

July 2010

## Semi-Annual Report

**An airplane flying between two cities deviates from a straight line 90% of the time. Pilots focus on five crucial dials to make sure they reach their destination. Similarly, you can use five economic 'dials' to help in reaching your long term financial goals.**

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We generally refrain from making commentaries overly investment-centric. A focus on the market implications of the daily economic and political news inevitably leads to making short term market predictions. Fortunately—and this is backed up by science and fact—you don't have to be able to make short term market predictions to have a successful long term investment experience.

However, a philosophy of not making forecasts is not synonymous with a lack of awareness of what is going on. But it does guide us in making decisions about what to pay attention to. What drives investment returns over time is not investment selection and timing promoted by the financial media and vast majority financial advisors. But, rather five economic or financial factors coupled with successfully managing investor behavior. In the future, we will address investor behavior; for today we will focus on the five economic factors we'll call the Five Dials.

### Setting the stage

For equity investors, the last three years have been—let's use classic Canadian understatement—frustrating. Generally, most global stock markets in Canadian dollar terms peaked in the spring of 2007, and then proceeded to fall from peak to trough by over 40% (some individual markets declined less

and others more). While some global stock markets bottomed out in November 2008, most major stock markets bottomed in early March 2009. The 2008 bear market was particularly frustrating because it was the second in a decade. The implications for investors were returns during the last 10 years which were much less than expected.

Then the thirteen month period from March 2009 to April 2010 brought good news: the rebound in stock prices was unprecedented. Most global stock markets rebounded by 60% or more, recovering roughly 75% of the previous losses. There are two very interesting aspects of this thirteen month period. Firstly, stock markets appreciated strongly, well in advance of the confirmation of good economic news: in other words, stock markets looked forward and priced in brighter economic expectations. Secondly, there was not a correction of even 10% during these thirteen months.

The news has changed again over the last six to seven weeks, as most global stock markets have corrected by 10% or more. Given the huge rebounds from the low points, this is hardly surprising. One might say a correction of some sort was predictable, but the timing of this correction—or of any correction, for that matter—was not.

With the financial crisis of 2008 still uppermost in

# “How to access the collective wisdom of the world’s smartest financial minds.

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many people’s minds, investors are now asking some variation of the following question. Is this recent correction is just a correction or is it more serious—perhaps the beginning of another major bear market?

If only we could access the collective wisdom of thousands upon thousands of the world’s smartest financial minds to answer this question. Well, the great news is that we can. We can do it by looking at the current information already priced into stock and bond markets through the Five Dials.

## **Placing the Five Dials in context**

The Five Dials are analogous to the five most crucial dials or gauges that airline pilots rely on to fly their planes. Although there may be hundreds of dials and gauges in a cockpit, if the core five indicators are at the appropriate level, the pilot can be confident that the plane will successfully reach its destination. Paying attention to a set of five economic indicators can give investors a similar confidence in reaching their financial goals.

Focusing on the Five Dials gives clarity. There is no need to forecast the implications of the risk du jour, whether it be Greek debt problems (bear in mind that Greece has an economy the same size as Los Angeles County); sovereign debt contagion; the overheating or slowing Chinese economy, depending on which figures you have confidence in; global bank taxes; additional government regulation and intervention; inflation or deflation fears, depending on which pundit’s views you find most credible, etc.

All of the concerns listed above, and many others, are already priced into the markets. If the information is public, it is safe to assume that it is absorbed and priced into bond and stock markets. Let’s take a moment and think this through. Picture the stock and bond markets as huge voting machines, in which the participants have significant financial

stakes. If some negative news surfaces which causes the stock market to sell off, the narrative in the financial media is that, “Traders are taking profits.” This explanation doesn’t make sense. Did those “traders” have a secret conference call in the morning to agree they were going to sell their shares? Who exactly are these traders selling their shares to? Are the stocks of Canadian companies just being thrown from the Toronto Stock Exchange into Lake Ontario? Of course not. For every seller there is a buyer. Someone, somewhere is taking the other side of this trade. If that were not the case, the trade could not happen. Even on the most negative days, although some traders *sold* stocks, the same amount of shares were also *bought* by traders or other market participants.

Many people mistakenly assume that markets are dominated by individual investors. In reality, 70-80% of the volume in stock and bonds markets is accounted for by institutions, who can afford to hire the best in-house talent and hire the best outside consultants. These institutional shops really do attract the best and brightest minds: each and every year, the top 1% of graduates of the most prestigious universities in the world enter careers in finance. Of these, the absolute cream are hired by institutions. As an indication of how extraordinarily competitive this area is, consider my own case: in 1997, I was one of 1,467 people worldwide who earned the Chartered Financial Analyst (CFA) designation. CFA Charter designations are issued in chronological order and my charter number was #25,653. In 2009, there were roughly 9500 new CFA charters awarded, bringing the total number to over 90,000. And growth continues to be exponential: in June of this year, 139,900 individuals from 160 countries wrote one of the three levels of the CFA exam.

The point being made here is that one should never underestimate the caliber of the “trader” or market participant taking the other side of a buy or a sell.

# The Five Dials can explain most of the variability in stock and bond returns.

This not only provides clarity, it helps investors manage their single biggest risk—their own behaviour as they react to short term volatility.”

## What the Five Dials indicate

The Five Dials represent five fundamental economic factors that can explain most of the variability in stock and bond returns. Apart from the clarity this provides, the other great advantage is that you don't have to forecast them: the information is readily available on a daily basis in the bond and stock markets.

While we don't think these five economic factors should be used to make any short term predictions, comparing the current levels to historic levels offers some clarity.

Brief descriptions of the Five Dials are given below, along with some comparisons to historical levels. Two of the dials are related to the bond markets and three others to the stock markets. This will serve as an introduction, which I'll build upon over time.

## The Five Dials—a brief description

### Dial #1. Bonds: Interest Rates or “Term Premium”

This is basically the interest rate being paid on a “risk free” asset, such as 30 day government T-Bills versus the interest rate on a government bond with a longer term, say five years. Historically, the difference between these two—or “term premium”—has been about 2% per year. Investors could have earned this extra 2% per year over time by holding longer term investment grade bonds versus cash or short term GICs.

The most striking point about today's interest rate environment is that short term rates are at unprecedentedly low levels. For example, Canadian government T-Bills are paying roughly .5% and the average one year GIC in Canada is currently around 1.25%. With inflation running around 1.4% per year, both of these options are offering negative real (after inflation) returns before tax!

### Dial # 2. Bonds: Credit Spreads

This is the difference between top quality government bonds and bonds of lower quality, whether they are investment grade corporate bonds or high yield bonds. Although credit spreads vary over time, they tend to be very broad in periods of economic weakness; conversely, in periods of economic strength, they tend to be fairly narrow.

Credit spreads reached their widest level in November 2008, at the height of the financial crisis, and have narrowed significantly since then. Currently, they are around an average level compared to historical levels.

### Dial #3. Equity Premium

The equity premium has been the excess return of the stock market over a risk free asset such as government T-Bills. Historically, this premium has been about 8% per year. However, investors do not earn this extra return without risk. Variability is the main risk with the equity premium: in some years this can be hugely positive, whereas in other years—which can extend into periods of years—this premium can be negative.

The equity premium is probably the hardest thing for individual investors to earn. Not only is patience required, there are numerous individual behavioural factors that stand in the way as well.

### Dial #4. Value Premium

The value premium is the difference between lower priced stocks and higher priced stocks. Price isn't the stock price, pure and simple. It's a price scaled by some sort of metric, such as price-to-earnings, dividend yield or book value. The most stable metric over time tends to be book value. Historically, for example, if you sorted all of the stocks in the United States by book value, you would find that

the lowest priced third outperformed the highest priced third by about 3-4% per year. You would get similar results with other markets such as Canada, Europe, Asian and the emerging markets.

It is debatable why the value premium exists. Some would argue that it is behavioural based and others that it is a risk/return factor. Regardless, it is a factor with an expected higher rate of return. Put another way, it is a risk worth taking because there is an economic reward in doing so. Investors should expect to earn this premium over time, but not necessarily all of the time.

#### Dial #5. Size Premium

The size premium is the difference in the returns of smaller stocks versus larger stocks. Sometimes called the “small cap” premium, it has historically been about 2% per year.

As with the value premium, it is debatable why the size premium exists, but it is a factor with a higher expected rate of return. However, there can be large yearly variability in these results. For this reason, having extra exposure or tilting portfolios to capture these premiums is a long term strategic asset allocation decision.

If we look at the three equity factors on a price-to-earnings, price-to-book value and dividend yield basis, we can conclude that currently most global stock markets are at average to slightly below average (i.e., lower) valuations compared to historical levels. While we think benefits of dividend yield are over-rated, and investors should focus on total return versus income, it does provide an interesting example. In Canada, the dividend yield of the TSX 60 (large cap stock) index is now approximately 2.7%, versus a five year Government of Canada bond that is yielding roughly 2.5%. So, on a pure yield basis, investors are receiving a higher income in stocks than in government bonds. This yield advantage of stocks versus bonds has been the case for the

past 18 months. The last time this situation occurred was in the mid-1950s.

The bottom line is that current equity valuations are certainly reasonable. Over time, lower valuations translate into higher future expected returns.

In the past I have discussed three of the Five Dials—those relating to equities—via the *Fama-French Three Factor Model*. Although any model is just an approximation of reality, the Three Factor Model works quite well as it is able to explain about 95% of the variability of the returns of stock portfolios over time.

#### Summary

To sum up, the idea of focusing on just five fundamental economic factors is to provide some clarity—which is difficult, we acknowledge, given uncertain economic conditions and rapidly changing times.

In our experience, the biggest risk many investors face in reaching their financial goals is their own behaviour as they react—and often overreact—to short term negative or positive volatility in the stock market.

The ability to step back and look at the big picture can certainly help in dealing with typical behavioural biases. Many investors are swayed by their emotions and the siren call of unrealistic “hope mongering.” They are inundated by the noise of the financial media and the predictions of pundits. They spend time and resources in the quest for a magic bullet that will hit their financial targets.

Wouldn't it be safer and more effective to concentrate on these Five Dials and let the thousands upon thousands of the world's smartest minds figure out—through the public stock and bond markets—the hundreds of other dials for us? By focusing on five fundamental factors, we can piggyback on the collective work done by brightest, smartest market participants in the world—all of whom have financially voted their future expectations into current bond and stock prices.



**Steve Lowrie**

**Chartered  
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Portfolio Manager and Financial Advisor, Steve Lowrie, has over 18 years of industry experience with both small and mid-sized (non-bank owned) firms.

His **Chartered Financial Analyst (CFA)** designation—earned in 1997—is globally recognized as the pinnacle of professional excellence within the investment community. In offering unbiased solutions to help his clients achieve their financial goals, he combines his expertise with the science of investing to develop and implement investment strategies.

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