The QAM letter that highlights recent developments that we think either affect the markets or are important to understanding them.

"One of the major biases in risky decision making is optimism. Optimism is a source of high-risk thinking."- Daniel Kahneman

Physics Envy

As we write this the S&P 500 is over 1,500, just a few percentage points below its all-time high of 1,565 on October 9, 2007. During 2012, the S&P 500 did not close down, on a year to date basis, once. This has only happened in three other years over the past 56.

The equity markets started off 2013 on a strong foot. This has been credited to the resolution (in principle) of the so called "fiscal cliff", solid corporate results, an agreement in Washington to extend the government's borrowing power, some strong data from the US economy in particular, and the global economy in general, and also by the seasonal inflows into stocks (RRSP in Canada and 401K in the US).

With ongoing shifting in sentiment from pessimism to optimism, it is no surprise that Bloomberg reports optimism is on the increase with close to two-thirds of investors planning to increase their holdings of equities during the next six months. While the increased optimism is merited based on fundamentals, it is more a result of the realization that the world has not met its financial Armageddon.

Equity valuations remain attractive. Notwithstanding, we need to remain mindful that optimism can grow beyond what fundamentals merit and make markets overshoot. Sometimes to the point of creating a bubble.

"I can calculate the motion of heavenly bodies, but not the madness of crowds." Sir Isaac Newton once observed when asked about the rise of the South Sea Company. The South Sea Company was a British company founded in the early 18th century, formed as a public-private partnership to consolidate and reduce the cost of national debt. The company was granted a monopoly to trade with South America. At the time it was created, Britain was involved in the War of the Spanish Succession and Spain controlled South America. There was no realistic prospect that trade would take place and the company never realized any significant profit from its monopoly. The Company stock rose greatly in value as it expanded its operations dealing in government debt, peaking in 1720 before collapsing to little above its original price. This became known as the South Sea Bubble.

Years after Newton's observation, market analysts and finance academicians still suffer some sort of physics envy. There is a tendency in modern economics and finance to model everything and to use mathematical formulas to predict the value of every security, index or market.

Unfortunately, markets are greatly influenced by the individual`s irrational psychology and, unlike the fundamental laws of physics, are prone to ignore mathematical models without ever asking for permission or feeling any type of regret.

Bull markets are followed by bear markets which are followed by bull markets which are followed by bear markets which are followed…….. The single main difference this time is that we are in the uncharted territory of unprecedented global Central Bank liquidity. Volatility levels seem to be contained by the intense presence of the Fed and other Central Banks as participants adjust their expectations. The enormous liquidity injected into the system (Fed Balance Sheet hit 3 trillion US dollars last week, more than tripling in size since September 2008) provides a clear support for assets that naturally hedge inflation like real estate, commodities and stocks.

Valuations are still attractive for equity markets in general, and particularly when compared to government bonds and bonds of large high-quality companies.

As investors we have to remind ourselves that a time will come (again) when everyone feels that risks are at their minimum, over-confidence can take over and elementary precautions start to get neglected. Time and time again investors are tempted by past performance and tend to buy into stocks late in the game.

Diversification across asset classes and within asset classes, systematic rebalancing and a disciplined approach like the one offered by QAM are the only true allies of a long-term investor, even in times of rising markets.

<u>Q4/2012 in Perspective</u>

Performance as of December 31, 2012 (CAD)

	3 months	1 year	3 years	5 years	10 years
S&P/TSX Composite Index	1.70%	7.20%	4.80%	0.80%	9.20%
S&P 500 Index	0.60%	13.00%	8.80%	1.60%	2.30%
MSCI EAFE Index	7.60%	14.90%	2.10%	-3.20%	3.80%

Government of Canada Benchmark Bond Yields

	31-Dec-12	30-Sep-12	31-Dec-11
2 year	1.14%	1.06%	0.95%
10 year	1.80%	1.73%	1.94%
30 year	2.37%	2.32%	2.49%

Source: Bloomberg / UF

The TSX Index lagged most international markets in 2012 as the Materials and Energy sectors both had disappointing returns (-6.9% and -3.6% respectively). These two sectors combined represent 45% of the index. The best performing sectors for the TSX were Health Care and Consumer Staples (both returning above 20%).

In 2012, the S&P 500 returned 13.0% to investors in $CAD. The widely reported Dow Jones Industrial Average (DJIA) returned 10.24% in $CAD. Both indices are held out by industry and media as being representative of large capitalization stocks in the U.S. So why the difference?

To explain the difference we have to get a little into index creation. The DJIA is a price weighted index while the S&P 500 is a market cap weighted index. Not to get too bogged down into the complexities, the DJIA is sensitive to the change in prices of its constituents regardless of the size of each company, whereas for the S&P 500 a 1% change in Apple (the largest company as of the end of 2012 representing over 3% of the S&P 500) would affect the index more than a 1% change in say McDonald's (0.70% of the S&P 500). In addition, the fact that Apple, Google and Berkshire Hathaway are not members of the Dow Jones but are 3 of the top 20 holdings of the S&P 500 and each returned over 12% for 2012 explains a large part of the difference.

The EAFE index returned 17.9% total return in USD and 14.9% in CAD. This was driven mainly by a rebound in Europe (65% of the index weighting). Germany, returning 27%, was the top performer. The main drag on performance was Japan (20% weighting) which only returned 6%. The only countries in the EAFE that actually performed worse than Canada in 2012, besides Japan, were European peripheral nations at the heart of the Euro crisis (Portugal, Ireland, Greece and Spain) along with Israel. Combined however these 5 nations make up only a 4% weighting in EAFE.