**Subject: The Signature Line - Recent market returns come with risks...**
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**Conversation:** The Signature Line - Recent market returns come with risks...

# The Signature Line

*Your Quarterly Update on the Markets and how it Affects You!*

January 2011

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WHAT MAKES US DIFFERENT?

WAS 2010 GOOD FOR YOU?

WHAT PEOPLE ARE SAYING ABOUT ME (IT'S ALL TRUE!)

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**Dear Mike,**

Happy New Year! I hope that you too had a great holiday season and that 2011 will be a prosperous and healthy year for you. I also hope you are starting the year with a comprehensive financial plan in place. If not, let me know and let's have a coffee and see if I can help.

As this is the January edition of *The Signature Line* it is dedicated to a review of the past year and reflection on the coming year. For a bit of a change, rather than rattling off the statistics I thought I'd discuss the gains made in "the market" last year, as it's an interesting lesson. The index, or "the market" returns are not always a broad representation of the actual stock exchange and this past year (the last quarter in particular) was an example of just a couple of sectors leading the charge, and carrying significant risk with it. While most equity portfolios certainly made gains last year some may not have fully participated, or took too much risk in order to get those gains. Read on to learn more.

If I can answer any questions or provide more information, please e-mail me, follow the links and/or give me a call anytime.

Regards, Mike Robinson
www.signaturefs.ca

## What makes us different?

Everybody calls you and everybody wants your business but you can't see what makes one "financial advisor" different from the rest. Right? When it comes to investment advice, here's what makes Signature Financial Security and Value Partners Investments different:

**Concentration, Communication and Accountability.**

**Concentration**. I've never heard of anyone who has generated any significant wealth by investing amongst dozens, or hundreds of investments, like most brokers or mutual funds advocate. Investing in a small concentrated number of profitable well-managed businesses generates wealth. That's what we do.

**Communication**. You should know exactly what businesses or investments you own and exactly why you own them. You should be able to ask about those investments and get effective and direct answers. That's what we do.

**Accountability**. Your "investment advisor" should have personal vested interest in the success of their investment recommendations. If you are having trouble sleeping at night, so should your advisor. Your advisor should be accountable to their recommendations. That's what we do.

## Was 2010 good for you?

Diversify across sectors; make sure accounting earnings translate into genuine cash flow; emphasize companies with pricing power and sales that rise stably over time; and, crucially, be vigilant about valuation (the difference between a great company and a great investment is valuation). **These are the footings of a successful long-term equity investment plan** and each forms an important component of the business evaluation process used at Signature Financial Security through Value Partners Investments. The long term, however, is a collection of many shorter periods, not all of which pay heed to such fundamental metrics.

The second half of 2010, and especially the year's final quarter, represents such

an interval. While central bankers openly fret over challenges to growth and the media spreads any concerns like wildfire, investors have confidently embraced the market's most economically sensitive and historically volatile sectors. Among favoured groups, resource stocks (particularly those of mining enterprises) have been the strongest gainers.

For an investment philosophy such as ours, as outlined at the top, with a fundamental aversion to risk, such a market backdrop is less than ideal. Discipline and emotional detachment are integral to success over long periods, but in the shorter term this commitment to approach can sometimes leave one uninvited to the main room of the market party. In Canada, where resource stocks account for an uncommonly significant share of our market, the effect of recent trends has been particularly acute - over the past 12 months, mining and materials companies have accounted for fully half of the TSX return. In light of these conditions and the prevailing view that commodities will continue to soar in 2011, I devoted this commentary to the conspicuous absence of mining stocks in our VPI portfolios and why we are unlikely to add this sector in the quarters to come.

As stewards of client capital, charged not only with generating a sufficient total return in the equity component of portfolios but also with mitigating risk and volatility, it has always been difficult for us to make room for mining stocks. In the long run, these companies tend to earn very low returns on invested capital and generate free cash flow only sporadically. Resource businesses are also among the most capital intensive and are often highly levered, with returns more dependent on capricious commodity prices than on factors within management control. Though it may seem hard to believe given the surge in metals prices experienced over the past half decade, the weighted average rate of earnings growth for Canadian mining companies since 2005 has been just 1.2%, or about 2/3 *lower* than the rest of the companies in the TSX (certainly not the type of performance a critical observer would expect under such favourable operating conditions). Further, because mining share prices have risen much more rapidly than earnings, valuations on these stocks now sit at historic highs, both in absolute terms and relative to the rest of the market. This means that a continuation of the charging bull market in raw materials is required not only to drive further stock appreciation, but even to justify current share price levels. Conversely, any significant pull back in commodities would leave many of these richly valued names highly exposed, especially if markets begin to sense that actual earnings in the sector won't approach imbedded expectations.

If an investment manager is to look past the intrinsic shortcomings of these businesses to build an "it's different this time" case for mining exposure (as many seem to be doing), at least one of the following conditions must be anticipated: developed economies will shortly move past the significant structural burdens imposed by the recent financial crisis and assume a much steeper path of growth (including a substantial recovery in consumer spending and home building); and/or China will rapidly transform from an export and construction driven economy to one with a significant domestic consumer component.

Although economies are stabilizing in the West and fears of a double-dip recession have all but dissipated, it is nonetheless difficult to envisage a scenario where spending on commodity intensive items such as automobiles and new homes reaches the debt driven fever of four years ago. On the contrary, recent data show that Americans are devoting available funds to balance sheet repair ahead of consumption, with personal debts being whittled down and the savings rate reaching levels not seen since the early 1980s. Though this prudence will ultimately set the world's largest economy on a more stable foundation from which consistent growth may be generated, it does little to drive immediate demand for "stuff" and, by extension, raw materials. Elsewhere in the developed world, the issues faced by Europe - demographic, political and, foremost, financial - are also inhibitive to a recovery in discretionary spending or the launch of significant infrastructure initiatives.

In China, materials consumption had been driven principally by the need to satisfy the West's voracious appetite for consumer goods. When that wellspring of demand was abruptly tapered by the financial crisis, the Chinese government stepped in with a massive program of infrastructure build and capital expenditure geared at filling the void and keeping national growth rates at elevated levels. Now it's widely assumed that the newly wealthy Chinese individual will emerge to pick up the baton of consumption and ultimately drive commodity prices even higher. While this is an appealing story - repeated in numerous strategy forecasts for the year ahead - a cursory peak below the surface reveals that the average Chinese citizen is not yet behaving according to plan.

Despite rapid income growth over the past decade, private consumption as a share of GDP in China has actually fallen from about 46% in 2000 to 35% today. At the same time, the urban Chinese household sets aside twice as much of its income today as it did 20 years ago, with savings rates having risen from 15% in the early 1990s to over 30% in recent years. On the surface, these figures appear confounding: if China is on a rapid track to westernization with incomes growing at a breakneck pace, why aren't its citizens spending like us? The answer to this question undoubtedly lies in the nature and speed of change thrust upon its people. In 1989, State-Owned Collective Enterprises employed 81% of the Chinese population with the guarantee of lifetime employment; this figure had fallen to 64% in 2006 and is presumably much lower today. As Chinese individuals suddenly face the personal financial risks that we in the West have known for centuries, it is not surprising that their collective caution and propensity to save has increased.

The highly concentrated nature of private wealth in China also makes a "democratic" move to consumption problematic. Even in prosperous cities such as Beijing or Shanghai, where earnings have risen rapidly, the average annual middle class income is still only about $10,000 and, according to the World Bank, the nation's per capita GDP remains behind such basket case countries as Botswana, Algeria, Namibia, Grenada, and Iran. This low absolute level of individual income

has not impeded a massive construction boom, however, driven by easy credit and the belief among speculators that property prices will climb indefinitely. A recent survey showing that well over half the apartments in Beijing, Shanghai, and Hainan are empty reveals the effects of this building surge, while a separate university study estimated that approximately 65 million houses and apartments currently stand vacant in China's urban areas. Assuming a modest three people per unit, this is enough space to house more than 15% of the entire population, calling into question how much additional construction will be required in the intermediate term to shelter those migrating to cities (especially when much of this migration has been drawn to jobs in the construction industry itself). Just outside Guangzhou, the industrial and trade centre of South China, the world's largest shopping mall sits 99% vacant, while elsewhere in the country, approximately 500 malls have been built in the last five years awaiting the arrival of China's consuming class. Wary of the potential downside to a bubbly property market, the government has begun to curb speculative activity, raising mortgage rates and down-payment requirements on second homes and banning loans for the purchase of third properties. If building activity is plateauing, this may explain why about 300,000 tonnes of refined copper is reported to sit idly in Shanghai warehouses alone; it also bodes ill in the near term for a country in which construction is estimated by some to account for as much as half of gross domestic product.

Without doubt China will be a more prosperous and freer country a decade from now and, in the west, the economic worst is likely behind us. That doesn't mean, however, that companies expected to prosper from these long term positives should be bought at any price and it certainly doesn't mean that the path to growth will be without potholes - unfortunately, most mining and materials companies are currently priced for immaculate perfection. As an extreme example of what can happen when fundamentals and valuations become widely disconnected, it is worthwhile to consider the internet. As a device, the internet has impacted all of our lives to a far greater extent than any of us could have predicted 10 or 12 years ago; on this front, most investment analysts got the story right. After rising parabolically, though, the stocks associated with the web crashed spectacularly, with only a fraction of these companies even in existence today. This occurred because analysts and investors made the mistake of taking an alluring underlying story and extrapolating its financial value in exponential terms, **something we are not willing to do with client assets**.

Up until Labour Day, North American equity markets had exposed investors to a great deal of volatility, but produced almost no return for 2010. At the end of August, the Chairman of the US Federal Reserve gave a speech lamenting the tepid pace of recovery and suggesting that a second round of monetary stimulus ("Quantitative Easing 2") might be necessary to stave off a return to recession and ensure that deflation did not take hold. Focusing not on the fundamental concerns voiced by the Fed, but on the flow of liquidity that would be required to deal with these risks, stocks began a steep ascent the following trading day, with capital flowing to economically sensitive groups such as mining and materials and avoiding defensive sectors like pipelines and consumer staples. Our cautious

stance in equity portfolios meant that we missed a bit of this rally, causing our performance to fall a bit behind industry benchmarks for the year (our Canadian pool returned 12.55% vs. 17.61% for the benchmark). However, we do not see value in comparing ourselves against speculators and an irrational market. Our benchmark is whether or not we build wealth for clients in a prudent and risk-averse manner. When comparing the last quarter or annual results against the industry benchmarks, while the result appears slightly disappointing on its face, we are certain that **much of the market turnaround was driven by speculative forces which oblige a level of risk exposure with which we are not comfortable.** Looking out to 2011, we are confident that the reasonable valuation and strong dividend yield of our equity portfolio will provide both a solid base for return as well as relative protection against a possible re-pricing of market risk.

If I can answer any questions, please feel free to contact me at any time. I'd be happy to fully explain our investment strategy and discuss any of our holdings.

Check out what we're all about by visiting www.signaturefs.ca.

Call me at (403) 226-0321 or e-mail me at mike@signaturefs.ca.

Mike Robinson

## What are people saying about me?

**"All I ever saw in the past was my broker making commissions, while I didn't seem to be making any money at all. I love the fact that Mike puts his money where his mouth is. We win together and lose together."**
***Jack Baird, Owner -JBE Ltd.***

**"I appreciate the transparency in my investment accounts. I can see what I own and I'm kept up to date whenever there's a change in the portfolio and it's clearly explained why something has been bought or sold.**

**Mike clearly explains our investment strategy so I know what we're doing with my money rather than just me turning it over and hoping for the best."**
***Zoe Agashae, Principal/Owner -Crimson Ventures Inc.***

**"Mike is a true partner in the relationship. He worked with me and helped me move forward in both the good times and the bad times. He's a business owner himself and he understands my situation well. Not only does he help me with my financial affairs but he also helps me with my business."**
***Don Carter, President/Owner, Carter Marketing Group Inc.***

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Mike Robinson is an investment representative of Quadrus Investment Services Ltd.

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