

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

"The most common cause of low prices is pessimism - sometimes pervasive, sometimes specific to a company or industry. We want to do business in such an environment, not because we like pessimism but because we like the prices it produces. It's optimism that is the enemy of the rational buyer." – Warren Buffet - 1990 Berkshire Hathaway Chairman's Letter to Shareholders.

Twenty-Twelve

As we get closer to the New Year we start to see all sorts of forecasts for 2012. Poor Twenty-Twelve, so much pressure to please so many different experts' predictions of what it will bring!

Not unlike its predecessor, Twenty-Twelve will bring its own set of surprises:

- Most analysts predicted 2011 to be a relatively positive year for stocks. Not many anticipated that the TSX Index would fall more than 20% at one point in the year, and definitely not many anticipated the level of volatility that the markets experienced in the second half of the year.
- Not many anticipated that Canada (developed) would grow more than Brazil (emerging) in 2011.
- While the general consensus was that interest rates would go up in 2011, interest rates actually went to historic lows and long-term Government of Canada bonds currently yield less than 2.5%.
- The S&P rating agency decided that the US government debt was not as risk-free as finance textbooks assure it is. Not many saw this coming.
- The US economy didn't collapse, nor did it shrink to microscopic levels; actually the last set of economic data is not coming out so bad.
- The bond markets woke up to the idea that Italy might have a debt burden a little too high and that some of the Eurozone countries might have a problem fulfilling the euro convergence criteria of the Maastricht Treaty.

In order to manage true short term risks some level of analysis on the current state of affairs is necessary. However, we don't think that a prediction of what the economic or political situation is going to be in the next 12 months will influence the success of our clients' long-term portfolios.

Daniel Kahneman was awarded the 2002 Nobel Prize in Economics for his work in prospect theory. Prospect theory is a theory that describes decisions between alternatives that involve risk.

One of the conclusions of his work is that people tend to use transformed probabilities when making decisions as opposed to objective probabilities. These transformed probabilities can be viewed as subjective probabilities.

Investor's risk-aversion changes over time as a function of investment performance. This makes prices much more volatile than underlying fundamentals and, together with the investor's loss aversion, leads to a larger equity risk premium (in simple terms – higher returns).

We can use Prospect Theory to understand what is affecting the markets at this time. The drama surrounding the Eurozone and the political paralysis in the US is transforming the probabilities investors assign to different asset classes.

The comfort of holding cash yielding close to zero in nominal terms, and a large objective probability of losing 2% or 3% after inflation, dominates over the probability of higher returns in Equities.

When we travel in an airplane we rely on our pilots to deliver us to our destination safely. Notwithstanding the extensive skill, experience and training that our pilot has, of particular importance to arriving safely is to pay attention to the plane's instruments. This is particularly true when flying in clouds. If a pilot ignores their instruments there is significant risk of failure, sometimes catastrophic.

Clients rely on their investment advisors' skill, experience and training to assist them in arriving at their financial destination. Not unlike a pilot flying in clouds, when we are faced with unclear and sentiment driven markets we must have the discipline to pay attention to our instruments; Fundamentals like P/E ratios, Earnings and Margins, Balance Sheet solvency, Return on Equity, Dividends and Interest Rates relative to actual and expected inflation as well as the slope of the yield curve.

With P/E ratios in the low teens for North-American Equities and below 10 for European Equities, fundamentals at this point indicate that there is value in Equities for the long-term investor.

It remains to be seen what Twenty-Two will bring us but the long-term investor is going to be well served by investing in a well diversified portfolio that reflects their risk tolerance, time horizon, and income & liquidity needs.

Market perspectives and portfolio positioning

Performance ending November 30, 2011 (CAD)

	1 month	1 year	3 years	5 years	10 years
S&P/TSX Composite Index	-0.2%	-3.3%	12.8%	1.9%	7.6%
S&P 500 Index	2.1%	7.0%	6.9%	-2.4%	-1.5%
MSCI EAFE Index	-2.6%	-4.3%	3.6%	-5.7%	0.8%

Source: Bloomberg

Despite all the volatility in 2011, the S&P 500 is up 1.8% as of December 22. That translates into 4.5% in CAD terms as the US dollar appreciated YTD.

The heavily resources-weighted TSX is down 9.4% YTD as of December 22. More and more the TSX is viewed as a play in global growth and the general view in global growth prospects was rather gloomy throughout 2011.

The EAFE index is not surprisingly down 10.55% YTD as of December 22. Large multinational Europe-based companies know more than anybody at this point how pessimism produces low prices.

The Fixed-Income area continues to be very challenging. There are many investors under significant pressure to get higher yield. We don't think that a duration extension strategy is warranted in the current environment when going from the short term to the long spectrum of the yield curve (25 years plus) provides only 1.5% of extra yield.

Happy New Year

We want to take the opportunity to wish you and your families a peaceful holiday season and a healthy, happy and prosperous 2012.

As the Desiderata poem says, the world is full of trickery. But let this not blind us to what virtue there is; many persons strive for high ideals; and everywhere life is full of heroism. The universe is unfolding as it should. With all its sham, drudgery, and broken dreams, it is still a beautiful world. Be cheerful.

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