Quadrant
ASSET MANAGEMENT

QAM Update
January 2012

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

"*There is nothing new except what is forgotten.*" – Rose Bertin

Risks

Investing in general requires an understanding of expected returns but, more importantly, an understanding of the risks associated with the actions taken to obtain those returns.

Fear is still the dominant emotion in the market with many investors sitting on the sidelines. Despite the fact that the S&P 500 is up 20% since its October 2011 lows, the extreme volatility experienced in the second half of 2011 affected investors' psyche, already hit and still dealing with the aftermath of the "Second Great Contraction" as Reinhart and Rogoff called the financial crisis of 2008 in their book "This Time Is Different: Eight Centuries of Financial Folly".

Safety is a good thing but it can be overdone. In the financial markets safety is a tricky concept, as we explained in our last Update. The perception of safety transforms probabilities and makes us lose sight of the fact that if expected returns don't exceed inflation (2.9 per cent for 2011), the purchasing power of invested capital will be gradually eroded over time.

The Bank of Canada publishes the Financial System Review on a semi-annual basis. The last December issue highlights the five major risks to the stability of the Canadian Financial System:

1- Global Sovereign Debt

The Euro-area debt crisis has triggered a general flight to safety in international markets. A further escalation of tensions in this area would undoubtedly have negative effects in the stock markets in terms of volatility. But we shouldn't forget that probabilities are that those tensions are more likely to have a short-term effect and affect mainly the debt markets, in particular of Europe. We believe that once policy makers address the situation more forcefully, basically in a way that will debase the Euro while creating better fiscal arrangements, the longer-term perspective for stocks is favorable, especially compared to cash or bonds.

2- Economic Downturn in Advanced Economies

Deleveraging in the developed world is limiting growth. Provisions for loan losses remain above pre-crisis levels but have declined markedly since 2009. A critical area is the real estate market in the USA. The last set of data coming from the housing market, however, shows that markets are doing their job. Record low mortgage interest rates, some improvement in the job numbers and low home prices are giving people the confidence to enter the market.

3- Global Imbalances

The unsustainable debt accumulation in some developed countries and the corresponding asset accumulation in some emerging economies create the ever present risk that these imbalances might unwind in a disorderly way. This is of particular importance to the Canadian Stock market given its high weight in resource-based companies and its exposure to global growth.

4- Low Interest Rate Environment in Major Advanced Economies

Interest rates are at historically low levels. A combination of weak economic conditions and accommodative monetary policy is pushing yields down. As we have mentioned in past QAM Updates, we are in the presence of a period that creates the conditions for financial repression, as explained by Reinhart and Rogoff, to take over. Governments generate a financial repression tax by way of maintaining low interest rates while inflation runs high, in effect paying back debt with a devalued currency.

5- Canadian Household Finances

The indebtedness of Canadian households has continued to rise. The widely followed debt-to-income ratio is in the 150 range now, higher than the ratio in the USA and close to the number it reached in the USA before the 2008 crisis. Notwithstanding the flaws with this measure, it does indicate that households are becoming increasingly vulnerable to a reduction in employment levels. This, in turn, would have adverse secondary effects on consumer confidence, the housing market and Canadian household net worth.

The capital markets are nothing but discounting machines that reflect in share prices the present value of future cash flows weighted by the consensus probability of its occurrence. The undervaluation of most equity markets relative to other asset classes, and particularly compared with bond markets, should eventually trigger a rally in stocks once some of the risks listed above are better addressed and dissipated. We agree with the premise that there is limited downside risk on equity markets as pessimism is the dominant sentiment weighting.

There are of course other risks (geopolitical tension in various areas in the world, potential natural disasters, etc.) that could trigger a period of volatility but none, we would argue, are highly probable nor long-lasting impediments for economic activity to continue.

When saying that equity markets are undervalued we focus mainly in two areas: corporate earnings and valuations.

Corporate earnings have been very strong in the post-2008 crisis, with S&P 500 earnings reaching new record highs in 2011. While there have been some media articles that question the sustainability of these earnings, long-term experience is that earnings are stable and show a growth tilt over time as companies pass onto consumers the effect of inflation and capitalize on the real growth of the general economy. Of course if the U.S. economy experiences a recession there will be a reduction in earnings but we see it as a short-term effect more than a long-term prospect.

When looking at current market valuations, we believe the equity markets are attractively valued on a longer-term basis. Presently, the S&P 500 is trading at 12.8x earnings, well below its long-term average of 15x – 16x. Pundits argue that valuations have shown not to be a good predictor of short-term returns. But history and mathematics show that stocks provide superior long-term returns from these low multiple levels once natural reversion to the mean takes place.

Market perspectives and portfolio positioning

Market Performances as of December 31, 2011 in CAD$

	3 month	1 Year	3 Years	5 Years	10 Years
S&P/TSX Composite Index	3.59%	-8.71%	13.18%	1.30%	7.03%
S&P 500 Index	9.31%	4.40%	7.46%	-2.94%	-1.60%
MSCI EAFE Index	1.06%	-9.75%	1.85%	-6.84%	0.51%

Index returns are total returns - Source: Bloomberg

We agree that short-term rates won't move much in 2012, given the Federal Reserve's (and other Central Banks around the world) position to provide liquidity to the markets.

In our view longer-term bonds are simply too expensive at these levels to provide any upside potential given extraordinarily low yields, except in a deflationary scenario that we at QAM don't foresee. For that reason the Fixed-Income area continues to be very challenging, particularly for long-term portfolios.

It is our recommendation to always maintain a well-balanced portfolio that takes into account the ability to take risk at the individual level, mindful of investment horizons and liquidity concerns. We think that a better understanding of the risks affecting the markets provides the basis for continued allocation to stocks through a professionally managed mandate.

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