LEITH WHEELER INVESTMENT OUTLOOK

Third Quarter 2009

The Role of Bonds in a Portfolio: Not Just a Cameo

As we approach the anniversary of the worst financial crisis since the Great Depression, what lessons have we learned and what can we look for in the future?

Best Supporting Actor: Asset Allocation

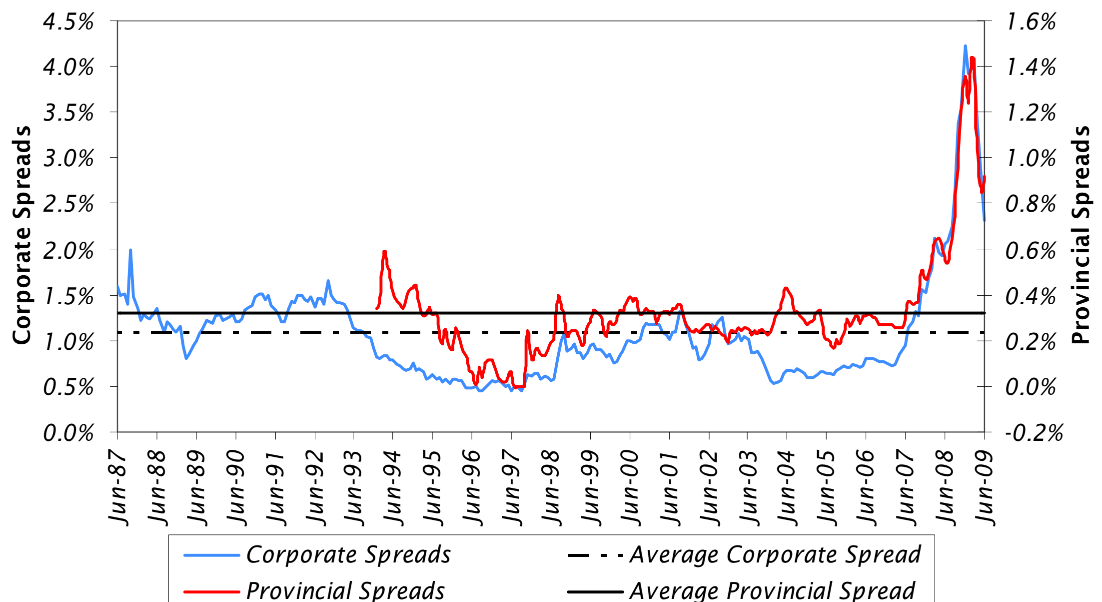
One thing lost in the bull market that preceded the credit crisis was the role that fixed income plays in a portfolio. Investors became accustomed to the starring role of equities as they delivered seemingly "risk free" double digit returns. The relatively low single digit returns from bonds became increasingly unappealing, causing some investors to reduce or eliminate fixed income altogether from their investment portfolio. What was overlooked during this period was that bonds have lower long term returns than equities because of the much greater certainty of both the amount, and the timing, of returns. As a result, bonds outperform riskier assets in times of economic or financial stress as recent experience has shown. For example, despite the recent rebound in equity markets, bonds have still managed to outperform equities by a large margin over both the last one and two year time periods. This is a stark reminder of the role that bonds play in a portfolio and the importance of keeping a portfolio in line with its appropriate long term asset mix.

On June 20th and 21st, 18 people made up a Leith Wheeler team that participated in the ***Ride to Conquer Cancer,*** a bike ride from Vancouver to Seattle.

The team raised over $85,000 to benefit the BC Cancer Foundation, in memory of Murray Leith and numerous other friends and family affected by cancer.
www.conquercancer.ca

Taking a Turn In the Spotlight: Value in Corporate and Provincial Bonds

Although much of the panic (falling prices and very high yields) that gripped credit markets at the beginning of this year has eased, as the chart below shows, both corporate and provincial bonds are still offering yields above their long run average extra yield compared to government of Canada bonds.



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There are of course some good reasons for this as the economy remains weak, and credit availability is still very restricted. However the extra yield available from taking some corporate credit risk remains compelling, both on an outright basis and against the backdrop of very low overall yields. There is another, more subtle reason to expect continued improvement in credit spreads, the natural evolution of the credit cycle. Because of the reduced availability of credit and its higher cost, for the next few years we expect both corporations and consumers to be busy paying down debt which should eventually lead to less risky balance sheets and tighter spreads.

In addition to the value offered by the overall credit market, the volatility of the past year has also resulted in a number of security specific investment opportunities. In the initial panic stage of the crisis, anything that wasn't a federal government bond was sold, and the prices of risky assets declined virtually across the board. The recovery we have seen so far has not been as uniform. Bonds issued by large, well known companies have outperformed lesser known or less liquid issues, often with no regard to actual creditworthiness. This has left some "unloved" bonds with very attractive valuations. One example is commercial mortgage backed securities, bonds that are backed by a pool of diversified mortgages on a variety of different buildings which include Canadian shopping malls, office towers and hotels. These securities require careful monitoring, are time consuming to analyze, and have been battered by association with the other securitized products that have performed so badly in the US. It is possible to buy a Canadian issued bond where if all of the 49 mortgages in the pool defaulted, and the properties underlying the mortgages could only be sold for 40% of their original values, the bondholder would still get all their capital back. None of the mortgages in this example are in default or delinquent currently, and in return for taking this amount of risk the investor earns about 4% more than a comparable government of Canada bond! Very attractive when you consider bank bonds yield only about 0.5% more than a comparable government of Canada bond.

Waiting in the Wings: Inflation?

The extraordinary measures that have been put in place by central banks and governments in both Canada and around the world appear to have accomplished the goal of preventing a further collapse in the world economy. However some economists have been worried that the sheer amount of both fiscal and monetary stimulus that we have seen raises the risk of a sharp increase in inflation once the economy recovers. There are several strong arguments against this being a short or even medium term problem. The first and most obvious is the fragile state of the economy. Close to record and still rising unemployment, declining residential and commercial property markets and the large, and increasing, amount of excess productive capacity all argue that inflation pressures in the near term are going to be muted. An additional drag on the economy will be individuals deleveraging themselves from the bloated amount of debt that they took on over the past two decades, a process that will take an extended amount of time. All of these factors support the argument that despite the fact that nominal interest rates are very low, they are not a bubble about to burst.

The Final Act

The amount of stimulus that has been put in place combined with the difficulty of timing the removal of that stimulus does raise the risk of inflation coming back eventually. In addition, many policy makers have made it quite clear that if they had to choose between inflation or deflation, inflation would be the lesser evil. This necessitates a careful monitoring of economic conditions as an inflationary environment could be detrimental to fixed income returns if a portfolio is not positioned properly.

Looking ahead, careful security selection and portfolio construction will continue to be very important, especially with the backdrop of continued economic uncertainty. The turmoil and associated fluctuations in the prices of non-government bonds has given active bond managers more attractively priced investments to choose from which should result in some reasonable returns over the next few years. To reiterate, this argues **for** sticking to an appropriate long term asset mix with a diversified portfolio.

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