

LEITH WHEELER INVESTMENT OUTLOOK



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What's in a Catch Phrase?

It's Different This Time

The elegance of a good catch phrase is that it conveys an unquestionable truth in just a few words. The complexity of the real world can be brushed aside with a simple adage. Shorter is better in today's impatient, sound bite driven world. The movie "The Perfect Storm" gave executives of public companies a simple way to excuse a terrible financial report. Apparently running a company is analogous to a tiny ship trying to survive a once in a century meteorological event. "We couldn't help it, we were hit by the perfect storm" they would explain. Nassim Taleb, a popular Wall Street trader turned best selling author, brought us the term "Black Swan" to describe a very rare, unpredictable and catastrophic event. Suddenly "Black Swan" events were appearing everywhere, quickly rendering the term meaningless. There are countless examples like "Tipping Point" and the "New Normal". But "It's Different This Time" is one of the all-time classics.

A year ago, in the midst of the market correction, we made the argument that stocks looked attractive if not downright cheap. Rather than panic, it was the time to buy or, more likely, hang on to the stocks you already owned. This kind of level headed thinking does not sell newspapers.

At the time, the headline grabbing argument was that the global financial system was about to collapse and we were heading for a 1930's style depression. This was not to be a typical recession. Don't you know "it's different this time"?

Green Shoots

At some point on the path to total destruction, investors realized that this time wasn't as different as they feared and stocks rebounded quickly. Suddenly, the "green shoots" of economic recovery were sprouting everywhere and so began an epic rally that rivals any seen in the last 60 years. Within just 2 weeks of the trough on March 9, the TSX Composite had retraced its 16% decline and was flat for the year. So if you had blinked, you missed your chance to get in at the bottom. The speed of the move caused many market pundits to agree that by April, the market had bounced too quickly and investors may yet get a better chance to time their entry. Anyone who had listened might still be sitting on the sidelines pulling their hair out. The market added another 34% and finished the year up 59% from that elusive bottom.

The experience of the past year confirms that our ability to time the market remains statistically indistinguishable from zero. Despite our wise advice to hang on to your stocks a year ago, we hadn't exactly advised you to exit at the top of the market in June of 2008. This is not new for long standing clients. We have always advised of the industry's (and our own) inability to 'time' the markets. We continue to believe that the most reliable path to successful equity investing is to maintain a bottom up focus by buying good businesses at reasonable prices. Our investment approach remains unchanged and we have a high degree of confidence that the stocks in your portfolio will provide good long term returns.

A Bird in the Hand is Worth Two in the Bush

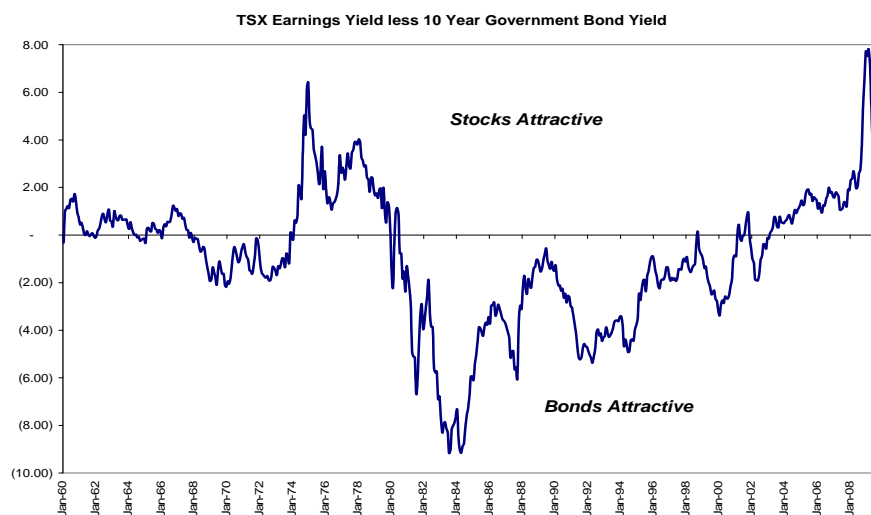
Obviously, this well known phrase refers to a preference for certainty over the risk of pursuing a greater reward. A catch phrase that has stood the test of time since the 6th century B.C. must certainly be beyond reproach. However, despite their strong rally, we think stocks (the two in the bush) remain attractive especially in comparison to government bonds (the one in the hand).

To support this argument, let's revisit the concept of earnings yield which we used to show that stocks were cheap a year ago. Recall that earnings yield is simply the annual earnings of a company or in this case, the index, divided by its price. Last December, TSX stocks were offering a 10% earnings yield but, as was pointed out, the level of earnings was sure to fall. In fact, earnings did fall and combined with rising stocks, the earnings yield is now 5.3%. A 10 year Government of Canada bond currently offers a 3.5% yield.

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As you can see in the following graph, the earnings yield on stocks has been below the 10 year Government bond yield for most of the 80s and 90s. On average, the earnings yield has been about 1% **below** the bond yield over the 50 years covered in the graph. So with the current earnings yield almost 2% **above** the bond yield, stocks still look attractive relative to bonds in spite of the stock market rally and the recessionary impact on earnings. Stocks have also been getting progressively cheaper relative to bonds since 1981.



And while a bond pays a coupon that doesn't grow, stock owners benefit from growth in earnings and dividends. In Canada, earnings generated by TSX stocks have risen at a 6% annual rate since 1960. With no change in the earnings yield, this would produce a 6% increase in stock prices. Assuming 45% of earnings are paid out to shareholders, growing dividends would add 2.4% to this return for a total annual rate of 8.4%.

Be fearful when others are greedy and greedy when others are fearful.

One reason that investors are demanding a higher earnings yield is the perceived risk of owning stocks. To put it mildly, the last 2 years have raised awareness of equity risk. Although we have had a strong year for stocks, the love affair is still not what it was 10 years ago when the cult of equities was in full force. Fortunately, some catch phrases, like the one heading this section, are coined by smart people like Warren Buffett.

After the strong stock markets of the 80s and 90s, investors' expectations for equity returns became excessive. Everyone from day traders, who made money despite themselves in a rising market, to pension plans, who raised actuarial assumptions based on recent experience, knelt at the altar of equities. But disillusion has been growing since the collapse of the technology bubble. The S&P 500 finished the decade with an annual return of -1% and the TSX produced just 5.6%, easily making it the worst decade for equities in at least the last six.

So after a decade of sub par returns and rising volatility, some investors are throwing in the towel and opting for the comfort of low risk bonds. Pension plans are lowering equity return assumptions or eschewing risky equities altogether and matching their obligations to pensioners with bonds. Short sellers are the new day traders.

It is these kinds of signals that should get long term equity investors excited about stocks. When investors have finally lost faith, you want to be buying.

Net-Net

We have been active buying high quality businesses at valuations which in some cases are well below anything we have seen for a decade. The businesses in our Canadian portfolio produced a return on equity of 14% over the past year despite the economic downturn. This compares to 12% for the market. Even better, the stocks currently in our portfolio have earned a 16% return on equity, on average, over the past decade and we have no reason to think they won't get back to that level as the economy improves. We are not paying more for this higher return as the price to book ratio on our stocks is equal to the market's ratio. Our companies also generate these higher returns with less risk as their balance sheets are significantly less levered with debt. Finally, the dividend yield on the portfolio is 2.7% and the companies we own have a track record of growing dividends at 20% a year. This yield statistic becomes even more compelling once the Canadian investor compares dividend tax treatment versus interest from bonds.

Net-net, I'll take the two in the bush.

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