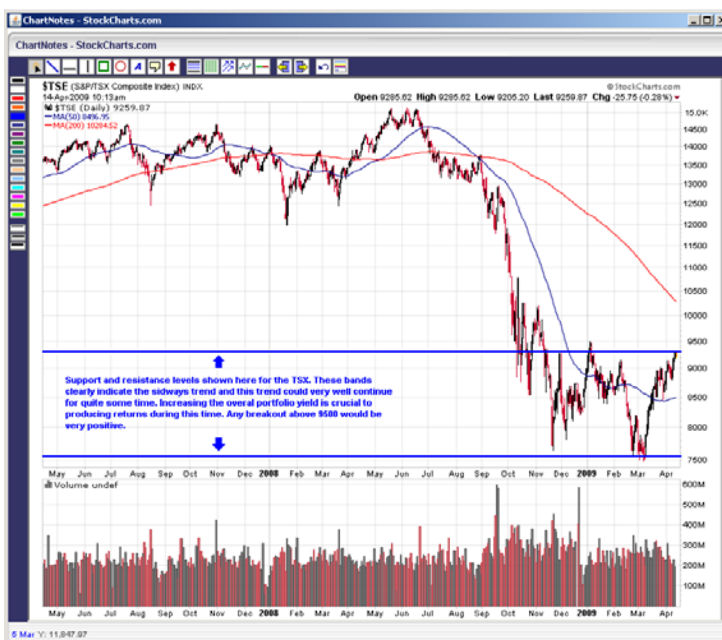
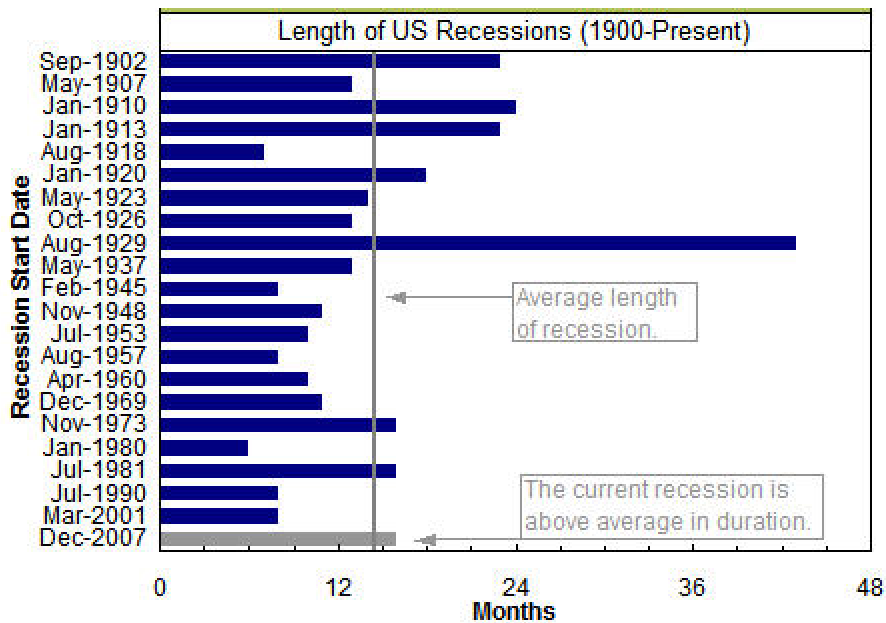
Buying Strong Businesses in a Difficult Environment

In my February 2009 edition of "The Armstrong Perspective," I recommended an allocation of 70% in equities (including 20% in precious metals and 20% in energy) and 30% in cash. I reasoned that we are in a severe recession linked to a deflating credit bubble, and that the government policy responses will lead to inflation down the road. I also noted that dividends can help investors achieve returns in this type of environment and recommended primarily large-capitalization companies that I believe are good long-term investments. My views on the current environment remain the same, but I do have some interesting updates and ideas to discuss in this edition.

In the first quarter of 2009, the TSX initially continued to decline but then surged towards the end of the quarter to finish nearly flat for the quarter. Since November 2008, the TSX has been in a sideways trading trend. The current rally may test the 9500 resistance levels established in January. (See chart below). A breakout above that level would be a positive indicator for the market in general. However, strong countertrend rallies are a characteristic of bear markets, and a retest of the lower levels of the current trading range could also occur in the coming months. Any suggestion that the market has "turned around" is inaccurate and the TSX is merely at the higher end of this sideways trading trend.



Turning to the economy, the current recession in the US began in December 2007 and has already exceeded the length of the average recession. This suggests that unless the economy is facing a depression, investors can start asking whether a bottom has been reached or will be reached in the coming months. While this is a reassuring thought, I continue to take a conservative approach. The unwinding of the credit bubble continues. For example, the fundamentals of commercial real estate in the US have shown more signs of deterioration recently, and central banks have resorted to quantitative easing (effectively printing money to buy assets) in an attempt to keep interest rates low. I am considerably underweight in what I view as the more risky sectors of the market, notably financials, consumer discretionary, manufacturing and industrials.



Precious Metals:

The economic recessions in the US and in Europe will continue to plague Canada and the returns on the TSX. I believe that it is dangerous and foolish to assume that the economic problems in the US will be solved without further economic damage. Can investors really expect that the same policy makers, economists, regulators, and politicians that inadvertently but negligently created the credit crisis and the housing bubble are going to be able to solve the problem without creating further issues. I don't believe they can continue the bailout policies of merely printing money and giving it to the companies that negated their risk management without drastic consequences. Significant inflation is really the only plausible result.

Warren Buffet recently addressed this issue in his annual letter to Berkshire Hathaway shareholders:

“This debilitating spiral has spurred our government to take massive action. In poker terms, the Treasury and the Fed have gone “all in.” Economic medicine that was previously meted out by the cupful has recently been dispensed by the barrel. These once-unthinkable dosages will almost certainly bring on unwelcome aftereffects. Their precise nature is anyone’s guess, though one likely consequence is an onslaught of inflation.”

The largest creditors of the US are also paying attention. In a recent speech, Chinese prime minister Wen Jiabao expressed concern about the safety of China’s $1 trillion investment in US government debt. China has become increasingly vocal about what it perceives as Washington’s mismanagement of the global economy and financial system. If China decides to trim its US debt holdings, or even stop adding to its position, it could have a significant adverse effect on the ability of the US to fund its deficits at current rates and the value of the US dollar.

This is especially true given that Japan and middle-eastern oil producing nations will probably be incapable of buying as much US debt as they have done in the past. Japan is facing a massive drop in its exports due to the global recession and the oil producers have fewer petro-dollars to recycle into US debt due to lower energy prices.

Quantitative easing is not a sustainable economic policy, but the monetary authorities in the US could be faced with the choice of more money printing or higher rates to attract foreign creditors, which could crush the economic recovery they are trying to engineer. President Obama recently stated that the US will face trillion dollar deficits for years to come. The US has created an unenviable situation for itself. I believe precious metals will continue to benefit from the threat of inflation and the current uncertainty.

In addition, there are signs that the status of the US dollar as global reserve currency is eroding. There are now serious discussions about replacing the dollar with IMF Special Drawing Rights, a currency basket comprised of dollars, euros, yen and sterling, or reverting to some type of gold-linked currency. China has recently made efforts to use the Yuan as the currency for overseas trade settlement.

Hedge fund manager George Soros recently stated:

"I think the dollar is now under question and I think the system will need to be reformed, so that the United States will be subject to the same discipline as is imposed on other countries. Being the main issuer of international currency, we have been exempt and we have abused that because we have effectively consumed 6.5 percent more than we have produced. That is now coming to an end."

These recent developments reinforce my views that investors should have a 20% weighting in precious metals.

Silver bullion outperformed gold in the first quarter increasing 14% vs gold up 4%. Silver tends outperform gold on rallies so we could see some interesting performance out of the primary silver equities especially as gold jumps through $900/oz and approaches $1,000/oz once again.

In March I met with senior management of Silver Wheaton Corp. and came away from the meeting very impressed with their prospects. Highlights of their presentation include a $3.90/oz average purchase price for their silver (compared to a current silver spot price of US $12..65/oz), a very small debt load (which they expect to pay off by mid 2010), and an anticipated doubling of their yearly silver sales to 23 million ounces over the next three years without any further capital expenditures. Based on this outlook, I will be looking for opportunities to add to holdings in Silver Wheaton if the right opportunity arises while maintaining the same overall allocation to precious metals.

Positions in the Precious Metals Sector:

Central Fund of Canada (CEF.A) 5%

Goldcorp Inc. (G) 5%

Yamana Gold Inc. (YRI) 4%

Pan American Silver (PAA) 3%

Silver Wheaton Corp. (SLW) 3%

Energy:

Energy stocks have had a terrific quarter. While crude has not rebounded to $90, there are signs of price recovery to the $50-$55 range.

As discussed in previous editions, the longer term fundamentals of energy consumption remain strong and Canada remains one of the best places to invest in energy production.

Producers have scaled back on exploration and drilling to conserve cash. The supply response will not be instantaneous when global demand recovers, which will likely cause future price spikes. I continue to recommend a 20% weighting in companies in the energy sector.

Positions in the Energy Sector:

Canadian Natural Resources (CNQ) 5%

Canadian Oil Sands Trust (COS.UN) 5%

Vermilion Energy Trust (VET.UN) 3%

Husky Energy Inc. (HSE) 3%

EnCana Corporation (ECA) 2%

TransCanada Corp. (TRP) 2%

Base Metals:

I have not added to either of my two previous recommendations currently. An upwards move in both Anglo American PLC and Vale have made me cautious of a pullback in the stocks as there has been no positive

economic data to warrant a price increase. I am currently watching these two very closely and will be a buyer on any pullback as I believe that the base metals sector has declined so far as to become undervalued. I am recommending a very underweight position of 6% to the base metals sector.

Companhia Vale do Rio Doce (Vale) (RIO) 3%

Anglo American Plc. (AAUK) 3%

Financials:

As I mentioned in my last edition, I have remained underweight financials for quite some time. However, during the first quarter I have added partial positions in TD bank, Royal Bank and Great-West Lifeco at prices below where the shares trade today. I plan on adding shares of Manulife soon.

It has been the right decision to underweight financials over the last couple of years, as demonstrated by the chart of the Canadian financial index below. Now, many of the risks to their businesses have been recognized by the market, and I have added some high-quality names at lower prices and yields upwards of 7.5%.

The financials are adversely affected by the unwinding of the credit bubble, so I am not convinced that the short term will be smooth for them. However, I am viewing them as a long-term investment, and I believe the long-term returns will be satisfactory.

Financial Sector recommendations:

Toronto Dominion Bank (TD) 3%

Royal Bank of Canada (RY) 3%

Manulife Financial Corp (MFC) 2%

Great-West Lifeco Inc. (GWO) 2%

Consumer Staples, Health Care, Agriculture, Business Services, Water:

During the first quarter I have added positions in Rogers Sugar Income Fund, Thompson Reuters Corp and CB Richard Ellis Group. As mentioned in my February newsletter Rogers and Thompson provide a well above average yield while buying companies that are trading close to their historical lows. CB Richard Ellis is a long term turn around story and clients will be pleased with our entry level. I am still recommending a 14% weighting in this sector as outlined below.

Consumer Staples Sector ETF (XLP) 2%

Health Care Sector ETF (XLV) 2%

Thompson Reuters Corp. (TRI) 2%

Claymore Global Agriculture ETF (COW) 2%

Powershares Water Resource ETF (PHO) 2%

Rogers Sugar Income Fund (RSI.UN) 2%

CB Richard Ellis Group Inc. (CBG) 2%

Cash

Given the uncertain economic and market environments a 30% weighting in cash is in line with my conservative portfolio recommendations. A 30% weighting in cash plus a 20% weighting in the Precious metals sector clearly shows a bias towards safety and protection as I continue to see risks in the US economy. The fact that the market has dropped so significantly coupled with very attractive yields in relatively conservative equities dictates that some investment at the current time is warranted. However, keeping 30% on the sidelines provides investors with the flexibility to react and remain nimble in these

volatile and uncertain times. The miniscule yields on cash securities versus the equally disappointing yields on 5 and 10 year bonds make a compelling argument for the safety and liquidity of cash holdings.

Conclusion

As discussed above, my views on the current environment remain the same, and recent developments reinforce certain of the trends I have identified in previous editions. One key to navigating this environment is to keep time-tested investing principles in mind. I am doing this by focusing on valuation and strong businesses, recognizing the power of dividends, respecting the risk of inflation, and keeping a healthy cash position in hand to respond to opportunities. I believe we are currently well-positioned to participate in a bear market rally, a market turnaround or a sideways trading trend; all of which are possibilities. The central theme of generating a yield from an equity portfolio is essential to smoothing out returns while investors wait to be rewarded for having significant cash positions on the sidelines during these volatile times.

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