Trick or Treat!

As we approach the end of October investors must discern whether the very large equity returns during 2009 and monster returns since the March 2009 lows are indeed a treat to savour or a mean trick being hoisted on equity investors. Even though the last few days in October have proved to be a little scary the ghosts of Octobers past have largely spared equity markets this year.

While a rebound in equity prices after a period of economic turbulence and near panic selling is not unusual the strength of the current rally has caught many by surprise. Implicit in these strong equity returns is the belief that the economy will recover quickly and strongly from a recession that many have described as the worst since the 1930's.

In our view a "V" shaped recovery is not likely. Historically, serious recessions, like the one we have just experienced caused by asset bubbles and compounded by extensive debt have taken a long time to work themselves out. It took several years for a similar situation to resolve itself in the late nineteenth century, the economic turmoil experienced during the 1930's took years to right itself and Japan is still recovering from its asset and debt induced collapse in the late 1980's. Just as in similar historical situations, recovery from the current downturn will likely be slow and long.

The unemployment situation in the United States is serious. Official statistics supplied by the Department of Labor indicate that the unemployment rate is hovering around ten per cent. Some commentators believe that the real unemployment rate is closer to seventeen per cent when all those that have stopped looking for work or are working part time are included in the figures. In the face of such high job losses consumer confidence is fragile. Not surprisingly, consumers are reluctant to spend and are more concerned with replenishing savings and/or reducing personal debts. In addition, once the various

government stimulus programs end such as "cash for clunkers" and home buyer incentives consumption is likely to moderate quite sharply from recent levels.

The global banking system is still recovering from last year's near death experience. While balance sheets, capital levels and asset quality are improving the banking industry is not out of the woods yet. As a result, bank lending continues to be tight and small businesses in particular are still having trouble getting loans. Tight credit coupled with weak consumer consumption has resulted in low capital spending levels and tepid business confidence.

Equity investors have been buoyed by corporate earnings that have exceeded expectations. Much of this improvement in earnings has come from cost cutting and restructuring measures. The majority of the companies that we follow have actually reported marginal or negative sales growth. Most management teams report that while the sales decline has stopped there is very little pick up in actual demand. Furthermore, they do not foresee a return to previous levels of growth for some time. Not surprisingly, insider selling has been very strong during the past several months as equity prices have continued to rise.

Perhaps most worrisome is that the appetite for excessive risk has returned. Some market observers have commented that hedge funds and speculators are borrowing US dollars at close to zero interest rates and investing the proceeds in the financial markets. In Canada, we have witnessed a renewed interest in speculative resource investments. In the past this behaviour has not bode well for future equity returns.

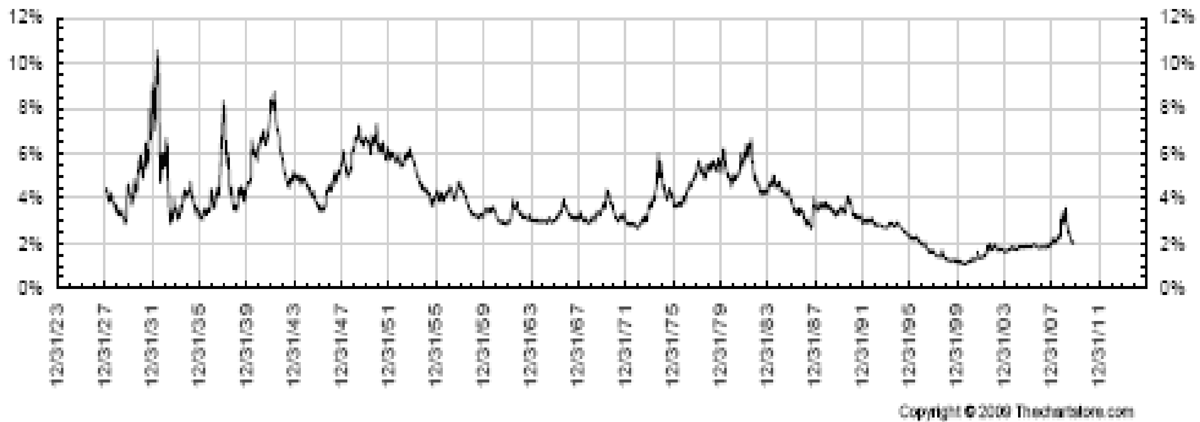
As the above discussion indicates we are skeptical of the strength and sustainability of the current economic recovery and believe that risk is once again quite high. Our concerns are reinforced by current valuations. As the charts below indicate, valuation levels are above their long term averages. Market Capitalization as a % of GDP is at the upper end of its historical range while the S & P 500's Dividend Yield is far below its historical average.

Chart 1

Total Market Capitalization as % of Nominal GDP

Chart 2

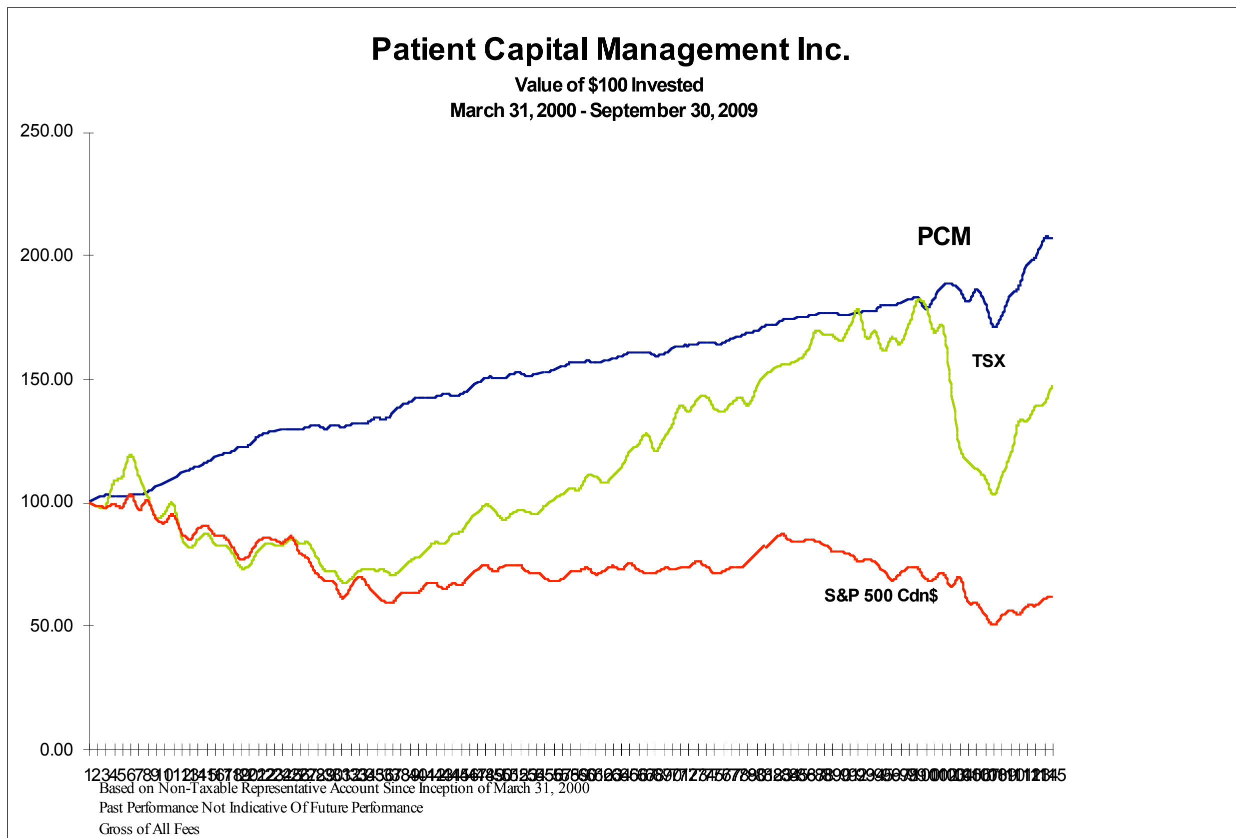
S& P 500 Dividend Yield



As we have often stated, valuations always drives future long returns. In light of the high valuations illustrated above we would expect future equity returns to be quite low from current levels. Furthermore, investors will likely experience a nasty surprise should growth not materialize as expected.

Below is our long term performance chart. From a "mile high' view our out performance appears as a smooth and steady progression.

Chart 3



However, if we look at the annual calendar year returns presented below in Table 1 our performance looks anything but steady and smooth. Two important points stand out. First we have not experienced a negative return while the TSX and S & P 500 in CAD have lost money in four and five of the last nine years respectively. Secondly, we have underperformed the indexes during certain time periods; sometimes by quite a substantial margin.

As our results demonstrate, the long term preservation of capital clearly trumps a sequence of high returns and substantial losses. As we often state; slow and steady wins the race!

Table 1[1]

PCM Calendar Year Returns

	PCM	TSX	S & P 500 C$
Mar. 31, 2000 to Dec. 31, 2000	7.64%	-4.77%	-8.29%
Dec. 31, 2000 to Dec. 31, 2001	19.01	-12.57	-6.46
Dec. 31, 2001 to Dec. 31, 2002	3.28	-12.44	-22.74
Dec. 31, 2002 to Dec. 31, 2003	10.15	26.72	5.29
Dec. 31, 2003 to Dec. 31, 2004	7.37	14.44	3.12
Dec. 31, 2004 to Dec. 31, 2005	3.44	24.13	1.76
Dec. 31, 2005 to Dec. 31, 2006	6.11	17.26	15.74
Dec. 31, 2006 to Dec. 31, 2007	3.61	9.83	-10.27
Dec. 31, 2007 to Dec. 31, 2008	4.53	-32.93	-22.95
Dec.31, 2008 to Sept. 30, 2009	11.08	30.04	4.45

We are fortunate; most investment organizations could not tolerate the substantial deviation from the indices that we have experienced. Their clients would be uncomfortable with a lag in performance for even a short period of time.

At PCM, we are very fortunate to have a client base that understands our approach. Not only have you allowed us to look wrong in the short term in order that we may be right in the long term, you have been very encouraging and supportive of our efforts!

[1] Based on Non-Taxable Representative Account
Gross of all Fees and Expenses
Past Performance is Not Indicative of Future Performance

PCM has been described as quite different in its business and investment philosophy. However, it is truly you, our clients who are unique. Working with all of you is a privilege. Thank you!

Vito Maida
October 30, 2009