Rapport

Signposts

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Signposts

Signposts play an important role in our daily lives, pointing out the best route for us to follow to reach our desired destination. They also exist in the world of investment strategy. Some are obvious, many can be quite subtle, but if we want to reach our investment goals, it is important to pay close attention to what they are signaling. CEOs and investors who obey those indicating which way the stock and bond markets may be headed are bound to be more successful in the longer run than others who fail to do so. Though the current bull market may have yet to run its course, I believe the time has come to start thinking about the signposts warning that more challenging days may lie ahead, and the good times will inevitably come to an end. No list is ever complete, so please feel free to graft your concerns to mine in the hope of never getting caught out when the bell tolls!

TOP-OF-THE-MARKET INDICATORS

In *Go Figure* I noted that a jump in mutual and hedge fund sales usually indicates the stock market is approaching its peak. When redemptions take hold, it is likely near its bottom. Many investment management companies have had a tough go in the past number of years. The turn in their fortunes may have come in June 2005 when net sales for the month hit a seven-year high. If this were to become a trend, causing the portfolio managers to bid up stock prices in order to get the new-found cash invested, one can reasonably expect the market leaders to do even better, and new issue offerings to be snapped up on a moment's notice. Eventually even the dogs of summer may get their day in the sun. When this happens it is time for every CEO to secure the outfit's balance sheet, and for astute investors to start cashing in their chips!

For those looking for other top-of-the-market indicators, six in particular come to mind. The first has to do with private equity. The US$12.5 billion committed to the Blackstone Group's latest buyout fund, a record amount, is surely a sign that there may be too much money about and a dearth of exchange-listed bargains to buy.

The idea that unsuccessful public companies can do better if they go private is another. A US$1.2-billion offer to take the golf club company Callaway private, to say nothing of the speculation about the Ford Motor Company, proves my point.

The Chuckwagon Barometer is the third. At the 2005 Calgary Stampede the average amount paid per canvas was $57,653, $2.08 million in total. This marks an 11 percent rise from the previous all-time high in 2001.

The fourth has to do with the level of investor optimism and, according to Investors Intelligence, it is at a seven-month high. Some of the investment newsletters it tracks are so bullish they are said to be sprouting horns, a warning signal that many individual

investors may have already committed most of their cash to stocks, and there is little left sitting on the sidelines to push prices still higher. As intelligent investors have come to realize, most advisors are followers rather than leaders. The more bullish they become, the more likely the stock market is to decline.

With the number of issues reaching new fifty-two week highs running at almost 95 percent of all new highs and new lows combined, the stock market rally may soon be bumping its head up against the ceiling. Though trading volumes continue to increase when prices rise, and drop when they decline, which in itself is a positive indicator of better times to come, I would caution that those with all their eggs in just a few baskets might be well advised to start thinking seriously about reducing their exposure to above-average risk investments.

Finally, with corporate profits tracking at 11.3 percent of GDP in the US, and 13 percent in Canada – levels not seen since the mid-1960s and well above the longer-term average of 8.5 to 9.5 percent – one must guard against getting too carried away. History tells us that when CEOs believe they have entered a new era of better profits businesses expand, employment and wages rise, margins slide, the outlook becomes clouded, eventually challenging multiples and stock prices.

STOCK SPLITS AND CONSOLIDATIONS

When times are trying and stock prices have tumbled, many CEOs are advised to consolidate the company's shares in the hope of achieving a more respectable, or at least marginable, price. Once a stock has enjoyed a long upward run, the very same advisors inevitably suggest that a split be considered, thereby making the shares more affordable for small investors, giving them a bigger bang for their buck, or so they say!

From an astute investor's perspective, stock consolidations are more often than not an indication that the worst is over and share prices are likely to improve. An impressive number of share splits is usually a sign of a maturing bull market, a time to reduce one's portfolio exposure to stocks. Or, expressed another way, top-performing stocks are never subject to consolidation, and nobody would ever call for a share split when a stock is down and out, and the issuer would appear to be on its last legs! At the moment there are but a modest number of stock splits being announced. However, that could change come the spring of 2006, when CEOs may try to breathe new life into flagging stock, royalty and income trust unit prices, knowing that a moderating increase in earnings may not be enough to do so.

RESEARCH ANALYST INFORMATION MEETINGS

Having been a member of the Toronto Society of Financial Analysts for the past forty years, it bemuses me every time I hear about a CEO swaggering across the country only too willing to spend time telling anyone and everyone a good news story when the enterprise's shares or trust units are flying high. Yet why is it that these same gadabouts are usually nowhere to be found when times are difficult, the security's price is flat on its back, the current and prospective investors, customers and suppliers need to be assured that all is not lost? Could it be that these types could care less as they have little or none of their own money at risk? Or, might it be because they simply have precious little understanding of what makes the world go round and how the capital markets can be made to work to their advantage, come what may?

When CEOs who have not been heard from or seen for the past number of years come knocking on your door, chances are the price of the stock or trust unit in question has already completed the major part of its upward move. A sudden explosion of research analyst information meetings can be a telling sign that there is little in the way of more good news to come. A lack of them often signals that the bottom in the price cycle may be near or just passed, a particularly good time to buy, though the last person to know this is likely the closeted CEO!

On the other hand, those who develop and maintain a broad base of research analyst sponsorship not only temper the impact of bad news, they inevitably realize relatively superior multiples of cash flow and earnings during both buoyant and troubled times. They also have the benefit of receiving ongoing advice from those who are on the firing line talking to longer-term investors, the very people who can make a real difference.

PLAYING ABOUT WITH NUMBERS

In an attempt to keep investors entranced despite a fading earnings cycle, there is little to gain and much to lose by playing the shell game with earnings reports – low-balling expectations and then trying to wow 'em with the actual numbers. The evidence is this. During the 2005 second-quarter pre-reporting period, the ratio of S&P 500 companies lowering guidance to raising it was 2.1:1, the biggest in eight quarters and almost twice last year's average. Just weeks later, the number of outfits exceeding those (lowered) profit estimates outnumbered those falling short by almost 6:1, nearly double the historical average.

But why not? At this stage in the cycle, most companies have wrung about all they are likely to get from margin gains; the low-hanging earnings fruit was picked long ago and most investors know so. Only those who have the ability to deliver superior performance stand to outperform, with broader industry and market trends taking a back seat. Therefore, it is not surprising many misguided CEOs are trying to create the impression of delivering results that are beyond expectations. However, this sleight of hand may well fuel unrealistic profit expectations for future quarters and, if that is the case, the pikers will eventually have to pay dearly for their lack of forthrightness. It may well harm their personal and the company's credibility for many years to come, and also have a negative impact on future cash flow and earnings multiples. It is, simply put, not worth the risk!

BEWARE THE DIFFERENCES IN STOCK MARKET BENCHMARKS

North American stock markets often suffer through what is known as the summer doldrums, a time when traders typically spend more time at the lake than in the office. This year things seem to be different. As noted earlier, trading volumes have been solid and stock prices have been rising in the continuing rally off the April 2005 lows. The overall state of the North American economy remains healthy and consumer confidence is relatively robust. It is suggested that the S&P 500 composite has 1,300 firmly in its sights; 2,300 for the Nasdaq composite; 11,500 for the Dow Jones industrial average; and, the S&P/TSX composite may soon breeze through its 2000 all-time high of 11,389!

That said, the superior performance of the S&P/TSX, compared to the S&P 500 and the Dow Jones in the past while, is almost strictly due to the respective weighting in energy, being approximately 26, 9.5 and 5 percent. The sector that most negatively correlates to energy has been technology and, from a relative weighting point of view, the S&P/TSX is

weakest in this regard, particularly so compared to the Nasdaq. Given as energy related stocks have accounted for 62 percent of the S&P/TSX composite's 19-plus percent gain to date 2005, investors should resist comparing apples with oranges when it comes to the major North American benchmarks. As far as Canadians are concerned, we have got to hope that the breadth of our stock market improves, as it is highly unlikely that the current performance leaders can continue to carry a disproportinate share of the load for ever and ever!

The good news is that the revaluation of the renminbi will serve as a positive first step to removing a major risk overhanging the capital markets, that of the excessive trade imbalances that have developed in the global economy. If the US trade and budget deficits decline, and China moves to ease trade tensions, there should be a further increase in the demand for and price of Canada's base metals and other raw materials. All of which will have a positive impact on the performance of the S&P/TSX composite, while effecting the other major benchmarks to a lesser extent.

RELATIVE VALUATIONS

In the final analysis, whatever the stock market's state of euphoria, investors have always to stop and ask themselves about relative valuations. In 2004 the gains were primarily driven by earnings growth. In 2005 it has been more to do with investors willing to accept paying ever-higher multiples. As of late July, the S&P/TSX composite has been trading at almost twenty times trailing twelve-month earnings, up from less than eighteen times in early May. The price-to-earnings ratio, based on forward twelve-month earnings projections, has risen from around fourteen to about sixteen times. Though these levels may be said to be mildly overvalued, corporate earnings stamina remains robust and we have yet to see any catalyst capable of stopping the rally dead in its tracks.

However, if you are looking for a potential scapegoat, watch the bond market. Though the rise in core inflation may be modest, the central banks in Canada and the US seem bent on raising short-term rates, and a significant upturn of say 50 to 75 basis points from the 4.25 percent level in the ten-year US bond rate could spell trouble for the stock market. If it remains flat, or drops as some suggest it will in time, the rally should continue on its merry way. That said, since mid-2004 in almost every instance where the S&P/TSX composite has passed a 500-point milestone, it has subsequently retreated to below its fifty-day moving average before resuming its climb. Should it pull back to the 10,500 level or thereabouts, investors will once again have to determine if its relative valuation, vis-à-vis long-term bonds, justifies another upward move or not. Only time will tell but I am willing to go out on a limb and suggest that we have yet to see the top for the Canadian stock market. It could be several years off if we all play our cards right!

However, that does not mean that one's portfolio should stand pat. Such is never the right strategy. The following commentary illustrates why such is so.

It is customary for the investment industry to depict the world's biggest stocks as being supertankers, able to cruise uninterrupted through any storm. Unfortunately, that is not true. As their performance often sucks wind in subsequent years. In the case of index funds, the portfolio positions weighted by market capitalization, the results can be devastating when these sort of stocks revert to the mean in terms of cash flow and earnings multiples. The best way to beat the odds is by choosing stocks on fundamental values, like trailing five-year revenue and operating income, and so on. Two apropos examples come to mind: Nortel Networks Corp. and Home Capital Group Inc.

On July 26, 2000, Nortel recorded its all-time high closing price of $123 before plunging into the abyss. An investment of $10,000 on that day would now be worth less than $500. In contrast, less well known Home Capital's stock over the past ten years (June 30, 1995 to June 30, 2005) has generated a total return of 13,736 percent, an average annual gain of 63.65 percent. A $10,000 investment in its case would now amount to $1,370,000-plus, the best overall return of any stock in the S&P/TSX composite index. Given as millions of people will want to refinance adjustable-rate mortgages in coming years, its prospects remain very promising. So why is it that most institutional investors failed to sell Nortel before it peaked to jump aboard the Home Capital bandwagon? Had they done so there is no telling how much better their funds might have performed for investors. Such is a valuable lesson worth learning, and one never to forget!

REDUCE PORTFOLIO RISK

The Canadian stock market has come a long way in the past few years. Risk has now become a factor that we must all pay closer attention to. If we do not, we could be sorry when momentum slows and stock prices correct as inevitably they will.

Quite obviously the energy and related stocks have had a wonderful run. The up-channel has been in place for better than two years. The price of oil has risen from US$18 to US$68-plus. (Technically speaking, the downside risk is US$46.80 per barrel, its May 19, 2005 low.) Nonetheless, I believe these stocks will continue to do well, although they may no longer be the only game in town!

As to the stock market's other darlings, the royalty and income trusts, the calibre of many of the newer offerings is not in keeping with the standards of the past. Though there continues to be strong demand for those that specialize in managing diversified portfolios of other income trusts, such can be a sign of the top of the market, never the bottom. In a way, these funds remind me of Geneva-based Investors Overseas Services' infamous Fund of Funds, an absolute world darling of the late 1960s, which eventually came a cropper when redemptions mounted and its holdings in other funds had to be liquidated causing massive selling of stocks about the globe. While I doubt such would ever come to pass in this case, it is a possibility to be aware of.

Such is not, however, a concern of the underwriters whose sole focus has been, and still is, to sell whatever they can before the income trust gravy train runs out of steam. The fact that nearly one-third of the 2005 IPOs are trading below their issue price does not seem to phase them. Proof of what I speak is their willingness to continue to try and convert an ever increasing number of US companies into trusts, even though most Canadian individual and institutional investors are not interested in supporting their cause given as nearly all these prospective issuers are only interested in cashing out for the best possible price rather than building longer-term value. Furthermore, there are other prospective issuers which should never become trusts because their capital costs are high and cash flow is volatile. Although I may be a bit harsh in my remarks, I do not believe I am racing to judgment for, at this point in the stock market cycle, investors are becoming more demanding than they were in the past for fear of staying too long at the income trust party!

Then there is the case of Mullen Transportation Inc. The numbers speak for themselves. A $10,000 investment a decade ago would be worth $83,000 today, the stock having risen from $8 to $62 before being converted into Mullen Group Income Fund. Unfortunately, the trust structure takes the capital investment decision away from management. Though such

may be justifiable in other companies, given as this star performer has been able to take a dollar of retained earnings and make it grow at 17 percent a year, by paying out all of the cash flow and limiting the ability to increase the underlying value, the unit holders are being deprived of substantial capital gains, the least-taxed form of investment profits. Hopefully the Canadian government in its study of the possible negative impact of trusts on productivity and economic growth will come to the same conclusion, and take steps to eliminate the double taxation of dividends, rather than have investors take the trust route to make ends meet. Steps should also be taken to improve Canada's competitive position by reducing the crippling tax rates on earnings, savings and investment, shifting the onus to consumption where it belongs. Doing so will help to reduce investor risk and encourage our brightest entrepreneurs to shine.

IN SUMMARY

We live in interesting times, some would say exceptional! Nonetheless, there are signposts to read and changes in direction to take if we ever hope to stay on track and keep ahead of the competition. As noted in the introductory comment, this list of concerns is not complete, so please complement mine with others that may cross your mind and add to the equation. Skyrocketing housing prices is an obvious one. The corporate compensation arms race and the likelihood of accounting fraud resurfacing are two more. I could go on and on but I won't!