

Winter 2004

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

---

# Goodman Private Wealth Management

## From Our Perspective

---

The start of each calendar year is always an interesting time. The newspapers are filled with reflections of the year that has passed and with forecasts of the future. When I am asked for my predictions, I almost always feel the need to state that I am not an economist, nor am I a stock market strategist. I do not have a postgraduate degree in analytical mathematics or extensive experience in advanced statistical analysis and multinational monetary affairs. But I have survived as a long-term equity investor with strength as a keen market observer and with a bias towards pure fundamental valuation, based on logic and respect for cash flow and probability.

The credibility that I bring to anticipating what might happen in the future is of the chronological variety – about 40 years of doing my thing. Chronological credibility exists when you have enough wisdom to recognize a mistake – just after you make it a second time. In thinking about the future, I am often reminded of wisdom from the past. Maimonides, a Jewish philosopher, said, “The future always looks better than the past.” John Naisbitt, the renowned futurist, believed that “the best way to predict the future is to understand the present”. Mark Twain suggested that while history never repeats, sometimes it rhymes.

What separates Maimonides, Naisbitt, Twain and other philosophers from most people is the fact that their thoughts are about the longer-term future, not the next 12 months. I don't believe anyone can speak with assurance about the next 365 days. In fact, with respect to investing, my time horizon is usually 5 or 10 years.

My personal observations from previously trying to glean investment clues from a study of the past and present, indicates that the greatest investment reward comes to those who – by good luck or good sense – find the occasional business that can grow sales and profits far more than industry or the economy as a whole. My belief is that when you find such a business, you should invest your money in it for a long time. And I can say with assurance that despite the changing times and the

## From Our Perspective (continued)

many spectacular investments that have already occurred, some for me and many for others, I am sure that there will be many, many more such opportunities in the future.

There is very little that is certain in the investment world other than that skillful investment management and knowledge about a specific industry or company can have a profound effect on the success of an investment portfolio. We should always expect the unexpected in an uncertain world. And the unexpected – by definition – cannot be forecast. This is not to say that we should ignore the past and present. To the contrary, if we work to understand the past and present, we may be able to arrive at some approximate judgments about what lies ahead.

Today, we are living in a time that follows what was the longest uninterrupted economic expansion in history. This growth gave us the longest continuous bull market in stocks on record, and delivered to the United States the highest rates of stock market returns in over 100 years. It is really hard for most of us to accept that there is in fact a secular change taking place. The academic community looks to the 1990s and forecasts that future index returns will fall in-line. It is my belief that they will be proven wrong.

The secular shift that I expect, and under which I have been operating for some time, concludes that the stock market has adopted a new set of rules, while most market participants still play by the old ones. The long-term ownership of a business always requires discipline to a philosophy of valuation and growth as related to an individual's risk-reward profile. The overall risk-reward profile of the market will be gradually changing through this secular shift that I am suggesting. Amongst most investors, greed and speculation is taking a back seat to caution. Sound valuation techniques and current income payouts have become much more important – witness the Income Trust boom in our country that some are now incorrectly calling a mania.

The philosophy of active fund investing will grow in importance. Institutional investors will come to realize that it is more important to make money than to beat an index. And business school professors will recognize the power of Behavioral Finance in place of Modern Portfolio Theory while finally concluding that index investing is not a foolproof strategy.

What we see happening today tells us that the tough lessons have not yet been learned. That is why technology stocks are up 50% in 2003 even though it is difficult to find very many with real profits. In fact, of all the technology stocks that have doubled during 2003, not one of them had any meaningful earnings. As my friend Don Coxe likes to say – “the rats are returning to the sinking ship”. I like to call it a dead cat “memory” bounce.

The current stock market rally, which really began a little more than one year ago and is making us all in this business feel better, is the result of unprecedented cuts in U.S. interest rates; massive cuts in U.S. taxes; a 20% decline in the relative value of the U.S. dollar; two wars; a continuing world-wide effort to eliminate terror; staggering defence expenditure (and the associated \$500 billion U.S. federal deficit); significant increases in money supply whenever necessary to soothe a bearish feeling; and importantly, major public relations campaigns by Alan Greenspan and the Bush administration in what is now an election year.

This is what has caused a global re-flationary environment, an economic recovery and a soaring stock market. Nevertheless, we believe that the global economic recovery while positive will be more volatile and take longer to unfold than the consensus is forecasting. In our view, we have entered a stock market where volatility will be high, but from start to finish the indices will end up at levels very close to where they began. What worked for many investors in the long bull market of the 1990s is not likely to work during this next period. And, if history is any guide, this stock market environment could last for many years. In case you are wondering, I can assure you that the current stock market is unfolding in a manner remarkably similar to that of comparable periods in the past.

We have gone from fear of deflation and worldwide depression to a global reflationary environment, and we are now headed from the throws of reflation to the early warning signs of inflation. The fear or perception of inflation usually creates an environment where corporate earnings have difficulty keeping pace with increased costs and price-earnings ratios move lower. The inflationary perception could make 2004 a tough year for those investors who have not correctly adjusted their sails.

## From Our Perspective (continued)

We see a continuation of the theme we have spoken and written about during the past two years – namely the emergence of New Leadership. One of the keys to successful investing will be a continued focus on finding tomorrow's leaders. While many stocks went up substantially in 2003, the market is likely to become much more selective in 2004.

Listed below are the investment themes that we expect to last for more than a single year. These are the considerations that dominate the Goodman Private investment process.

- In general, financial and technology related businesses will give way to commodities and resources, and especially energy.
- A declining U.S. dollar will create global currency concerns and gold will continue to react positively.
- Real estate equities will be awarded an inflation premium, something not seen since the 1970s.
- The reemergence of investors' search for current income will remain important.
- Investment dollars will continue to flow to the booming Asian community – China, Taiwan, Japan, India and South Korea.
- The bond market will show that it has completed a generational bull market and yields will rise, but only moderately.

We expect that over the next five years, China will emerge as a global manufacturing power in both mass produced, low cost goods and home grown, high tech products, both for export and domestic consumption – and India will not be far behind. At home, we know not to invest in those industries or companies that are trying to compete with these emerging powers. In short, the balance of global economic power has begun to shift, the result of which is likely to further redistribute the world's manufacturing away from the United States. Taken together, our disciplined investment process and our diligent search for new leadership should keep investors in good stead for the coming year and beyond.

---

### *The Global Economy, Bonds and the Stock Market*

Some evidence of an emerging global economic recovery led by the U.S. and China pushed bond prices slightly lower in the latter stages of last year. However, the move was limited by the market's expectation that central banks will keep interest rates low into 2004, given the absence of inflationary pressures. Also of note, The U.S. dollar continued to trend lower, the result of Asian central banks seeking to maintain a fixed exchange rate or limit the appreciation of their own currencies.

The Canadian government bond market moderately outperformed the U.S. Treasury market during the fourth quarter of 2003. The improving economic environment supported corporate bonds as they once again outperformed government bonds. Meanwhile, concerns about longer-term inflationary pressures increased the demand for real return bonds, resulting in a strong performance relative to nominal bonds.

Entering 2004, the global expansion is poised to continue, albeit modestly, assisted by strengthening growth in the U.S. We expect financial conditions to remain supportive of growth beyond household spending and into the business sector. Growth in corporate profits has led to a rise in capital spending, but only a moderate improvement in employment suggesting that businesses remain cautious. A strengthening economy may support employment growth going forward. We expect domestic inflation to remain subdued in the short term in light of continued productivity gains and surplus productive capacity in the global economy.

The U.S. Federal Reserve is expected to keep rates unchanged early in the year as the economic recovery progresses and we expect it to reassess its position as the year moves on. It is quite possible that we will experience a modest increase in interest rates in the second half of the year as the effects of election positioning are felt in the U.S. economy.

The U.S. dollar has found near-term support; however, we expect the downtrend to resume and take it moderately lower by the end of the year. Current market sentiment towards the dollar is very negative in light of mounting deficits. These factors are counteracted somewhat by the firming U.S. economy and resistance from policy makers whose currencies are appreciating – most notably, Asian central banks whose countries benefit greatly from a strong U.S. dollar.

## From Our Perspective (continued)

Economic growth in Canada should be supported by an improvement in U.S. and global growth. The Canadian dollar's strong appreciation against the U.S. dollar will temper domestic demand growth and inflation, which should drift below the Bank of Canada's 2.0% target this year. Consequently, the Bank of Canada is expected to maintain a bias towards lower rates during the year. In light of our U.S. dollar comments, the Canadian dollar will probably sit near current levels or perhaps lower for the foreseeable future.

The weakness of the U.S. dollar has dramatically impacted the euro economies. Further increases in the euro would continue to restrain external demand and domestic investment in the euro zone at a time when low interest rates seem unable to stimulate local economies. As a result, we expect the European Central Bank to ease interest rates in order to counter any further appreciation in the euro. In light of these conditions, government spending should be slightly increased this year in hopes of a gradual improvement in economic activity. In the U.K., a strengthening economy, and associated inflationary pressures, leads us to believe that the bias at the Bank of England is to higher rather than lower interest rates in 2004.

Elsewhere, economic growth has been most resilient in the Asian region, particularly China, Australia and New Zealand. China's economy is expected to remain strong, driven by export demand and strong foreign investment while growing demand for various inputs and continued low interest rates will likely contribute to building inflationary pressures. Outside China, Asian growth remains export led with domestic demand lagging. Japan will continue to benefit from improving global demand that will support exports and industrial production. The Bank of Japan is expected to maintain a zero interest rate policy to counter persistent deflation, which appears to have reached a terminal stage.

In our bond portfolios we continue to favour corporate bonds, although the drivers of performance in 2003 is likely to limit relative performance opportunities going forward. With the expectation of near term inflation remaining low, real return bonds are not likely to repeat their strong relative performance in the coming year. On a longer-term basis with central banks pursuing reflationary policies, real return bonds remain an important investment tool. Overall, Canadian bond investors can expect to earn a low positive return on a diversified bond portfolio in 2004.

	2000	2001	2002	2003	2003 (\$U.S.)
S&P TSX Composite Index	7.4%	-12.6%	-12.4%	26.7%	
S&P 500 Index	-5.5%	-6.5%	-22.7%	5.3%	← 28.7%
Dow Jones Industrial Index	-2.5%	-1.4%	-17.4%	2.5%	
MSCI World Index	-9.9%	-11.4%	-20.4%	9.4%	← 33.8%

Returns measured in Canadian dollars

***Despite the falling U.S. dollar, 2003 provided some relief to equity investors.***

***However, we think stock market returns will be harder to come by starting in 2004.***

Canada's leading stock market finished the year with another strong quarter as virtually all industry sectors posted positive returns. Virtually without exception, our Canadian investments followed suit and moved significantly higher during 2003's final quarter. Overall, our efforts continue to be focussed on ensuring that our client portfolios are well positioned for the future – that all sails are adjusted accordingly. Hard assets continue to be a focus in the portfolios with investment in energy, gold and real estate being a part of most accounts. Long-term supply-demand imbalances and the creation of a North American energy policy should support high energy prices for years to come and accounts for our positive view of energy related businesses. A continuing long-term weakness in the U.S. dollar and the general need for portfolio inflation insurance, points us in the direction of gold and real estate. In each area, we have identified businesses that meet or exceed our demanding investment criteria and valuation standards.

Of note in the financial services area that dominates Canada's market, Canadian bank valuations are appropriately at the high end of historic trading ranges, offering reasonable dividend yields in light of modest growth prospects. Furthermore, the Canadian life insurance companies, specifically Sun Life and Manulife are well positioned to outperform the market in 2004 as acquisition benefits become more evident in earnings reports. We continue to believe that good wealth management companies will be able to grow free cash flows faster than the rate of growth in household financial assets, which tend to grow in high single digits over the long-term. The financial services industry in general remains very profitable, and in times of subtle economic growth typically performs well.

## From Our Perspective (continued)

Owners of balanced accounts, continue to be well rewarded by a strategy designed to protect capital in down markets and participate when equities move higher. In general, our asset allocation in most accounts sits about 50% equities and 50% fixed income including a cash position earmarked for new opportunities in the equity market.

Currency risk – the most dominant story of 2003 – had a significant impact on our investments outside of Canada and as a result, stock market returns in the U.S. were muted when measured in terms of the Canadian currency. Thankfully, dramatic currency losses were experienced at a time when equity markets experienced a strong recovery. Investment in U.S. businesses proved fruitful for Goodman Private accounts as performance as a whole outpaced the popular indices. Likewise, Global equity markets followed the upward path of North American markets; however, currency losses dampened investment results in this area as well. Despite swimming against the currency tide, our global equity investments performed well in excess of the common benchmark during 2003.

Ironically, the *bad news* for 2004 is that we have been recently inundated with good news – consumer confidence is high, employment data improving, personal income up, manufacturing data getting stronger, and billions of dollars in U.S. personal income tax refunds anticipated in coming months. All this positive news has resulted in current equity valuations that reflect considerable optimism. Our general outlook for equities markets is best characterized as modest price advances with increasing volatility. We await the opportunity to utilize anticipated volatility to build positions in great businesses at very attractive prices.

---

Former U.S. Secretary of the Treasury, Robert Rubin, said in his recent book, *In An Uncertain World*, “Beyond the obvious potential for catastrophic events and disruption is the effect of increased fear and uncertainty on confidence – which is always central to business and consumer behavior.” The message is that the mood and positive momentum that is driving the current stock market ebullience can change very quickly.

For our team, managing money on behalf of our clients is like playing a global chess match. We make use of probabilities discerned from hour after hour of hard work while operating in a world devoid of anything provable in advance with absolute certainty. There is pressure, intensity, daily competition, and a day does not go by when someone cannot show you a mistake you made. To make matters more difficult, in today’s environment, unlike when I started my career, not all stocks are cheap. In fact, most, by my valuation standards, remain expensive. That however, is the challenge – to get around the noise of the day, dig deeper than most, do more work than most, and enjoy the thrill of uncovering an idea that helps a portfolio to perform. We know that these ideas are out there, and that’s why we do what we do.

Wishing you a happy, healthy and prosperous 2004.



**Ned Goodman, B.Sc., MBA, CFA**  
on behalf of the Goodman Private Wealth  
Management team