

Monday, April 12, 2011

First Quarter 2011

This last quarter, with the earthquake, tidal wave and nuclear disaster in Japan, with the rebellions in North Africa and the civil war in Syria, has been nothing if not eventful. I tend to spend my days talking about the here and now. It was 30 years ago that I started in this business (almost 29 years in this office) and to mark that anniversary, in this letter, I would like to indulge in some reminiscing. I am going to review some episodes in my investment career and try to relate my experiences then to my attitude about various asset classes (gold, stocks, currencies) now. If you prefer to avoid investment advice smeared with nostalgia and just want to know what your rate of return was for the first quarter and for the last 12 months, skip to the attachments that follow this letter.

What I like to think of as the first seminal event in my career came in the winter of 1980-1981 (although I wasn't officially hired as a stockbroker until April 1981) when I turned on the TV and saw people literally lining up outside in freezing cold weather to buy gold for over \$800 U.S. an ounce (or today, adjusted for inflation, \$2,360 U.S.).



Source: RBC Trend & Cycle April 8, 2011

Early 1981 was near the end of a 16 year period when financial assets, like stocks, had done poorly and hard assets, like gold, copper and oil and, the shares of companies that produce gold, copper, and oil, did very well.

Recently I have been reminded of this historical parallel as gold has again, after several years of price gains, become a powerful lure. Five years ago I invested in bullion (especially silver bullion) for about the first time since the 1970's not because I like bullion as an investment (my general preference is to invest in companies that make things, especially things that I can pick

up) but because I thought all paper currencies might become suspect. But it is an immutable law of commodity investing that eventually;

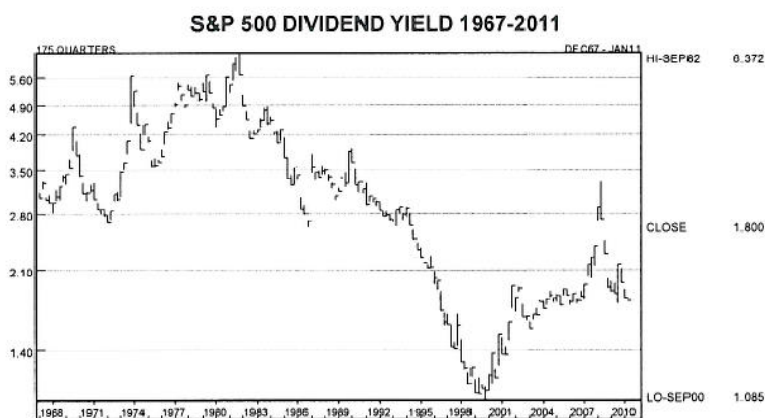
- 1) supply will rise to meet demand and,
- 2) that price spikes are followed by price routs as supply is created and ultimately overwhelms demand.

I don't know how to value gold (it doesn't pay interest or dividends) but I have enclosed (for those who've said they'd like to receive 'feature' articles) an analysis by Veritas, the independent research boutique. They quite contrarily argue that the supply of gold is now growing and is going to outstrip demand shortly.

Warren Buffett has, as usual, a colourful way of framing the issue: "You could take all the gold that's ever been mined, and it would fill a cube 67 feet in each direction. For what that's worth at current gold prices, you could buy all – not some – all of the farmland in the United States. Plus, you could buy 10 Exxon Mobils, plus have \$1 trillion of walking-around money. Or you could have a big cube of metal. Which would you take? Which is going to produce more value?" CNN Money.com, October 19, 2010.

Now people may not be lining up outdoors to buy bullion and gold miners today, but gold and silver are at all time highs and gold has begun to seem like a one way bet. When values of an asset class seem high to me what I often do (timidly) is try to be careful not to buy more and to take only some partial profits because, as I've learned, you just don't know how big a bubble will get.

The second seminal event of my investment career came only a year and a half later, in the summer of 1982. In the midst of what up until then had been the worst recession since the 1930's, my 12 month salary guarantee had been cancelled after 6 months (I now know that there is a rule against that). I called everyone I'd ever heard of (who wasn't family), and many more besides, to talk about what was then called the three 6s. Stocks were trading at an average of 6 times earnings, at 0.6 times book value and with a 6% dividend yield.



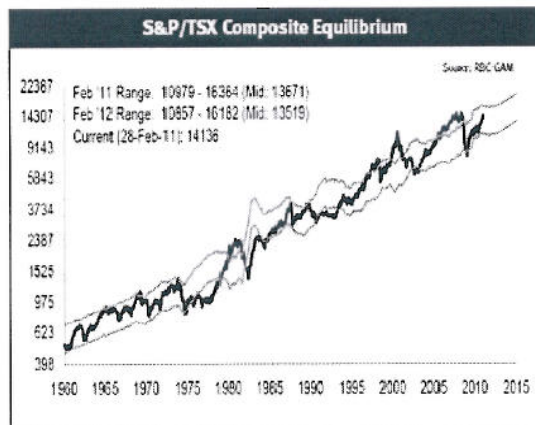
Stocks, I kept repeating, were more expensive in the worst of the Great Depression. My pitch, that stocks had never been cheaper, was so well received that my gross commission for June 1982, (and I've never had a month where I worked longer hours) was \$465, of which I got to

keep 18%, before tax, for the month. Luckily Kristin and I, newly married, were able to live on love. (Kristin Middleton that is, and speaking of weddings, we're still waiting for our invitation to Kate's to arrive). Later that summer the greatest bull stock market ever known was born and it lasted 18 years.

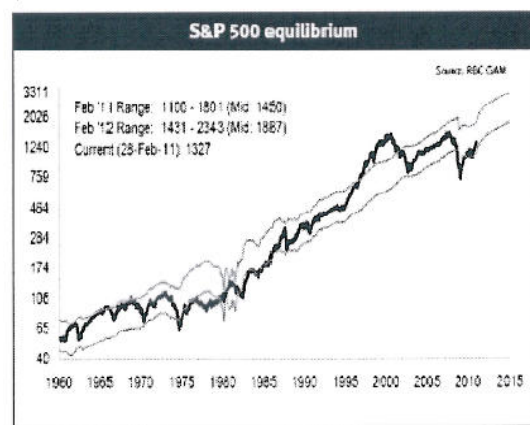
Another good thing came out of that summer of 1982. My colleague Bill Moriarty left R.A. Daly to join Dominion Securities a few months before I did the same. Bill brought with him to our new employer a tool he had just developed and which he had back tested to 1962. He called it his *Equilibrium Model*. It plots stocks against a theoretical "fair value" band based on normalized earnings and valuations and so gives some historical perspective to the price of the stock market. RBC's current Strategist, Dan Chornous, CFA, reprints the *Equilibrium Model* every quarter.

I first printed it in this quarterly letter in October 2000 to illustrate the enormity of the stock market bubble of the late 1990's. The late 1990's were difficult for me as an investor who worries about preservation of capital. From 1997 to 2000, at least every second quarter, I pointed out in these letters that stocks had never been more expensive, but the technology stock bubble just seemed to grow (until it didn't). The last time I published the *Equilibrium Model* was in my letter of April 2009, to show that stocks were then as far below fair value as they've ever been.

Stocks have about doubled since then, but the S&P 500 is now just at the lower edge of the valuation band. The Canadian stock market has moved into the top half of the band.



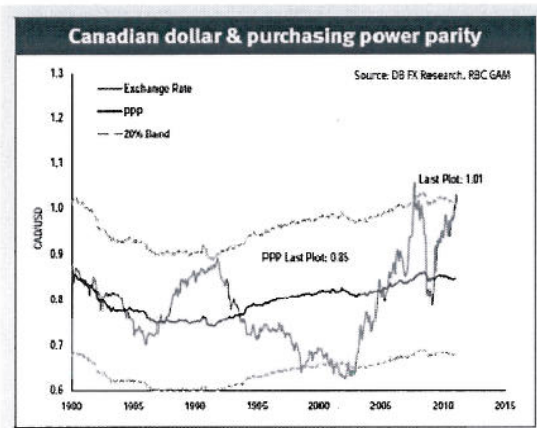
Source: RBC GAM, March 2011



Source: RBC GAM March 2011

Another memory that stands out in my career was the period in 2001 when Canadians despaired of having their own currency. The Chief Economist of a rival firm (who is still an oft quoted media pundit, so I'm not naming names) famously declared that Canada should just adopt the U.S. currency, and the sooner the better because the conversion rate would only be worse in the future (after the Canadian dollar achieved parity in 2007, she changed her mind. Economists and strategists are paid to predict. As a brother told me long long ago, if you're going to predict, predict often). The chart below plots the Canadian/U.S. exchange rate against a band based on calculations of purchasing power parity (a measure of a price of a basket of goods in each currency). In 2001, when prominent Canadians seemed ready to abandon a separate currency, the

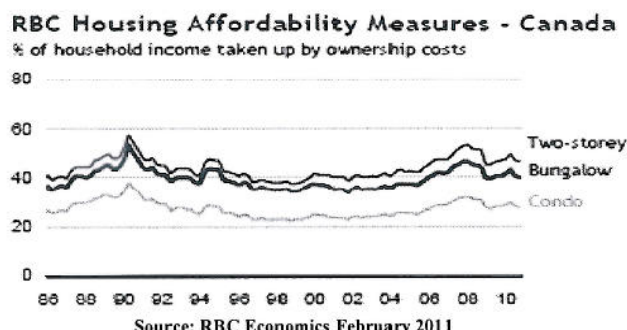
Canadian dollar was more than 20% below Purchasing Power Parity. Today, when Canadians are disdainful of the U.S. dollar, the loonie is more than 20% above this measure of fair value.



Source: DB FX Research, RBC GAM, March 2011

Purchasing Power Parity is not helpful for short term currency trading and for the next few months(?) the Canadian dollar has a lot going for it (high oil prices, the prospect of rising Canadian central bank administered short term interest rates, sound public finances) but in the long term, I have to think value will eventually win out.

The last asset class I want to address in this letter (which has already become too long and indulgent) is residential real estate. I remember turning on the TV in early 1990 and seeing people literally lining up to buy houses in Toronto for above their asking prices. The stock market had crashed in 1987, in response the Bank of Canada had cut interest rates and, people were confident that they don't make real estate anymore. Toronto house prices did not regain their 1989 peak until 2000. Since 2000 however, inflation-adjusted housing prices have been steadily rising. As David Macdonald wrote (in [Canada's Housing Bubble, An Accident Waiting to Happen](#) – published by the Canadian Center for Policy Alternatives, August 2010): "Housing prices for 20 years, prior to 2000, stayed in a narrow range of between 3 to 4 times provincial annual median income. Today, however, housing prices adjusted for income are out of their historical range, costing 4.7 to 11.3 times Canadians' annual income."



Macdonald argues that Canadian house prices need not crash, they could correct slowly or quickly. Canadians have been feeling smug about how well the value of our homes have held up and how well our banks have held up. I like to add - so far.

So, in my history as an investor I have seen people line up to buy gold at bubbly prices in 1981, and then watched it collapse to \$255 U.S. in 2001, and rise again. I have seen stocks sink into despair in 1982, rise to euphoric heights in 2000, and sink again into despair in the winter of 2008-2009. I have seen Canadians disdain their own currency in 2001 and turn their back on the greenback today. I have seen Canadians alternate between considering their homes a home, or an investment. And through it all, 30 years stuck in the rat race, all I've ever really been trying to do is to invest sensibly, while somewhat humbly recognizing that, to me, the future is basically unknown.

Sincerely,

George Stedman, CFA
Portfolio Manager

Please visit us at www.georgestedman.com