GOODMAN PRIVATE

Wealth Management

From Our Perspective

FOCUS+ REVIEW – SUMMER 2003

A message from Ned Goodman and the
Goodman Private Wealth Team

Uncertainty has always been the enemy of stock market gains and our bet is that it always will be. The continuing war in Iraq, widespread discovery of corporate indiscretions, and the collective anxiety of investors awaiting evidence of an economic recovery have created an environment that continues to be fraught with uncertainty.

The most prominent example of this uncertainty is the indecisive outlook for the global economy. Economic experts quoted regularly in the financial press express a wide divergence of opinion. Some suggest that we are at the onset of a period of deflation with reduced economic activity to be expected on a global basis, while others predict a period of increased inflation, the result of a more robust global economy.

Meanwhile, investors, unsure as to what is next for the economy and stock market, are enduring a period of vulnerability marked by a sharp decline in their appetite for risk. As the old stock market saying goes, "when in doubt, get out". Many investors have indeed bailed out, but that happened some time ago. The stock market is not currently being impacted by panic selling, but rather by a lack of buying, or what is better termed a buyers' strike. This feeling of vulnerability is common after the bursting of a bubble. So too is the stock market rally that we have experienced recently. We have talked a lot recently about the similarities of this market to the one that followed the 1973-74 bear and a quick look at graphical representations of the two periods suggests that the behaviour of stock market participants has changed very little in the past three decades.

Unfortunately, investing has become an endeavour where the reliance on the thinking of others has replaced action based on independent thinking and common sense. Investors don't want to think for themselves, they want to believe. The late 1990s – along with most other periods of stock market excess – is an excellent example of this phenomenon. It is clear that group think continues to exist in this bear market as it does in all stock market periods, good and bad. Today many investors have placed their faith in hope; hope that the stock market will go up.

The recent rally in stock prices has many wondering if we are on the verge of a new bull market; if the good times are back again? But, a closer look at several key pieces of data suggests that a new equity market party may not be set to begin just yet. In many cases, rising stock markets have been fueled by yesterday's heroes. The most recent quarter produced some very exciting returns in many stock market indices around the world – in fact, double digit returns were not uncommon – but telecommunication and technology names played a very prominent role. We view this as a classic case of investors remembering the past and buying the stocks that went down the most.

	Q3 02	Q4 02	Q1 03	Q2 03	Q2 03 ($U.S.)
S&P TSX Composite Index	-5.0%	7.5%	-3.5%	10.6%	
S&P 500 Index	-4.0%	8.0%	-9.9%	6.5%	15.4%
Dow Jones Industrial Index	-5.5%	9.4%	-10.9%	3.7%	12.4%
MSCI World Index	-5.8%	7.3%	-11.7%	8.0%	17.0%

Returns measured in Canadian dollars

Quarterly stock market index returns continued on a roller coaster ride…

… A very strong Canadian dollar limited gains for Canadian investors.

We made a statement several months ago that expressed the opinion that we were not at the beginning of a new bull market or even at the end of the bear market, but rather, at the beginning-of-the-end of the bear market. This opinion hasn't changed. The fallout from the technology driven bubble of the 1990s has been much like it was following similar experiences in the past. We expect to see a drawn out period where the direction of the stock market is decidedly sideways. Warren Buffett's recent comment that "The hangover may prove to be proportional to the binge" suggests that he views the future in much the same way. One thing is certain, for the generation of investors who have lived through this bear market, the experience will impact their investment decisions for many years to come.

It is our hope that the conflict in Iraq subsides and that the long rebuilding process gets underway. Increased freedoms in Iraq may mark the beginning of new freedoms throughout the Middle East and ultimately an early step in determining a new world order. Although the Iraq situation is weighing on the popularity of President Bush, we believe it is likely that his aggressive plan to cut taxes to stimulate the U.S. economy will prove successful and that he will be granted a second term in office by the American people. Interest rates around the world have initiated the reflation of the global economic system that should lead to renewed economic growth. Each of these developments may well contribute to improved confidence and an increased appetite for risk on the part of investors.

While our search for the businesses that will represent the new leadership continues, some clues are emerging. A deflationary spiral in an environment of lower interest rates, aggressive tax reform and deficit spending would be unprecedented historically. While it could happen, it is not a very likely scenario. From our perspective, it is more likely that we could experience a period of moderate inflation where investments in hard assets including real estate, energy assets and gold should positively impact investment portfolios. China is a second area of great interest. With unparalleled manufacturing competitive advantages – and Wal-Mart as it global distributor – China presents interesting implications for investors. We expect that China will soon assemble more goods than the rest of the world combined. In order to do so, the Chinese will need to significantly expand that country's infrastructure and its production capacity. We are looking for businesses that can supply China with the products and services it requires while avoiding North American businesses that themselves do what China does best. Finally, our participation in the Canadian income trust market is ongoing; it continues to flourish using a business structure that provides a tax-efficient income stream that makes a great deal of sense for investors during these "hangover" markets.

Economic growth remained weak in the major economies during the second quarter of 2003. In the U.S., a diminished focus on geopolitical events did not immediately translate into an improvement in U.S. business and consumer confidence although more recent data reflects a modest improvement from earlier in the year. The U.S. Federal Reserve responded to the weak economic environment by reducing short-term interest rates once again and is likely to keep them low for the balance of the year. A continuation of moderate growth in both consumer spending and income (supported by low borrowing rates) should underpin a recovery in the second half of the year while lingering excess capacity will keep inflationary pressures subdued.

Canadian economic growth slowed as a result of the generally weak global economy and a strengthening of the Canadian dollar. Additionally, the impact of SARS and the discovery of mad cow disease temporarily strained various sectors of the economy. Faced with a weakening economy and subsiding inflationary pressure, the Bank of Canada reversed course and reduced short-term interest rates early in July. We expect to experience further rate decreases which along with an improving U.S. economy, should stabilize economic growth in Canada.

Among the large industrial economies the outlook for the U.S. continues to remain the most favourable. Economic growth in Europe remained slow hindered by weak domestic demand and the rise in the euro. The European Central Bank (ECB) finally responded by cutting rates 50 basis points in June. The adoption of a stimulative interest rate policy was reinforced by the constraints imposed on fiscal policy by the Stability and Growth Pact. Further easing by the ECB is expected this year to offset the impact of the strength in the euro over the past year and to revive the economy. Economic growth in the U.K. is improving benefiting from the existing stimulus of a weaker currency, low interest rates and increased government spending. Consequently, the Bank of England is expected to leave interest rates unchanged near term. The Japanese economy continues to stagnate under weak domestic and export demand and persistent deflation. Burdened by a huge public debt, fiscal policy remains restrictive. The Bank of Japan has added liquidity; however, the actions have been insufficient to halt deflation and revive the economy. Excluding Japan and Hong Kong, Asian growth remains strong, led by China. Globally, this should contribute to inflationary pressures, especially for commodities.

Driven by stalling economic growth and perceived deflation risks, bond yields reached generational lows in June that we believe will mark peak bond prices for the year. A subsequent shift towards an improved economic outlook and a reassessment of deflationary risks contributed to a sharp reversal in the bond market beginning in mid June. Over the balance of the year we expect improved confidence in the economy and the impact of policies aimed at encouraging global economic growth to exert pressure on bond prices.

The easing of geopolitical risks and better equity market returns helped to stabilize the U.S. dollar during the latter part of the second quarter. If the near term unfolds as we expect it to, U.S. economic outperformance will cause the euro and the yen to come under pressure. Structural rigidities in the euro region and fiscal restraint should limit the euro's upside and contribute to increased investment flows into the U.S. Meanwhile, in Japan, persistent deflation and lingering risks to the financial system should weigh on the yen. We do not expect the strong appreciation in the Canadian dollar to be sustained. A weakening economy and lower interest rates should result in near term weakness in the Canadian currency. In our view, the decline in the U.S. dollar is largely complete.

Going forward the Canadian bond market is expected to outperform the U.S., the result of the recent adoption of a lower interest rate bias by the Bank of Canada and a better fiscal position. In the second quarter, corporate bonds significantly outperformed government bonds. While most of the outperformance potential has already been realized, limited supply and rising profits should sustain the current spread differential over government bonds. Real return bonds underperformed nominal bonds without inflationary protection during the second quarter, however, we continue to expect they will outperform for the year as investors look to insulate fixed-income portfolios from the eventual pressures caused by improving economic conditions.

Share prices of our Canadian investments moved up nicely in the first half of 2003; on average, preserving capital in the first quarter and outpacing the broad market indexes in the second. This despite the fact that we decided not to invest in the technology and telecommunication sectors – two areas that experienced strong price performance during the period. Our selection of favourite Canadian businesses is largely unchanged from the beginning of the year and we are happy to report that many have demonstrated operating results that exceeded our expectations. In accounts where we had cash to invest we increased our investments in familiar names. In the coming months, we look forward to reporting on several other very interesting opportunities we are currently studying.

Businesses structured as income trusts have represented an important part of our investment approach for some time and are deserving of special mention. After having outperformed the broader equity market indices for some time, income trusts tested in the first half of 2003, the thesis of many stock market gurus who had predicted the demise of the trust market as soon as equity markets showed new signs of life. The theory being that investors would herd out of the trust market in search of higher returns. We think that the foundation for the popularity of income trusts, namely changing demographics and the shifting preferences of investors in favour of receiving some of their gains in the form of income, will not change with a rally in the equity markets. Income trust businesses continue to provide a measure of good performance to investor portfolios that have suffered through the prolonged bear market.

Our U.S. portfolios also outperformed the broad stock market through the first half of the year, but were negatively impacted by the strength of the Canadian dollar. The strong U.S. market performance was driven by rebounds in areas hard hit by the impact of the conflict in Iraq; diversified financial businesses where prices were driven to artificially low levels by the bear market in equities and renewed investor interest in the technology sector. Alan Abelson delivered one of our favourite quotes of the first half of the year when he said recently, “Wall Street is famous for many things and not the least of them is that it has the attention span of a gnat.” As the war in Iraq winds down, the “street” has once again turned its attention to such colossal concerns as to whether company XYZ would report a penny more or a penny less than consensus estimates for quarterly profits. As a result, we expect share price volatility to continue.

Global equity investments have disappointed investors over the past few years in part the result of dramatic relative declines in European and Asian financial markets at the same time that our dollar came to life. In addition, foreign investors have been affected by the same paralyzing grip of uncertainty that has impacted North American investors. We have chosen patience as the most constructive method to combat uncertain times and continue to view our investments with the long term in mind. We maintain select investments outside of North America while insisting that we are able to perform the same diligent analysis to which we subject investments located closer to home.

Balanced accounts have benefited from a period of strong equity and fixed-income performance. The resurgent popularity of Balanced Funds in the mutual fund industry supports our thesis that many investors of varying sizes now favour a more conservative approach to managing their investments. My personal investment philosophy has favoured this same balanced approach for much of my investment career. I believe a great deal of comfort is achieved at a small cost by constructing a portfolio with cash, fixed-income securities and equity securities including income trusts. We are very proud of the performance record we have established in managing accounts with such a mandate.

“Noise” in the marketplace has always impacted investment thinking, but history has proven that it has no effect on the fundamentals that determine the long-term success or failure of a business nor should it have any impact on our efforts to find businesses that will become the leaders of tomorrow. There is considerable academic debate today questioning the long-term superiority of equities over bonds. Much of this comment is related to the suffering of large pension funds brought about by an aggressive exposure to equities at the peak of the stock market bubble in the late 1990s. The decision to invest in equities ultimately comes down to belief. If you are an optimist, and I am, and if you believe that creativity and innovation will persist in our society, and I do, then you believe in the prospect of future positive economic growth. Equities have always thrived in an environment of positive economic growth. Some commentators suggest that lower returns will be the result of slower economic growth, and that may be. But with interest rates at generational lows, a 5-6% equity market return leaves lots of room for an intrinsic value based portfolio manager to do better.

I will leave you with some wise words I read some time ago:

Which way the next 1,000 to 2,000 points in the market will go is anybody’s guess, but I believe strongly that the next 10,000, 20,000 and 40,000 points will be up... if you believe in the strength of American resolve, hard work and innovation, then take a long-term view and believe in our economic system. I certainly believe.

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on behalf of the Goodman Private Wealth Team