

Monday, October 10, 2011

### Third Quarter 2011

In the third quarter the Canadian stock market index's total return, including dividends, was -12%. Other stock markets were also sharply lower. It is not every quarter that the portfolios I manage outperform the stock market by some 10%. I am very aware you cannot eat relative returns and our third quarter results were absolutely nothing to boast about. With unprecedented volatility the stock market has been making almost daily 1% moves for the last couple of months so I don't want to be relaxed.

There is an old expression in sailboat racing - 'better lucky than smart'. Not losing a lot of money in the 3<sup>rd</sup> quarter was arguably lucky but we applied various strategies to try to help luck along. By strategies I don't mean techniques for predicting whether there will be a full-blown euro-zone sovereign debt collapse or, just the collapse of the three little PIGs (Portugal, Ireland, Greece), or whether China's boom will end in collapse.

Our overarching principle of investing is the importance of diversification because the future is uncertain. Very obviously we beat the stock market because we weren't all in the stock market. We had, and try always to have, a cash reserve (often in the form of short term bonds that are equivalent to cash). Some cash was invested in August and September. We also stubbornly have had some fixed income investments, including even some government bonds, despite their measly returns. Jim Grant calls the yield on government bonds (1.5% for 5 year Canadians, 1.1% for 5 year US treasuries) confiscatory, a word I rather like, because inflation is higher than that. Jim Grant also coined a great line a few years ago, which I'm happy to repeat: Government bonds have always been used to define the risk-free rate of return. Now, Grant says, government bonds offer "return-free risk".

Another aspect of our diversification strategy has been to invest in some non-Canadian, global companies. The 6% gain in the US dollar during the quarter dampened the ride for investors in US listed global companies.

Not only did our portfolio outperform but the stocks in your portfolio outperformed the stock market too. The reason for this was our long-running strategic emphasis on dividends, especially growing dividends. For instance most of our energy investments are pipelines. They make money from their pipes' through puts and only indirectly from the price of oil and gas. Because pipelines have been a reliable source of rising dividends, most pipeline stocks touched new highs in September. We saw similar resilience in telephone and utility stocks as well as consumer staple stocks. All, I believe, because, in a low interest rate world, investors are obsessing about reliable dividend income.

Another reason our stocks on average didn't fall as much as the stock market averages is because of what we haven't emphasized in portfolios. While recognizing that in the very long-run the world is running out of everything, I have been relatively skeptical for the past few years about investing based on the overly popular idea that China is relentlessly industrializing. Therefore we've had less money invested in things like industrial metal mines and in oil and gas producers than are in the indices. Commodities have always been a boom and bust business. I prefer to invest in companies that make things. Canadian manufacturers have been generally poor investments for years in part because of a weak economy but also because of a relentless rise in the Canadian dollar (and the rise in the Canadian dollar was in part because of the relentless demand for Canadian commodities from China). We are finding bargains among them.

Another element of our investment strategy has been to keep the balance of a portfolio fairly steady, so we are inclined to gradually buy the type of assets (stocks or bond or cash) that have been weak. There is another old saying in sailboat racing – 'sail towards the darkest cloud'. That is where the strongest winds will be. In the last couple of months we have been investing cash very gradually by buying shares of favorite manufacturers whose stock prices have been crushed. However, the lesson of a favourite book of mine - "Fastnet, Force 10" – is that some weather events are not survivable in a sailboat. So it is with investment portfolios. We need to be very careful about chasing ominous dark clouds and in investing in the unseaworthy.

I have written many times about the seasonal tendencies in the stock market. Remember SAD – seasonal affective disorder. We tend to get gloomy in the fall and August and September tend to be the worst months of the year. The 4<sup>th</sup> quarter tends to be the best of the year. Certainly I wish I had taken seasonality more seriously by selling when the flowers bloomed last spring so I would have been in a position to buy even more now when the days are getting shorter. Well not today specifically. Today the stock market in the US is way up and we generally only buy on down days.

Having described why we didn't lose as much as the stock market in the last few months, I should be clear about the other consequence of these strategies: When the so-called 'risk trade' comes back on, we won't make as much either. The 'risk-trade' is said to be either on or off. When it is on then stocks, oil, copper, the Canadian dollar, etc. go up.

I'm writing this letter on a sensational Thanksgiving Monday which makes me reflect all the more on how fortunate I am. Fortunate to have the clients I do and I'm thankful too for all the hard work of my colleagues Andras Birkus (who just found out he's passed the final CFA level 3 exam) and Margarita Martinez Elizondo, who joined us in February and whose name I never tire of trying to roll off my tongue.

Sincerely,

George Stedman, CFA  
Portfolio Manager

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