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

"When asked what the stock market will do: ***It will fluctuate****."* – J.P. Morgan

TINA: There Is No Alternative

"There is no alternative" (referred to as *TINA*) was a slogan often used by the Conservative British Prime Minister Margaret Thatcher. In the political economy, it has come to mean that "there is no alternative" to economic liberalism - that free markets, free trade, and capitalist globalization are the best or the only way for modern societies to develop.

TINA started to be used by analysts and traders on Wall Street towards the end of 2013 to explain the apparently unstoppable rally in stocks across all markets with little alternative for returns from other asset classes.

In 2013, the US stock market experienced one of its best years since 1997 – the peak year in the middle of the bull market of the mid to late 1990s. For the year 2013, the S&P 500 delivered a total return of 32.4% (USD); over the last 27 months, the S&P 500 has returned 71.72% (USD).

At QAM, we look at the use of the TINA acronym as a warning sign. Experience tells us that many market participants don't consider the political economy when making buy or sell decisions in the short term. They are, for the most, part following trends and prices. Accordingly, sentiment clouds reason and dominates market movements by creating its own momentum in the short term. Can this positive momentum continue?

The investment industry traditionally defines risk as volatility. We at QAM look to reduce downside risk (or volatility), considering both the probability of occurrence and the potential magnitude. Downside risk is more often than not a consequence of paying too much for the assets acquired. In other words, valuations are a major determinant of the downside risk of an investment.

At the beginning of 2013, the S&P 500 was trading at a price/earnings (P/E) ratio of 14 times trailing earnings. That means that, on average, an investor buying "the market" was paying $1.00 for annual earnings of just over 7 cents. In absence of any earnings growth (or declines) this implies a 14 year "break even" period.

At the end of 2013, the S&P 500 was trading at a P/E of 17 times trailing earnings. That means that, on average, an investor buying "the market" is paying $1.00 for annual earnings of just less than 6 cents. Again, in absence of any earnings growth (or declines) the implied "break even" period moves to 17 years. Given a P/E ratio of 17 times earnings, the market's earnings would have to increase by 17%, with no corresponding increase in share price, for P/E ratios/break even periods to drop back to 14 times earnings. Yet, according to analyst estimates compiled by Bloomberg, aggregate earnings for the S&P 500 are estimated to grow 9.7% in 2014.

Wall Street forecasts have to be taken with a grain of salt. Historically these forecasts have proven to be overstated by as much as 20-30% on average. In our view, 10% bottom-line growth will be difficult to achieve for two main reasons: revenue growth doesn't look strong enough to support it (4% for 2013) and profit margins are at historic highs (9.7% vs 7%).

The higher price that one pays for an investment versus its earnings, the longer the "break even" period on invested capital will be. It is more expensive. This corresponds directly to the investment having a higher probability of failing to produce positive returns, which is the very essence of downside risk.

QAM sees broad equity markets (particularly the U.S. market) as fairly valued to a little overvalued at this stage. In absence of earnings growth (good) or continued expansion of P/E ratios (not so good) we expect far more muted returns from equities. Negative returns are not out of the question for the broad market.

However, there will always be companies within any market that demonstrate superior earning power and better balance sheet structure compared to the stock market in general. Accordingly, the shares of such companies provide better downside protection should a market correction happen. This is an argument in favour of active versus passive management for equities in the current market environment.

Investors with short investment horizons or high liquidity needs should review their position very carefully. For those with long term horizons and liquidity needs covered, you should continue to monitor your portfolio and possibly step up rebalancing frequency.

Stock markets fluctuate and corrections do happen, but stocks (even if fairly valued) of well managed companies are still the best long-term hedge to inflation and provide the best long-term return potential as intelligent management finds ways to rationally create value and efficiently allocate capital.

Q4/2013 in Perspective

Performance as of December 31, 2013 (CAD)

	3 months	1 year	3 years	5 years	10 years
S&P/TSX Composite Index	7.30%	13.00%	3.40%	11.90%	8.00%
S&P 500 Index	14.00%	41.70%	18.60%	14.80%	5.30%
MSCI EAFE Index	9.00%	31.90%	11.00%	9.90%	5.30%

Government of Canada Benchmark Bond Yields

	31-Dec-13	30-Sep-13	31-Dec-12
2 year	1.14%	1.19%	1.14%
10 year	2.76%	2.54%	1.80%
30 year	3.23%	3.07%	2.37%

Source: Bloomberg / UF

Canadian stocks returned 7.30% for the quarter and posted gains of 13.0% in 2013, but underperformed both the U.S. and world markets for the third year in a row. Health care, industrials and consumer discretionary sectors demonstrated strong results, with weakness displayed by the materials and utilities sectors.

The US stock market returned 10.5% in local currency (14% in Canadian Dollars) in Q4 2013 and it experienced one of its best years since 1997 with a total return 32.4% in US dollars (41.7% in Canadian Dollars). Industrials were the strongest sector in Q4 2013 and one of three sectors to return more than 40% in 2013 (along with Consumer Discretionary and Health Care).

European stocks returned 9% for Q4 and 31.9% for the year in Canadian Dollars.

Medium to long term rates continued their ascending trend in Q4 that started at the beginning of the year. Government of Canada Benchmark 10 year bond yields increased from 2.54% to 2.76% for Q4 and increased by almost an entire percentage point through 2013. The yield on the 10-year US Treasury almost doubled from 1.62% at the beginning of May to a two-year high of nearly 3%. Earlier in the year Warren Buffet had mentioned that he felt "sorry for investors that have clung to fixed-income investments" but supported the Fed measures that created this low interest rate environment as they had "to hurt somebody, and the savers were convenient".

The Canadian dollar lost about 6.5% versus the U.S. dollar for 2013 after marking its high in January and then trending down all year till December. It lost 2.9% for the fourth quarter. Some analysts predict an 85 cent dollar, a further decline of 9.5% from current levels.

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