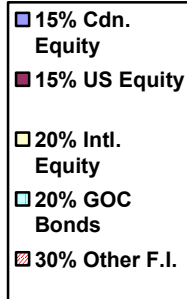
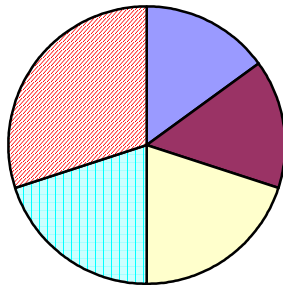


# 2006: A 50/50 Year

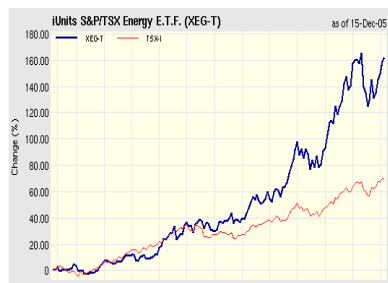
Published by Shaunnessy Investment Counsel,  
December 29<sup>th</sup>, 2005

## Summary:



The Economist has pronounced that 2006 will be "a year of living dangerously". From our perspective as portfolio managers and investors, we concur that the level of risk is higher today --- though it must be emphasized that risk is not yet reality --- and we are entering 2006 with a 50/50 asset allocation of equities to fixed income instruments in our model portfolio. This is an unusual scenario (fixed income usually represents no more than about 40% of a portfolio) which mirrors the risk/ reward prospects of each asset class at this time. There are many disparate factors to consider, but the central theme is that much depends on the breadth and depth of any correction in the US and the Fed's reaction to it.

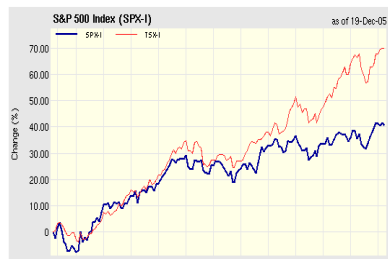
## Canadian Equity Markets:



3 year TSX composite and energy stocks (upper line)

Many Calgarians are off to Hawaii over Christmas to savor how well the TSX and energy stocks in particular (upper line) have done since mid-2004. Canada heading into 2006 has arguably the strongest fundamentals of all G7 economies but faces a challenging restructuring of its manufacturing sector, especially in the automotive arena, and will be stressed by growing regional imbalances. Investor appetite should remain strong through the first few months of 2006 for energy, select mining stocks and some large caps in anticipation of M&A activity. In the second half of 2006, Canadian equity markets are expected to level off and provide lower rates of return as corporate profits decline from current peak levels and non-energy related economic activity slows down. At worst, Canada may surrender to a perfect storm brought on as a result of the relatively high value of the Canadian loonie against the US dollar, rising short-term interest rates, a recession in the US and declining oil prices (say to US\$45). No one can be sure that this storm will hit, but its potential has raised the stakes, and as a precaution, we have diversified away from Canadian equities.

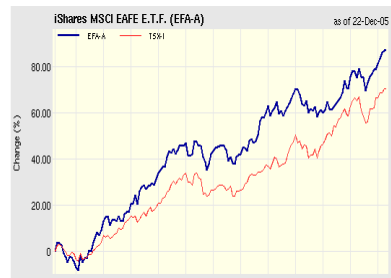
## US Equity Markets:



3 year TSX Composite (upper line) vs. S&P 500 not adjusted for currency

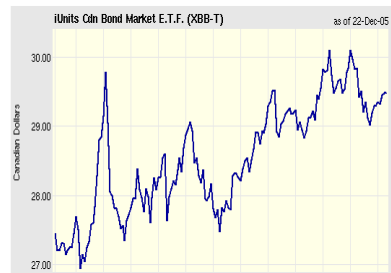
Unfolding events in the US in the coming months will have profound worldwide ramifications but impacts Canada more than most (80% of Canadian exports head south). The concern is this: will the Fed engineer a soft landing or overshoot with its rate hikes and trigger a recession? The US consumer and federal government have a record high and rapidly growing pile of debt. For the first time, US mortgage debt equals corporate debt, and that debt is becoming a liability. The affordability of housing for first-time buyers in the US has hit a 20-year low, raising the risk that the underlying assets supporting the consumer debt will stop adding or even decline in value. Not only that, thanks to the boom in construction, four out of ten jobs created in the past couple of years are housing related and may be vulnerable. With rising energy (especially natural gas) and financing costs, the US consumer may be reaching the tipping point. In this context, the largest and most robust US behemoths with significant international exposure should be best positioned to weather this

## International Equity Markets:



3 year TSX Comp. (upper line) vs. MSCI EAFE not adjusted for currency

## Fixed Income & Bonds:



3 year chart of the Canadian bond market (XBB-T)

year's environment before assuming leadership in 2007. Investing in the US has benefits over investing in Canada, especially if you're looking for a well diversified group of "super-stocks" to ride out a recession and believe (as we do) that the Canadian dollar has limited short-term upward potential.

High prices for energy will erode profits in those sectors that are manufacturing based (although it is worth noting that several Asian countries provide energy subsidies and are inclined to be very interventionist). If coupled with a recession in the US, a global slow-down is likely to follow and foreign equity markets will not provide the high returns generated in 2005. On the other hand, Canadians are no longer required to park 70% of their assets at home and, given our high currency today, it is timely to diversify portfolios for the long term. The TSX represents a mere 3.5% of the global investment universe (or the equivalent of just GE, Exxon and Microsoft) and Canada's roster of true blue chips is declining in number and diversity (70% of the TSX is limited to financial, materials and energy stocks). As in the US, super-sized international stocks provide safer investment destinations (albeit with single digit returns) and boost real diversification. International sector tilts, in particular into gold and some emerging markets, could provide needed lift. Rapid industrialization and growth in China and India is a huge shift but neither of these economies is sufficiently independent of US consumer demand to be free of a general market decline. Increasingly both countries are feeling pressure to become more open, develop a banking industry and a better governed business culture.

Despite a rise in short term interest rates, fixed income assets look attractive to us on a risk/reward basis, especially when compared to expected single digit returns in stocks. Our model core asset portfolio (a hypothetical portfolio not adjusted for individual risk tolerance) going into 2006 has an overall allocation of 50% (higher than normal by at least 10%) to fixed income and may generate as much 40% of total portfolio returns. Of the total portfolio, the fixed income component consists of approximately 20% GOC bonds, 20% US high yield and Canadian income trusts with the remaining 10% in cash or gold bullion (a proxy for cash but without the currency risk). Our analysis of Canadian income trusts suggests that as a group this investment trades at a consistent premium over long term debt and is most similar to US high yield bonds. By holding highly diversified index based income trusts vehicles (such as our own TSX-IEP.UN) we can provide an attractive yet risk-managed opportunity to improve overall portfolio return.



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