Ending 2013 on a Positive Note

We are pleased with the results of our investments for 2013. Our Total Return Portfolio gained 18.0% for the year and our High Yield Portfolio gained 25.1%. In comparison, the TSX Composite Total Return Index gained 13.0%.[1]

Rather than comment extensively on the various companies that contributed to those returns, we are going to adopt a broader perspective for this 2013 year-end edition of the Armstrong Schmidt Perspective. We are going to broadly address the following topics: 1) the Canadian economy and stock market; 2) the U.S. economy and stock market; and 3) our outlook for 2014 and beyond.

Canada

We are fairly neutral on the prospects for the Canadian economy in the short term. Ideally, we would like to see evidence of stronger exports and business investment and less reliance on housing and consumer spending. We doubt that the Canadian consumer can carry the torch much longer.

Canadians were once known as financially conservative, but that characterization is no longer accurate. The average Canadian today is carrying a high personal debt load and experiencing weak growth in personal income. We are seeing stories in the media about Canadians taking our sub prime car loans, forgoing RRSP contributions and otherwise making bad financial decisions. The average Canadian's net worth depends on house prices remaining high and interest rates remaining low, and both factors are subject to change.

That said, if global economic growth leads to higher commodity prices and increased demand for Canadian exports, then our economy could still perform decently over the medium term.

We have found it desirable to diversify outside of Canada for our stock selections in recent years. In recent months, our purchases of new Canadian holdings have been minimal. That said, there are still some great companies listed on the Toronto Stock Exchange, some of which are long-term holdings in our portfolios.

One example is Manulife Financial Corp. The company's shares began 2013 at $13.51 and ended the year at $20.96, registering a gain of over 55%, not including dividends. At the end of 2013, Manulife was a 7.6% position in the High Yield Portfolio and an 8.3% position in the Total Return Portfolio. In comparison, Manulife makes up just over 2% of the TSX Composite Index. Clearly our decision to overweight Manulife benefited clients in 2013.

United States

In 2013, the U.S. stock market was one of the top performing markets globally, exceeding most investors' expectations, including ours. Thankfully we had positioned portfolios with a substantial weighting in U.S. equities, beginning in 2011 and 2012, with more additions in early 2013.

Interestingly, anyone who has read our past newsletters will recognize that we never made a bullish call on U.S. equities as a group. Instead, we simply identified some specific companies in the U.S. through our research process that we believed were high quality companies trading at undervalued prices. In 2013, those investments produced excellent returns.

Bank of America Corp. is a good example. In our Total Return Portfolio, we started buying its shares in Q4 of 2012 at US$9.52 and then added more in Q2 of 2013 at US$12.76. The shares started 2013 at US$11.61 and ended the year at US$15.57 for a calendar year gain of more than 34%, not including dividends or currency exchange. As we continue to view the shares as undervalued in the US$15 range, we do not plan to sell any Bank of America in the near-term. At the end of 2013, Bank of America was a 5.6% position in the Total Return Portfolio.

Two other examples of U.S. companies that performed well for us are MGM Resorts International and General Electric Co. Our purchase price for MGM was US$12.60 per share early in 2013. After an 87% gain in 2013, MGM had become a 3.6% position in the Total Return Portfolio. We hold GE in both the Total Return Portfolio (4.3% weighting at year-end) and High Yield Portfolio (4.8% weighting). GE gained 34% during 2013, not counting dividends or currency exchange.

With all U.S. companies that have performed well in 2013, we must consider whether the gains were justified, or whether they have come too far too fast. It is true that the U.S. bull market is starting to age, and all bull markets eventually come to an end. The U.S. economy spent the year in a state of modest growth and recovery, providing support to equities, but perhaps not enough to justify the entirety of the gains.

It is fair to say that U.S. equities as a group are now significantly less attractive. We notice this every day as we do company-specific research. We are now finding fewer opportunities in the U.S. than we have in any of the past several years. Our goal is always to find high quality companies at undervalued prices. There are plenty of high quality companies trading in the U.S. markets, but it has become difficult to find many that we consider undervalued.

Many of the high quality U.S. companies that we do still view as undervalued are already in our portfolios.

2014 Outlook

We believe that we can earn decent returns in equities in 2014 for our clients by being selective. The strong 2013 performance of U.S. equities in particular may not be repeatable, but we look forward to the challenge of identifying new opportunities. Our method will remain consistent – search for high quality companies trading at undervalued prices. If we fail to find compelling new opportunities and our current holdings are sold as they return to fairly valued or overvalued levels, we are not afraid to hold a higher percentage of cash. The stock market will always present opportunities to those who are patient.

Interestingly, we are starting to look at emerging market equities for the first time in many years. 5-10 years ago, many emerging market equities traded at premiums to North American equities because investors believed they had higher growth potential. Now the narrative has shifted to focus more on the political and currency risks of investing in emerging markets, and valuations are starting to become more

attractive. No purchases are imminent, but seeing markets cycle from overvalued to undervalued due to investor perception is always fascinating.

Also, we want to reiterate the potential of our existing holdings. The Total Return Portfolio and High Yield Portfolio already contain a diversified selection of companies with the potential to generate attractive returns in 2014 and beyond.

Thank you for reading, and thank you for your business. We wish all of our readers a happy 2014!

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[1] All return numbers discussed are taken from the returns of the model account for each respective discretionary PIMG portfolio. These numbers are generated using Dataphile software and individual client's account performance may vary. These numbers are not a promise of future performance.

Michael Armstrong and Andrey Schmidt are Investment Advisors with CIBC Wood Gundy in Vancouver. Their clients may own securities mentioned in this column. The views of Michael Armstrong and Andrey Schmidt do not necessarily reflect those of CIBC World Markets Inc. CIBC Wood Gundy is a division of CIBC World Markets Inc., a subsidiary of CIBC and a Member of the Canadian Investor Protection Fund and Investment Industry Regulatory Organization of Canada. This information, including any opinion, is based on various sources believed to be reliable, but its accuracy cannot be guaranteed and is subject to change. CIBC and CIBC World Markets Inc., their affiliates, directors, officers and employees may buy, sell, or hold a position in securities of a company mentioned herein, its affiliates or subsidiaries, and may also perform financial advisory services, investment banking or other services for, or have lending or other credit relationships with the same. CIBC World Markets Inc. and its representatives will receive sales commissions and/or a spread between bid and ask prices if you purchase, sell or hold the securities referred to above. © CIBC World Markets Inc. 2015.