

Portfolio Review – Q4 2009



The performance of the markets in 2009 was a welcome relief relative to the carnage of 2008. Corporate bonds, equity securities and commodities all performed well. The table below summarizes market performance as of December 31st, 2009 in Canadian dollar terms.

Market Indices (\$Cdn)	Year 2008	Year 2009	Q4 2009
TSX (Canadian market)	-35 %	31 %	3 %
S&P 500 (US market)	-24 %	6 %	3 %
Nasdaq (mainly tech.)	-27 %	23 %	4 %
MSCI World	-27 %	12 %	2 %
MSCI EAFE (Int'l)	-30 %	13 %	0 %
iShares Cdn Short Bond	8 %	4.3 %	0.4%
US\$ relative to Cdn\$	22 %	-16 %	-2 %

In 2009, a composite of the Growth portfolios that we manage outperformed the FPX Growth index (5% T-Bill, 25% fixed income, 35% TSX, 15% S&P 500, 20% International equity) by more than 7%. Similarly, the Conservative Growth composite outperformed the FPX Balanced index by 7%. The FPX indices are published daily in the National Post.

Portfolio Activity

During the third quarter, we sold our holdings in the **PH&N High-Yield Bond Fund** because as corporate yields declined, and thus the price of the fund increased, we were able to realize a capital gain in addition to the periodic interest that the fund had paid quarterly. We used the cash to add to our higher-yielding corporate bond holdings and to purchase **First Capital Realty** 6.25% 31Dec16, **Macquarie Power & Infrastructure** 6.5% 31Dec16 and **Primaris REIT** 6.3% 30Sep15 convertible bonds. Convertible bonds provide the option of converting the bonds to the underlying equity at a pre-defined ``conversion`` price. If the price of the underlying equity surpasses the bond`s conversion price, the price of the bond then tracks the equity price. These securities provide some potential equity upside beyond the 6% plus coupon payment. The underlying equities for all three of these convertible bonds pay dividends and in the event any of these companies encounter financial woes, the dividend would be cut or eliminated before the convertible bond coupon payment is affected.

Thomson Reuters (TRI – TSX), **Medtronic** (MDT – NYSE), **TransCanada Pipelines** (TRP – TSX), **Husky Energy** (HSE – TSX) and **ManuLife Financial** (MFC – TSX) were added to accounts

where appropriate. A major concern regarding Manulife is the liability it has from guaranteeing the return of capital on their annuity and segregated fund products. This has resulted in the balance sheet capitalization being highly sensitive to the level of the equity market. MFC suffered two price setbacks recently, one when the dividend was decreased by 50% and the other when it issued new shares at \$19. These two actions, however, have improved Manulife`s balance sheet to a “fortress capital” level, so along with its expanding presence in Asia, it remains a world-class insurance company.

For a few accounts, riskier resource company purchases of **Paladin Resources** (PDN - TSX), a uranium miner, **Sherritt International** (S – TSX), a nickel, cobalt, thermal coal, oil and gas and electricity producer and post-split **Encana** (ECA – TSX) were made. Encana recently split into two companies, an oil based company called Cenovus Energy and a natural gas oriented company that retained the Encana name and stock symbol. The price of natural gas is presently depressed because new horizontal drilling technology has freed large supplies of gas stored in shale deposits. Encana, a premier, low cost natural gas producer should do well with any recovery in the natural gas price.

Teva Pharmaceuticals (Teva - NADQ) was sold because of our concern about the continued sales growth of Copaxone, Teva`s major proprietary drug for the treatment of MS (Multiple Sclerosis), that accounts for one-third of the company`s earnings. Competitive products for the treatment of MS are in final clinical trials and, in some cases, relief from MS can be accomplished by clearing blockages in the blood vessels exiting the brain. We have always been on the alert for any threat to the Copaxone franchise.

Towards the end of the quarter we started to purchase **China Mobile** (CHL – NYSE). The stock has been weak recently due to the restructuring of the telecom industry last year by the Chinese government. CHL was forced to operate their network using the new TD-SCDMA Chinese standard whereas China Unicom (CHU – NYSE) was allowed to use the more ubiquitous WCDMA standard. With more than 700 million wireless subscribers, the Chinese market should be large enough to support its own unique telecom standard. CHL seems undervalued considering it has 60% plus market share and is trading at about 11x P/E with a 3.3% dividend versus CHU at 18x P/E with a 2% dividend.

Outlook

It is the season when economists and prognosticators provide their predictions for the upcoming year. In reading their forecasts the overall consensus for 2010 would seem to be as follows:

- A slower economic recovery than is typical after a recession with low probability of a “double-dip” (i.e. two more quarters of negative GDP).
- Higher equity prices but more subdued than the 2009 market gains.
- Energy and materials prices to be firm because of strong demand from emerging markets such as China and India.
- Concern about government debt particularly in the US where the debt to GDP ratio is comparable to the WW II era. One way to eliminate debt is through high inflation which reduces the value of yesterday’s debt load and eases the fixed interest payment burden.
- There will be low inflation in the short term and moderate inflation in the long term.
- Central banks will begin to raise interest rates in the second half of 2010 but not too drastically.
- High-yield and shorter term corporate bonds will provide a return equivalent to their coupon with minimal principal risk.
- Bearish on long term government bonds because of treasury bond oversupply and higher inflation expectations.
- The decline in the US dollar, relative to other major currencies, will stabilize.

Bob Farrell, a legend at Merrill Lynch & Co. for several decades published 10 rules for investing, rule number nine is “**When all the experts and forecasts agree -- something else is going to happen**”.

So we wonder what could be different than the consensus. At one end of the spectrum, we could have another credit scare resulting in a “double-dip” recession and deflation. This would be good for bonds. At the other end of the spectrum, economic growth could surprise on the upside leading to higher GDP, inflation and interest rates. This would benefit equities and hurt bond prices, particularly for longer-term bonds.

So, from a tactical standpoint, at this market level, we are slightly below our equity strategic asset allocation levels, at approximately 55 – 60% equity for growth portfolios.

Reminders for the New Year

- **RRSP** contributions for the 2009 tax season are due by March 1, 2010. The maximum deduction limit for 2009 is \$21,000 and for 2010 is \$22,000.
- **TFSA**s (Tax Free Savings Accounts) are still a great idea for everyone 18 years of age and older. The maximum allowable contribution is once again \$5,000 for 2010 and any unused portion of the \$5,000 contribution limit from 2009 will be carried forward and added to contribution room for 2010.
- **RESP** contributions for this year must be made by December 31, 2010. Contributing early in the year puts the 20% government grant (CESG), which is paid directly into the RESP in the month following the contribution, to work right away. The year in which beneficiaries turn 17 is the final year in which the grant is paid.
- **Home Renovation Tax Credit** eligible purchases need to be made by February 1, 2010. You may be entitled to receive up to \$1,350 so save the receipts and submit them on your 2009 tax return.
- www.ecoaction.gc.ca provides details about Federal and Provincial cash back incentives to home owners who make environmentally friendly renovations or alterations to their homes.
- The new year is an excellent time to review the **estate planning** checklist below:
 - Have you prepared and signed a will ?
 - Have you prepared and signed a financial and personal care power of attorney ?
 - Have you named beneficiaries for your RRSPs, RRIFs, TFSAs, life insurance policies and pension plans ?
 - Does your family/executor know the location of your financial records, will, insurance policies, income tax returns ?
 - Does your family/executor know the contact information for your professional advisors ?
 - If you are an executor or power of attorney for your parents or relatives are you up to date on the above-mentioned items ?

If you have any questions or comments regarding items discussed in this newsletter please contact us.

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