

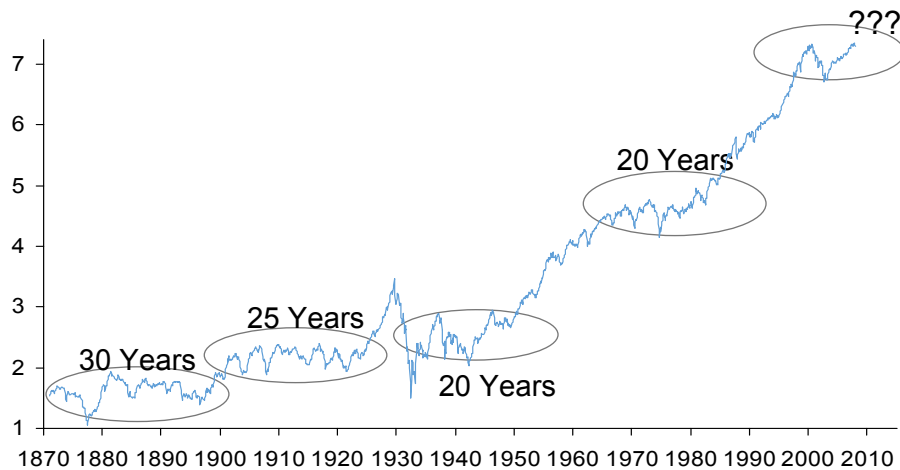
Investing in Range-Bound Markets – Dividends Matter!

The following is a condensed version of Kim Shannon's address to the recent CFA Institute Equity Research and Valuation Techniques Conference which was held from December 2-3, 2008 in Toronto.

Sionna's investment philosophy is based upon bottom-up, fundamental research; however, we do like to spend some time considering what makes markets move and studying how these movements relate to historical patterns. Sionna believes that the bursting of the tech bubble in the year 2000 signified the end of the biggest bull market in U.S. and Canadian equity market history. This, in turn, triggered the beginning of the range-bound market in which we currently find ourselves. We believe that there is a good chance that we will remain range-bound, where the market typically bounces up and down but the long-term trend is sideways, for the foreseeable future and would like to outline our thoughts on how best to invest in this type of market.

History has shown that after a major mania, the overall market capitulates, consolidates, and goes sideways for a minimum of 20 years and for as long as 30 years. As the chart below helps to demonstrate, markets have been range-bound in approximately 103 of the past 139 years. We tend to use U.S. stock market information to look at these historical trends as the available information is longer (TSX only goes back to 1956). In addition, because of the significant economic ties that exist between the two countries, the U.S. serves as an excellent proxy for the Canadian market.

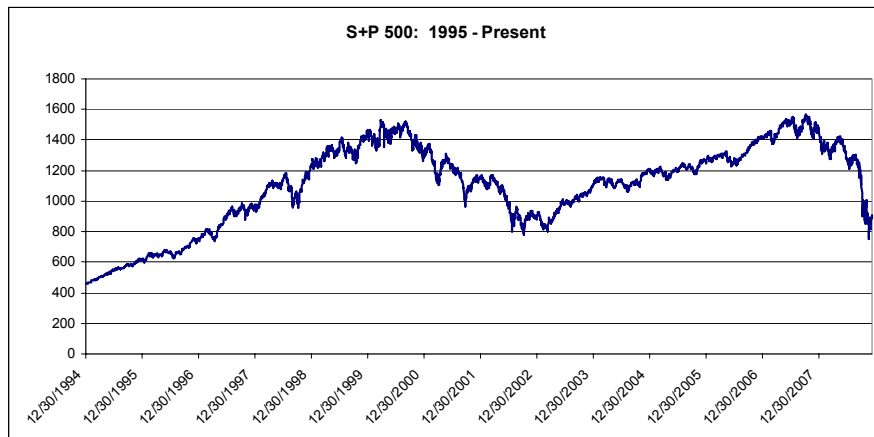
U.S. Stock Market



Source: Wells Capital Management

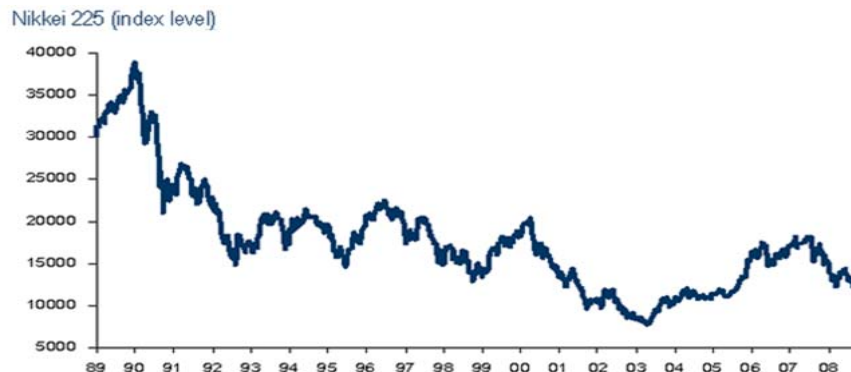
This chart shows that secular bull markets are not the norm and that these range-bound periods are much more frequent than most people realize. These long periods of sideways market behaviour are characterized by overall stagnant stock prices and periods of tremendous volatility. It's not until all of the speculative excess, which built up during the bull run, is flushed from the system that a new bull market can begin again.

The chart below focuses on the current U.S. market and illustrates some of the characteristics of a sideways market. The U.S. market, as represented by the S+P 500, is currently at a level that is just below 900, which means that the Index has returned to the level that it was at in 1997, more than 11 years ago. On price appreciation alone, had you purchased an index fund based on the S+P 500 back in 1997 and held on until now, basically, you would not have earned a thing. One of the characteristics of a sideways market is that passive investing is not effective. Active stock picking is required to potentially achieve a return that may come close to resembling the market's overall, long-term average nominal annualized return of 9.5-10.5%.¹



Source: Bloomberg

Another characteristic of a range-bound market is that huge volatility occurs during these periods of time. Markets can reach record highs under these conditions, as many of the world's markets did over the past year or so. Mini bull runs are not uncommon. However, the difference between these sideways periods and a secular bull market is that, rather than rallying through previous highs as the market did after the 1987 crash, these high points are generally followed by a significant pull back. During a sideways market, you go through more frequent and volatile downward swings. These highs and lows, in fact, define the market's range. To get another close-up look at what a range-bound, sideways market looks like, the chart below depicts the Japanese market, which has been trapped in this pattern for nearly 20 years.

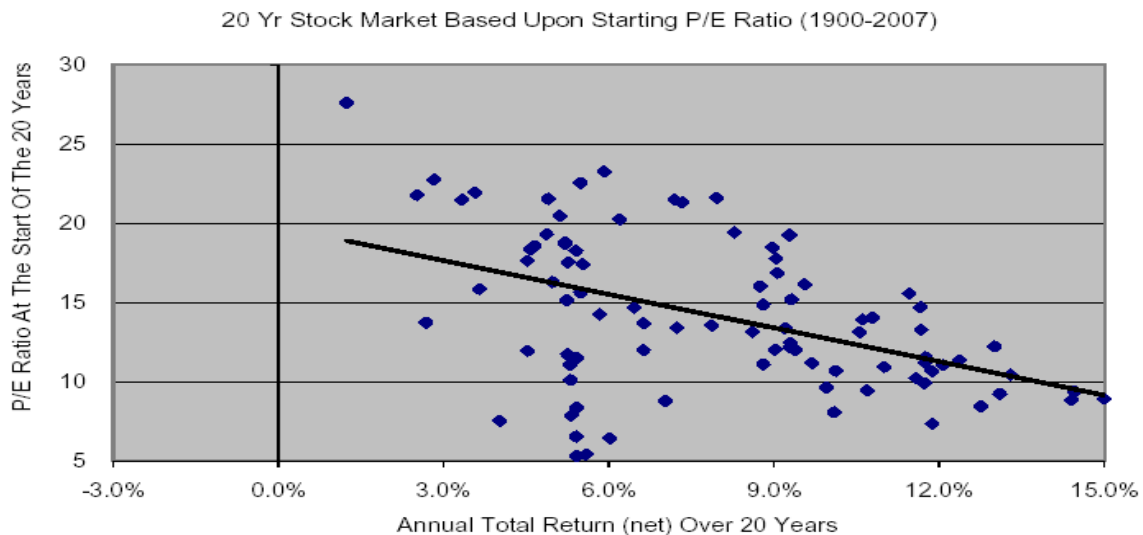


Source: Bloomberg, Merrill Lynch

¹ "Where, Oh Where are the .400 Hitters of Yesteryear?" Peter L. Bernstein, Financial Analysts Journal, November/December 1998, Vol. 54, No. 6: pp 6-14.

One more significant characteristic of a sideways market is that, historically, it does not end until the overall market P/E multiple is taken down, typically to a single digit. This can take a long time to achieve. As discussed, price (P), is basically flat over the long term in a sideways market, despite its volatility; therefore, most of the “heavy lifting” required to get the P/E into single digits often will come from earnings (E) growth. As stock prices remain in their sideways trending range, earnings should continue to slowly grow at a real long-term annual rate of 1.9% (long-term average from 1870)², gradually eroding the P/E multiple until it bottoms out at a single digit. Because average earnings growth is so modest, historically, it has taken a minimum of 15 years to take all of the excess out of the system and get to a single digit P/E. Once reached, a single digit P/E multiple for the overall market is a good sign that the excess has been flushed from the system and the foundation is in place to establish a new secular bull market.

The trend line in the chart below helps to illustrate this point. On the vertical axis is the P/E ratio and on the horizontal axis is the market’s annual total return over a 20 year period. The trend line shows that the higher the P/E ratio is at the beginning of the 20 year period, the lower the market’s annual total return will be. Outsized annual total returns (>10%) over a 20 year period cannot occur until the market’s average P/E ratio is at or below 12x.



Source: Crestmont Research

Currently, the S+P 500 sports a trailing P/E multiple of 19x which, according to the trend line, implies a below average return over a 20 year horizon. As discussed earlier, the market’s P/E multiple is likely to fall through a combination of relatively flat, long-term stock prices and the slow growth of earnings.

Given Sionna’s thesis that the market has been in a sideways market for the past 8 years and that it will continue to perform in a range-bound manner for the foreseeable future, it is important that our portfolios be positioned accordingly. We believe there are two keys to investing in a range-bound market.

² “Earnings Growth: The Two Percent Dilution” William J. Bernstein and Robert D. Arnott, FAJ, September/October 2003, Vol. 59, No.5:pp.47-55.

The first key is to focus on *dividend yield*. There are three sources of total equity return: earnings growth + change in the P/E multiple + dividend yield. A company's dividend represents a cash payment or a "realized gain" to a shareholder that cannot be taken back once it has been paid. In periods of volatility, this consistent return is welcomed. Dividends have been the most consistent component of an investor's total return through all types of markets. To illustrate the importance of yield in a range-bound market, the following table breaks down the three sources of total equity return in different types of markets.

	Range-Bound Markets Average	Bull Markets Average
Earnings Growth	5.6	5.6
+/- P/E Growth	-4.6	7.0
= Stock Return	0.7	13.0
+ Dividends	5.3	3.7
Total Return	5.9	17.1
Inflation/Deflation	4.9	2.5
Total Real Return	1.0	14.2

Range-Bound Markets: 1906-1924, 1937-1950, 1966-1982

Bull Markets: 1950-1966, 1982-2000

Source: Vitaliy N. Katsenelson "Active Value Investing - Making Money in Range Bound Markets," 2007

The table compares sources of total return for Range-Bound and Bull markets. In a range-bound market, the average annualized return is 5.9%, of which 5.3% comes from the dividend yield. That means that 90% of an investor's total return during these range-bound periods was derived from the dividend yield. In contrast, during bull markets, dividend yield only comprises 22% of the market's total return.

Aside from being a consistent source of return, yield is also important because it can act as a floor for a stock's price in volatile times. When price declines, the yield on a stock increases. If the dividend is sustainable, investors will begin to purchase the stock and provide support for its price as they become more attracted to its yield. To maximize results under range-bound conditions, high-yielding stocks with sustainable payout ratios are a critical component of the portfolio. (Caution: at Sionna, while we recognize the importance of dividend yield, we are currently concerned that the traditionally high-yielding financial services sector may not serve as a safe haven during the ongoing credit crisis and have therefore decided to avoid many of the companies in this sector).

The other key to investing during a range-bound market is to select *low multiple stocks*. Low multiple stocks tend to offer better capital protection as high multiple stocks have much more room to collapse. Where the dividend yield has been the most consistent portion of an equity investor's total return over time, the most volatile portion of the total return equation has been the P/E ratio. Because the overall average P/E for the market eventually bottoms in the single digit range, those stocks that trade at low multiples don't have as far to fall as those that trade with high P/E multiples. It is for this reason that high multiple stocks face the greatest pain when the market swoons. We believe that a portfolio that consists of low multiple stocks will perform relatively well as the overall average P/E for the market erodes.

Although we believe that the market is in the midst of a period of secular stagnation, we feel that there may be opportunities for active investors to beat the market's return during this time. To maximize relative return, we believe that it is critical for our portfolios to aim for a dividend yield that is higher than that of the market, and a P/E ratio

that is below that of the market. (As noted later in this report, because of our current aversion to the Financials sector, the portfolio's yield is in line with the market's.) These characteristics (amongst others) should help to ensure that our portfolios are participating in a significant portion of the market's total return during the sideways cycle. In addition, the portfolios should be positioned to sidestep significant multiple contractions when selloffs occur, and participate in rallies, which will also occur along the way. We are optimistic that quality, value-based stock selection should be able to outperform (as it has in the past) the overall, range-bound market.

Addendum: Comment on our Underweight of bank Stocks (January 2009)

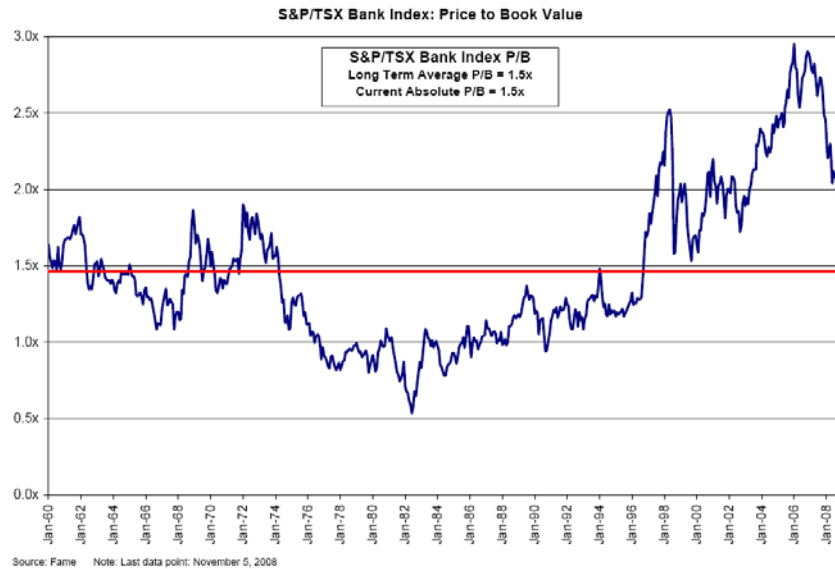
Sionna's November 2007 piece, *Value thoughts to Ponder in an Emerging Credit Crunch*, highlighted our concern that underlying fundamentals and valuations in bank stocks were vulnerable to a potentially widening credit crisis. As a result, Sionna informed our clients that we were shifting to an underweight position "until the full magnitude of the challenge is better understood". While the last year has brought further understanding of the breadth and severity of the credit crunch, we maintain an underweight exposure to Canadian bank stocks. In evaluating this position, Sionna continues to monitor bank ROE levels, capital allocation progress, and bank stock valuations as signposts for when to increase our exposure.

As a result of the credit crisis, Canadian banks have likely entered an extended period of low earnings growth and below-trend ROEs. Sionna believes that bank ROEs are likely to be sustained in a 10 – 14% range (knowing that, in recessions, ROEs can fall much lower). Lower ROEs reflect slower loan growth, higher loan loss provisions, and weaker capital market-related profits. Analysts continue to revise earnings expectations lower, slowly recognizing the significant shift that has taken place in industry profitability. At this time, consensus estimates remain too bullish and will continue to be adjusted lower over the coming year.

In 2008, following several years of steadily increasing dividends and meaningful share re-purchases, banks shifted to become net issuers of capital. The report card for this capital allocation is poor. As outlined in the table below, in 2005 - 2007, banks were active share re-purchasers at prices 30 to 110% higher than they are currently issuing equity. The banking industry's capital allocation strategy of buy high / sell low is leading to significant dilution that ultimately must be included in investors' analysis. Although dividend yields appear attractive, we are concerned that expensive newly issued capital (equity, preferreds, and debt) may be partially funding the banks' continued dividend distributions.

05-'07 Repurchases			2008 Shares Sold			Capital Raising Activities			
Shares Repurchased '05-'07 (millions)	Approx. avg price	Approx. cost (millions)	Shares sold in 2008 offering (millions)	Price	Approx. Proceeds (millions)	Common Equity Issued - 2008 (millions)	Pref Shares Issued - 2008 (millions)	Debt Raised - 2008 (millions)	Total Capital (millions)
45.9	\$45	\$2,066	14.4	\$34.60	\$500	\$500	\$650	\$9,270	\$10,420
31.6	\$54	\$1,706	65.2	\$35.25	\$2,300	\$2,300	\$1,025	\$4,890	\$8,215
20.5	\$63	\$1,292	36.7	\$30.00	\$1,100	\$1,100	\$700	\$5,900	\$7,700
19.3	\$77	\$1,486	45.3	\$65.26 - \$67.00	\$2,940	\$2,940	\$300	\$2,150	\$5,390
9.0	\$69	\$621	34.9	\$39.50	\$1,380	\$1,380	\$1,420	\$6,215	\$9,015
14.2	\$60	\$852				\$0	\$325	\$1,250	\$1,575

The credit crisis is facilitating a re-valuation of global equity valuations. Canadian bank stocks are now 39-56% below their all-time peak levels. As outlined in the following chart, on a price / book value basis, bank stocks have fallen from record valuation levels of nearly 3.0x to an average of 1.5x. Sionna cautions that, in previous downturns, bank stocks have traded at, and even below, book value. At current prices, banks do not exhibit much value and appear to offer limited returns over the foreseeable future.



As events unfolded in 2008, Sionna eventually went to a half-weight position in banks, which lead to an underweight in financials. We believe in maintaining our industry group weightings to +/- 5% of the Index's and rely on our solid stock selection skills to win the game of investing. Occasionally, Sionna will take a more aggressive stance, when valuations and long-term secular trends indicate that a significantly underweight position might assist us in preserving client capital. The secular growth in financial services that benefited from the decline in interest rates from the early 1980s appears to be over, replaced with a more challenging and slower growth environment. Accordingly, Sionna is maintaining our defensive underweight position until low valuations emerge to entice us back to a market-weight position.