Of myopia, markets and manager risk.

WEEKLY INVESTMENT PRE/ REVIEW ------ May 12 th, 2009

- Thank you **Gary Bettman**, **Jim Balsillie** and **Jerry Moyes** for providing Canadians with a superbly entertaining sideshow last week. Your little drama is pushing current news about the stocks and the economy off of the center of our collective radar screens. This is useful because investors have been paying far too much attention to the minutiae of economic and capital markets (like the Dry Goods Index, LIBOR, VIX, energy prices etc.) and this sort of myopia only promotes short term thinking and market volatility.

- Stress buster: on Wednesday of last week, the **Obama administration,** in a step designed to restore investor confidence, quantified the risk remaining in the US financial sector. The results of the so-called stress tests, which gauged the financial abilities of the 19 largest banks in the US, were better than expected and concluded that 10 banks needed to raise a further US$75 billion to boost their capital ratios while 9 have a clean bill of health. The 10 banks are not expected to have any difficulty in raising the necessary capital (of course they could shed liabilities too) and it is interesting to note that the **Bank of America** and **Wells Fargo,** who absorbed **Merrill Lynch** and **Wachovia** respectively, at the behest of the US government, are the very banks that now have to raise the most additional capital as directed, once again, by the US administration. Generally investors are willing to embrace stability while overlooking the contradictions and the mess US administrations have made of the notion of the free enterprise.

- **Spring is in the air:** Unemployment rates are high but the rate of job losses is *slowing*; US housing is showing signs of *recovery*; consumer spending is *stabilizing*; GDP declines are *moderating*. What a change in tone! It seems that many metrics are now supporting the cautious belief that the recession has bottomed and that things are not going to get worse. Even in capital markets, where there's fear that the +30% gains in stock prices since March may only be a bear market rally, there are many observers who think the gains are not unwarranted. The **National Bank's** Pierre Lapointe wades in by asking: "Does the rally have legs?" The answer is *very* cautious and indirect based on a historic review (going back to the 1926 recession) of P/E ratio patterns following market troughs. The analysis concludes that given today's economic and earnings expectations, a range of 835 to 1000 for the **S&P 500** is a reasonable trading range. Last week the **S&P 500** closed at 929, or right in the middle of that range. The equivalent reasonable trading range for the **TSX Composite** is 8800 to 11,200 and with last week's close at 10,237, Mr. Lapointe and his team feels that Canadian stock markets are closer to the upper limit of what is deemed to be a reasonable valuation. Overall, based on their analysis, the economists at the **National Bank** reiterate their view that the North American economy is on target for a year-end recovery and specify that the recent rally is not "in disconnect with our economic assumptions regarding the global economy" --- in other words this is not a bear rally. Uncomfortably shifting in their seats we imagine, the economist then proceed point out the obvious: "the recent rally has been driven by the hope that the economy is turning around …. the economy --- and companies --- now need to deliver the goods." Our view is simpler: the stock market crisis is over and portfolios that continue to be over weight in bonds are too defensive and are foregoing income opportunities elsewhere --- they are not being paid to wait out the market. We think this way because our investment horizon is 12 – 18 months, not 12 – 18 days.

- **Manager risk**: Our view is that the manager can be the single greatest source of risk to your portfolio, and perhaps therefore, the more managers or 'experts' one has, the greater the risk: that might explain the huge losses in 2008 at the **Caisse de Depots** and at the **University of Toronto's** pension and endowment funds. The U of T's losses in 2008 reached $1.5 billion of a total invested of $4.3 billion under the oversight of a staff of 14 drawn from Bay Street with a board comprised of Canadian investment gurus --- *you couldn't have more expertise than that!* The single largest loss (about $600 million) in the portfolio is attributed to a substantial bet on the rise of the Canadian dollar (it peaked in 2007) that should have been liquidated in early 2008. However, it is the overall asset mix approved by the U of T's Board that proved to be disastrous, if not imprudent. For example, the largest exposure of 49% was to alternative and hedge fund investments using funds of funds vehicles (that have poor transparency, generally bad long term results and high fees) which, among other things, resulted in a $5 million exposure to a fund run by Mr. B. Madoff (one of apparently 400 funds that the U of T was exposed to). These risky investment decisions were made all the more precarious by an exposure to bonds of only 15% with the balance (36%) invested in common stocks. Thus, when markets collapsed in the storm of 2008, the U of T funds were sailing with full sheets to the wind in exactly the wrong direction.

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