REVIEW & COMMENTARY
1ST QUARTER 2006

When Bush comes to shove

Certainly from all the issues surrounding the United States, the President is trying to do whatever he can to regain some of his lost political luster. Given the growing levels of discontent among his own party due to a variety of things, most notably his unyielding stance towards Iraq and his support for foreign ownership of U.S. port operators, his decision to reshuffle his executive branch may have been in hope of providing an even greater distraction than his Vice President. Ironically, avoiding the hunting trip with his Vice President may turn out to be his most memorable move in the first quarter of 2006.

Of greater importance for investors, the President ushered in a new Federal Reserve Chairman, Ben Bernacke, in rather seamless fashion. While it is not clear what has finally wakened up the U.S. bond markets to the fact that interest rates have been moving up steadily for the past year or so, Bernacke's relatively benign remarks recently at his first official Fed meeting started a modest decline in bond prices. While the price movements themselves may not be significant, there has been a disconnect between bond prices and interest rates set by the U.S. Fed Committee for some time. The Fed, under Mr. Greenspan, raised rates significantly, however, bond prices remained surprisingly high (and yields surprisingly low) during his tenure. While it has been rumoured that China spends approximately $200 billion annually buying U.S. treasuries to protect their own currency, and thus may explain some if not all of this 'disconnect', the recent upward move in gold may suggest China is starting to diversify, as they had previously avowed, away from U.S. Treasuries.

The economies in North America are sound. As we had stated in prior publications, imagine how strong the U.S. economy might be if oil prices were in the $30's and the billion or so spent monthly on military operations in the Middle East were re-channeled? Unemployment is the lowest in the President's and his predecessor's term, real estate prices remain robust and commodity prices are strong. Corporate balance sheets are healthy, cash flows are growing and the number of significant mergers and acquisitions is accelerating indicating growing corporate confidence.

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The combination of Bush's fiscal management and the residue of his actions in the Middle East have translated into good things for Canadian investors. High oil prices, demand for metals, and low interest rates are helping Canadian equities set a torrid pace for the past year or so. The first quarter of 2006 was no exception for the TSX index which posted gains of close to 8%. You might think that conservative money managers like SIM Ltd. would feel quite content with such strong performance numbers but we don't; in fact it makes us feel somewhat uneasy. Here is why.

The tendency in most dramatic market movements is that the index leadership is often concentrated in few hands. The majority of stock indexes use market weights for its measurement process- in other words, the higher the market cap of an individual stock within the index, the more influence it will have on that index. The Dow Jones and SP500 are like this- so is the TSX. Remember when Nortel was over 35% of the TSE index? That was during the glorious days of the tech boom and bust. Not that we are predicting anything imminent, however, it does raise some concerns. The TSX SP index has become increasingly dependent on oil stocks- even more so now that Income Trusts have been fully included into the index. At the end of March, the energy index was roughly 30% of the TSX/SP index and so was the financial service index.

It is difficult for investors to remember, particularly in exceptionally strong equity markets, that it is important to have a well diversified portfolio. Many managers who are 'index chasers' (live and die by their relative performance to a specific index) most often weight their portfolios as close to the index as possible, often trying to emphasize certain stocks within the heavily weighted sectors in an effort to outperform. While it may provide outstanding short term returns in the strong equity markets, it is always important to remember that as quickly as markets rise, they fall even faster. And when you aren't well diversified, you often give up as much as you have gained, if not more, in much shorter time.

This is not to say that we have soured on oil stocks. Many long standing clients have significant gains and weightings in the sector but we still have many "boring" companies (as they were recently referred to on ROBtv) that have yet to participate to the same degree as either the financials or oil companies. Probably the most difficult part of our jobs is to explain why we continue to hold onto positions that don't 'move'. We have always strongly believed that the best long term equity investments provide income, either through dividends, income distributions or interest. The Canadian banks have been fabulous examples of combining both income and growth over time. On average, the dividend growth of the Canadian major banks has compounded in excess of 10% annually over the past 10 years. But it is important to remember that a well diversified portfolio will withstand market volatility particularly in markets that have become increasingly weighted in one or two sectors.

So we continue to push back the temptation to chase short term returns particularly when they are so heavily weighted in few sectors; long term, boring is sometimes better.

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