REVIEW & COMMENTARY
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Slow and steady may win the race…but there are a few things that will eventually put some financial strain on equity markets- principally oil prices.

Over the past 14 quarters, the U.S. S&P500 companies have grown earnings in double digits for one of the longest periods of consecutive profit growth in history. Certainly the S&P500 has done well throughout that time, gaining over 23% (though not when translated back into Canadian dollars). But there are a number of issues facing this historic run, namely high oil prices, rising interest rates and some unwelcome visitors, namely Katrina and Rita.

Hurricanes and other natural disasters have a significant short term economic impact, but many of the victims return. For example, after Hurricane Hugo hit South Carolina in 1989 and the earthquake in San Francisco, that disrupted the World Series, real estate values in those specific regions were all higher within a year of the disaster, according to Fortune Magazine. Though many companies may profit from the rebuilding of these devastated areas, increased sales of basic materials may be offset by higher raw material costs thus holding profits relatively stable.

The U.S. federal government has pledged, in round figures about $200 billion to help with the clean up in Louisiana. The problem is that U.S. budgetary deficits have been growing and make President Bush's promise to halve these deficits prior to his relinquishment of his office fiscally impossible. The expansion of these deficits exacerbated by the ongoing occupation in Iraq, and the eventual inclusion of the middle class in the Alternative Minimum Tax, will put further strain on the progress of the world's largest economy. Add Chairman Greenspan's unrelenting conviction to raise interest rates, oil and gas prices close to historic highs, and there is every indication that economic growth and corporate profits will come under pressure.

To give full consideration to this possibility, what should investors do? Often we have looked at the alternatives- basically, cash and fixed income. If rates continue to ascend, then short term fixed income maturities may provide the best results. A few years ago hedge funds became popular since they were supposed to provide nominal returns regardless of the market direction given their ability to be short or long. However, over the past several years, it has been proven that while they often trade more frequently than most managed accounts, certainly ours, they do not provide any more of a safe haven, or superior returns than a well balanced portfolio. Thus, we would continue to consider conservative investing appropriate. In the face of rising interest rates, fixed income investments are best kept relatively short. Given the current level of short term interest rates, they will not provide superior long term results. Thus, while profits may be under some pressure, we continue to recommend a healthy portion in equities.

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It is often when the markets are extreme, in either direction that investors become impatient and look to change strategies. Though oil prices have dominated the TSX/SP index and index returns are presently heavily weighted towards them, many diversified equity portfolios have been unable to keep up with the index. This happens periodically and challenges the patience of many investors and the resolve of managers. But remember when Nortel represented slightly more than 30% of the index? With the inclusion of Income Trusts to the TSX/SP, the energy weighting will be roughly similar. Thus, whether or not oil remains at these levels, prudence should dictate that it will be very difficult to outperform the index, if oil prices continue to climb. On the other hand, it should be easier, given that weighting, if oil prices stabilize or decline. Thus, we continue to believe that the most purposeful of strategies is one that requires little reconstruction but sometimes lots of patience. Patience is required given that the level of under performance during very strong markets is often greatest when returns have been heavily reliant on one or possibly two influential sectors. That is why we have always been comfortable with providing a balanced portfolio with some fixed income and focus primarily on equities which pay dividends and provide income to investors.

This brings us to another potential maelstrom- Income Trusts. Though it may have been coincidental, it was shortly after one of the CEO’s of a major Canadian Bank publicly stated that he had considered putting some of his bank’s businesses into Income Trusts, that the Federal Government decided to wreak havoc on Income Trust investors by denying any advanced tax rulings on potential trust conversions. Further, discussion has been circulated within the financial journals, that the Federal Government may start to tax businesses that have adopted the Income Trust model. While we would be more comfortable with the government eliminating or reducing the double taxation on dividends, it is not often that the government adopts the most logical approach. Coincidently, a report from the same bank’s brokerage division, recently printed in the Globe and Mail’s Report on Business, suggested that more taxes are collected putting income into individuals hands through the Income Trust format (if capital gains are included) than if it were retained in a regular corporate structure. And while we continue to consider the Income Trust sector a suitable way to invest for income and growth, we do believe that there may be more turbulent times ahead for investors.

But despite this caveat, we continue to believe that investments that provide the possibility of growth and income should dominate an investor’s portfolio. That way, no matter which way the economic winds blow, your portfolio should be able to provide you with consistent, tax-efficient, long term returns.

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