

## **Quarterly Commentary: Second Quarter 2009**

While analysts were closely monitoring the tentative progress of the “green shoots” of potential economic recovery, the second quarter of 2009 launched a global equity markets’ growth spurt that more than recouped the declines experienced during the first quarter.

Many will long remember the quarter that saw the bankruptcies of the iconic Chrysler and General Motors, but investors seemed to believe that the worst of the financial crisis had passed. Despite a temporary June pause, key indexes posted double-digit gains for the quarter.

### **Steward of your life goals**

Recent events widely covered by the media have left many investors, advisors, regulators and people in general angry and disillusioned with the investment industry. “How could this happen?” they ask in unison. “What’s to prevent other investors from being cheated out of their life savings?”

It is a difficult time for the investment industry and their clients so I want to offer my thoughts.

While I am among those angered and saddened by these events, I believe the majority of financial advisors are honest. Many factors contribute to an advisor’s decision to deceive or take advantage of clients. It is hard to say what causes people to take the wrong path in any profession. Once they venture down that path, however, they may find it impossible to return.

Most of us enter the business to help others achieve their life goals as we realize ours – pragmatically and through hard work. I am honoured by the people who ask me to be the steward of their life goals and who feel good about bestowing that trust on me.

As I approach 30 years in the investment industry, I believe it is first the trust that I earn from you that keeps me committed and growing within it.

### **How safe are your investments?**

You may recall I sent you a communication last November describing the mechanisms that are in place to protect your investments. I think it is timely to offer some highlights from that email.

First, I want to review the legislative safeguards that have long been in place to protect your assets at ScotiaMcLeod. Well-established and well-capitalized, Scotiabank, and wholly owned ScotiaMcLeod, provide the foundation on which I serve you. The federally operated Office of the Superintendent of Financial Institutions (OSFI) regulates ScotiaMcLeod and insurance for your deposits is provided by the Canada Deposit Insurance Corporation (CDIC). As well, ScotiaMcLeod is a member in good standing of the Investment Dealers Association of Canada (IDA).

I am regulated by the IDA and licensed by a number of provincial securities regulators including the Ontario Securities Commission. My licenses are in good standing and I have never had an infraction or client complaint.

### **Canadian Investor Protection Fund (CIPF)**

The CIPF was created in 1969 to insure the accounts of clients of eligible members such as ScotiaMcLeod. This protection covers "general accounts" and "separate accounts". General accounts are cash, margin and foreign currency accounts. General accounts together are insured for up to \$1 million for each individual.

Separate accounts are 1) retirement accounts such as RRSP's and RRIF's 2) RESP's and 3) joint accounts where each co-owner is authorized to act with respect to the entire account. All three categories of separate accounts are eligible for up to \$1 million of coverage each. This coverage is activated in the event of the bankruptcy or insolvency of ScotiaMcLeod.

## **Fixed Income**

If you hold provincial or federal bonds, they are backed by the full faith and credit of, for example, the Province of Ontario or the Federal Government. This means that interest payments and the payment back to you of the principal amount of the bond at maturity is as solid as the issuer. For British Columbia and Ontario the bond rating is "AA" and for Federal and Alberta bonds the rating is "AAA". These are of excellent quality and very solid. I limit fixed income investments to AAA and AA rated government and corporate issuers.

## **About equities**

Equity investing does not offer guarantees regarding the safety of your principal, as stock returns are not insured. Equity investing is a long-term process and comes with risks that can be company or industry specific as well as dependant on economic conditions. I believe holding a very large number of companies worldwide is less risky than holding a small number of stocks and the reward is worthwhile.

## **Hedging with bonds**

There are certain truisms that every investor should acknowledge, especially if they rely on investment returns to maintain their lifestyle. Michael Nairne of Tacita Capital, one of Canada's most articulate financial commentators, begins his Bond Hedge article with one such truism: "For the long-term investor, risk is not about volatility – it is about a long-drawn-out period of dismal stock returns." He continues his cautionary tale: "The nexus of excessive stock valuations and a massive economic shock that leads to plunging stock prices, monetary instability and sub par growth can result in years of disappointing returns."

Nairne depicts best, median, and worst-case scenarios for S&P 500 values over the next 20 years. A median result would put the odds at 50% that your Loonie today grows to \$6.28 in 20 years. On the upside, there is a 5% chance that \$1.00 could grow to \$25.35 or

more. On the downside there is a 5% chance that a Loonie could reach only \$1.55 or less over the same period. It is the last scenario that Nairne suggests should prompt people living off their returns to consider a hedge by diversifying into high quality bonds; in particular, bonds backed by “the full faith and credit” (the full taxing authority) of governments.

There are two reasons to consider this strategy. First, government bonds provide a greater potential for future cash payments due to their negligible default risk. Second, government bond returns seldom move in lock step with stock returns. In bad economic times the correlation between government bonds and stocks goes deeply negative – government bonds do well and stocks do poorly as happened in 2008. By combining government bonds with stocks you get a more diversified portfolio that provides superior downside protection with reasonable growth potential.

He concludes, “For the long-term investor, government bonds are an essential hedge against a long-drawn-out period of dismal stock returns. The current robust rally should not blind investors to this fundamental reality.” I agree.

Some of you may have friends who are concerned about the safety of their investments and don't have the time to conduct their own research. I invite them to call me to discuss their concerns. Or please feel free to share this letter with them.

If you have questions or suggestions I would like to hear from you. I wish you a safe and enjoyable summer.

Yours sincerely,

David R. Bruce  
Portfolio Manager