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Third Quarter 2012

In the 3rd quarter stocks were markedly higher and interest rates remained fantastically low. The details on the indexes and your portfolio for the last 9 months are attached. Also enclosed are your results for the last 12 months.

Sometimes it is difficult to see the forest for the trees and in our day to day at the office we are absorbed with particulars. The details of individual portfolios – there always seems to be stuff going on in our clients' lives and money coming into or out of their investment portfolios. We are also, on a day to day basis, fixated on security selection and price – always hoping to find a great investment at a good price.

However in these quarterly letters I often step back from daily concerns to think and write about the big picture. I usually try to explain a little about how financial markets have affected your portfolio and to muse a little on what we are doing about it. For example, in this year's first quarter letter I illustrated how much better the U.S. stock market had been doing compared to the Canadian market. The Canadian stock market is all about commodities (about half the market) which were down because of slowing demand from China and financials (another third) which are links in a worldwide financial chain that includes European banks. Last quarter I illustrated how difficult it is to predict the markets by pointing out that after the big slide in stocks in the spring, the Royal Bank's strategist raised his outlook for stocks not but the day after RBC Dominion Securities' strategist lowered his. (As a follow up and for the record, on October 3rd RBC DS's strategist raised his outlook for stock prices from "underweight" to "neutral".)

One of the things keeping bonds so incredibly popular and interest rates so ultra low is the fear of 'event risk'. Known unknowns include the risk of European break up and the risk of the 'fiscal cliff', which is Fed Chairman Ben Bernanke's term to explain the bad consequences of the rise in tax rates and government spending cuts that, if the lame duck Congress can't reach a compromise, are scheduled for December 31st. (Congress couldn't come up with a better plan last year so they kicked the budget down the proverbial road to a date which is now just around the corner.)



The irony of me writing about macro economic factors like one stock market versus another is that prediction does not have a lot to do with my thinking. We try to react to macroeconomic factors. For instance, bond prices have moved way up for years. Bonds yielding 1%-3% appear expensive. The dividend yield on stocks is more than bonds yield and companies typically don't payout even half their profits in dividends. As part owners of the companies, we own our share of both profits the companies pay as dividends and their profits that are reinvested. At 14x earnings the earnings yield on stocks is 7%. Therefore we favor stocks, especially stocks that are unconventional sources of investment income as the obvious sources of dividends have been somewhat bid up. The Canadian dollar has moved way above purchasing power parity so we favor U.S. stocks, especially in industries that are not available in the Canadian stock market.

Instead of the forest I'd like to write a little about a subject of longer term interest: trees. I love trees. As Jeremy Grantham of GMO points out they grow 8% a year. (My mother loved trees and could identify them even in winter from their bark alone. She graduated in Botany from McGill in 1946.) We made money in trees in the 1980's but for 20 years we couldn't. It was one thing after another; a) There were restrictions and tariffs on exports to the U.S. b) There were environmental issues. c) There was a pine beetle infestation. d) There was an epochal collapse in the U.S. home building industry.

These factors may be turning: a) Under the Softwood Lumber Agreement of 2006, which has been extended to 2015, export taxes on shipments to the U.S. fell from 15% to 10% in June in response to higher lumber prices. b) Most of the Canadian lumber industry has been independently certified to internationally recognized standards. Some companies are even generating bio-energy from waste wood, further pleasing environmentalists. c) British Columbia's mountain pine beetle infestation has peaked. According to BC's Ministry of Forests, Lands and Natural Resource Operations (May 30, 2012), 53% of merchantable pine is now killed. The worse year of the infestation was 2004. The rush to harvest newly killed trees is ending, creating capacity constraints. d) The US housing market aided by favorable demographics and affordability has begun its long road to recovery. RBC's Paul Quinn estimates that "30-40% of North American lumber goes into new houses with another 25-30% used in repair and re-modeling in a normalized housing market." (RBC DS, June 22, 2012).

How to invest in trees to profit from a turn in the U.S. housing market is an interesting question. Many of the very large forest products companies make a paper of one sort or another, and I think the paper business is in decline. Some much smaller companies are purer plays on lumber but may not be geographically diversified which, given global climate change, is a concern. Winter is a seasonally soft period for new home construction. I hope to use it to sort through these choices.

Sincerely,

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