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A Message from  
Ned Goodman and the  
Goodman Private Wealth  
Management team

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# Goodman Private Wealth Management

## From Our Perspective

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We have entered a time in the investment industry when the rules of the game typically change. Long bear markets cause investors to reassess if and how they participate in the capital markets. This evaluation is heavily influenced by the memories of the recent past, which can significantly shape the individual investor's appetite for future investing.

There is no doubt that much has changed in our world and in the smaller arena of finance and investing. If the recent past has been a test of our collective willingness to trust, we have failed – and with good reason. A small number of corporate executives, Wall Street leaders and public accounting professionals have changed the way a generation of investors look at the investment industry and investing in general. Blinded by greed and the excesses that overnight wealth can bestow, many of these former shining stars will find themselves forced to settle for a more meagre existence as the wheels of justice begin to turn.

A point of inflection means that the future will share few of the features of the past. We believe this to be very true for the investment industry today. Much of what has defined the industry over the past 25 years is about to change and investors would be well advised to sit up and take note. Investing is a business where successful new ideas and methodologies work well until they are accepted as mainstream at which point their advantage is lost. There will be many changes but two areas that promise to be very different involve analytical research and index investing.

**Research**, the work that investment professionals perform when they study an investment opportunity and/or monitor the progress of an existing investment, is at the heart of our profession. Our success is defined by our investment performance and our results are often a product of how hard we work to find opportunities that have been overlooked or misunderstood by others in the marketplace. Unfortunately, far too many portfolio managers and investment advisors came to rely on the work of others whose interest was more aligned with the revenue

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generating activities of the firms they worked for than meeting the needs of their investing clients. Indeed even those who did not have this conflict were influenced by others and took a short-term outlook dominated by momentum based investment strategies and speculative activities.

I am happy to tell you that we have always believed and supported the importance of objective research undertaken for the sole benefit of our clients and unitholders. We have a team of investment professionals – portfolio managers and analysts – who work diligently everyday, evaluating existing investments and new opportunities. It is with interest that we note that all the talk about research suggests that portfolio managers make fewer trades when they do their own homework. On this we can speak from experience. Independent research undertaken in our own backyard and a minimal trading, business person's approach to investing based on a longer-term outlook has been a hallmark of the Goodman Private investment process since inception – and a part of my personal investing philosophy from the very beginning.

**Index investing**, or buying a portfolio that is expected to perform more or less in line with the stock market indices that you read about in the newspapers (*S&P/TSX* or *Dow Jones Industrial Average* for example), is an option available for investors to consider. Despite having been in existence for some time, *indexing* gained prominence in the investment world during the heady days of the 1990s when stock market indices went up day after day (or if they didn't go up today, they certainly would tomorrow). Our view is now as it was then, that this practice makes little sense given the difficulty of constructing and managing such a portfolio and the backward-looking method by which stock indices are created – a process I might add, investors know surprisingly little about.

Stocks continually move in and out of investor favour and thus in and out of the indices. Stocks are added not because they are good investments but because their prices went up – and they are added only *after* their prices move higher. Likewise, stocks are removed as a result of declining share prices. The notion of when is a good time to invest in a company based on an assessment of valuation never enters the equation. When stock markets are charging ahead at 20% or more per year, nobody cares. But when index return expectations decline to mid single digits, as we believe they should in this environment, careful investment selection can make a world of difference. Most investors have an idea of the rate-of-return they must earn on their investments in order to meet their long-term objectives. Lower stock market returns increases the importance of

finding a financial advisor and a portfolio manager who you can trust to add value to your portfolio. Now more than ever, it is critically important to pick your investing partners carefully.

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Evidence of a strengthening U.S. economic recovery emerged during the third quarter and current momentum suggests that the fourth quarter will also be strong. Several factors support the economic recovery being sustained into 2004 although the pace is likely to moderate. Most prominent is the current set of favourable financial conditions including low short-term interest rates, bond yields near multi-year lows, higher equity prices and a lower U.S. dollar. In addition, efforts to reduce corporate financial leverage in recent years should lead to corporate profit growth and eventually, a boost in business spending. Consumers have benefited from steady income growth and remain attracted to low financing rates despite relatively high debt service burdens. Finally, housing activity remains robust and house price appreciation has enhanced household net worth.

Much has been written about the fact that the improvement in the U.S. economy has not been matched by a recovery in job growth, particularly in the manufacturing sector – a factor that is likely to slow the pace of the recovery. The absence of job creation remains a consequence of the investment boom of the late 1990s that created excess supply in much of the industrialized world and what some have called the “de-industrialization” of the U.S. economy. This overhang should keep downward pressure on an already low inflation rate and the perception of deflationary pressures may persist. In order to sustain growth, the U.S. Federal Reserve is expected to leave interest rates unchanged through to mid 2004.

As for the U.S. dollar, aggressive monetary easing and the propensity for consumers and businesses (albeit limited to date) to spend rather than save has contributed to a large and growing current account deficit in the U.S. Furthermore, continued low interest rates as well as government spending and tax reduction initiatives are likely to worsen this imbalance between spending and savings. This reality combined with rising U.S. government spending and a growing budget deficit means U.S. reliance on foreign capital has risen substantially. Asian central banks, in particular, have been huge buyers of U.S. bonds investing dollars acquired from either sales of their domestic currency – undertaken in order to prevent their currencies from appreciating against the U.S. dollar – or from the trade surpluses built on the back of a pegged, undervalued domestic currency. Near-term, the cyclical economic recovery should attract capital inflows,

## From Our Perspective (continued)

providing support for the U.S. dollar within what we believe will be a multi-year decline. A higher U.S. dollar in the near term will reflect what amounts to a rally in a longer term bear market for the currency.

The Canadian economy slowed during the quarter affected by slow U.S. growth earlier in the year, a series of economic shocks and the strong appreciation in the Canadian currency relative to the U.S. dollar since the beginning of the year. In response, the Bank of Canada reversed course and reduced rates 25 basis points in July and again in September. While the recovery in the U.S. will benefit Canadian exports in the near term, the trend toward a higher Canadian dollar will have negative implications. We expect the Bank of Canada to keep interest rates low to assist the Canadian economy during this adjustment.

The economies of the Euro region improved although the two largest nations, Germany and France, lagged. Progress has been hindered by the restraints of the Growth and Stability Act, the cautious approach by the European Central Bank toward easing interest rates and a rising Euro. In our view, slow economic growth and receding inflation should spur the ECB to reduce interest rates. While the Euro is likely to appreciate against the U.S. dollar over time, relative weak economic conditions do not currently support further appreciation in the near-term.

In the Asian region, the Chinese economy continues to post strong growth driven by both investment and consumption. Despite a rising trade surplus, China's currency is unlikely to be allowed to move materially versus the U.S. dollar over the next year or two. Japan achieved positive growth although deflation concerns remain persistent. Driven by capital inflows and the broader decline in the U.S. dollar, the Yen appreciated during September although uncertainty about the sustainability of the economic expansion will likely encourage Japan's authorities to limit the currency's rise. Overall, the long awaited global economic recovery, led primarily by the U.S. and China, appears to be underway.

In general, increasing bond yields during the most recent quarter returned the bond market to more reasonable price levels. However, a slow shift from an environment flirting with deflation to one with moderate inflationary pressures combined with the structural problems of the U.S. current account deficit will put upward pressure on global bond yields, the impact of which we may well feel by year-end. In our view, the near-term outlook for the Canadian bond market is more favourable than that of its U.S. counterpart. In particular, improved prospects for the Canadian economy, low external financing requirements and rising business profits should continue to support corporate bonds. All

things considered, we expect Canadian bond investors are likely to earn a low positive nominal return on a diversified bond portfolio.

	Q4 02	Q1 03	Q2 03	Q3 03	Q3 03 (\$U.S.)
S&P TSX Composite Index	7.5%	-3.5%	10.6%	6.7%	
S&P 500 Index	8.0%	-9.9%	6.5%	2.3%	← 2.7%
Dow Jones Industrial Index	9.4%	-10.9%	3.7%	2.9%	3.2%
MSCI World Index	7.3%	-11.7%	8.0%	4.5%	← 4.6%

*Returns measured in Canadian dollars*

***Quarterly stock market index returns were positive but down from the previous quarter...***

***... effects of the rising Canadian dollar had only a slight impact on Canadian investors.***

The Canadian stock market followed the lead of most others around the world and continued to move higher in the most recent quarter. Overall, our Canadian investments benefited from higher stock markets as the trading prices of many of our investments followed the markets' lead. Activity in our Canadian portfolios was limited to just a few transactions and most of our work was focused on monitoring the improving operating results of the businesses we already own in client accounts.

Notably, the majority of our investments within the financial services industry advanced during the quarter extending a trend that has been in place for most of the year. Business activity involving financial services companies continues to be very interesting. Canadian insurer Manulife announced a planned merger with John Hancock Financial Services Inc. which is headquartered in Boston while CI Fund Management Inc. announced further consolidation intentions within the mutual fund industry. Manulife's actions in particular will provide a good example of what is likely to unfold in other large Canadian financial companies – a group of businesses that represents more than 30% of the Canadian stock market. Canada is fortunate to house some very strong financial institutions that are generating strong cash flows in a relatively mature market, and these institutions must find opportunities to invest excess cash flows internationally.

The income trust market in Canada continued to be popular with investors of all types as demand from retail and institutional investors remained strong. In fact, the managers of the Ontario Teachers Pension Plan, one of the largest institutional investors in Canada, made a strong positive statement of the merits of the trust structure when it announced an increase to its investments in this area.

## From Our Perspective (continued)

Looking ahead, we are expecting more supply in the income trust pipeline over the next few months and have maintained cash reserves that will enable us to continue to add investments on a selective basis. A short downturn in prices in September that followed disappointing news out of several income trusts reinforced our position that investors (and journalists) must view trusts for what they are – businesses. There are good ones and there are bad ones – and even good ones will disappoint investors from time to time. Challenges at individual trust businesses underscore the importance of investing in a diversified selection of trusts; an endeavour that requires the same expertise that is necessary in evaluating any equity investment.

We maintain that balanced accounts represent the best asset management approach for investors regardless of net worth. The results generated in our balanced accounts continue to illustrate the benefits of including fixed income and equity securities in a portfolio using a margin of safety, capital preservation strategy. Our split between equities and fixed income investments is cautious but remains tilted in favour of equity ownership of sound businesses.

The U.S. stock market produced positive investment returns in the quarter, but failed to keep pace with the gains made in Canada (Canadian investors will be happy to note that the rapidly rising Canadian dollar took a breather in the third quarter of this year having minimal impact on Canadian dollar denominated returns). While we do not measure our success in terms of three-month periods, our U.S. investments moved ahead nicely relative to the broad market.

Global equity market returns have been stronger recently and have generally outpaced returns generated in the U.S. stock market for at least two quarters. Most notably, investments in Hong Kong, Japan and South Korea have helped portfolios that include a global mandate move higher.

It should be noted that most investors work with the “rear-view mirror approach” only wanting to buy into a 12-month rising market. A key point however, is that as a professional investor, I know that the stock market is leading indicator of better times – usually moving 3-6 months ahead of fundamental changes. As we move forward many questions remain unanswered. Most importantly, the subject of investors’ confidence, and how investors will behave as time marches us along the current market cycle? Recent evidence suggests that the investor psyche while shaken, is not defeated. We do not appear to have lost a generation of investors due to the poor environment and bad publicity of the past three years. Only a small number of investors look to have given up on equities for good. It is clear that a rising equity market is still the best catalyst to get people investing again – although those that stayed the course, understanding the important difference between *temporary price fluctuations* and *permanent loss of capital* will have fared best. Return expectations are still a bit high in some corners but they have come down; a development that is good for all investors. Importantly, the evidence I have seen during my travels across the country suggests that most investors recognize that they are best served by advice from a trusted and competent financial advisor partner that they trust is working in their best interest.



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