



George Stedman, CFA  
Portfolio Manager

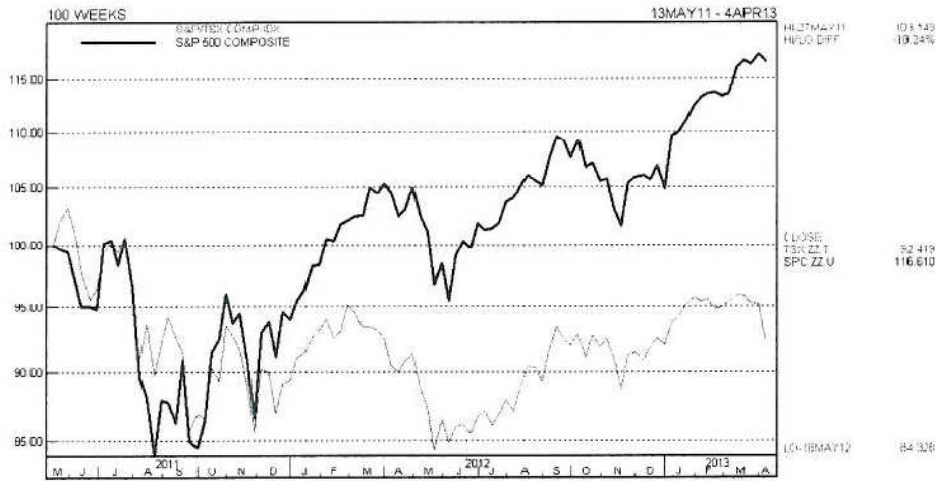
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### First Quarter 2013

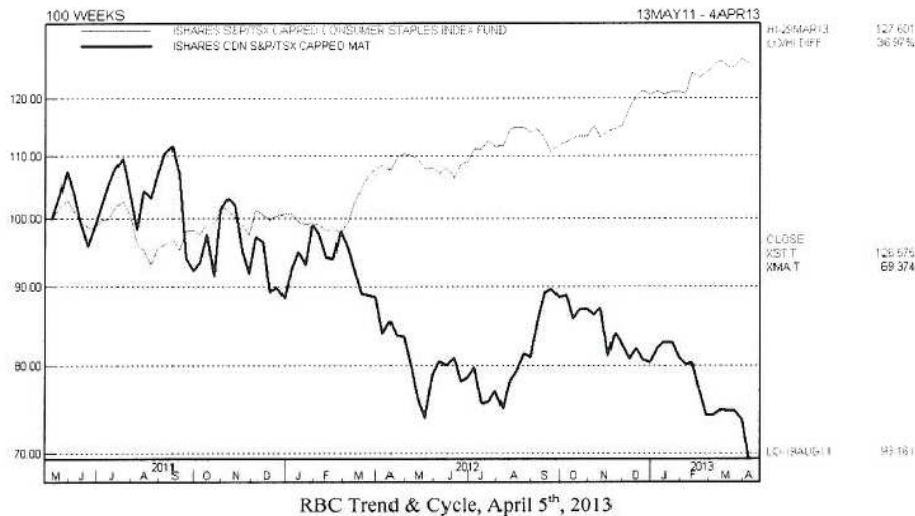
In the first quarter the Canadian stock market (S&P/TSX Composite Total Return Index, the faint line below, which was up 3.2%) was once again trounced by the U.S. market (S&P 500 Total Return in Canadian dollars up 13.2%, the dark line below). In Canada in the first quarter all 15 of the worst contributors to the TSX were from the resource segment of the index.



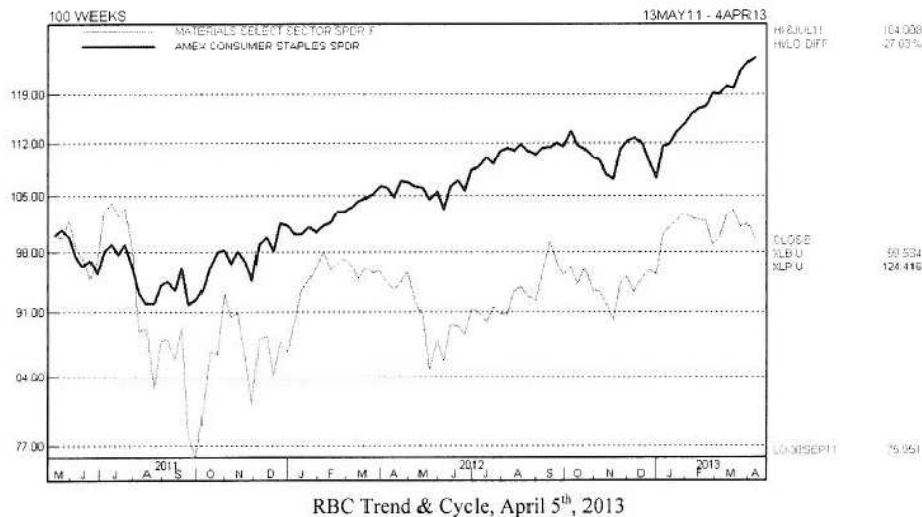
RBC Trend & Cycle, April 5<sup>th</sup>, 2013

The difference between the Canadian and US stock markets' return is a reflection of the make up of the indices. Consider the recent performance of the TSX Staples sector (XST – which includes for instance Loblaw and is the faint line below) versus the TSX Materials sector (XMA – which includes Goldcorp, and is the dark line below).

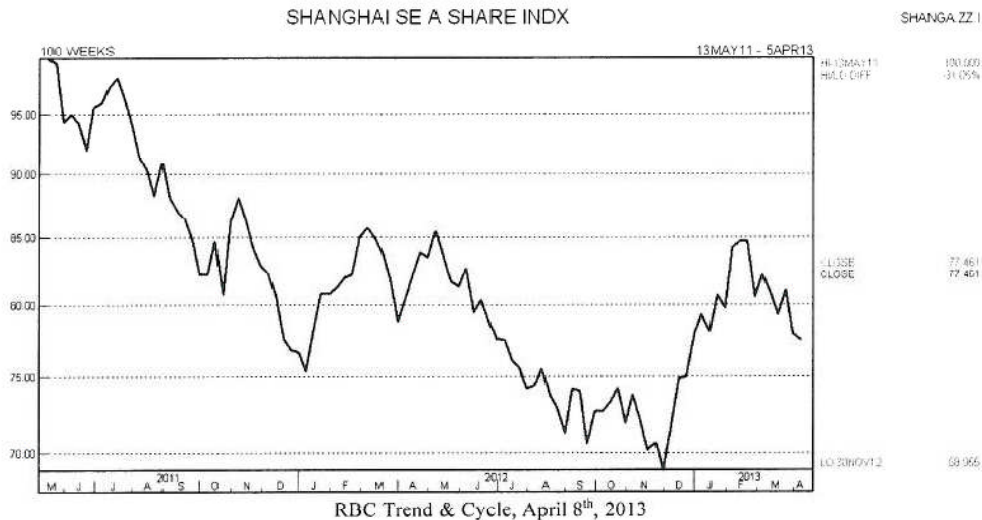




This comparison looks much the same for these sectors in the S&P 500, except the material sector (XLB, the faint line) in the big US index contains more packaging companies and less mining companies than the Canadian version. The staples sector includes for example Procter and Gamble.



Like commodities, in the first quarter the Chinese stock market was weak. From time to time over the last couple of years I have discussed the Chinese property boom and its implications for Canada's resource laden stock market. Last month CBS's 60 Minutes documented vast empty cities and miles of empty apartments (March 3, 2013, Google it, it makes for dramatic viewing).



As Randall Forsyth observed in Barron's (4/1/13) the rise in consumer staples stocks “speaks volumes about investor attitudes. In an uncertain world, no price seems to be too high to pay for this sector’s relatively assured cash flows and decent dividends.” I normally try to be cautious about buying what might be called “feel good” stocks. As a value seeker looking for the unpopular (because of the margin of safety they offer) I feel I should be uncomfortable about my new stock selections. To stiffen my resolve to buy the unloved I apply quantitative screens to the stocks I’m following. The screens are intended to steer me away from buying popular and successful companies at too high a price.

After all, virtually every company is a bad investment at a certain price and virtually every company is a good investment when the price is low enough. The crucial distinction is between a good company and a good stock. The legendary investor Peter Lynch famously advocated investing in growing companies that make products that you use. However he was also sensitive to the price paid. He compared a company’s growth rate to its price earnings ratio. He wanted the growth rate to be more than the p/e. (One Up On Wall Street, 1989)

Of the statistical measures that we track there are 4 that I emphasize. Based on my studies and my experience, I have found these 4 standards helpful in identifying companies that are unlikely to collapse and that have the odds tilted in their favor;

**Return on total capital averaged over 5 years.** We use return on total capital instead of the better known return on equity because ROTC is indifferent to whether companies are financed by debt or equity. It helps to identify companies that are consistently profitable. Using the five year average helps to highlight consistency.

**Free cash flow yield.** Cash flow is more difficult to manipulate than earnings per share. Free cash flow is money that can be returned to shareholders. Today the set of companies we monitor have on average a free cash yield of 5.6%. We highlight the ones which are above average.

**Dividend yield** is a straightforward basis for comparison. Dividends represent management's assessment of future profitability.

**Price to sales ratio.** James O'Shaughnessy has shown (What Works On Wall Street, 2005) that stocks with a low price to sales ratio tend to do better. We look for a price/sales ratio of less than 1.6.

We rank weekly some 105 stocks that interest me and highlight them as they move from relatively undervalued to overvalued. I find it fascinating to observe the ebb and flow of popularity and to see what kinds of companies turn up as bargains from time to time.

Global central banks' near zero interest rate policy may or may not force a 'Grand Rotation' from bonds into stocks, but it is certainly creating a relentless pressure to own less government bonds. I resent being pressured.

In each of the last 3 years stock markets rose from the fall to the spring, which is the normal seasonal pattern. Seasonality aside, what absorbs me is how to protect your family's life savings from what Nassim Taleb called 'black swan' type events. Not buying statistically expensive stocks is one way to help protect your portfolio from calamity.

Sincerely,

George Stedman, CFA  
Portfolio Manager

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