challenging or perilous, it is important to stand back and take stock of who you are, and what you are, as I have had time to do. This leads me again to remind myself (and you) of what it is we do. We are investors – long term investors. We gather information, and continue to gather information. Ultimately, we make changes to our asset allocation or investment selection when we begin to see correlation in what we are reading or hearing about over the course of time, when we begin to see parallels in what we observe in our daily life, and the theory or postulations of our myriad number of advisors. Often, our clients provide us with the deep insights into general market realities and themes, or warn of us dangers and opportunities lurking nearby by way of everyday conversations. They do this simply by sharing their lives with us.

So what are we seeing, reading, sensing and preparing for? Three realities have shaped our insights, asset allocation, and investment selection for 2012.

1. Bond yields are low and bond prices are high – flashing yellow signs that indicate a 30 Year bull market in bonds may have drawn to a close
2. In general, larger companies have been able to strengthen their financial picture, and are in better shape today than they were in 2008/2009.
3. The shoe is on the other foot now. Developing economies are in better position than developed economies to weather the current economic headwinds

Bond Yields:

Bank of Canada Target Inflation Rate	1% - 3%
Total Consumer Price Index (CPI)	2.9%
Core Consumer Price Index (CPI)	2.1%
6 Month Canada Treasury Bill	0.90%
2 Year Canada Bond Yield	0.95%
5 Year Canada Bond Yield	1.26%
10 Year Canada Bond Yield	1.93%
30 Year Canada Bond Yield	2.48%

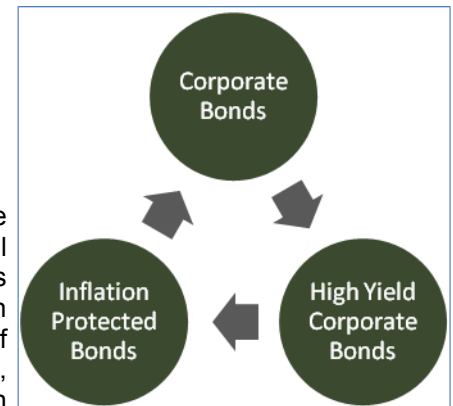
Table 1 Bank of Canada, Rates/Inflation, and Bond Yields

The table above demonstrates the single biggest quandary for bond investors in 2012. Fearful investors buy bonds. They want to lessen the risk of equity markets and buy the 'safety' of bonds. If an investor were to purchase a 10 year Government of Canada Bond, the current yield (what they would earn) is 1.93% which is less than the current anticipated increase in the cost of living of 2.9%. This investor would enjoy the safety of bonds, but lose out on purchasing power each and every year by about 1/3.

The challenge is that we have been convinced that as we near and enter into retirement, the majority of our financial assets should be invested in bonds. Just when retirees begin to draw, and depend on their financial assets for their income, the ability of these assets to help them maintain their lifestyle and accomplish those retirement dreams are immediately challenged. Now, before anyone suggests that I am advocating a move away from bonds, let me say unequivocally – No! While government bonds are yielding incredibly low returns, corporate bonds are reasonably higher. I continue to recommend a three-legged stool approach to investing in bonds. Whatever the asset allocation towards bond (how much of your portfolio is allocated to bond investments) this allocation should be divided into three equal parts.

1. Corporate Bonds
2. High Yield Bonds – Including Global Bonds
3. Inflation Protected (or Linked) Bonds

The purpose of this investment mix is to provide protection and opportunity for modest growth in all sorts of interest rate environments. Corporate bonds will do well if interest rates remain stagnant or even drop a little lower. High Yield bonds will do well if interest rates stay at these levels or start to increase, and Inflation protected bonds will do well if and when interest rates begin to rise. When interest rates go up, the prices of bonds go down. If we are to believe that in the long term, interest rates will rise, then we first need to prepare for this with a solid foundation of fixed income of bond investments that will help us weather this type of headwind.



Corporate Financial Strength:

Over the course of the past few years, I have had numerous conversations with clients who have decided to change their financial reality. Either they have decided to lower or get out of debt, or change spending patterns to give themselves more free cash flow at the end of each month or year. Once this decision is made, it takes some time to change a personal financial picture, but I have seen meaningful changes occur with extraordinary positive outcomes.

When corporations decide to make this kind of change, they have a lever that individuals do not have. They can issue additional shares in the company, tapping into the equity markets. Since 2008, this type of action has occurred over and over again. Companies that were awash in debt and highly leveraged, issued shares, and used the proceeds to pay off the creditors, either lowering or eliminating their level of debt. Some sold off business units, or lowered overall expenses by making changes in their workforce. What they effectively did was change the structure of their balance sheets.

Like most individuals, making changes in their income or revenue was not necessarily in their control however they could control their expenses or change the structure of their assets and liabilities. Now, due to these actions, we have companies that have the same kind of cash flow as in prior years, but with meaningfully lower expenses or costs, and this translates into better earnings. So companies have better earnings, and if they are paying a dividend, and their share price has gone down, then their dividend yield is higher now, than before the 2008 financial crisis. What this provides to investors, are stronger companies, with similar or increasing earnings. If a company pays a dividend, this means that they can afford to pay their existing dividend better or even increase it. I see this as a very positive signal. In fact, I have not seen corporations in as good a shape in over a decade. This does not mean that they will immediately begin to demonstrate this with higher share prices (I wish...) but it does mean that they make better long-term investments, something that we are truly interested in.

Most important in this matter, is that for almost 8 years, I have avoided the US market completely, in favour of Canadian companies. This was due to highly leveraged balance sheets, a consumer that was highly indebted and becoming increasingly so, and because I could not

My friends at Leon Frazer and Associates Inc. provided me with the following table that speaks volumes about long-term investing. Leon Frazer manages the IA Canadian Conservative equity Fund, one of the best performing Canadian equity funds in 0211 (top 5) and a core holding in our client portfolios. Leon Frazer has been managing Canadian equities since 1939.

30-Year Flashback					
	TSX Level	CPI	30 Year Canada Bond Yield	Oil	Gold
Sept 1981	1,883	12.6%	17.7%	\$36	\$430
Sept 2011	11,624	3.2%	2.7%	\$86	\$1620

find any value relative to earnings and dividends. In fact, in the past decade, the S&P 500 Index (a broad measure of the US Economy) had an average annual return of 0.86%. However, since the beginning of 2009, US companies have issued massive amounts of equity, lowered their overall debt, and despite some challenging economic times, have seen an increase in earnings and are beginning to share this with investors in the form of increased dividend payments. I am finding some good values south of the border, particularly with the large multi-national companies that generate the majority of their revenue from outside of the US. Examples of this would be dull and boring companies like Coca-Cola, Heinz, Clorox, and General Electric.

Why is this important? First, I believe that the US Dollar is over-valued and will over the course of time, be devalued. This will help the United States to lower their overall debt. If the Greenback goes down, then foreign earnings, when repatriated to the US will buy more US Dollars, serving to increase earnings. Secondly, the consumer in the developing world is looking for quality products, and is finding much of this through the goods offered by US multinationals (more on this below). For the first time in 8 years, I will begin to allocate funds towards these types of investments. If a normal allocation to US investments is 30%, then we might ease our way into a 20% allocation over the course of 18-24 months.

Developed vs. Developing:

It used to be that the developing world was over-indebted and the developed world was a mass creditor to these nations. Brazil experienced a debt crisis of massive proportions in the 1980's as did Mexico in 1982. Mexico could no longer service its debt and asked for a 90 day moratorium, and a refinancing of its debt in 1982. 30 years later, the shoe is on the other foot. Now, it is the developed world that is experiencing its own debt crisis, while Latin American countries have relatively low levels of sovereign debt. Brazil has a growing GDP (Gross Domestic Product), a young population or favourable demographics, and improving access to credit for consumers.

Over the past 3 years, in reading the annual reports and executive summaries of companies that operate on the world stage, I have been frequently reading about the opportunities that exist in Latin America. With a young population, rising incomes, expansion of credit and banking services, and resource based economies similar to that of Canada, countries like Mexico, Brazil, Chile, Columbia and Peru are becoming of more and more interest. Investing in this region was very difficult, but in the past 2 years, more funds and index products have come to market, providing better prospects to take advantage of the opportunities. Scott Piper, portfolio manager with Brazil-based Itau Asset Management and sub-advisor to the Excel Latin America Fund states that there are "very positive secular tailwinds for growth in the region including "rising employment, a young population, a growing middle class and rising consumption". In Brazil the middle class is estimated to grow by 60 million people by 2014.

In 2005, I began to invest in India because while everyone was talking about the incredible opportunities in China, each time that I read about China, there was a phrase that was almost always present...'and India'. I say India as having similar opportunities, with better accounting and legal standing, but with its own set of complexities. However as Wayne Gretzky once famously opined...'I skate to where the puck is going to be, not where it has been.' The International Monetary Fund in its world Economic Outlook 2010 said that India will overtake Japan sometime between 2012 and 2014 to become the 3rd largest economy.

Where's the Opportunity? You Decide...		
Economic Fundamentals	Emerging Markets	US & Western Europe
GDP Growth	High	Low
Employment	Increasing	Stagnant
Demographics	Young	Old
Debt	Low	High
Banks	Strong	Weak
Middle Class	Growing	Shrinking
Currency	Appreciating	Depreciating
Money Flows	High	Low

Advisor.ca Vikram Barhat, September 29, 2011, Economic Lessons From Emerging Markets

One area which we have been investing cautiously, but consistently in, for over six years, has been Asia. While many investors have looked solely at the China opportunity, the region boasts strong economies and stable corporate earnings in Singapore, Taiwan, South Korea, Australia and Malaysia, and to a lesser extent, China and Japan. Our investment vehicle of choice is the BMO Guardian Asian Growth & Income fund, which focuses on dividend paying stocks and convertible bonds. The chart below demonstrates why this is a stellar investment, as it boasts the best risk/reward on a three-year basis. We are willing to give up growth in exchange for lower volatility. “The idea behind the strategy is to try and participate in one of the fastest-growing parts of the global economy, but to temper that with an appreciation that markets are volatile.” Robert Horrocks, Chief Investment Officer of Matthews International Capital Management, which is the fund’s sub-advisor.

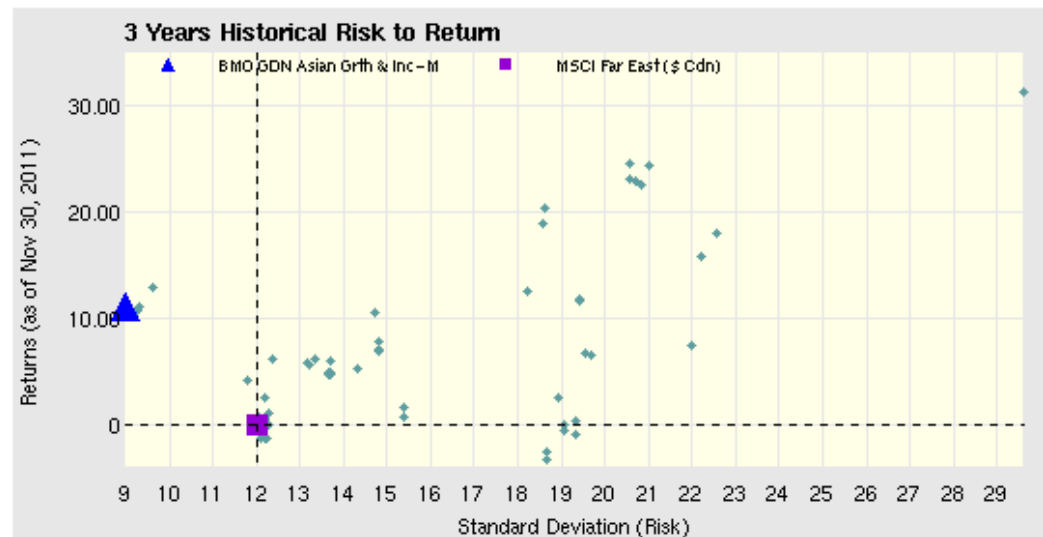
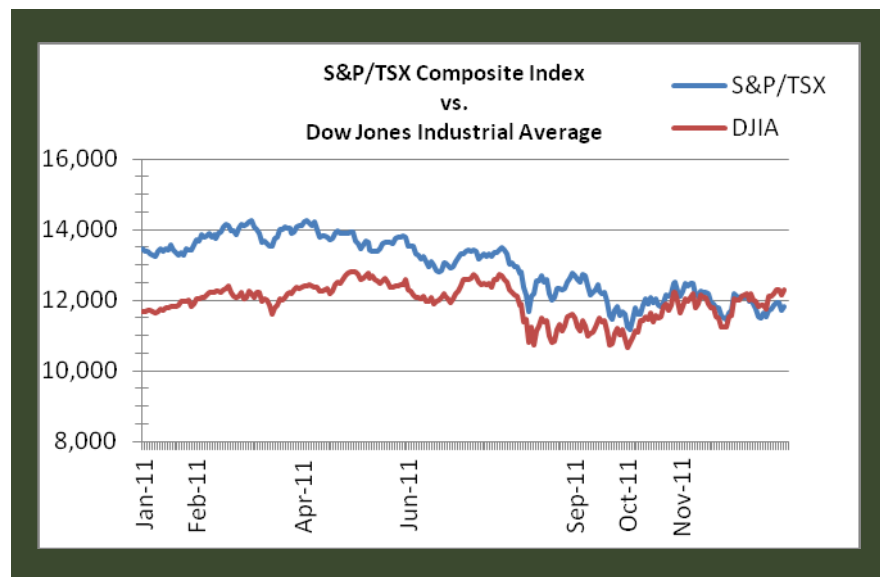


Figure 1 GlobeAdvisor.com Jan 3, 2012

As these emerging economies continue to grow and expand, and as consumers in these markets increase, companies in these economies will do well as they will not have to rely solely on the consumer in North America or Europe, but will have their own domestic markets to sell into. Similarly, our investment in the Mackenzie Cundill Recovery Fund which has a more global flare to it, but is focused on emerging Europe and Asia, provides us with access to these markets, but is more volatile (and thus has a lower allocation) looking for mispriced assets. In this volatile market, James Morton the fund’s portfolio manager is seeing many opportunities as the economic and business challenges around the world have brought valuations into his target range.

Final Comments:

When markets are volatile, investor's worst tendency is to add to their best performing asset or where they feel most confident, or feel they know best. Canada has been a stand-out on the world stage, and our economy and government debt and balance sheet is in the best shape among the G7. We have however, felt the volatility of the commodity markets this year, and underperformed compared to our neighbors to the south. The chart below highlights the S&P/TSX versus the Dow Industrial index over the past year. While we believe that the commodity bull market still has some ways to go, we believe that it is now time to diversify. We believe that equity markets will provide the best returns over the long-term, and that dividends will be as important a source of return in the coming decade, as interest and bond yields have been in the past decade.



Some of the current headwinds move towards resolution. We are headed into an election year in the United States, and the European Union continues to plod towards a standoff that hopefully will lead to concrete actions. Will we see a restructuring of the European Union in some form or other? We highly think so. When and how this will come about is only a guess. We are already seeing a shift in interest rate policy in Latin America, India and China, and these shifts should serve to keep these markets growing at a steady pace.

Personally, I am looking forward to 2012 and all the changes it will bring, both personally and professionally. As I reflected on the past year, and looked ahead to the coming year, it struck me how much I enjoy my role and the job that I do for you my clients. It is a responsibility that I take most seriously and endeavour to provide you with the best service and advice possible. Thank you again, and best wishes to you and your families in 2012!