Life in the Fast Lane

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In the era of the dot.com bubble, the ethical lapses were great, the conflicts many, and the cost in terms of investor trust nearly unspeakable. Each time scandals occur market reforms result but, despite their expansive nature, they do not provide insurance against misconduct in the future. True reform lies not in statutory or codified detail, rather it comes from a strong moral compass that is applied by leaders who demonstrate ethical courage. It calls for doing more than the law requires and less than the law allows!

Contrary to the dictates of *homo economicus*, to be guided by a code of ethics does not entail sacrificing one's self-interest. A genuine concern for others is a natural human drive. An organizational culture that recognizes and nurtures such through active implementation will prosper. In the business jungle, as in the primeval one, critical characteristics are honesty, fair dealing, and cooperation. Unfortunately, the investment industry has a tendency to live by the maxim that you eat what you kill, so conflicts of interest and betrayal are all part of the game. If you want a trustworthy friend on Bay Street, get a dog!

Investors are continually bombarded by bad news – war, terrorism, recession, deficits, malfeasance, speculation, you name it. The good news is that those with a diversified perspective can have the confidence to believe in the profitability of a systematic programme of portfolio rebalancing, its implementation essential in bad times as well as good ones.

Looking back over the past half century, the North American economy has continuously been able to assimilate events that were initially nerve-wracking in kind. Methodically trimming winning segments and supplementing losing ones to maintain a portfolio's normal strategic proportions, has proven to be a powerful – if not perfect – approach. It is the only way to obtain some modest alpha without making significant active bets. Bad events do not last forever, and opportunities abound for a diversified portfolio. Neither investors nor CEOs should ever panic when scary events occur with such regularity. They are often the doorway to greater opportunities.

With billions of dollars in investment banking fees at stake, top-ranked research analysts are still a hot commodity garnering substantial pay packages. Though they may no longer tailor recommendations to the demands of the underwriting calendar, nor tip off institutional clients and friends of impending mergers or acquisitions, their integrity remains somewhat suspect. Similarly, half-baked regulations have not put an end to rampant insider trading and other transgressions which continue to cost investors dearly. So it is not surprising the man on the street is ever more cautious when it comes to investing, be it directly or through an intermediary.

INTRIGUING INVESTMENT MEASURES

Shareholder yield is an intriguing investment measure. It is arrived at by adding dividend yield to the percentage of shares outstanding purchased through buyback programmes in the past year, using the number of shares outstanding as of twelve months ago as the base. Other value-investing parameters include: the price-to-earnings, price-to-cash flow, price-to-book value and the price-to-sales ratio, again based on the past four quarters of financial numbers. There is also the earnings yield to consider, which is the inverse of the price-to-earnings ratio. When it is higher than the yield on high-grade corporate bonds, stocks are relatively cheap – for the company if it wants to buy back shares, for a corporate acquirer financing a takeover with its own bonds, and for a portfolio investor whose alternative is owning corporate bonds.

If you would prefer a more down-to-earth measure, I refer you to the *Stock Trader's Almanac*. Over the past fifty years, in the thirty-five instances when the S&P 500 was up for each of the first five trading days of a new year, which it was in January 2006, the index closed up for the year thirty times, for a winning record of 85.7 percent. Unfortunately, the most recent exception occurred in 2002, which also happened to coincide with mid-term elections in the U.S. With high energy prices and a possible slow down in automotive sales and housing starts, investors might be well advised to temper their enthusiasm over the stock market's auspicious start this year.

THE OUTLOOK FOR THE STOCK MARKET

In the bond market, the primary and overwhelming source of return is the interest rate at the outset. In the stock market, the two most significant factors are the sum of the initial annual dividend yield plus subsequent earnings growth, and the speculative return, being the annualized percentage change in the price-to-earnings multiple. The Canadian equity market rose by nearly 22 percent in 2005. Gold, industrial mining, crude oil and natural gas, and oilfield service stock prices are expected to continue along their merry way in 2006. Even the challenged forest products industry sector is getting into the act. This trend will add to the strength of the Canadian dollar, whose near-term upside is around U.S.92 cents. Having surpassed the preceding top of U.S.$500, gold bullion's next target is the U.S.$720 rally high reached in a turbulent 1980. That, however, will require some doing. Having bottomed-out at 230, the near-term goal for the S&P/TSX capped gold index is said to be 400.

There were seventy-four initial public offerings in 2005 totaling $6.8 billion. The forty income trust IPOs amounted to $5.3 billion, and twenty-two were trading at discount to their issue price by year-end. Only five of the twenty-six first-time stock offerings were so. Many blame the investment bankers for a lack of due diligence in bringing lesser quality income trusts to market, or for mispricing the units to begin with, or both. On the other hand, investors must take some of the blame for not paying close enough attention to the merits of an issue, or the lack thereof, in part because income trusts had outpaced the stock market for many years and were expected to continue to do so. High debt loads, aggressive distributable cash estimates, and rich payout levels were among the factors that hammered many of last year's IPOs and will be watched out for in 2006. Lest we forget, income trusts are but equity in sheep's clothing. Each must be able to stand tall based on its own merits. Like common shares, price appreciation can never be guaranteed!

As the technical analysts see it, the S&P/TSX composite topped out in September 2000 at 10,378, fell to a quarterly low of 6,180 two years later, and recovered to end 2005 at 11,272. The low point in 2002 was just less than 60 percent of the previous peak value, while at the end of last year the Canadian stock market was slightly better than 108 percent above its third quarter close in 2000. Interestingly, it has declined in the first half of recent decades, followed by a recovery and a sustained uptrend. In keeping, the S&P/TSX composite could reach 13,000 by year-end 2006, representing a 25 percent increase above the record set in 2000. Some forecasters are calling for it to surpass 14,000 in the final up-leg of this up-cycle, the 50-day and 200-day moving averages to provide strong support during pullbacks. An argument commending this prognostication is that resource and capital investment booms, once started, tend to last for a goodly number of years. The benefits to Canada of growing employment and higher wages, driven in large part by the energy and mining sectors, will help to increase personal disposable income at a faster rate than seen in the past fifteen years. Which should result in continued growth in consumer spending.

One caveat is that the impact of the substantial increase in business capital investment may be dampened somewhat as much of the demand will be sourced from abroad. Nonetheless, growing free cash flow can be expected to spur mergers and acquisitions, particularly in the resource industries. While domestic-oriented manufacturers should do better, the export-oriented sectors will once again outperform in 2006, and beyond. Since many of the larger natural resource and related entities are quite highly priced, investors would be better advised to stick to the small- and mid-caps, where more modest valuations can still be found.

LEVERAGE IS A DOUBLE-EDGED SWORD

Leverage magnifies losses just as easily as it does gains. Hedge funds use sophisticated techniques to mitigate the risks, such as short-selling and options. However, there is no proof these hot shots do any better in the long run than investors who buy shares of well-financed, dividend-paying growth companies at a reasonable price, and stay put come what may on a day-to-day, week-to-week, or even year-to-year basis. As has been suggested, the lure of fat pay cheques has prompted plenty of mediocre talents and cads to launch hedge funds, with predictably disappointing results. Capable investors stand a better chance if they stick to their guns and not get carried away by those charging inordinate fees and promising the moon!

The U.S. current account deficit is another matter all together. After twenty-eight years of unbroken shortfalls, the total is now U.S.$5,000 billion. While it would be wrong to treat the U.S. spending problems lightly, why has the debt level not led to a visible crisis? Why is the rest of the world continuously willing to lend America more money, and to do so at very low interest rates? Why is the U.S. willing to assume this huge burden? And, if it is the largest debtor, who is the largest creditor? Why do the developing countries invest heavily in U.S. treasuries when the best economists all tell them they risk loosing half of their savings or more? One possible explanation has to do with the “economic dark matter” theory. It suggests that the consequent offsetting expenditures have come with a substantial amount of know-how which has resulted in earnings that have more than covered the cost of the borrowed money. In other words, the U.S. has consistently earned substantially more on its overseas assets than it pays on its liabilities, and foreigners seem to be less capable of doing so with their investments in America. Once these U.S. offshore assets are valued according to the income they generate, there has not been a big external imbalance and there are no serious global distortions. Few other arguments make as much sense. Maybe Armageddon is not just around the corner!

Of note, with the single exception of Vermont, U.S. states are prohibited – either constitutionally or by statute – from running budget deficits. In the past when hard times hit, they often raised taxes, which tended to prolong the lean years. Now they are more inclined to cut spending, and taxes too. As a result state spending as a share of the overall economy has shrunk significantly since 2001. Further tax cuts can be expected now that all fifty states are rolling in revenue. The very same can be said of many of the major cities across the U.S., including once-bankrupt New York. If only the likes of the province of Ontario would do the same. Instead, when the going got tough it tried to spend its way back to prosperity by boosting expenditures by 20 percent, and increasing taxes to an all-time high. As a result, the province has ended up being even deeper in debt. With a revved-up economy and great gobs of federal cash, it will take at least another three years for it to balance the books. It is not high time we Canadians learned a lesson or two from our American cousins? I think so. Don't you?

In the early 1980s there were thirty-two large U.S. industrial corporations that qualified for Standard & Poor's top credit rating (AAA). Whether victims of global competition or just more tolerant of risk, there are but six today. Time was when the junk bond market was the vital source of cash for companies wanting to borrow billions. Today it is a matter of so-called leverage loans, which are speculative in grade, secured by company assets, and the cheapest and most plentiful supply of debt capital available in North America. The terms are so attractive they have pushed junk bonds aside as the predominant debt instrument for buyouts, all part of the broader shift in credit markets to jack up leverage and shift risk through new instruments such as credit default swaps and collateralized debt obligations. The trouble is, unlike regular old junk bonds, they have floating interest rates which could be disastrous for companies that have taken on too much debt. Investors funded a record U.S.$29 billion in these sort of loans in 2005, three times as much as junk bonds, as borrowers ratcheted up debt burdens to the highest level since 1999. Not surprisingly, the risk of default is now greater than ever before!

IMPROVING SHARE VALUATIONS

As to the Canadian market for equities, TD Newcrest, the institutional arm of TD Securities Inc., topped the block-trading list on the TSE in 2005 at 16.1 percent of total value. GMP Securities L.P. handled the greatest number of shares, at 12.0 percent. In terms of total trading of Canadian stocks in Canada and the United States combined, CIBC World Markets Inc. led the pack for yet another year. The more-or-less even split is a tribute to the firm's effort since acquiring Oppenheimer & Co. in 1997. The ability to trade Canadian stocks at the best possible price, on any exchange, is obviously becoming increasingly more important to clients of all stripes.

On the corporate side, every Canadian CEO and CFO dreams of developing a strong following by U.S. research analysts and investors. Building such a base of support may allow for greater access to the largest and most liquid capital market in the world. A NYSE or Nasdaq listing can also be an important stepping stone to higher valuations, as the S&P 500 typically trades at 1.2 multiple points above the S&P/TSX composite. At present, the Canadian stock market is slightly more expensive, primarily due to Americans bidding up the price of our biggest and best resource stocks. It will not be so if long-term interest rates rise, earnings growth slows, and the North American economy takes a turn for the worse. In which case U.S. institutional investors will once again prove to have no hesitation in selling foreign securities first, causing havoc in the process of doing so in less-liquid capital markets. They will only become buyers again once an upward trend in stock prices has been reestablished. That is why it is vital Canadian companies maintain a well-established base of sponsorship in Canada, as chances are we will be the only buyers willing to step up to the plate when the stock market is struggling.

According to the Investment Dealers Association of Canada, 2005 was a banner year. Financings totaled $48.9 billion, a 2.5 percent increase over the previous year's record level. CIBC World Markets Inc. ranked first again, having participated in 117 deals to the tune of $10.85 billion. Canaccord Capital Corporation was involved in the greatest number of financings, being 120 issues for $1.75 billion. Much of the strength was due to income trusts, which cooled in the fourth quarter as the federal government decision in September to review the tax rules put a chill on unit values and new issues. This trend continued into 2006, as short-term interest rates rose and stock market volatility increased.

LOOKING TO THE FUTURE

Things may be changing for the better. The long campaign of short-term interest rate hikes, which sent the U.S. federal funds from one percent in June 2004, to 4.75 percent by March 2006, seems to be working: the housing market began to cool in the fourth quarter of 2005, while core inflation has slowed. History is on the bulls' side. The Federal Reserve Board has waged five tightening campaigns since 1983. In four of them, the stock market has gained an average 15.5 percent in the following twelve months, the exception being May 2000. But stocks were wildly overvalued then, the forward price-earnings ratio for the S&P 500 at 24, versus the historical average of low double digits. Furthermore, corporations have record amounts of cash to fuel acquisitions, increase capital spending and dividends, and effect buybacks to protect stock prices when earnings growth decelerates from 15 to 20 percent to the more normal range of 8 to 10 percent. We also happen to agree with the Standard & Poor's equity analysts who say the S&P 500 is trading at more than a 15 percent discount to the average trading price-to-earnings ratio since they began tracking this data in 1988. Even if the current ratio of 16.7 times 2005 earnings contracted to 16, 2006 will still be a good year for equities. Despite a number of spectacular disappointments, earnings surprises are having a very positive impact on share prices, and should continue to do so. However, the quality of the balance sheet, interest coverage, the dividend policy, buybacks, and corporate credibility will become increasingly more important factors as time goes on.

THE KEY TO SUCCESSFUL INVESTING

Varying suppositions seek to explain how investing works. The efficient-market theorists claim the pricing of securities is completely rational and reflects all information known to investors. If there is a piece of news, investors will act promptly and adjust the common share or income trust unit prices accordingly. The only exception relates to small and mid-caps which characteristically lack research analyst sponsorship to keep investors in the know. While the foregoing hypothesis may be helpful, it does not convey the whole story of how people invest, as there is little doubt psychology plays a critical role in making them pick one choice over another. Human emotions, such as fear and greed, have a lot to do with investor decisions. Behavioral academics cite the madness-of-crowds phenomenon as an important driver. Many people make the same mistakes over and over again. The most prevalent one is to pile in at the top of the market when the smart money is getting out. They buy what's hot and avoid what's not! Another quirk is overconfidence. Unfortunately, people rarely know as much as they think – creating even more price inefficiency. The key to success is to buy into great businesses when they are out of favour and selling below their intrinsic worth, and stay away or sell when the opposite is true. Whatever, do not allow your emotions to rule your head.

If you diversify your portfolio appropriately by owning different types of securities, you can reduce the volatility without affecting long-term returns. There are several important factors to be aware of. First, diversification is boring. Secondly, you are never going to feel excited about every investment position as not all will be performing well at the same time. If such is not the case, you are not properly diversified!

If a type of holding outperforms the rest of the capital market, portfolios inevitably become over-weighted in that sector. The longer these trends persist, the more gratifying they seem to be. Eventually, it may come to be conventional wisdom to own just the banks, income and real estate trusts, and resource stocks! Confirmation that such is so can be found in the statistics published by the Investment Funds Institute of Canada which suggest the burgeoning inflows of money have primarily been going into Canadian resource, dividend and monthly income funds. If you are one of these sort, history tells us you are setting yourself up for some disappointing years ahead. But, it does not have to be that way if you systematically rebalance your portfolio toward worthwhile areas where you have little or no exposure.

The S&P 500 in Canadian dollars lost 27.7 percent between January 2000 and January 2006, when the S&P/TSX composite index gained 40.2 percent, in part because the value of the greenback dropped and that of the loonie soared. Some gurus are now suggesting large capitalization U.S. and international stocks are attractively priced and should be bought. However, I think the purchasing power of the U.S. dollar will remain relatively weak for the foreseeable future, so Canada is still the better place to be. While it may be argued that the very low savings rates in North America are no cause for alarm as they do not take into account the value of people's assets having appreciated at an even faster pace than debt, may I caution that the very same theory was put forward before the infamous stock market crash of 1929! Such is reason enough that you make sure your investment portfolio is properly diversified, even if it means holding boring common stocks and income trust units and bonds, and feeling a whole lot less enthusiastic about the capital markets. Life in the fast lane may not be all it is cracked up to be if you fail to stay several steps ahead of the usual crowd of ne'er-do-wells.