The Real Cost of Capital

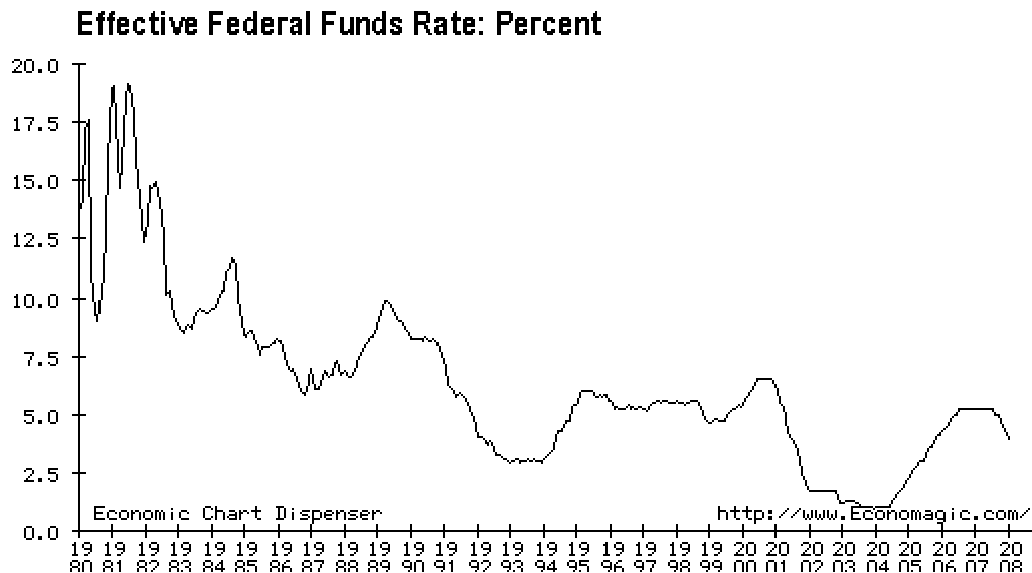
It has been a difficult six months for most stock market investors. Many respectable investment managers and stock market pundits have struggled to generate positive returns, and they are now trying to assess the impact of the credit crisis many of them failed to predict. Since July 2007, the S&P TSX Composite Index is down 9.3 per cent, and the Dow Jones Industrial Index has declined 15.1 per cent. Many individual investors cannot decide whether to sell and cut their losses, average down, or tune out the market and trust the old adage of buying good companies and holding them for the long run. Fortunately for investors with significant cash positions, the turmoil is creating opportunities for bargain hunters. I began advising clients to raise significant cash positions months ago, based on the preliminary signs of today's economic problems. To properly assess the advisability of continuing to hold large cash positions, and to explain my view of the future market environment, it is necessary to provide some economic context.

The performance of the U.S. economy remains enormously influential on Canada's economic and stock market performance, regardless of the recent benefits to Canada of high growth in other countries such as China. In my opinion, the U.S. economy is entering a recession. The risks that accompany a typical recession, including declining corporate profits, increasing unemployment and declining asset prices, have been amplified by past U.S. monetary and fiscal policy decisions and other factors.

The cost of credit (mainly interest rates and how they facilitate or restrict access to capital) is a crucial variable to examine when assessing the U.S. economy and stock market. From January 1, 1990 to June 25, 2003 the U.S. Federal Reserve lowered its federal funds rate from 8.25 per cent to 1 per cent. (The rate has subsequently increased to 3 per cent but there are indications that it may be reduced again in the near future.) During that time, everything from the first Gulf War to the bursting of the technology stock bubble to the attacks on September 11, 2001 to the corporate/accounting fraud of the Enron/Arthur Anderson scandal all served as justification for former Fed Chairman Alan Greenspan to create an environment of significantly (and sometimes artificially) low interest rates.

This low interest rate environment has fuelled substantial growth in both the U.S. economy and other economies worldwide. Since the stock market bottom in 2002 until recently, assets around the globe,

including stocks, commodities and real estate, have delivered impressive gains. On the other hand, the persistent low interest rate environment spawned excessive borrowing, irresponsible investing, decreased lending standards and high-risk speculation. It has also exacerbated the economic problems that are accompanying the U.S.'s multi-decade transition from being a thriving industrial economy to an economy mainly reliant on consumer spending. These negative factors are the main catalysts for today's credit crisis, the impact of which has not yet been fully appreciated.



During Alan Greenspan's term as Fed Chairman, a significant amount of the cheap money in the U.S. flowed into real estate. The U.S. housing market began to rise in the late 1990s. The market gathered momentum when interest rates hit artificially low levels in 2003 and became a mania of historic proportions by 2005, almost guaranteeing a messy ending. The economic history textbooks of the future will cite numerous reasons for the mania and subsequent bust. Among them will be the role of securitization in the U.S. mortgage finance system. The banks and mortgage brokers who originated the mortgage loans and assessed the risk of default did not retain those loans on their balance sheets. Instead, they sold the loans to investment banks that in turn packaged them and sold them to investors around the world. Under this scenario, mortgage originators were motivated to make as many loans as possible and disregard risk. They responded to those incentives by decreasing lending standards and increasing loan volume. In many cases, mortgage loans were made without down-payments or proof of income.

Buyer psychology also played a big role. Prospective homebuyers, some fearful of never being able to afford a home, some greedy for the seemingly low-risk profits of buying a bigger home or even multiple homes,

pushed prices higher using mortgage financing that they could not truly afford. The psychology is well captured by Florida's Ron Shuffield, President of Esslinger-Wooten-Maxwell Realtors' prediction in the March 25, 2005 New York Times that the boom in his area would last indefinitely because "South Florida is working off of a totally new economic model than any of us have ever experienced in the past." From 1995 to 2005, the U.S. homeownership rate climbed from 64 per cent to 69 per cent. The conventional wisdom was that residential real estate was the best investment – "a can't-go-wrong proposition". Perhaps because many homeowners viewed their home equity gains as permanent, the popularity of home equity loans and home equity extractions by way of mortgage refinancings rose sharply. Some of this borrowed money flowed back into the economy in the form of consumer spending and some went towards down payments on even more real estate. The popular phrase to describe this additional borrowing was "using your home as an ATM" – the overlooked distinction being that cash coming out of a chequing account via a real ATM was not debt you had to pay back.

From the American homeowner to the Chinese factory owner, low U.S. interest rates have affected the economy on a global scale and contributed to a shift in the traditional nature of global economic dependency. Much of the spending that resulted from the U.S. housing bubble flowed offshore into the hands of oil exporting countries and Asian manufacturers. It contributed to the massive growth in industrial production and infrastructure in China and India, two countries that will be major players in the global economy during the coming decades. Canada feels both the U.S.'s pains and benefits from Asia's gain. China's insatiable appetite for natural resources has been well documented and has helped reinvigorate Canada's resource sectors in recent years. The strong Canadian dollar and the great returns of the TSX (since 2002 the TSX has basically doubled) are evidence of the impact that China, the U.S. consumer and low U.S. interest rates have had on the Canadian economy.

At the time of writing, the U.S. Federal Reserve is again in a rate cutting cycle, but the surrounding circumstances are far different than earlier this decade. Oil is US$100 per barrel. Gold is nearing US $1,000 per ounce. The credit crisis that initially was believed to be contained to subprime loans in the U.S. is now being recognized as a far larger problem. Events are happening that many commentators only a year or two ago believed could not happen. On a national level, house prices are falling sharply in the U.S. and many homeowners are walking away from their mortgages. Not surprisingly, as a result, many of the types of risky mortgages that fuelled the housing mania are no longer available. Large financial institutions such as Citigroup, Merrill Lynch and UBS are taking billions of dollars of losses and have been forced to seek capital injections on unfavourable terms. The solvency of various debt insurers is being seriously questioned.

Politicians are proposing various bailout schemes for homeowners and banks. One key question to ask during all of this is whether the U.S. Fed is merely perpetuating today's problems by lowering the fed funds rate again. If loose monetary policy contributed to today's problems, how can more loose monetary policy solve them? Can America really just borrow its way out of the economic problems? Clearly the real estate and banking industries will continue to be affected by the credit crisis, but it is also important to recognize the effect on the whole spectrum of industries and the global economy. With the economic context discussed above in mind, we must determine how to position our investments today for the medium and long-term.

Suggested Portfolio weightings:

Note: While portfolios are tailored to meet individual risk tolerances and financial objectives, these recommendations represent my vision of the ideal equity portfolio make-up. It will take some time for individual client portfolios to get to these weightings as certain investments have done very well recently. Given the elevated prices, I will only be taking fractional positions initially and will be looking for a pullback in certain investments to add further positions.

GOLD/SILVER 20%

- Central Fund of Canada (CEF.A) 7%
- Goldcorp (G) 5%
- Aurelian Resources (ARU) 3%
- Silver Wheaton Resources (SLW) 2.5%
- Pan American Silver Corp (PAA) 2.5%

OIL 20%

- Canadian Oil Sands Trust (COS.UN) 5%
- Vermilion Energy Trust* (VET.UN) 5%
- Canadian Natural Resources* (CNQ) 3%
- Petroleo Brasileiro SA (PBR) 3%
- TransCanada Corp* (TRP) 4%

SITUATIONAL INVESTMENTS 20%

- Consumer Staples Select Sector SPDR ETF (XLP) 4%
- The Claymore Global Agriculture ETF (COW) 4%
- Starbucks (SBUX) 3%
- Syntel Corp (SYNT) 3%
- Health Care Select Sector SPDR ETF (XLV) 3%
- PowerShares Water Resource Portfolio ETF (PHO) 3%

Gold and Silver 20%

Throughout history, gold has been a form of money. Silver, often called “poor-man’s gold”, has also frequently played a monetary role. However, in recent times in North America, few investors have embraced these precious metals as a store of value or an alternative to paper money. We now appear to be in the middle stages of a process of remonetization of gold and silver – a process that may result in more investors and other individuals awakening to the monetary value of these precious metals and adding bullion and shares of precious metals companies to their portfolios. While gold has value, it is also important to clarify what gold is not. It is not a buy and hold forever investment. The current bull market in precious metals will come to an end sometime in the next several years, and likely at much higher levels, and it will then be time to move on.

Gold Prices 1998 - Feb 22, 2008

Source: Bloomberg

Given the nature of the economic problems in the U.S. it is reasonable to allocate a significant portion of an investment portfolio to companies that hold gold and silver bullion and equities. This sector traditionally serves as an outstanding way to hedge against weakness in paper currencies. While the price of gold has risen sharply in recent years, it is likely that there will be substantial inflation in the global economy driven primarily by the attempts of central banks to “cure” today’s economic ills and long-term high energy prices. One more point regarding precious metals – expect volatility. Gold can have many natural enemies, as a swiftly rising gold price is evidence of the further reduction of public confidence in the world’s paper currencies. The ride, whether higher or lower, will not be smooth.

Cash 40%

During serious bear markets, investors who have large cash positions do not complain about low yields. Having a large cash position gives a portfolio flexibility. The flexibility to add to certain positions and conversely take new ones if market expectations change is crucial to managing risk. This flexibility facilitates tactical trading. Given the nature of the economy at present, a 40 percent cash position is not unreasonably large as these are very uncertain times. It should be noted that the yield on short-term cash products versus

the yield on 5- and 10- year government bonds provides a realistic argument for the safety and liquidity of cash.

Energy 20%

Despite the credit crisis acting as a drag on global growth, the world economy as a whole will continue to grow over the next several years. This growth will result in increased energy consumption. The concept of "peak oil" has recently been gaining credibility, and deserves consideration, as the price of oil stays stubbornly high in the face of U.S. economic weakness and bearish predictions. Peak oil theorists are not arguing that we will run out of oil entirely any time soon; rather, they believe that the amount of oil produced in the world on an annual basis either has peaked or will peak in the fairly near future.

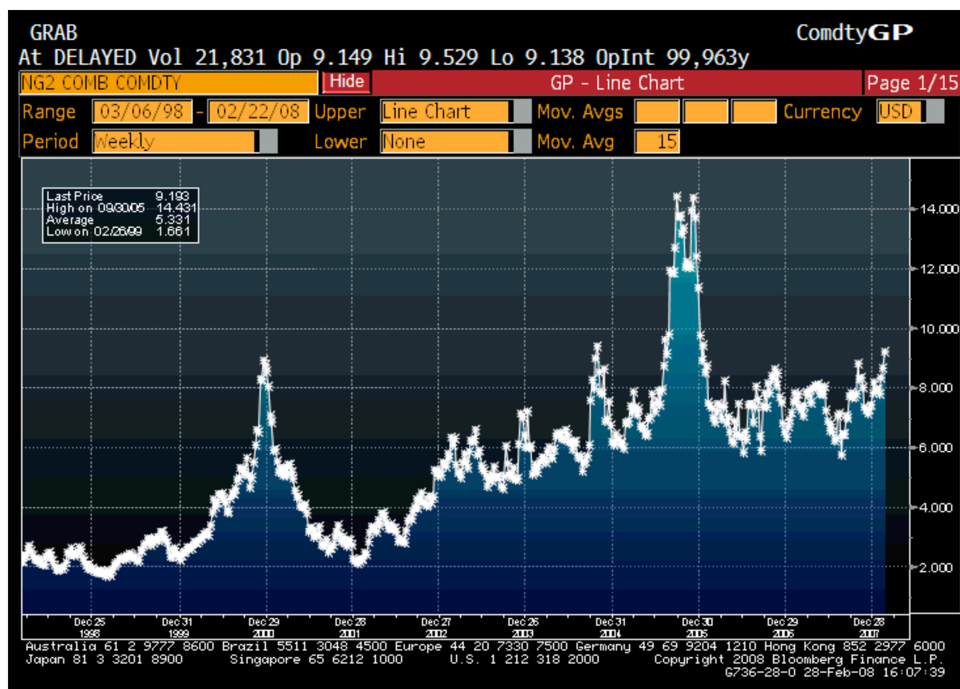
Crude Oil Prices 1998 - Feb 22, 2008

Peak oil theory has been slow to gain traction. Traditional economic thought teaches that increasing prices for goods bring forth additional supply, as productive efforts are shifted to take advantage of the opportunity for profit. The additional supply then will often drive prices lower again. Therefore the cure for high prices is…high prices. Peak oil theorists argue against this line of reasoning as it applies to oil production by citing geological facts. They say that oil reserves all over the world are depleting and major new discoveries are not occurring quickly enough to replace reserves and increase production. For our purposes - constructing a good investment portfolio - we need not wade too far into the peak oil debate to

simply recognize that global demand is constantly increasing while major new discoveries are few and far between. These trends will continue to affect oil prices until real solutions are found and implemented on a large scale to reduce the global economy's reliance on liquid petroleum fuels. In addition to geology, oil bears ignore geopolitical issues at their peril. Because many of the newly discovered reserves and exploration prospects are found in politically sensitive areas, a major premium should be placed upon companies that can either produce oil in stable environments or have a proven track record of finding new reserves globally.

Canadian Oil Sands Trust, TransCanada Corp and Canadian Natural Resources are three domestic companies that are conservatively positioned to profit from their competitive advantage in the North American energy sector over the long-term. Vermilion Energy Trust and Petroleo Brasileiro SA (commonly referred to as Petrobras) are, in my opinion, two of the best ways to get exposure to global exploration while not taking on undue risk. They both have an outstanding track record of gaining access to and finding energy assets. A 20 per cent weighting in energy stocks is justified in the current environment, despite the high probability of a bumpy ride caused by other investors who miss the big picture and sell energy stocks whenever there are signs of U.S. economic weakness.

Natural Gas Prices 1998 - Feb 22, 2008



Situational Investments 20%

Certain sectors of the market traditionally outperform during bad economic times. One of these is the consumer staples sector. I am recommending a 4 per cent weighting in the Consumer Staples Select Sector SPDR ETF. This exchange traded fund has exposure to some of the greatest wealth creating companies in history. The top ten holdings include consumer products giant Procter & Gamble, Wal-Mart, Coca-Cola, PepsiCo, Kraft Foods, Colgate-Palmolive Co., drugstore giant Walgreen and brewer Anheuser-Busch. These are traditionally companies that are very defensive in nature and tend to provide decent returns during uncertain or volatile markets. Although this ETF trades in US dollars, most of these companies make a significant proportion of their sales outside the U.S. This investment should be viewed as long-term in nature.

XLP - The Consumer Staples Index

Also under the heading of situational investments, I am suggesting the Claymore Global Agriculture ETF.

As a result of global growth, many people in less developed nations around the world have more disposable income and are upgrading their diets. The increased use of farmland to produce crops for ethanol is also supporting the prices of agricultural commodities.

Starbucks and Syntel Corp. are two specific value investments that I believe will outperform the market over the long term. Combined they make up a relatively small portion of the portfolio but have the potential to be great long term trades.

The Health Care ETF and the Water ETF fill out the situational investments grouping. These are both included to take advantage of secular trends in an ageing population and a focus on global water consumption and usage.

Conclusion:

The nature of the credit crisis, in which the U.S. and the global economy find themselves, is a problem without an easy solution. There is clearly negative growth in the U.S. economy and a full-blown recession appears imminent. That recession coupled with escalating levels of inflation (artificially low interest rates, high oil prices and massive inflows of government bail-out capital) has the potential to create stagflation. Stagflation, if it occurs, will surely spell even more volatile and negative markets. It is my hope that with the portfolio allocation suggested here investors will insulate themselves from much of the negativity. The recommended portfolio will provide a stable platform from which to continue investing in growing sectors and will provide the flexibility to react as opportunities present themselves. If the current economic indicators prove to be a harbinger of negative markets, then many deep value investment opportunities should present themselves.

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