

Market technicals: On the face of it, the chart below looks terrible! But scratch a little deeper, and what it's really saying is that stocks are priced low and therefore attractive. On a 5-year basis, investors moved out of stocks (see **TSX Composite** chart below) in 2008 and prices have yet to recover. The 200-day moving average is flat and above the 50-day moving average providing a measure of the level of the deep pessimism that currently pervades. This is not dissimilar to 2001 after technology stocks went bust and traumatized investors fled capital markets and bought real estate instead.



Having been burned by stocks, real estate, hedge funds, commodity plays, and various packaged debt instruments (that apparently no one understood), where are traumatized investors fleeing to today? ----- bonds, that's where.

Bonds (see blue line above) provide a safe-haven for your capital --- or so people think. The rational today is that the global economy will (might?) experience a double-dip and that deflation is coming and therefore the right play is to exit stocks, shelter in government bonds, GICs or Treasury Bills and wait for the storm to pass and then buy back in. Aside from the enormous challenge inherent with market timing, for investors with an investment horizon of 6 months or more, this is the wrong strategy, and here's why:

- 1) Bonds yields are at historical lows and therefore have a significant interest rate risk. As governments continue to issue more and more debt, interest rates must rise and will do so precipitously. Therefore the bonds investors buy today, will be worth commensurately less in the future unless they are held to maturity (for a significant opportunity cost rather than the capital loss). Since 2008 investors have been so focused on credit risk (and continue that pattern now with the focus on sovereign debt risk) that they're forgetting all about interest rate risk. In the next several years, Government bonds are the risky investment.
- 2) Earnings forecasts are very positive. The **S&P 500** consensus operating earnings are forecast to rise by 44% in 2010 and 16% in 2011 to an all time record level of U.S. \$95.03. Strong earnings momentum is the catalyst for higher share prices and that earnings strength will be demonstrated in the Q2 10 reporting season starting in July. Given how traumatized investors are, stock prices may not respond automatically, but over the next 6 months, continued earnings growth must propel the **S&P 500** index (and other markets like the **TSX**) well above today's

levels. This earnings scenario is also supported by a steep rising yield curve (a proxy for expected economic growth) which implies that the U.S. economy will not contract in the foreseeable future.

- 3) Stocks are 'cheap'. On a valuation basis, equities as an asset class are remarkably cheap relative to bonds. For example, since 1962, our analysis shows that the dividend yield on the **S&P 500** was equivalent to 50% of the 5 year Treasury bond yield. Currently, the index dividend yield is 112% of the 5 year bond yield. In other words, if an investor buys the **S&P 500** index today, the annual dividend income alone will be 12% higher per year than if the investor bought a 5 year bond. Additionally, if the index in 5 years is above today's level, then investors will have capital gains and therefore be considerably better off than receiving par value for government debt.

It is understandable that the media and many investors fear a return to the dark days of Q4 '08 and Q1 '09 just as they did in 2001/02 following the tech crash and the events of 09/11. Today's traumatized investors are very focused on sovereign debt, the uneven pace of economic recovery in the U.S., on volatile currency and commodity values, and any and all other incidental setbacks that may occur ---- and there are plenty of bad news stories. This negative focus is misplaced as the underlying trends imply that even if stock prices don't rise materially in the near future, holding bonds will still result in lower yield returns and in the long run, bonds have the greater potential to lose you money whereas stocks have the greater potential to provide capital gains based on today's valuations.

In summary: earnings are strong, stocks are cheap and significantly higher index levels await --- all that is left is to learn to take "yes" for an answer when it comes to buying stocks.

Warren Buffett's words of wisdom: Substitute '*easily-understandable index*' for '*easily-understandable business*' in the quote below and our investment philosophy is the same and was never more true of stocks than it is today.

"To invest successfully, you need not understand beta, efficient markets, modern portfolio theory, option pricing or emerging markets. You may, in fact, be better off knowing nothing of these. That, of course, is not the prevailing view at most business schools, whose finance curriculum tends to be dominated by such subjects.

Your goal as an investor should simply be to purchase, at a rational price, a part interest in an easily-understandable business whose earnings are virtually certain to be materially higher five, ten and twenty years from now. You must also resist the temptation to stray from your guidelines: If you aren't willing to own a stock for ten years, don't even think about owning it for ten minutes. Put together a portfolio of companies whose aggregate earnings march upward over the years, and so also will the portfolio's market value."

Warren Buffett

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