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

"The object of life is not to be on the side of the majority, but to escape finding oneself in the ranks of the insane" - Marcus Aurelius

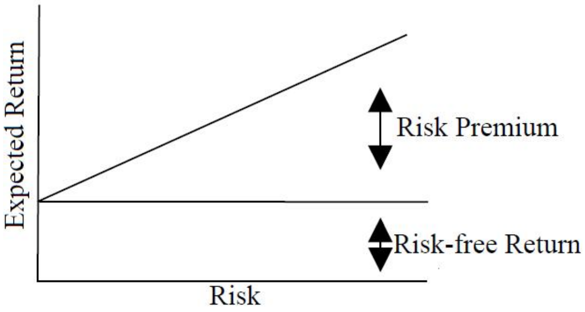
Insanely Rational

We talked in our last Update about quantitative models in the investment industry and their failings in being of use to the individual investor to achieve long-term investment results. One of the many problems with most of these models is that risk is measured as volatility, or standard deviation, while the true risk faced is that of not reaching financial objective(s). Portfolio management in this context must consider far more inputs than just volatility.

It is our experience that most people are unable to properly identify their investment horizons and tolerance for risk or, for that matter, returns that they need to meet their objectives. While we all desire superior returns (whatever that means), many cannot withstand the short term volatility that is inevitable, particularly with equity investments. In addition, the definition of "superior returns" is often influenced by sensationalized media reports or simply the "fishing tales" of neighbors and acquaintances. Many times this is offset with the horror stories of market collapse and financial Armageddon. It is this cycle of fear and greed and the associated reactions that is the most destructive to long term returns.

One core tenet of understanding portfolio management is the simple fact that risk and returns are connected, always. In order to manage a portfolio, one needs to pay attention to both elements, particularly as they relate to their long term objective(s).

However one measures risk, one fundamental truth of the capital markets is that risk will be rewarded with returns over the long term. While this may not hold true for a specific security (or in shorter periods) it is more certain across an asset class (i.e. a collection of securities) and over the long term. In simple terms we rationally expect more returns from a small cap stock versus shares of long established large cap "blue chip" companies. Likewise, we expect more return from a commitment to a 5 year bond versus holding a Treasury Bill. This extra compensation for risk in moving from one asset class to another is often referred to as a risk premium. Typically risk premiums are expressed as an increment over Treasury Bills.



The Equity Risk Premium is the single most important reason why people invest in the stock market (and even private companies and real estate - even though management is a more influencing factor in these asset classes), yet it is one of the most elusive measures among the media (and sometimes investment professionals) and widely misunderstood by the general population.

There are numerous ways to measure or estimate Equity Risk Premiums:

1. Historic Equity Risk Premium is the historical differential return of the stock market over treasuries. This measure of risk premium is objective in nature and will only depend on the measurement period. For very long periods, almost all analyses will agree, or at least be very close. Furthermore, and not surprisingly, long term historical equity risk premiums are most often positive.

2. Expected Equity Risk Premium is the expected differential return in the future of the stock market over treasuries. This is an expectation on future relative performance. It is subjective by nature and highly dependent on the inputs used (future dividends, growth, etc.).

3. Implied Equity Risk Premium is the required equity premium that arises from assuming that the market price is always correct. This is calculated directly from the cost-of-capital estimates of companies by deducting the yield on government bonds to obtain the required excess return and weight by market cap. While there is a level of objectivity in the mathematical approach, it is only valid over very long measurement periods.

Even though the Historic Equity Risk Premium is equal for all investors (although not necessarily the one experienced by a particular portfolio in a particular period) the Expected Equity Risk Premium calculated by different investors will vary. It will vary because the "period" will differ and it will vary because the assumptions about the future will differ.

All our different measures cause us to be confident that the long-term investor remains in the presence of a positive Expected Equity Risk Premium. Our confidence is reinforced by our discussions with many purely equity portfolio managers, both active and passive.

Following from the influences of the fear and greed cycle referred to earlier, investors can easily find themselves attracted to asset classes that did well recently versus those that have not. This reverse consumer approach to investments of buying when prices go up and feeling like selling when prices decline is a problem for a believer in rational value investing and reversion to long term risk premiums.

Cash, Bonds and even residential real estate in Canada at the moment have this feel and taste.

With interest rates providing a return below current and expected inflation (worse if taxed) we know that something has to give.

The 18th Annual RBC Homeownership Study indicates that an overwhelming majority of Canadians (90%) are confident about real estate in Canada as an investment. At the same time, Mawer Investment Management notes in their quarterly report, that an average home costs 84% more in Canada than the U.S. ($372,762 versus $203,100). In their house price survey, the Economist reports a Canadian calculated price-to-income overvaluation of 32% and a price-to-rent overvaluation of 76%. Something will have to give here also. [1].

At the beginning of this Update we question volatility as an appropriate measure of risk. Acceptance of some volatility, particularly over the short term, is often the necessary price to pay for long term portfolio growth. We continue to work with each of our clients to determine the right blend between risk and reward in meeting their long term objectives.

Market perspectives and portfolio positioning

Performance as of March 31, 2012 (CAD)

	3 months	1 year	3 years	5 years	10 years
S&P/TSX Composite Index	4.40%	-9.80%	15.60%	1.70%	7.20%
S&P 500 Index	10.20%	11.70%	14.10%	-0.90%	-0.60%
MSCI EAFE Index	8.70%	-2.60%	8.80%	-5.80%	1.30%

Government of Canada Benchmark Bond Yields

	31-Mar-12	31-Dec-11	30-Jun-11
2 year	1.19%	0.95%	1.59%
10 year	2.11%	1.94%	3.11%
30 year	2.65%	2.49%	3.55%

Source: Bloomberg / UF

Given the important appreciation in market prices over the last two quarters, especially in the U.S., many analysts are warning that a correction could occur. Corrections (technically defined as a market decline of 10% or less in a relatively short period of time) are part of being involved in the equity markets.

As we have suggested over the past months, our clients should continue to focus on a balanced portfolio that reflects their risk tolerances and provides for liquidity needs while capturing positive inflation-adjusted returns from a well-constructed portfolio of stocks. Despite the fact that a correction could affect the markets in the next few months, we understand that it would be an opportunity for long-term investors to add valuable businesses to their portfolios.

Longer term, we continue to see attractive equity valuations, particularly relative to fixed income instruments. Review and rebalance of asset mixes versus long term targets will be critical as valuations in equities expand and perhaps become overvalued in the face of an environment of overly positive sentiment.

(1) http://www.economist.com/node/21551486