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FUND MANAGER ROUNDTABLE

Instability over the past few years has made investors wary of equity markets. Significant obstacles to growth still exist, including the European debt crisis and the sputtering American economy. But these problems have created opportunities for investors, and there is still money to be made in this sideways market. In the next section, four of Canada's leading fund managers offer tips on where to invest in the coming year.

So 2013 could be a rocky year? Fantastic. Four of the country's top fund managers say that's exactly the environment that offers up the opportunities of a lifetime **BY BRYAN BORZYKOWSKI**

PHOTOGRAPHS BY DANIEL EHRENWORTH

From left to right: David Taylor, Bill Webb, Kim Shannon and Norman Raschkowan

'I love the fear'

While investors may not like the current market's instability, an uncertain climate is a fund manager's best friend. *Canadian Business* brought four of the country's top portfolio managers together to talk about how volatility is affecting their work, and where they think the markets will go next year. The bottom line? There's no reason to be afraid of equities, despite the ups and downs. Invest like these managers and you won't fear the market ever again.

CANADIAN BUSINESS: ***Let's start by looking at the big picture. What's your outlook for 2013?***

DAVID TAYLOR, President and CIO, Taylor Asset Management: I'm cautiously bullish. I like the valuation of the equity market, I love the fear, I love the capitulation and I love the fact that investors have bailed on equity markets. I like the fact that the average investor is over-invested in fixed income and has a healthy cash position. It reminds me very much of late 2002.

NORMAN RASCHKOWAN, EVP, Investments, Mackenzie Financial Corp.: I agree. We're in an environment where valuations are very attractive. I think equities should do quite well, but the scenario is binary. There are a number of macro issues that are hanging over the markets' prospects, such as the European Union sovereign debt crisis, the U.S. fiscal cliff and China's slowing economy. If things work out over the next couple of months then chances are the next 18 months are going to be wonderful. If the next two months are ugly then the next 18 months are going to be really, really hard.

BILL WEBB, EVP and CIO, Gluskin Sheff & Associates: The world is a very uncertain place right now, but, that said, returns on capital and equity valuations are some of the best we've seen, especially in North America. Balance sheets are strong. While the macro economy and consumers are in difficult situations in some places, corporations are in terrific shape. So we think the outlook for equities relative to other asset classes is quite favourable.

CB: ***The economy is facing a lot of headwinds. The U.S. is slowly recovering, but there are issues with America's deficit, for one. Are these going to be problems?***

DT: These are problems, but at the same time central banks around the world are responding very forcefully in very unconventional ways. It tells you how bad the situation is, but they're doing the right things and now we're verging on global co-ordinated easing. We've had the European Central Bank start to move, we've had the Fed essentially announce open-ended quantitative easing. The country that needs to fall into line would be China through monetary and fiscal stimulus. I expect that to happen after the change over in power in November.

CB: ***Is quantitative easing—or QE, when the U.S. government buys bonds to help spur lending growth—doing its job?***

NR: QE has proven itself to be less and less effective every time they come up with a new version. I think the real key to recovery is China going ahead with stimulus and the Europeans finally fixing their banking system. I think there are still a lot of fundamental changes that need to be made in Europe. I think Europe stays broken and therefore global growth will be subdued until they put in place pan-European deposit insurance and until they recapitalize the European banks with some form of a Toxic Asset Relief Program-type initiative.

CB: ***Do Europe's problems present more buying opportunities?***

DT: I think it's already priced in the market. Europe is less broken, and as its outlook becomes more positive, the markets will climb the wall. I'm not saying that things can't get drastically worse, but my opinion is things are getting better. I think the market will get past the issues and move on and I think there's incredible opportunities. I've never seen an arbitrage opportunity to buy high-growth companies at value prices. As value managers, we never see growth companies. We've tended to buy cigar-butt, garbage businesses at value prices. This is the first time I can buy growth companies.

KIM SHANNON, President and CIO, Sionna Investment Managers: If I could just jump in here, after being 12 to 13 years in a sideways market Canada so far has a 4% return this year. I think that what we're going to see in the future, because values right now are fair, investors are going to get, on average, 6% to 9%, maybe even a little better, and that's certainly going to beat the opportunity set that you're seeing in fixed income today.

CB: ***But Canada has lagged behind the U.S. significantly over the last couple of years.***

KS: If you talk about the last year and a half that may be true, but Canada tends to do well in sideways markets compared to the global markets. With the exception of last year, Canada's been in the top six best-performing of the top 18 major markets for every single year since 2000. So maybe we gave it up for a year, but I wouldn't say that Canada is done outperforming in a sideways market.

DT: I agree with Kim. The Canadian market has outperformed significantly over the last five or six years and it can't outperform every single year. I would bet on the Canadian market and the U.S. market to outperform bonds and cash over the next five years. In fact, I'd say they would significantly outperform a number of dividend-paying stocks and real estate investment trusts.

CB: ***What is it going to take for the Canadian market to see gains again?***

NR: What drove the Canadian market's outperformance between 2003 to 2010 was the commodity rally. You had strong growth

Norman Raschkowan

in energy prices and commodity prices right across the board. The reason Canada hasn't been performing over the last couple of years is because commodity prices have been moving sideways-to-down as global growth has been decelerating. If you get China kicking in and re-accelerating its growth then you're going to see commodity prices respond. That's the big question for Canada. If China postpones its stimulus or if its stimulus isn't as effective as it has been, then commodity prices will move sideways and then Canada will probably lag the U.S.

CB: ***So then, is Canada a good place to invest?***

BW: We think Canada is a good place to be, and we still have most of our equity exposure to Canada. In the middle of that you're going to see an exceptional opportunity in the United States. So we like both markets. In particular in Canada we've started to increase our resource exposure quite significantly.

But I want to say two things: I agree with Norm that China is an important card in this. I find it very hard to believe that the Chinese will not stimulate their economy. The Chinese government will not risk having growth below 5%. They tend to really stimulate after a leadership transition, so I think that will happen. Secondly, even with the fairly slow-growing global economy that we've had, look at where commodity prices are. We've got oil at $90, we've got copper at $3.70, we've got gold near record highs. That's good for a significant part of the Canadian market.

CB: ***Speaking of China and its slower growth, is the emerging market story—buying companies that have exposure to developing countries and to China—still as relevant?***

NR: It's important to appreciate that China is a very competitive market and the businesses that compete there face much different and much tougher operating margins than what they might face in, for example, Europe or Latin America. So companies that have focused their business strategy exclusively on growing in China, that's very tough.

IF THE NEXT TWO MONTHS ARE UGLY, THEN THE NEXT 18 MONTHS ARE GOING TO BE REALLY, REALLY HARD

CB: ***Do you like the Canadian companies that have exposure to China?***

KS: Canada doesn't trade significantly with China; it's more that Chinese demand sets the world price for commodities. We benefit from that. Out of all the major markets in the world, we have the largest resource exposure in our stock market. If the global world price goes up we get a better price. But that doesn't necessarily get reflected in the stock prices. We've seen gold go from $250 an ounce to $1,700 an ounce. And yet Barrick Gold didn't rise as much because their underlying cost structures have been rising fairly dramatically.

CB: ***Who's getting the money next year? Will people keep moving into high-yielding large caps?***

KS: We're concerned that the high-yielding equities have become overdone, and we're finding that the riskiest names now in our portfolio, sadly enough, are the highest dividend-paying stocks. Canadian telecommunication companies, for example, are the most expensive in the world. Canadian banks have become extremely pricey compared to other banking systems around the world. Normally, in sideways markets, 90% of your return comes from dividend yield, so dividends are important. But be careful what you're paying for that yield.

DT: There are dividend stocks that aren't overpriced. This is the arbitrage that I'm talking about. It's not either dividends or non-dividends, you don't have to make a decision to buy non-dividend-paying stocks. In the U.S. there's a whole host of high-growth dividend-paying stocks. I'm talking about the financials in the U.S., about technology, industrial products and consumer staples. These companies are growing at twice the rate of an Enbridge, a Rogers, a BCE or many infrastructure stocks. They're growing at twice the rate and have half the valuations and their payout ratios are a third.

NR: We are at the early stages of a yield bubble. The low interest rate environment, which the central bankers have pretty much ensured is going to persist for some time, is going to cause that bubble to continue to inflate. So you are seeing valuations in telecom and REITs and so on, getting more expensive compared to the rest of the market. There are great opportunities to build a diversified portfolio that's still going to give you an attractive yield. You just need to look beyond the traditional utilities, telecom and pipeline type stocks.

BW: We think the income stream from dividends on common stocks—even if it's a relatively low dividend—will actually bring people back into the equity market. They'll realize they're going to earn more from their dividend stream than from being in a fixed-income stream. I think we're in the early days of seeing that happen. You're also seeing corporate behaviour change. You're seeing companies like Apple and others that never paid dividends before buying stock back and paying dividends.

CB: ***Why aren't people getting back into the equity market?***

BW: It's typical behaviour for folks who are afraid. They've been traumatized by the volatility in the market and they're more concerned about preservation of capital. What they fail to look at is the risk-adjusted returns. You don't need to swing for the fence in this environment. Just construct a diversified portfolio that's going to get you a decent return through a combination of dividend yield and capital appreciation without taking too much risk.

DT: Both 2008 and 2009 were traumatic for investors, but it's like they got hit by lightning, so they ran out and bought life insurance. But the recession, in my view, was a one-in-100 event. To get insurance against a one-in-100-year event is foolish. I'm a big proponent of dividend-paying stocks, but while Enbridge is growing its dividend, nobody can convince me that it should have the same yield as TD Bank. If it did, investors would wake up and say, "Instead of a 4% dividend the stock's down 25%." That's how overpriced these are. Through my career Enbridge has traded between 12 and 15 times earnings; today it's 25 times earnings. Honeywell, John Deere and the railroads traded at 15 to 20 times earnings and now they're at nine to 12 times. It's completely flipped, and it's all because 2008 and 2009 is etched in the brain of investors and they never want to go through that again. So they think they've reduced risk, but I believe they've massively increased their risk.

KS: In terms of investors, they've experienced weak returns for 12 years, they're disgusted, they're exiting the scene. And where are they moving into? The asset class that's had its 30-year best return in financial market history. We've had 30 years of declining interest rates, we hit a record low this summer with 1.5% on 10-year government bond yields. Equities and dividends alone are giving you 3% and inflation's around 2.5%. So when you put your money in a 10-year government bond today you're losing purchasing power over a decade. But 2008 taught investors that a known loss is better than an unknown future opportunity, and that's where investors are today. And they'll start to realize it's a mistake, but they're not there yet.

CB: ***What about interest rates? Will central banks raise rates? What will happen then?***

BW: They're not going to raise interest rates until there starts to be signs of inflation, which they would love to see, or until they see really significant economic growth. The day will come, but the Fed has already told us 2015, so they'll raise rates when they raise them and we'll see what the environment looks like then.

CB: ***There are a lot of global, high-yielding companies in Europe. Should investors be looking there?***

DT: Yes. If you believe the euro's going to fall, look for multinationals that happen to have their office there but can benefit from a lower euro, like exporters. That's a great place to look for value.

CB: ***What Canadian sectors should people consider?***

DT: Canadian oils. Stocks got killed when heavy oil spreads widened—they fell 40% to 50%. Now the spreads are back to where they were and the stocks are up 15%. Americans got out of our resource sector—there's not one single large American investor that owns any Canadian resource—so I think the pendulum will swing and they'll come back to our oil companies again.

BW: We think the resources sector, broadly speaking, got quite washed out, so we've been adding to our exposure to energy, to many of the heavy oil players as well as some of the low-cost natural gas producers with very strong resources. One of the challenges in the Canadian market is that there are not a lot of real long-term secular growth companies, like technology companies and consumer discretionary companies. That's where having some exposure to the U.S. is a good thing, because you just have a wider swath of companies to choose from.

CB: ***What about the banks? There's some concern over slower loan growth and worries about household debt. Will that affect our financial companies?***

BW: We actually increased our exposure a couple months ago after being light on the banks. Even in a slow-growth environment these companies are, on average, generating 18% returns on equity. They also made a number of dividend increases—some that were expected and some of that were not. We think the balance of the year is going to be strong for them. They're not ragingly cheap but we find them reasonably attractive. We like the ones that have some international growth opportunities like Bank of Nova Scotia and TD, which have fairly strong retail franchises.

DT: Let me say something about banks: You can buy the U.S. financials trading at below book with 30% payout ratios and trading at eight times earnings and the housing market's improving. Or you could buy a Canadian bank trading at 2.5 times book, 12 to 13 times earnings with 40% payouts and the housing market's slowing down. To me it's not logical.

DIVIDENDS ARE IMPORTANT. BUT BE CAREFUL WHAT YOU'RE PAYING FOR THAT YIELD

KS: We sit in the same camp as you, David, in that overall the Canadian banks are fully priced and they're likely to be dead money for the next several years because we see that there's tremendous pressure on their earnings. For a period of time you saw that return on equity, or the ROE, was rising dramatically, which was almost shocking for a mature industry—they had 20% ROEs. But I think they're going back to the historical ROEs, because we see, globally, a demand for more and more capital on banks, and by definition if you raise capital you drop your return on equity. We're putting low to mid-teens ROEs through our models, and they're more than fully priced. We think that there's greater opportunity in other sectors of the Canadian marketplace than the Canadian banks.

CB: ***What about the threat of a slowing housing market?***

NR: I'm really not that pessimistic. I don't think the situation is as dire as some of the commentators and Mark Carney, the Bank of Canada governor, seem to suggest. You've got to look at it as there being two markets. There's residential homes and then there's the condo market. The condo market is overbuilt in certain areas—you're seeing that impact on Vancouver and you're certainly seeing it in Toronto. But the condo market isn't the same as the single-family home market in Toronto. That's pretty stable, and, frankly, supported by low carrying costs and a growing economy. The economic context is such that I don't think the banks face huge risks there. And of course mortgage insurance in Canada is largely government-backed.

DT: I disagree. I think the condo market and the housing market are one. One of the reasons why we've seen such a build up in the condo markets is because there's no where to go. If you want to own a house in Toronto you've gotta move north to the suburbs. The condo market is moving, there's no question about it. I live in Toronto and I'm in a condo and I look at the number of unsold units. They've been on the market longer than ever before. And yet, in the next two and a half years, there are going to be more brand-new condos all around me. I don't know who the buyers of these condos are. To say that the housing market is relatively strong but the condo market is overplayed is wrong.

Kim Shannon

To me, it's all one market. If you look at house prices as a percentage of disposable income, we're at almost record highs.

CB: ***Besides U.S. financials, what parts of the market have the best valuations?***

DT: U.S. industrial products, staples, some retailers and some tech stocks. In Canada large-cap resources and some Canadian insurance companies are worthy of picking at.

NR: I'd agree. The U.S. industrials, technology, health-care companies and some of the European consumer staples companies have very attractive valuations.

David Taylor

BW: We've been adding to our U.S. health-care exposure and technology very significantly. In U.S. technology there are many high-quality companies trading at really absurd valuations with very strong balance sheets. Also parts of the media sector in the United States—Comcast and Viacom are all names we've had in our portfolios.

CB: ***Let's talk about portfolio construction. What should investors actually do with all this information you've just give them?***

DT: As I've been saying, a lot of investors are up to their eyeballs in these dividend income funds. If you look at the biggest funds in this country, they're $15 billion and $20 billion dividend income funds and they're Canadian, so 50% of these $20 billion funds have to be invested in Canadian income stocks. If I was running a fund like that there would probably be only seven stocks I'd buy—and all these funds own the same seven stocks. So I've been telling investors: "If you think you have an equity exposure by buying these funds, you don't, you've actually doubled up on your fixed-income exposure. You've got to diversify from low-growth overvalued dividend stocks to high-growth undervalued dividend stocks." To me that's the most important message I can give to investors.

BW: We argue that Canadian investors shouldn't be entirely invested in Canada. They should have some international exposure. Our U.S. exposure for a typical client is at about 15%. That's up from two years ago, when it was almost zero exposure. Canadian equities make up about 25% exposure, and we've been gradually reducing the income-oriented component and raising a more diversified value-oriented resource exposure. We also still think there's room for really well-managed hedge funds that take out market correlation for people who don't want to deal with all the volatility and the macro risk. We can make money both on the long and short side, so we maintain a pretty significant allocation in our hedge funds.

KS: I've always believed in 500-year-old investment advice from a guy named Jacob Fugger the Rich. He advised putting your money in equal parts stocks, bonds, real estate and gold coins—gold coins back then was the currency of the day so he meant T-bills. The real message he gave investors was to rebalance frequently, which is to sell what's making you the most money and put money in the segment that's doing the worst. Investors today should be trimming their fixed-income exposures and putting it into the other areas of the market overall. There's a fascinating study by Crest Investment Partners that says rebalancing is most effective when you're in a sideways market. I've been hearing a number of commentators suggest to investors that they should be making big macro bets. That's a shame, because we're in an environment where the boring, stable, rebalance-back-to-your-ideal asset mix is likely to get you the best result in the long run.

CB: ***How often should people rebalance?***

KS: Probably quarterly. The big pension funds rebalance back to their ideal asset mix every day and they get better long-term returns.

CB: ***Norman, what are you telling clients?***

NR: In this environment you want a minimum exposure to government bonds. If you can stand not having any then that's great. You need some fixed-income element because the truth is we may be wrong about the interest rate environment. That said, you're much better off in corporate bonds. Credit quality is improving, but that's not being reflected in the yield spreads. You're still getting much more attractive yields, premiums and better quality high-yield bonds. On the equities side, in the three balanced funds I manage we're underweight on Canada and overweight on foreign, particularly the U.S. The U.S. offers

IT'S A SIDEWAYS MARKET, BUT THERE ARE GOING TO BE SOME GREAT OPPORTUNITIES

the best trade-off between risk and reward. In a good environment, it's going to do very well. And in a rough environment, it's still going to do better than most. So in terms of equity diversification it's extremely important to have that American component. And we have probably about as much cash as we've ever had—we're over 10% cash in our balanced funds. That cash is likely going to go into equities, we're just waiting for the opportunity.

CB: ***What about alternative assets like gold?***

BW: There's a lot of different ways of defining alternative assets. There's commodities, real estate, private equity and hedge funds. Most of our clients will have exposure to some of those things. We've consistently told people that they should have some exposure to truly disciplined hedge funds, funds that are trying to short the market. When you have a strong market view that's defensive you could actually short and try make some money. So that's the alternative asset class that we've liked.

KS: The TSX alone is 11% gold. When you look at the S&P 500 in its history it's never been more than 1% gold. Historically gold stocks traded at premium multiples to the market, but today they're trading at market multiples or a discount. I think of them as an insurance policy for a Canadian portfolio.

CB: ***I know you're all stock pickers, but gold bars have done better than gold stocks. Would you recommend owning bullion?***

KS: Investors could consider owning some bars in their portfolios. But you've recently seen a couple of major producers, like Barrick, change their CEOs. You're seeing that they're starting to manage those firms differently. I think they will become dividend-paying stocks. They started to pay dividends,

Bill Webb

but they will become significant dividend payers. Throughout human history, all fiat currencies have been debased, so the relative value of gold has the potential for going up. The stocks will lag so we think there's a catch-up opportunity for the big-cap stocks.

DT: The stocks have been chronic underperformers compared to gold, but I think it's changing. It reminds me of McDonald's 10 years ago when, like the gold stocks, it was a growth stock. McDonald's, every year, had $3 billion in cash flow and reinvested $2.5 billion into opening new stores that were unprofitable and closed down a year later. The new CEO came in and said, "We're going to become a cash cow, we're not growth." The stock got killed and all the players got out. Then the stock went from $10 to $100. They kept capital expenditures at $2.5 billion a year, they had $2 billion free cash flow, they massively increased their dividends and bought back stock. It was just a change in investment strategy. And, of course, we chased out the growth guys and it became an incredible cash cow. I believe these gold stocks will do the same. It's going to take some time, but when I look at Barrick, to me this is a company that's got a 20-year reserve life, it's got 138 million ounces of gold and you're effectively paying six times cash flow at $30 for something with a 20-year reserve life—you're essentially getting 14 years for free. But the problem is you never get that money because historically they've always taken the cash and put it back in the ground. That's changing. We ran some numbers and if we look at a company like Barrick or Newmont and they sold forward 20% of their gold production they could buy back

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60% of their stock. They could literally take themselves private by selling forward 25% of production. That's how cheap these stocks are. So you will see massive buybacks and dividends. I'll go out on a limb and say gold stocks will become the growth story of the next two years.

CB: ***We've got to wrap it up—final thoughts?***

DT: It's a sideways market but there are going to be some great opportunities. The economy's going to improve slowly, but the markets are cheap and they're going to do very well over the next three years. I just started my company, so we've only got $625 million right now. In a sideways market you'd much rather run small funds so I can get in and out. There's a lot of fear out there so when a stock gets decimated, we can take advantage and get full positions off very small volume.

NR: I was asked recently if I'm still a believer in equities. That just shows you how negative the sentiment is around stocks. Next year is going to be good for investors. I'm in Kim's camp—we'll see a 6% to 9% type return, but people are going to have to get used to the volatility. It will persist; it's characteristic of this forced low-interest-rate environment. But as long as you're investing in good companies, you're going to come through it well and they're going to reward you in the long run. That's what people have to remember.

KS: I know that active managers can get normal market returns—close to 9%—and when we piece back our track record that's what we've delivered to investors. So I'm reasonably comfortable that, for the balance of the sideways market, we're going to see that investors in active funds should do reasonably well. Equities are historically the best-returning asset class, and I have no reason to believe it will be different going forward.

BW: Central banks have turned cash into trash. Cash is not the place to be. You're essentially earning nothing, but people are living longer and they need income streams. So you have to be creative. The volatility is going to be with us for a while and we'll have a few more years of this sideways market, but as a money manager, when we look at individual securities we find lots of companies we want to buy. And, as we've said, corporations are, by and large, in terrific shape. There are a lot of creative ways to make money.