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PORTFOLIOS

What you Need to Know: Insight on the Markets

Commentaries provided August 2011

Avery Shenfeld, Managing Director/Chief Economist, CIBC World Markets
Avery Shenfeld is the Chief Economist of CIBC World Markets Inc. He has been with CIBC since 1993 and is widely recognized as one of Canada's leading economists for his perceptive analysis and insight on North America economic developments and their implications for financial markets.

- Recent events have emphasized the value of a diversified portfolio.
- Reactions in equity markets are not about the downgrade. Equity market weakness is really about the lack of growth. At the outset of 2011, growth estimates were too optimistic. In fact, the U.S. nearly entered a recession in the first half of 2011.
- Two forces hindering growth are alleviating: high energy prices that affected consumer spending and the effects of the Japanese tsunami which impeded industrial activity.
- Concerns are that early signs are not as positive as hoped. We expect the U.S. to exhibit better growth in the second half of 2011; slow, but enough to avoid recession and allow equity markets to start to recover lost ground by the end of 2011.
- Also affecting growth is European debt. One solution is more central borrowing and news that the ECB is buying Italian and Spanish debt is a positive sign. The situation bears watching, in particular, the health of European banks that may be forced to take additional losses on sovereign debt.
- Also of concern in the U.S. is what happens in 2012. To maintain positive momentum, emergency tax relief needs to be extended into 2012, and extended unemployment benefits need to be continued.
- There are opportunities: yields on dividend-paying, domestic-focused assets will look attractive as the crisis settles down.

John Braive, Vice-Chairman, CIBC Global Asset Management
John Braive has been managing fixed income assets since 1983. In addition to his role as Vice-Chairman, Mr Braive is a member of the firm's Global Fixed Income team, the Investment and Strategy committees and the Board of Directors.

- There were many headwinds to the economy early in 2011; expectations were much too high and needed to be pulled back.
- CGAM did not think inflation would be an issue, so they positioned their fixed income portfolios to be long duration and long in the belly of the curve, as well putting on credit in good companies able to survive any weakness in the economy or commodity prices. This has benefited CGAM's positioning and strategy.
- Areas of strength include capital expenditures and some improvement in exports, but the U.S. economy is still troubled.
- Europe acerbated things as spreads gapped out for Mediterranean countries, forcing another European rescue package
- This is part of the deleveraging cycle that will last another four to five years and equate into lower growth than expected.
- Markets are panicking, CGAM is taking advantage of this and profiting for their portfolios.
- The outlook is murky and difficult. The downgrade may have performed a service for investors in the long run, as it may force the U.S. Administration and Congress to come up with a truly credible debt reduction plan.

Peter J. Eichler, Jr. Chairman, CEO, CIO and Founder Aletheia research and Management Inc.

Founded in 1997 by Peter J. Eichler, Aletheia is a proprietary investment company who believes that correct investing and ultimate investment success depends upon discovering what is knowable about corporations and their secular earnings prospects and applying this knowledge astutely. The firm employs independent, time-tested methodologies to maximize client wealth, anticipating investor perceptions rather than reacting to them. Aletheia pursues exclusive information channels that produce proprietary research and does not rely on traditional channels of information, such as Wall Street research, securities analysts or mainstream media.

Aletheia is a long term investor – we believe that history shows reacting to daily changes in global macroeconomic sentiment leads to unrewarding investment decisions for most market participants and that the events of the last few days will prove no different. Overall, the financial health of portfolios, as determined by the financial strength of our underlying portfolio companies, has rarely been better. Our investments generally continue to deliver stellar results, to enhance very strong balance sheets, to reinvest in their business, and to return capital to investors at prodigious rates (increasing dividends and buybacks). These fundamentals are largely ignored during times of uncertainty, but always win out in the end. And overall, valuations keep getting more attractive.

As we have highlighted many times in the past, Aletheia's strategies are constructed purely upon the most outstanding individual, stock-specific opportunities that our research process identifies, and not by macroeconomic or political forecasts. Perhaps today more than ever, we believe the strength of our research process in allocating capital to individual investments is beginning to assert itself once again. We believe the most important thing for investors to focus on during these continuing uncertain times is strong, individual investment opportunities, which we think over time is the best way to generate long-term, substantial outperformance. It is clear to us that our clients should ultimately be rewarded by that decision.

Fiduciary Management Inc.

Founded in 1980, Fiduciary is an employee owned independent money management firm based in Milwaukee, Wisconsin. Today, it manages over $4 billion in assets for Registered Investment Advisors, domestic and international institutions, and individual investors primarily throughout the United States. Fiduciary offers equity investment strategies that are firmly rooted in fundamental research and follow a disciplined, value-oriented process.

We are not surprised by the downward moves given the valuation environment and the amount of uncertainty around the globe.

With the volatility we have taken the opportunity on the down days to put some of our excess cash to work in new and existing positions, but more importantly this environment has opened up a few more companies that we were interested in but could not stomach the valuation on….down days are painful, but they create the long-term profitable investment opportunities for the future, and today there are more opportunities than 3 weeks ago.

Pictet Asset Management Limited

Founded in 1805 in Geneva, Pictet & Cie, the parent of PAM, is the largest private bank and one of the premier asset managers in Europe. Since its inception, PAM has focused on international equity management. Both directly in Geneva and through its worldwide network of offices and subsidiaries in London, Luxembourg, Tokyo, Singapore, Zurich, Montreal, and Nassau, PAM manages for a wide variety of institutional and private clients.

Pictet International Small Cap

Over the month performance lagged and is behind the benchmark year-to-date.

The market background to this poor performance was unfavourable, with the increasing concerns about slowing global growth and currency instability affecting more "cyclical" sectors, such as Industrials and Information Technology, sectors where we have an overweight position.

In particular, this contribution to poor performance came from several of our long-term holdings in Germany and the UK, which had made a relatively consistent positive contribution to performance throughout 2010. Examples include Symrise, Fuchs Petrolab and Kloeckner in Germany, and Spectris and Premier Farnell in the UK. In addition our Swiss industrial holdings were also weak due to the continued strength of the Swiss Franc.

There were also IT stocks that suffered particularly badly from related concerns about a downturn in the technology cycle. These included Elpida Memory and Tocalo in Japan, and ASM International in the Netherlands.

A second factor contributing to our poor performance in July was our overweight position in the Italian market. Our exposure to Italy is overwhelmingly in internationally exposed businesses, that should be relatively unaffected by country-specific concerns about Government indebtedness. Nevertheless, such was the poor performance of the overall Italian equity market last month, that stocks that had performed well YTD, saw significant reversals, e.g. Pirelli, Piaggio and Safilo Group.

Finally, our relatively low exposure to Australia was costly in terms of relative performance. We have maintained an underweight position there for some time as we have found it difficult to find attractively valued companies, but during July, returns of the Australian component of the benchmark were boosted by the strength of the AUD over the month. The same can be said of Japan where we have also been underweight and where the currency has been strong during July.

We are conscious that the level of under-performance last month has been significant, but we remain focused on the bottom-up process and are confident that the superior individual earnings prospects of our stocks (as reflected in the high aggregate level of the portfolio's EPS growth forecasts) should transcend these macro-economic and thematic headwinds.

Pictet Emerging Markets:

'The poor growth data out of the US coupled with increasing concerns over US and Eurozone sovereign debt have caused a significant sell off in equity markets. Emerging equities have not escaped and at the time of writing are 17.3% below the 2011 high reached on the 2nd May. Over the past month, the sharpest losses have been seen in emerging markets that have a high proportion of global cyclical companies (Taiwan and Korea) and those economies more exposed to the Eurozone coupled with structural imbalances (Hungary and Turkey). Inflation in the major economies of Brazil, India and China have yet to show conclusive signs of peaking which has also contributed to the negative short-term sentiment. During this major sell off emerging equities have, however, slightly out performed developed markets.

We have not changed our portfolio strategy significantly during this time. On signs of weakening US leading indicators, we did reduce positions in some of the more cyclical holdings in the portfolio including Samsung Engineering in Korea and Duratex in Brazil. We are also running a higher level of cash than in normal market conditions (3-4%) which provides some ready funding to take advantage of the increasing number of value opportunities should market conditions show signs of stabilisation. In particular we are looking at high quality franchises with organic growth opportunities that have been extremely oversold.

In the near-term, the ongoing growth and sovereign debt issues in developed markets are likely to overwhelm the positive underlying fundamentals of emerging economies and companies. Fundamentally however, at a government, consumer and corporate level, balance sheets are in a much stronger position in emerging economies compared to developed markets. In addition, in a world where the number one concern has switched from inflation to growth, those emerging regions offering strong secular growth prospects should be better placed to withstand the current uncertainties.

An additional relative support for some emerging markets (particularly those in Asia) may come from a moderation in inflation levels. Declines in oil and commodity prices will help in reducing cyclical inflation pressures at the same time that annual comparisons start to become very favourable. At the time of writing, 8 emerging countries have seen annual inflation numbers dip lower on the last monthly release.

Of little immediate comfort but worthy of note, valuations are moving towards very interesting levels. Global emerging market valuations of 1.6x price-to-book are 1 standard deviation below the long term average and the forward p/e has dropped to 9.7x (more than one standard deviation below the long-term average). Our database steel replacement cost indicator (a good proxy for overall market intrinsic value) is currently just 72% (100% being fairly valued to the replacement cost of capacity). On the negative side, we are mindful of the recent deterioration in the balance of earnings revisions which needs to be monitored carefully as the second quarter company reporting period progresses and full year guidance is affirmed or revised.'

Walter Scott Global Investment Management

Walter Scott & Partners Limited is an Edinburgh; Scotland based global investment manager and has been managing global investment portfolios on behalf of private investors and institutions since 1983.

For governments, companies or individuals, the same basic financial premise holds, it is not possible to borrow your way out of indebtedness, you must earn your way out. In that context, the broadly anticipated downgrade of US debt by Standard & Poors is irrelevant, the market has simply looked at the last minute agreement struck by the US government and deemed it an unacceptable failure to address the country's overall level of debt. Similarly, in Europe the market has looked at the so called bailouts and determined they are not bailouts at all and simply postponement of debt that will have to be repaid at some point. For most of this year, markets have remained remarkably robust given the economic and geopolitical uncertainties, but the collective patience with governments and monetary authorities appears to have run out and market participants are now acting to force a solution. Governments may be tempted to look again at printing money, in whatever guise, but it is far from certain that markets will again accept such short-termist measures to prop up flagging economic growth. Should the current market turmoil continue, US and European governments will be forced to act, although it is difficult to predict that any meaningful action will be taken with so many politicians on both sides of the Atlantic in pre-election mode. Without meaningful action, the markets will remain highly susceptible to circles of panic such as we are witnessing at the moment.

Such panic is indiscriminate and therefore has a natural close. For equity markets, at some point company fundamentals must be considered. In the short term, consensus earnings forecasts remain excessive and will have to be reduced, sooner rather than later, which may bring further short-term share price falls but longer-term corporate fundamentals will be reflected in individual share prices.

In such volatile circumstances, we remain committed and focused on Walter Scott's tried and tested investment process; identification of companies with the financial strength and strategic vision to grow over the medium to long term. We are obviously keeping a very close eye on all of the companies in the portfolio, to ensure that, fundamentally, each is performing as we expect. There may be opportunities to increase holdings in some portfolio positions and we may see attractive entry points into a small number of stocks. There is not the requirement though, for wholesale changes to portfolios that are well positioned in a select group of high quality, well-financed growth stocks. The superior quality of these companies should provide a degree of defensiveness. This has certainly been the case in the past and we have always believed that there is little merit in being whip-sawed into portfolio activity during times of heightened volatility. We believe the portfolios are aligned to companies that are 'long-term compounders', each possessing the ability to manoeuvre through the economic and market turbulence that we are currently experiencing

Brandywine Global Investment Management LLC
Established in 1986, Brandywine Global is a mid-sized investment firm based in Philadelphia. They are an independent subsidiary of Legg Mason, Inc., a global asset management holding company founded in 1899. Brandywine Global has more than 140 employees, with offices in Philadelphia, Chicago, San Francisco and Singapore covering more than 300 institutional client relationships.

The downgrade has increased investor risk aversion, which ironically has boosted Treasuries.

- This attests to the underlying strength of demand for Treasuries around the globe
- Going forward, downgrade should foster US fiscal restraint and government deleveraging – both positives for Treasuries
- Brandywine has benefited from long exposure to this market
- Current sell-off in risk assets should present opportunities in attractive sovereign debt markets with high yields, like Mexico, South Africa and Poland
- We continue to favor the dollar over euro (debt worries) and yen (Japan is intervening to weaken it)
- In the current environment of very low interest rates in the U.S., a large volume of dollars have been borrowed to finance positions in riskier assets
- Covering short positions should drive demand for dollars and increase valuations.

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