June Market Comments

General Comments

Spring is playing out according to historical seasonal patterns – weak for financial markets. In April, markets resisted falling, because earnings announcements were so positive. Apple stock, for example, dropped nearly $80 per share during April in the two weeks before releasing their second quarter earnings as investors were pessimistically betting that results would be poor. Then, similar to many companies during April, Apple significantly beat expectations, causing the stock to jump $50 higher overnight. **Strong underlying earnings and reasonable levels of economic activity seemed to be preventing a seasonal downturn.**

May has been different. Employment numbers started the month weaker than expected while GDP revisions provided by the end of the month were also negative. The middle of the month was dominated by speculation about Greece and Europe. Investors quit caring about the details of how companies were doing and instead moved to an attitude of global fear about how Greece and the European Union might derail financial markets. Money flows in May have gone into buying the safest fixed income instruments at yields well below inflation, and selling equity securities for any reason. Germany issued a zero-coupon bond for a five-year term that was very successful in the market. Those investors essentially agreed to be paid nothing – simply get only their capital back in five years, with cumulative inflation over those years eroding their purchasing power. That's how scared investors are behaving over Europe – they are willing to lock in a negative after-inflation return.

As more analysis of Greece is done, some conclude that the European Union is better off with Greece in it, while others conclude things would be better without Greece in the union. In May, I distributed analysis to you that explained the Greek situation. Currently, elections are happening in Greece and these may determine if Greece itself elects to remain within the economic union. Recently, talk of the IMF becoming involved in supporting the underlying value of the Euro has sparked a bit of optimism. The Greek election is June 15th and has turned into a vote about both austerity, and participation in the Euro. I am sure of one thing – **no one knows what is best for Greece and Europe, and the resulting uncertainty is generally negative for financial markets**. Expect markets to be dominated by headlines that are both positive and negative. Don't be surprised if stocks sell off as a Greek departure is imagined with the same dramatic consequence of the Lehman Brothers collapse, and then the following day (theoretically), markets soar as some EU member or political entity comes up with a barely comprehensible solution.

Investors now should consider multiple strategies. Many portfolio managers invest in businesses that have strong fundamentals, attractive valuations, and earnings potential – this works when investors are rationally considering markets. During times of political upheaval, business collapse, or media frenzy, investors may consider market timing, investor sentiment, and market momentum as larger sources for their investment discipline. The VIX (Chicago Board for Options Exchange Volatility Index) is one of the best ways of determining if one should invest rationally (when the VIX is low) or based on sentiment (when the VIX is high). Interestingly, even though the headlines today seem to argue for panic, volatility is still relatively low in the stock markets.

However, **at this stage there is some merit in being proactive** with investments based on the strong change in trend of greater volatility in stock markets beginning in May, the increasing negative advisor sentiment, and the negative momentum in many stock markets. There are inverse notes and volatility tools to benefit from when psychology dominates investor decisions, and methods of measuring momentum to determine where money is flowing. A low current volatility level suggests only minimal use of inverse protection, but momentum and sentiment argue in favour of having some protective instruments in a portfolio.

The restructuring of Europe, elections and potential austerity in the United States, and the global move to deleveraging all argue for a much lower growth rate than has been experienced over the past several decades. For many years to come, I expect financial markets to be challenging. Buying an equity index and simply holding it over the last fourteen years has often returned nothing to investors.

<u>There are two primary solutions.</u>

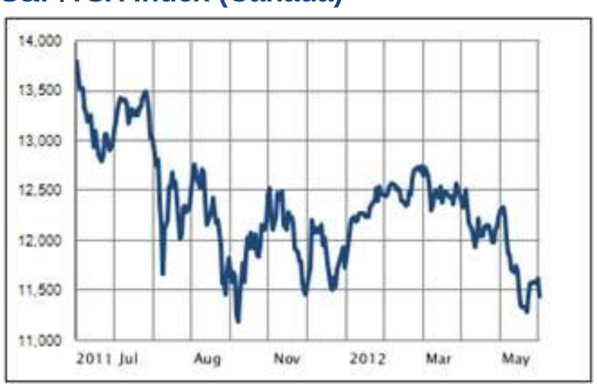
First, investors are likely to move to higher income-producing products. Canadian and US government bond portfolios have yields below inflation, even on longer-term bonds. These investors may consider migrating to corporate bonds that pay 4-6%, which are typically in the BB, BBB and A-rated range in Canada and in the United States. This change in fixed income can be supplemented by owning dividend paying stocks, which often have after-tax yields in excess of even corporate bonds. Stocks have the disadvantage of a lack of guarantee of principal, but the advantage of potentially rising with inflation, should it emerge.

Second, investors need to consider dedicating some of their investment strategy to trying to add value in timing the market. Proponents of asset allocation will point to long-periods of time, especially the 1980's and 1990's, as proof that an asset class alone provides nearly all the long-term return, while trying to select individual securities or time entry and exit points is a waste of time, and possibly damages performance. Proponents of market timing, such as any analyst with a Chartered Market Technician designation will claim that *timing is everything.* They will point to the 1970's and 2000's as evidence that no returns were made unless markets were timed. What both sides would likely agree to is that timing markets and securities is difficult. Since markets are run by behaviour and not science, they can never be perfectly predicted. If investors are willing to occasionally be wrong in using tools and a discipline that helps determine trends, timing the market to some extent can be included in managing a portfolio.

Each investor has to determine how much of the portfolio strategy should be generally in a static asset allocation, established by their personal situation and investment philosophy. Similarly, they should also consider how much of it could rely on a discipline that helps determine when different opportunities emerge or are disappearing both on an asset class level and on an individual security level. I tend to recommend that 80% or so of the investment strategy be based on the individual's unique and personal financial plan. But I do think that 20% or possibly more of a portfolio could be shifted based on economic business cycles, money flows, and various opportunities or lack of them. Note that the 80% still must be managed at a security level to constantly upgrade ownership to the best possible risk-adjusted investments. But cash, inverse notes, and less correlated assets to the market can be used during times when greater protection is considered prudent.

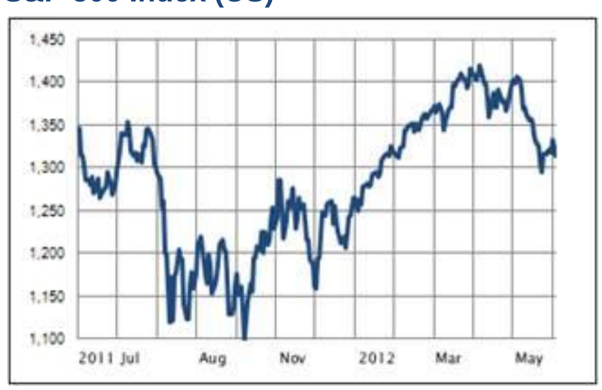
Market Snapshot

S&P/TSX Index (Canada)



Source: Thomson ONE

S&P 500 Index (US)



Source: Thomson ONE

Managed Accounts – April and May Transactions

Managed accounts are discretionary accounts in which I can proactively make trades in a client's best interest based on a written Investment Policy Statement and an intimate understanding of their financial goals. Conflicts of interest from commission are eliminated since commissions are not charged on individual trades. Logistical difficulties in contacting clients and obtaining authority for changes they would likely want are eliminated and all parties gain time not spent on discussing small details of individual securities. Instead, time can be focused on wealth planning and discussing what the client feels is important and wants to discuss.

The comments below represent changes I have already made for managed clients, but also represent a good source of ideas for those that manage their own portfolio and rely on me for implementation, ideas, and a source of professional feedback.

Summary: *The last two months were characterized more by decisions on what not to do, with relatively few overall changes in portfolios. Banks would not be bought, as they were expected to fall further. Energy stocks have been hammered to two year lows, but still seem to hold risk of falling further. Gold will still be an area of overexposure as printing money becomes a likelier outcome to aid European problems and as a third American quantitative easing program is likely to be announced in June. Technology and income producing stocks would still form core holdings in equity portfolios while economically sensitive positions would generally not be held. Four to six year corporate bonds yielding 4-6% still offer the best opportunity and the foundation of portfolios, considering how low government yields are and the likelihood that current low rates will persist for possibly years. And these same bonds are likely to be less affected by inflation. Real return bonds have no real return left in them; they will continue to be excluded since they pay nearly nothing. A small level of inverse securities were bought, to protect against further negative market momentum in June. A shift towards owning more equity in July and August is expected, but it will depend on opportunities in the market. The US stock market has become a much better relative place to invest than the exposure to limited sectors offered in the Canadian market, and will likely be the area of greatest equity increase. The US stock market is a different entity than the US economy.*

New Positions:

Black Diamond Group: Black Diamond rents modular structures for use as workforce accommodation and temporary workspaces. It also rents various types of oilfield equipment used in the exploration and production of oil and gas and to provide complementary services, including transportation, installation, dismantling, repair and maintenance of modular structures and oilfield rental equipment. It operates in three segments: Camps and Workforce Accommodations, Space Rentals and Energy Services. Camps and Workforce Accommodations provide modular structures designed for remote site accommodation. Space Rentals provides modular space solutions to a customer base in Canada and the United States. Energy Services provides an accommodations fleet for drill camps, geologist/engineer quarters and staff quarters. Black Diamond is a stock that has a bit of the best of both the growth and income worlds, with a 3.1% dividend and earnings expected to rise from $1.14 per share in 2011 to possibly $1.81 by 2013.

Horizons Betapro 60 Inverse ETF: This exchange traded fund takes positions in securities that should have a similar daily return characteristic as the inverse (opposite) of the S&P/TSX 60 Index. It moves up if the market moves down. This position is held purely as a timing instrument to protect the value of equity portfolios while investor sentiment weakens and momentum is down during European uncertainty. This security position will likely be exited within the next couple months.

Existing Positions Added To:

Rogers Communications: Rogers operates in three segments: wireless, cable and media. The company disappointed investors in its first quarter earnings announcement by missing expectations by 12%, mainly due to greater competition. The stock was in the $40 range and has weakened to a price between $35 and $36. It still has a very strong and stable cash flow and a very inexpensive valuation. With a 4.5% dividend, the company is part of the income strategy since earnings are expected to be generally stable and possibly grow over the next two years. Covered calls are often written on Rogers when it approaches a price in the high $30's, which enhances the income flow produces for clients from the stock. At this point it still represents a core holding in the portfolio, but should earnings miss targets in the coming second quarter, positions may be trimmed.

Completely Sold Positions:

Ishares MSCI Germany Index: This exchange traded fund provides investment results that correspond generally to the price and yield performance of publicly traded securities in the German market, as measured by the MSCI Germany Index. It has been a very strong market in Europe to own, but the uncertainty around the European Union may adversely affect the sentiment in owning any European securities. Despite the attractive 3.5% yield and ability to write covered calls on this generally strong economy, I consider it safer to be on the sidelines from all European investments at this time.

National Bank: National Bank shares hit their covered call target selling price in April and shares were assigned (sold). This eliminated all bank holdings in managed portfolios. Many bank stocks approached their highest historical prices in March of 2012, but have since dropped between 5-13% over the last several weeks. Banks are now within 5-10% of their target buying zone and I hope that during the summer there may be opportunity to re-purchase some of the banks at more reasonable valuations. Earnings that were recently announced by banks were generally in line with expectations, but showing very little year-over-year growth. Interestingly, many analysts highlighted the exposure each bank had to Europe, with Royal Bank having the highest exposure and consequently experiencing the greatest drop in its stock price compared to the other banks.

Covered Calls Written:

Alamos Gold July $21

Other Transactions:

In specific managed client accounts, there were purchases of Apple, Ishares Gold Bullion ETF, Open Text, and Tupperware. There were sales in some accounts of SNC Lavalin Group. There were a significant number of bond trades, but these were primarily on an individual portfolio basis.

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