

THE MONEYLETTER®

STRATEGIES FOR SUCCESSFUL INVESTING

STRATEGY

Tough markets call for a...

QUALITY DEFENSE

David Graham, CFA

IN THE PAST I FOCUSED ON small-cap companies. But on January 1 this year, I became co-manager of the award-winning **CIBC Monthly Income Fund**, a balanced fund that I now manage with Stephen Gerring. Under his direction, the CIBC Monthly Income Fund was named the 2006 Canadian Income Balanced Fund of the Year by the Canadian Investment Awards.

A balanced fund invests in both equities and fixed-income securities, with the dual goal of getting a reasonable income return from the portfolio and benefiting from market returns.



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As manager of the **Renaissance Small Cap Fund** over recent years, I maintained research responsibilities for the entire Canadian equity market, including dividend-paying Canadian equity securities and income trusts.

Both the equity and bond markets in Canada have had a rough ride since the autumn of 2007. With American housing prices falling and an expected decline in consumer spending, economists had generally been anticipating a slowdown in the US, with a spillover effect in Canada. When the subprime mortgage problems began surfacing in the latter half of 2007, investors started to shy away from bonds issued by banks and corporations, and instead invested in high-quality securities such as government bonds, which they felt contained less risk.

Equity markets were affected in a similar fashion. From Nov. 2, 2007, to Jan. 22, 2008, the S&P/TSX Composite Index declined 17%. On Jan. 22 the US Federal Reserve (the Fed) reacted by cutting the federal funds rate 75 basis points, to 3.5%. It cut the fed funds rate again on Jan. 30 by 50 basis points, to 3%. Since Jan. 22 the S&P/TSX Composite has risen by more than 13%, as the Fed's intervention restored investor confidence somewhat.

We think the rally that began in January is an expression of relief that the Fed appears to be actively seeking to ameliorate the effects of an economic downturn in the US. In our view, however, market nervousness could return if we see increasing evidence of a slowdown despite the Fed's efforts.

As we look towards the rest of 2008, it is difficult to say that all the problems have been solved. There will probably be further writeoffs by financial institutions that continue to have current exposure to subprime loans. And the problems may spread to other areas, such as auto and credit card loans.

As financial institutions tighten their belts in order to reduce their exposure, they are likely to be less willing to extend credit, which is bound to dampen both small business activity and consumer spending. It remains to be seen whether the first half of 2008 will see a full-blown US

recession, commonly defined as two consecutive quarters of negative growth. However, we expect markets to be volatile until there are signs that things are improving.

WHAT TO DO

Here are three simple principles on how to handle this period of volatility:

- ☛ Stay conservative and stick with high-quality companies.
- ☛ Be rigorous and disciplined in your buy and sell targets.
- ☛ Remember that the sectors investors have typically looked to for safety — financial services, telecommunications, and consumer staples — each have their own problems in this cycle and may not necessarily provide the defensive shield that they have in past cycles.

We think bonds are now fairly priced and could continue to do well if the economy slows and interest rates fall more than anticipated (bond prices rise as interest rates fall). We also feel that once investors see the economy returning to health, they will begin worrying about rising interest rates. In our portfolio we hold bonds more as downside protection and/or capital preservation in this type of rocky market, and less for the anticipation of capital gains. Currently, 60% of our portfolio is in equities.

EARNINGS RISK

In our view, the big risk for the S&P/TSX Composite Index is the potential for downward earnings revisions. Currently, bottom-up consensus estimates for the companies in the index are for 13% earnings growth in 2008 and 8% in

2009. Most of the growth is expected to come from the energy and materials sectors, so that the prospects for the Canadian equity market hinge on the direction of commodity prices.

As a result, we favor three of Canada's large utility operations: Pipeline company **TransCanada Corp.** (TSX: TRP), pipeline operator and natural gas distributor **Enbridge Inc.** (TSX: ENB), and electricity provider **Canadian Utilities Ltd.** (TSX: CU).

These are all commodity-based companies, with solid earnings and attractive dividend yields. In addition, because these companies are utility/infrastructure-type operations, earnings tend to be less vulnerable to fluctuations in the broader economy, while demand growth looks strong for the next several years.

Our energy weighting is currently slightly higher than the index. We are positive about oil, but we are also worried that with a surplus of production and concerns about an economic slowdown, the price could drop from its peak of around \$100 a barrel. Our largest holding in oils is **Canadian Oil Sands Trust** (TSX: COS.UN), which has a nice long-life profile with its 37% holding of the giant Syncrude oil sands project in Alberta, an 8% yield, and the prospect of further distribution increases.

Telecommunications services is another sector that has typically tended to be less volatile in difficult times. In this sector, we've seen **Telus Corp.** (TSX: T), **Rogers Communications Ltd.** (TSX: RCI.B), and **Manitoba Telecom Services Inc.** (TSX: MBT) stock drop recently over

concerns about slowing subscriber growth and the federal government's plans to allow a new entrant to compete with existing wireless providers. **BCE Inc.** (TSX: BCE) has also declined over worry that its announced takeover and privatization may fall through.

TOP TELCO PICKS

Based on our view that the BCE takeover will be completed, our top pick in this sector in terms of risk and reward is BCE. Our next choice is Rogers, which seems most capable of competing against any new entrants.

The financial services sector, currently representing 30% of the S&P/TSX Composite Index, should be an apparent key area for capital preservation in weak markets. This time, however, the banks have been perceived as the most likely hosts of any new financial mishaps. Two Canadian banks have already admitted to large potential exposures to the subprime market and have taken writeoffs, but there may be more to come.

CANADIAN BANKS OKAY

We see bank stock prices continuing to react to any news about credit markets. We don't have any concerns about the financial viability of the Canadian banks, but we don't expect any immediate price appreciation in this sector until the credit issues are settled. We are maintaining our core positions in the banks and balancing them based on our relative valuation for each bank.

It has been tempting to add to consumer discretionary positions in recent weeks. **Canadian Tire Corp.**, **RONA Inc.**, and **Lina-mar Corp.**, for example, have

declined because of concerns about lower consumer spending. Based on earnings forecasts, these three companies look like good value. But there is no indication how much their profits could fall in a slowdown. So we have to estimate how a slowdown could affect each company individually and act accordingly.

One holding we have added to is **Thomson Corp.** (TSX: TOC). Thomson is one of the world's largest electronic information companies, with over 80% of its revenue recurring on a subscription basis. It recently cleared regulatory hurdles for acquiring Reuters Group, a major competitor. This has caused weakness in the price of Thomson stock, because many of Reuters' customers are financial institutions. The theory is that many of these companies are facing severe losses arising from difficulties in the credit markets and are likely to cut back on purchase of information services as part of their cost-cutting measures.

Thomson's share price has thus declined significantly, to a recent \$34.81 from about \$50 one year ago, a discount we consider excessive. We are maintaining a conservative weighting in the consumer discretionary sector, with Thomson being one of two key positions. It is difficult to be too

positive on this sector when consumer spending may be the weak link in the economy.

NO CONSUMER STAPLES

The consumer staples sector generally also offers downside protection. But so far this year, the sector has been trailing the S&P/TSX Composite Index. With the continuing expansion of **Wal-Mart Stores Inc.** into Canada, there has been pressure on all the domestic food stores, and we have had no exposure to this sector.

Despite the gloomy news on other fronts, corporate spending provides one bright spot, particularly as it relates to global growth. Unlike consumers, corporations, with their still-strong balance sheets, have the ability to spend, particularly if the global economy is helping their sales. However, US consumer spending still accounts for about 70% of the US economy, and few companies are immune to disruption there.

We see the railroads, **Canadian National Railway** (TSX: CNR) and **Canadian Pacific Railway** (TSX: CP), as beneficiaries of corporate spending and a buoyant global economy. We also anticipate that global commodity demand will continue, and we have added positions in engineering firm **SNC Lavalin Group Inc.** (TSX: SNC), metals distributor and processor

Russel Metals Inc. (TSX: RUS), mine services company **Major Drilling Group International Inc.** (TSX: MDI), and Caterpillar products distributor **Finning International Inc.** (TSX: FTT). We view these as infrastructure players that should rebound along with the economy.

ROLLER COASTER IN '08

We believe 2008 could be a roller coaster market, because both good and bad headline news might influence investor sentiment. Our short-term strategy is to maintain stringent buy and sell targets for various holdings in the portfolio in case sentiment moves too far in one direction. As we move through the year, we will position the portfolio for a return in investor confidence.

Markets typically look six months ahead, so the next time we meet, we should have details about how to prepare for a recovery. ▼

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