



FEBRUARY 2010 | REPORT

January represented a pause in the recovery in Canadian stock prices which began in early March of last year. The pause was short lived as the S&P/TSX Composite Index rebounded 5.0% in February. On an annual basis we are now comparing the month-end level with close to the bear market bottoms. This accounts for the stunning 47.6% gain for the year ended February 28, 2010. As the year progresses, the comparisons will be against higher and higher levels so the one-year returns are likely to diminish.

Fixed Income markets were largely trendless in the month with the PC Bond Index gaining 0.15%. The one-year return for the Index was a healthy 7.8% with much of that return powered by strength in the corporate bond area, as the credit crisis of 2008-2009 receded.

S&P/TSX A COMPOSITE INDEX



STANDARD & POOR'S 500 INDEX



Source: Yahoo Finance

Some of our more engaged clients have been asking some difficult and important question of us recently. They have noted that there is an increasing number of exchange-traded funds (ETFs) available for investors. ETFs are essentially funds that trade on an exchange, are normally passive, and provide exposure to some investment sectors such as stocks or bonds. Early ETFs were designed to mimic the performance of a major index such as the S&P/TSX Composite Index or the DEX Bond Index.

Newer ETFs are often more narrowly focused, providing investors with exposure to specific sectors of the market such as golds or energy companies. Increasingly ETFs are seen as competition to active managers, such as ourselves or any other investment management company.

We certainly feel that ETFs have a place. We, in fact, have from time to time used ETFs to employ investment strategies successfully for our clients. For example, one client recently wanted to realize some capital losses but also to remain fully invested. We were able to achieve this by liquidating certain assets and using the proceeds to purchase an equity ETF. Thus, we were able to meet the client's short-term and long-term objectives.



But does the increasing prevalence of ETFs mark the beginning of the end for active portfolio management? Clearly we must have some vested interest in the answer to this question so we don't expect that ours will be the final say on the matter, but the following points do provide some legitimate support for active management's ability to provide value to clients over the long term.

By their very nature, ETFs are designed to provide exposure to a very specific sector of the financial markets - bonds, Canadian stocks or U.S. stocks being specific examples. They are not designed to provide a balanced, diversified portfolio. One of our most important jobs is to work with clients to determine and define exactly what their investment objectives are and to structure a portfolio to meet those objectives - and also to make changes to the structure of the portfolio when either objectives or financial conditions change. On their own, ETFs cannot fulfill this crucial role of active management.

We recently read an interesting article quoting a Goldman Sachs research report on why active management could be in for a period of outperforming both the Indices as well as ETFs. In our view the article made some excellent points.

We all know we have recently been through an extreme period in terms of volatility in the financial markets. At times of extreme volatility it tends to be major market themes that move stock prices. The credit crisis drove all stock prices down, in many cases with virtually no regard for the fundamentals of individual companies. The good companies were taken down along with the bad. As market volatility declines, individual company fundamentals should become more important factors moving stock prices. It is in this type of market that intelligent stock picking can result in better-than-index returns.

Another point we have highlighted in past client letters is the importance of declining inflation, and consequently declining interest rates, on rising stock prices since the cyclical peak in interest rates in 1982. Declining interest rates over time have resulted in gradually rising price earnings multiples in the valuation of all stocks. The normal ups and downs of stock prices have obscured this influence in any short period of time but an analysis of the levels at which market multiples bottom out shows a definite up-trend in a number of valuations metrics related to declining interest rates over the last twenty-nine years.

With interest rates at their current low levels, it is doubtful we will see a further cyclical decline in interest rates. If we are in for a period of reasonably steady interest rates then it is likely that, again, company specific factors may be more important than market trends in changing stock prices. This, again, would be an environment when individual stock picking could outperform ETFs and Index Funds.

So, if we are entering a period when we see lower overall volatility in the financial markets and a bottoming in both the rate of inflation and interest rates, this could be a good environment for portfolio managers with a stock picking investment style. And it wouldn't be the first time that major focus in the popular press about a particular investment vehicle marked the time it shifted from being an outperformer to being an underperformer.

If you have any questions about either our investment strategy or your portfolio specifically, please contact Brian Smith at your convenience.



Sincerely,

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