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MANAGER COMMENTARY

January 2013

2012 - A very good year despite the gloom

At this time last year, the global economy was emerging from a difficult year in which stocks were down and expectations for 2012 were generally pessimistic. Many economists predicted a recession in Europe and sluggish growth in the U.S. At the same time, the rate of economic growth in China was considered to be unsustainable with the country having to deal with inflation, a real estate bubble and slowing exports.

Worries about the global economy continued throughout the year as the Arab Spring, the sovereign debt crisis, the European crisis, and the U.S. "fiscal cliff" kept making the headlines.

2012 was also marked by uncertainty arising from elections in the United States, France, Russia, Greece, Japan, Libya, Egypt, and Venezuela. In addition, we should not forget the arrival of new leaders in China and North Korea, and closer to home, the elections in Quebec.

With respect to apocalyptic predictions… it goes without saying that if you are reading these lines, the end of the world predicted by the Mayas for December 21st 2012 did not take place.

2012 Results

The U.S. stock market in Canadian dollars (S&P500 +12.7%) outperformed the Canadian market (S&P TSX +7.2%). This was due in part to the weakness of cyclical commodities (materials and energy) - sectors whose weighting in the index is much higher in Canada (43.9%) than in the United States (14.6%).

In the portfolios we manage, our greater diversification in Canada and our stock selection based on company fundamentals have contributed to the strong results. 2012 was a year where value investing was rewarded: companies that generate higher profits year after year, use debt wisely, and trade at reasonable multiples performed better than the market.

Outlook for 2013

In the U.S., the start of 2013 was overshadowed by the fiscal cliff. The agreement reached at the last minute is merely a Band-Aid solution that puts off the problem to a later date. Also, many of the uncertainties of recent years are still not fully resolved. This is the case with the sovereign debt problem in Europe and geopolitical tensions in the Middle East. Nevertheless, we believe that 2013 will be a good year for the stock markets. In this regard, the following factors should be able to contribute to this scenario:

1. Corporate balance sheets

Companies have cleaned up their balance sheets in recent years. They now have plenty of cash that can be deployed for:
• Increased dividends;
• Share buybacks;
• Acquisitions;
• Capital investments in profitable projects and improved productivity.

2. Increased multiples

Since the 2008 credit crisis, bonds have served as a refuge for investors as evidenced by the substantial purchases of fixed income securities made since the crisis. However, with interest rates at historical lows, it is only a matter of time before investors too strongly weighted in fixed income become dissatisfied with paltry yields and momentum shifts back in favour of equities.

By way of illustration: As of December 31 2012, the 10-year U.S. Treasury bond yield was 1.75%, which means that for every $1 of return, an investment of $57.14 is needed. Meanwhile, U.S. stocks were trading at 14.6 times last year's operating profits - meaning that $14.60 in investment allows us to participate in a $1 of profit. Return on capital for equities was therefore 3.9 times higher than for government bonds.

Several companies have begun to take advantage of the current situation to cheaply finance themselves by issuing bonds to buy back shares. We believe this trend will continue and will benefit equity investors.

3. Monetary policy

Monetary policy is unambiguous. The Fed is maintaining a very accommodative policy and now ties its monetary policy to the unemployment rate. In Europe, the European Central Bank committed itself in July 2012 to take steps to ensure the survival of the euro. More recently, the Bank of Japan decided to expand its easing policy to ensure that its economy remains on a path to recovery.

4. Economic strength

Although expectations for global economic growth are lower than the long-term average, there are numerous signs of recovery:

- In the United States, home sales, housing starts and sales prices are rising as are the sales of durable goods (including cars). The rise in house prices has a significant impact on the net worth of American households and, consequently, on consumer sentiment and the financial system.
- Recent policy easing in China has had the effect of reviving its economy over the last two quarters. Growth is expected to exceed 8% in 2013 and will remain the envy of many other countries.

Our strategy

We continue to favor the securities of companies whose stability and cash flow can sustain dividends. This has recently been beneficial since the very low interest rate environment in recent years has helped to boost the value of securities with high dividend yields. At this stage however, the choice of dividend stocks must be done with great care as some of them have become too expensive in our opinion, while others finance their dividend payments entirely by issuing debt which is not sustainable.

We do our best to manage the risk of portfolios, taking care to invest in profitable, financially sound and well-managed companies. We firmly believe that well-diversified portfolios with securities selected through this disciplined approach will continue to provide superior long-term return.

In closing, we thank you for the trust you place in us. We assure you that we will continue to deploy all our energy and rigour to identify the best investment opportunities for you.

As always, we invite you to contact our managers to discuss your customised strategy and to update your asset allocation policy if needed.

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