

INvested

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INVESTMENT OUTLOOK

“In the coming decade, investors need to accept the reality that disruptive events will occur and not to lose their patience or investment discipline. ”

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A LOOK AT THE NEXT DECADE OF INVESTING

The recession of 2008 was the worst post-World War II economic contraction on record. On average, global stock markets experienced 50% declines from peak to trough and investors were left trying to make sense of the financial calamity that was upon them. ‘Patience’ and ‘discipline’ were the words we were preaching and ‘staying the course’ was rewarded in the following two years. However risk has become a nasty four-letter word again with Greece and the Eurozone grabbing the headlines and testing the mettle of equity investors. Questions of doubt have resurfaced in the minds of investors - are we going through 2008 all over again and do I have the tolerance and game plan to withstand the volatility?

How do we make sense of all of this? In today’s world, investors are constantly bombarded with news and information through electronic media, television, computers and tablets, which serve to heighten their concern and confusion. Adding to this anxiety, the previous decade proved to be challenging at the best of times for equity investors with the U.S. markets delivering zero return for 10 years. What will the decade ahead of us look like? To help us answer this question we look at the U.S. economy and put its current recovery in historical context.

Current Recovery: Slow & Steady?

Unemployment and housing prices have been the main factors contributing to lower consumer confidence and the slow pace of the U.S. recovery relative to the average post-WWII recovery. Unemployment continues to be stubbornly high and has been improving at a much slower rate than previous recessions. In addition, declines in house prices have had an adverse impact on economic activity and have left a supply overhang in the U.S. housing market. Real home prices are just beginning to show signs of a bottom and still may take up to five years to get back to pre-recession levels.

The bright spot in the current economic environment is corporate profits in the United States, which have recovered at a much faster rate than the average post-WWII recovery. Corporate balance sheets in the U.S. are flush with cash. However corporations have been reluctant thus far to deploy this cash for capital investment and hiring purposes. Until they choose to spend their cash, unemployment will remain high.

So how does the current U.S. recovery compare historically? The recession of 2008 was severe and systemic in nature and as such is difficult to put in perspective compared to any of the other recessions experienced in North America in recent history.

In their publication, *“This Time is Different,”* economists Carmen Reinhart and Kenneth Rogoff examined eight centuries of financial crises. Their findings show the declines in housing and unemployment experienced in the U.S. post-2008 are similar to what was experienced in the five most recent severe systemic financial crises (Spain 1977, Norway 1987, Finland & Sweden 1991, Japan 1992 and Asia ex-Japan 1997). All of these crises also had equally slow economic recoveries. In short, the events of the current U.S. recovery are unfolding in a way that is consistent with previous economic crises that were financial in nature. What is unique about the current U.S. recovery is the strength of corporate balance sheets and profitability growth. This factor alone leads us to believe the U.S. is not headed toward a Japan-like lost decade for investors. There is light at the end of the tunnel.

Low Interest Rates

Given the current economic backdrop, interest rates will likely remain low for an extended period of time. Ben Bernanke, Chairman of the Federal Reserve (the Fed), has vowed to hold rates low as long it takes for the economy to recover and has indicated that the Fed will not entertain raising them until 2014 at the earliest. For fixed income investors, having a Federal Reserve policy supporting low interest rates means they need to look beyond government bonds and focus on corporate bonds and preferred shares to generate income. What do low rates mean for equity investors?

A low interest rate environment and strong corporate profitability have underpinned valuations for stocks, making them attractive from a valuation perspective. The S&P 500 is currently trading below its historical average price to earnings (P/E) multiple (a measure of how cheap or expensive an investment is). Despite a strong first quarter in 2012, based on the market’s current P/E multiple, history suggests reasonable expectations for 10 year equity returns (Chart 1).

Chart 1: Historical 10 Year Returns Based on Starting Period Price to Earnings Multiple

Price to Earnings Multiple Range	10 Year Return
25x – 50x	1.5%
16.6x – 25x	8.1%
12.5x – 16.6x	10.7%
10x – 12.5x	13.3%
8x – 10x	14.8%
7x – 8x	16.5%

Source: Leith Wheeler Estimates & Bloomberg

However, the road ahead of us will be characterized by a slow, uneven economic recovery and potentially volatile equity markets. Investors need to be more diligent in selecting securities for inclusion in their portfolio.

As value investors, we aim to build diversified portfolios comprising of companies that can weather downturns and we focus on acquiring them at reasonable prices. Our process requires us to be different from the market and we strive to own businesses whose future prospects are undervalued by the market. Where do we look for these types of businesses and what are their characteristics?

Look for Dangerous Moats

The ideal business can be viewed as a castle with a protective moat surrounding it, filled with alligators and piranhas, to insulate it from competitive pressures. When looking for new investments, we assess management's track record of increasing and protecting their competitive advantage. The deeper and more dangerous the moat, the better the business model and competitive advantage. We also evaluate how successful management has been in allocating their capital for future investment and growth, and if they spend wisely to protect their competitive advantage.

Look off the Beaten Track

When we search for opportunities we try to look where others are not. We're interested in finding those businesses that others are ignoring; businesses that may have a temporary cloud over them because the market has unfairly discounted their future prospects. This type of approach provides for a margin of safety, allowing us to pay less than we think the business is currently worth.

Look on Both Sides of the Track

Peter Lynch, the successful manager of the Fidelity Magellan Fund popularized the strategy of "investing in what you know", focusing on the brand name consumer products you use on a daily basis. Historically, cities were bisected by the railway lines, creating the 'right side' of the tracks, where you would find upscale residential neighborhoods and successful consumer businesses and the 'other side' of the tracks, where you would find gritty industrial businesses that were far less visible to the average consumer. Lynch's investment ideas are found on the 'right side' of the tracks, however we believe now is the time to look on the 'other' side for investment opportunities. For example, you may not be purchasing items from companies supplying goods to infrastructure, construction, and aerospace industries but you might be surprised by their current order backlogs. Long wait times often indicate products are in high demand. These industrial companies are also selling their products or services to healthier customers, corporations with strong balance sheets, rather than retail customers who are more focused on saving. By following Lynch's strategy, an investor may be focused more on what they know and frequently consume and miss some of the less sexy but better long term opportunities available. By paying attention to both sides of the track, the consumer side and the industrial side, hidden gems can be uncovered.

When is safe not safe anymore?

Below we compare the financial results and market pricing (P/E multiple) of two publicly traded companies. One is seen as the safe, steady utility company, the other is a cyclical, earth moving and construction equipment dealer. As you can see, the growth and profitability of the cyclical company has been far better over the last decade, and it also retains more cash flow to reinvest and grow its business. The final distinction is price, as sometimes safe companies are not safe investments. The utility company is currently 50% more expensive, based on P/E multiple, than the cyclical company because investors have been seeking 'safe', non-cyclical investments and have driven up the price.

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From 2001 - 2011	Emera Safety	Toromont Cyclical
Earnings per Share	5%	16%
Dividend Growth	4%	12%
Dividend Payout Ratio	82%	30%
Average Return on Equity (Profitability)	9%	16%
Forward Price to Earning (P/E Multiple)	20x	14x

Source: Leith Wheeler Estimates & Bloomberg

So what would happen if these two companies swapped their current pricing or P/E? The 'safe' utility stock's price would drop by 30% and the cyclical equipment dealer's stock would rise 43%. Looking for investment opportunities where others are not allows us to find the less expensive, value investments with a greater margin of safety.

Suggestions for the Journey

As investors, we need to do our homework to find well-priced businesses where others aren't looking. We focus on high quality companies with minimal financial leverage giving them the ability to weather economic downturns. In the coming decade, investors need to accept the reality that disruptive events will occur and not to lose their patience or investment discipline. We feel that disruptions serve to create opportunities by allowing patient investors to purchase excellent companies at discount prices. Above all, investors should adopt a long-term perspective to get them through the journey that lies ahead.

The decade ahead of us will be challenging with unforeseen surprises for even the most experienced investors. At Leith Wheeler we are confident that our bottom-up value approach to investing and proven ability to stay patient and wait for opportunities to present themselves will continue to serve as the best defence against volatile, event-driven markets.