Portfolio Review – Q4 2008

Investors were relieved to see this past quarter come to an end, hoping for better days ahead. The TSX suffered a 24% loss in the quarter mainly due to a 30% decline in the energy and financial sectors. The table below summarizes the market performance as of December 31st, 2008.

Market Indices ($Cdn)	Year 2007	Year 2008	Q4 2008
TSX (Canadian market)	7 %	-35 %	-24 %
TSX Canadian Small Cap	2 %	-45 %	-27 %
S&P 500 (US market)	-11 %	-24 %	-11 %
Nasdaq (mainly tech.)	-6 %	-27 %	-8 %
MSCI World	-6 %	-27 %	-10 %
MSCI EAFE (Int'l)	-5 %	-30 %	-8 %
iShares Cdn Short Bond	4 %	8 %	4 %
US$ relative to Cdn$	-15 %	22 %	13 %

In reading the table above it is important to realize that the performance is reported in Canadian currency. For example, the 2008 S&P 500 performance was -45% in US dollars terms (-23% in Canadian dollars minus the 22% "US$ relative to Cdn$" change). Similarly, the Nasdaq and MSCI World indices had poorer performance in local currency terms.

Because the portfolios had a mix of cash, corporate bonds and equity, portfolio performance was better than the major equity indices but none-the-less, very disappointing. Some of the securities mentioned will not necessarily be included in all the portfolios because of the different risk profiles of our clients.

Portfolio Activity

Enbridge (ENB – TSX) was purchased during the sell-off in October. ENB have confirmed they will meet their earnings estimates for Q4, 2008 and have increased their earnings forecasts for 2009, a rare occurrence in the present marketplace. **GE** was sold as its finance unit continued to struggle and their AAA credit rating appears to be at risk of a downgrade. It also seemed timely to take advantage of the increase in the US dollar relative to the Canadian dollar. At about the same time, **Shoppers Drug Mart** (SC – TSX), a defensive consumer staples company, was purchased. SC has performed well, benefiting from the increase in cosmetic sales that often occurs during a recession. **TD Bank** (TD: TSX) was added to a few accounts when its price fell to the $40 level.

To realize tax losses and/or reduce equity content in the portfolios, **Isotechnika**, **Japanese Small Cap** and **Xerox** were sold.

Several government Step-Up bonds were redeemed by their issuers during the quarter. The resulting cash was used to purchase short-term, high-quality corporate bonds and PH&N High-Yield Bond fund, F-series. Five-year high-quality corporate bonds were yielding more than 5% and have been appreciating in value with the improvement in the credit markets. The PH&N High-Yield Bond fund was purchased because it provides diversification in the event some of the high-yield bond holdings default and is liquid (can be easily bought/sold).

Portfolio Analysis

Economic Investment Trust (EVT – TSX), a global closed end fund, typically trades at a 20% discount to its underlying Net Asset Value (NAV). Its price decline has been compounded by the dual influences of 1) a 35% discount to NAV at the end of 2008 and 2) the price decline of its largest holdings; EL Financial, Bank of Nova Scotia and Algoma Central. These holdings are presently undervalued. EL Financial's portfolio does not contain the exotic derivative securities that have impacted the US financial institutions. It trades at a discount with a Price/Book (P/B) value of 0.65, low relative to its peers who have a P/B greater than 1. Bank of Nova Scotia has struggled because of the credit crisis and recession but has minimal exposure to the US financial market and remains one of the better quality banks, worldwide. Algoma Central, which operates lake freighters in the Great Lakes, appears undervalued with a P/E of 5 and a P/B of 0.6.

Canadian small capitalization stocks have experienced a significant decline during 2008. Some YouFirst managed portfolios contain anywhere from 0% to 8% of small capitalization stocks, namely **Artis REIT**, **Canadian Hydro Developers**, **Avenir Diversified Income Trust** and **Hanfeng**. On average, these names declined by 60% during the market panic but recently have had a 40% recovery. Excluding cash distributions, this results in a decline of about 44% for the year, comparable to the Canadian small cap market index decline of 45%. Two of these names are income trusts, Artis Reit is presently distributing $1.08 per year or 15% based on the present price and Avenir Diversified paid out $1.00 in 2008, a 20% yield with an additional special distribution of $0.60 per unit declared in December.

On a positive note, **Teva Pharmaceuticals**, **Thomson Reuters** and the high-quality corporate bonds increased in price during the quarter.

There is some chance that we will re-test the November, 2008 market lows. Taking this into account, the conservative-growth and growth portfolios are underweight equities, holding anywhere between 40% to 60% in equity. Within the equity portion of the portfolio we are underweight energy, financials, industrials, materials and technology and overweight consumer, healthcare and utilities. Consumer staples, healthcare and utilities are considered defensive because during an economic downturn we still need to buy food, medical supplies, medical services, electricity and fuel. The remaining portions of the portfolios are in corporate bonds and cash.

Outlook

The outlook for the global economy is grim with one of every 500 US homes in foreclosure, escalating job losses, reduced corporate profitability, tight credit, and increased bankruptcies. Given this dismal situation, what can be said about the economy a year from now ? The answer to this question is important because the stock market will anticipate an economic recovery six to nine months in advance. Outlined below are some of the signs we will be looking for to ascertain whether a market move is simply a bear market rally or a new bull market.

- Stabilization of US home prices. The US mortgage sector is where the credit dislocation started so in order to rebuild consumer confidence home prices must stop falling.
- A break in the credit crisis. Corporate bond yields and mortgage rates have been excessive, 5 – 7% relative to government bond yields at 1 – 2%. This difference in yield, or spread, has started to narrow over the past couple of months resulting in an increase in corporate bond prices.
- An uptick in consumer confidence survey numbers. Recently the University of Michigan Consumer Confidence index has shown a slight increase, likely due to lower gasoline and consumer goods prices, and President Barack Obama’s inauguration. It will soon be evident whether this indicator continues to improve.
- A decline in write-downs and bailouts in the banking industry. In order for the economy to improve the financial system needs to stabilize.
- A stop in the decline of, or increases in, retail chain same-store sales.
- A reduction in the weekly reported jobless claims for non-farm payrolls. This number has steadily increased to over 500,000 per week in the US.
- An increase in both the manufacturing and non-manufacturing ISM (Institute of Suppliers and Manufacturers) indicators. A reading below 50 implies that the economy is contracting. Both indicators have declined into the 30s.

One of the earliest leading indicators is the stock market itself. When some of the above indicators begin to recover and the market is in a confirmed rally, it will be time to move from our equity underweight position.

RRSP Season is here again!

The RRSP contribution deadline for the 2008 taxation year is Monday March 2, 2009. The contribution limit is 18% of earned income minus any pension adjustments to a maximum of $20,000. We will contact clients soon in an attempt to avoid the end of February rush.

TFSA (Tax-Free Savings Accounts) Now Available

This new type of registered savings account has been deemed the most important personal savings vehicle available to Canadians since the introduction of the RRSP and is recommended for everyone 18 and over. Just a reminder:

- the annual contribution limit is $5,000
- any withdrawals, gains or income generated by investments in the TFSA will not be taxable or affect eligibility for federal income tested benefits or tax credits.
- unused contribution room will carry forward indefinitely

Please let us know if you would like more information or if you wish to open a TFSA and we would be happy to assist you.

RESP reminders

- the annual contribution deadline is Dec. 31, 2009.
- the Canada Education Savings Grant, paid by the federal government is 20% of the annual contribution to an RESP on the first $2,500 contributed each year until the end of the year in which the beneficiary turns 17. The grant is paid by HRDC in the month following the contribution.
- the maximum Education Assistance Payment available is $5,000 for full-time and $2,500 for part-time students within the first 13 weeks of a qualifying program, with no limits after that.

Doug Garner, P.Eng., CFA
President, Portfolio Manager
Jane Garner, BA, EPC
Vice-President