

Tuesday, July 10, 2012

Second Quarter 2012

The 2nd quarter was nearly a mirror image of the 1st quarter in the Canadian stock market. The S&P/TSX Composite Total Return was -5.7% in the 2nd quarter, after being up 4.4% in the 1st quarter of the year.

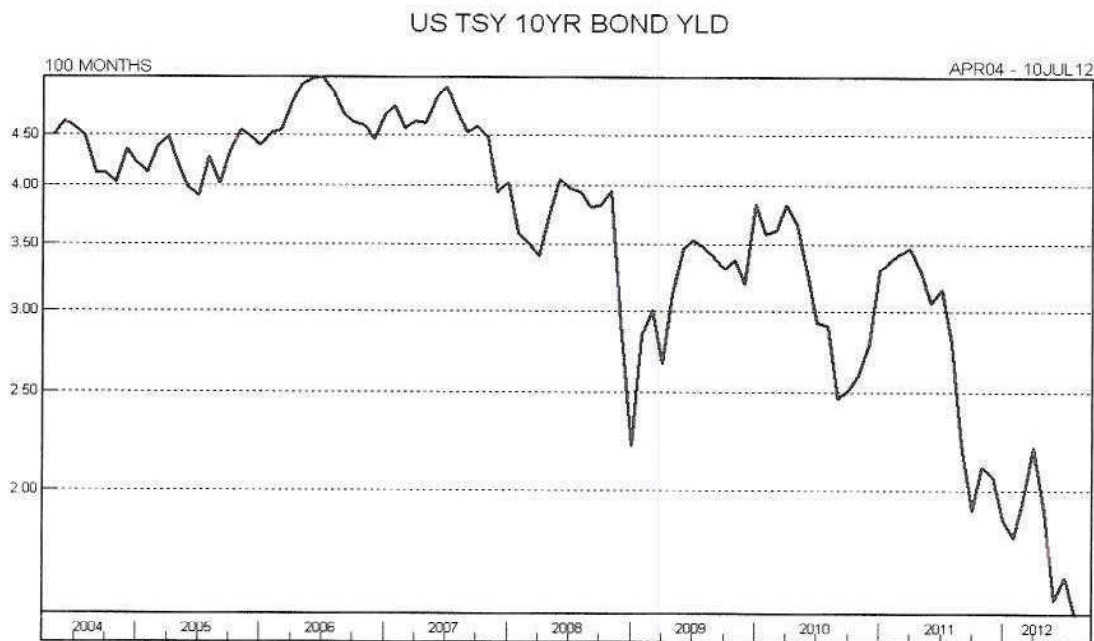
In the 2nd quarter stocks, oil, and gold sold off on growing concern about the future of the European currency union and concerns about slowing economic growth in China. Stocks sold off in the summers of 2010 and 2011 too. The economic backdrop if anything is worse this year. Europe has slid into a Great Recession of its own. In the U.S., employment has yet to improve even though there are some signs of life in the housing market. There are a list of looming fiscal issues (elections, fiscal cliff, debt ceiling again, potential credit rating downgrade) to worry about.

Again this quarter there was quite a difference between the resource laden Canadian stock market and the U.S. stock market. The S&P 500 was down -2.8% in US but only -0.8% measured in Canadian dollars. Over the last 12 months the two markets mirrored each other with the Canadian market down -10.3% and the S&P 500 up 11.3%, at least if scored in Canadian dollars (it was up 5.4% in U.S. dollars).

In early May, Hugh Hendry, the manager of the hedge fund Eclectica, commenting on Europe (“you just can’t make up how bad it is”) came up with my favorite quote of the quarter: “the political economy in Europe is such that the politicians chose to default on their spending obligations to their citizens in order to honor the pact with their financial creditors and so as time goes on, the politicians are being rejected.” (Hugh Hendry quoted by Zerohedge.com). This is a long process.

For investors one of the most remarkable consequences of Europe’s depression and China’s slowdown is ZIRP (zero interest rate policy) or ‘confiscatory’ bond yields. Who, except maybe Hugh Hendry, could have imagined just a few years ago when AAA 10 year US Treasuries yielded 5% that today they would be AA rated and yielding 1.5%. Both supply and demand factors have been at play. Worldwide there is a growing scarcity of so called safe government bonds. US and Canadian bonds are considered to be some of the best houses in the neighborhood. (Italy and Spain remember were once rated AAA.) Also, on the demand side, after years of poor stock market returns, investors have poured money into bond funds. Other

than during the winter of 2008-2009 you would have to go back to the 1950's to find a time when stocks yielded more than bonds.



This past Canada Day, I visited Ottawa with my family. It was my kids' first time on Parliament Hill and I was reminded of how much my father, who died 9 years ago, would have liked to bring them there to watch the parade and to wave the flag. He died at age 82 and my two uncles died months later, also at 82. Warren Buffett the world's greatest investor, will be 82 in August. His long time partner Charlie Munger, who is now 88, was asked about 10 years ago why he was gradually selling his Berkshire Hathaway shares. He observed that most men die in their 80's. We cannot just expect too many more investing lessons from the great one. Warren Buffett has never written a book himself, although there have been dozens that have been written about him. Rather he says he is writing one chapter at a time in the form of the Chairman's Message in the Berkshire Hathaway Annual Report. Buffet's letters to shareholders dating back to 1977 are available on Berkshire's website (not that there is any comparison but I do want to point out that my quarterly letters dating back 5 years are available on my website).

The other venue for wisdom from the Oracle of Omaha is of course the Berkshire Hathaway annual meeting in April. To me the most telling quote from this year's meeting was Buffett's revelation that in all of his and Munger's partnership (47 years), "We've never talked about macro stuff." (quoted by Jeff Matthews, NotMakingThisUp). I was reminded of Buffett's view, that talking about macro economic factors (such as the state of the economy, the direction of the stock market, interest rates, currencies) was a waste of time, by a remarkable example of mirror imaging within RBC. Within a day of each other at the beginning of June, Myles Zybblock, RBC Dominion Securities Chief Strategist, lowered his outlook and weighting for stocks while his predecessor in that role, Dan Chornous, CFA, who is now the Chief Strategist for the Royal Bank of Canada, raised his. Presumably Zybblock lowered his stock weighting because of the

emphasis he tends to put on the PMI, Purchasing Manager Index, which has been weak recently. Chornous probably raised his outlook because of the importance he attaches to the long-term trend in corporate profits versus the sharp decline in stock prices that occurred in April and May. Like a brother advised me some 30 years ago, if you're going to predict, predict often. One of them will be right.

Getting back to the 2011 Berkshire Annual Report, if you could only read one thing about investing every year, you could do far worse. This year I would especially urge you to read pages 6-7 and pages 17-19. But I also want to quote one passage directly. Buffett, unlike most money managers, doesn't usually talk up his investment selections. This year, after detailing the effect of stock buybacks, he explained why not:

“The logic is simple: If you are going to be a net buyer of stocks in the future, either directly with your own money or indirectly (through your ownership of a company that is repurchasing shares), you are hurt when stocks rise. You benefit when stocks swoon. *Emotions*, however, too often complicate the matter: Most people, including those who will be net buyers in the future, take comfort in seeing stock prices advance. These shareholders resemble a commuter who rejoices after the price of gas increases, simply because his tank contains a day's supply.

Charlie and I don't expect to win many of you over to our way of thinking – we've observed enough human behaviour to know the futility of that – but we do want you to be aware of our personal calculus. And here a confession is in order: In my early days I, too, rejoiced when the market rose. Then I read Chapter Eight of Ben Graham's *The Intelligent Investor*, the chapter dealing with how investors should view fluctuations in stock prices. Immediately the scales fell from my eyes, and low prices became my friend. Picking up that book was one of the luckiest moments in my life”

Have a great summer.

Sincerely,

George Stedman, CFA
Portfolio Manager

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