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Low valuations and expectations for stocks = opportunity

By Alfred Lam, CFA
Vice-President and Portfolio Manager, Investment Consulting

As we move into the fourth quarter of 2011, stock markets continue to struggle. We have prepared this edition of our October *Portfolio Construction* publication to provide some additional context on today's market conditions and to outline why we are optimistic, despite current market uncertainty.

We believe today's weak stock markets have more to do with confidence (how much investors are willing to pay) than fundamentals (value). Without a doubt, the underlying economies have turned weaker as consumers and businesses adopt a "wait-and-see" attitude and hold off spending. Looking beyond the headlines, we are encouraged by a few things:

1. U.S. corporate balance sheets are very solid. The cash-to-assets ratio is 6.3%, the highest level since the 1960s. (Source: Credit Suisse)
2. Business inventory levels are low, meaning there is limited room for production cuts.
3. Companies are buying back shares and insiders are buying shares – something we didn't see in 2008.
4. Government stimulus remains and interest rates are low and will remain low for a while. Global leaders share the same goal: to avoid a global recession.
5. In addition to low rates, the credit markets are open. This means individuals and companies are getting funding at reasonable rates. We had some stress in U.S. dollar funding for European banks in September and central bankers dealt with it quickly to avoid any stress to the financial markets.
6. The media have focused on excess leverage, but keep in mind every dollar owed is an asset for the lender. Emerging markets hold \$3 trillion of excess foreign currency reserves.
7. The average dividend yields of the S&P 500 Index and S&P/TSX Composite Index are higher than the respective yields of the 10-year U.S. and Canadian government bonds. This means that even with no growth in earnings and valuations of stocks for a decade, stocks will outperform bonds. Ten years ago, it was the opposite. The government bond yield was higher than both dividend yield and earnings yield.
8. Most importantly, expectations and valuations are both very low for stocks. Historically, looking ahead from this type of environment, returns have typically rebounded to above-average levels as we move out of market downturns, as illustrated by the chart on the next page. The chart shows the historical relationship between stock valuations as measured by the price-earnings (P/E) ratio and subsequent returns of the S&P 500 Index. The P/E for the S&P 500 as of October 3 was only 11.9 times trailing earnings – and historically, the average return at this valuation level for the following one-year period has been 16.5%.

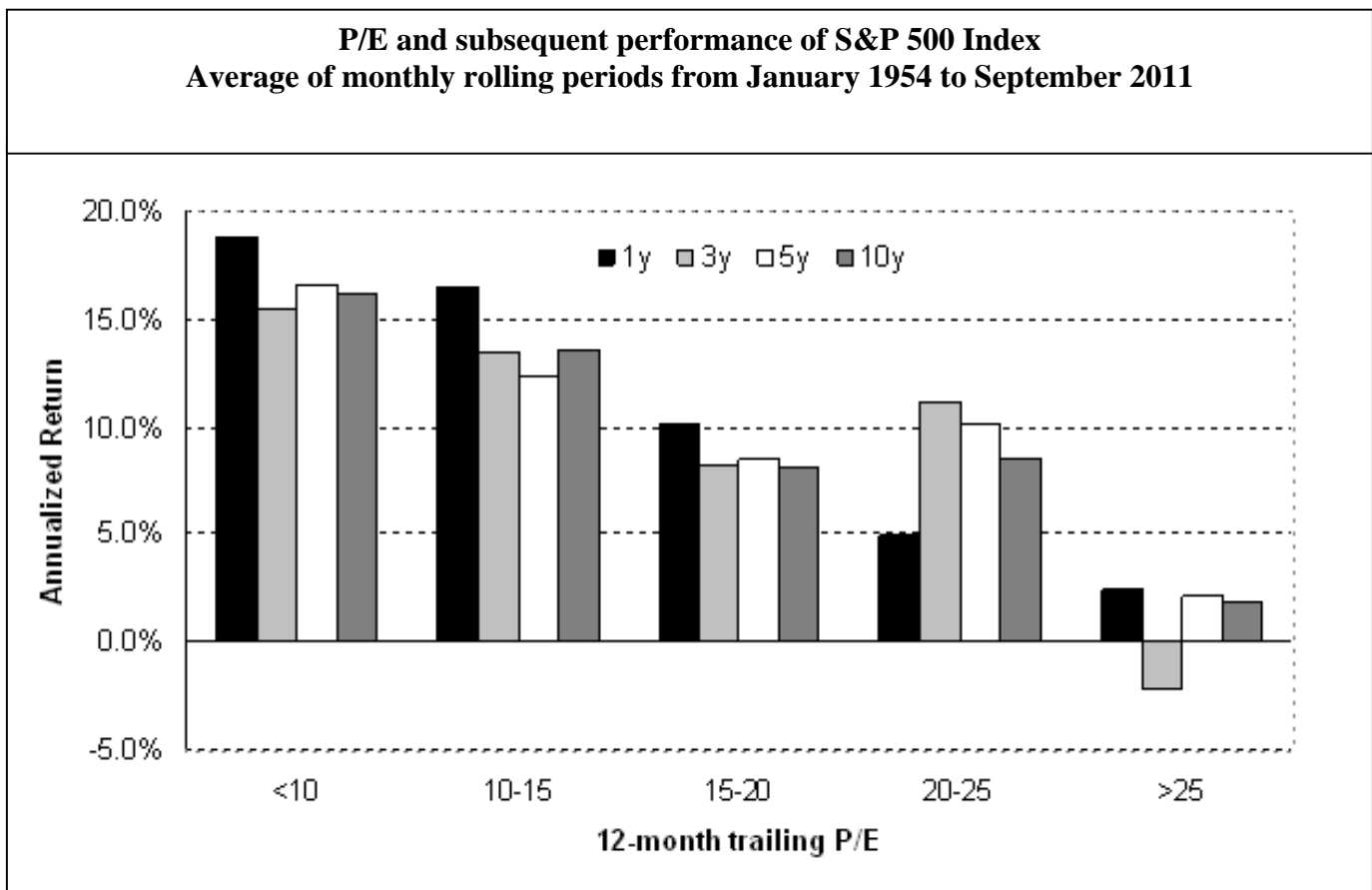
We believe we have employed proper strategies (asset mix, sector allocation and currency hedging) to manage our long-term downside risks. Given the extreme volatility we are experiencing, however, the strategies may appear to be inadequate over the short term. The best-performing asset class during this correction has been government bonds. But they were expensive and have become even more expensive. Five-year Government of Canada bonds, for example, had a yield of 1.31% (as of October 3, 2011). The real yield after [income](#) tax and inflation is estimated to





be -2%. This means the dollar you lend to the government today will give you purchasing power of 90 cents in year five. This explains why we have been very reluctant to invest in this type of over-priced “insurance” strategy because our short-term paper gains would turn into real losses over the long term.

We are adhering to our discipline by investing in properly diversified portfolios of quality stocks at attractive valuations. The markets will likely remain choppy until some kind of decision is made on Greece’s financial issues. In the meantime, based on our analysis of current market conditions and review of history, we believe stock investors who wait will be compensated with a higher-than-normal return when we move out of this challenging period.



Source: Bloomberg





Combined top 15 equity holdings as of September 30, 2011 of a representative balanced United Financial portfolio with alpha-style equity exposure:*

1. AltaGas	6. Power Financial	11. Astral Media
2. Empire Company	7. Laurentian Bank of Canada	12. Johnson & Johnson
3. Canadian Utilities	8. E-L Financial	13. Pason Systems
4. Bell Aliant	9. Monsanto	14. Boeing
5. Microsoft	10. CCL Industries	15. Jean Coutu

Combined top 15 equity holdings as of September 30, 2011 of a representative balanced United Financial portfolio with value-style equity exposure:*

1. Toronto-Dominion Bank	6. Suncor Energy	11. Roche Holdings
2. Microsoft	7. Royal Bank of Canada	12. Comcast
3. Barrick Gold	8. ExxonMobil	13. Mullen Group
4. Potash Corp. of Sask.	9. Ventas	14. GlaxoSmithKline
5. Boeing	10. Praxair	15. Simon Property Group

*Approximately 37% fixed-income, 7% enhanced income, 49% equities and 7% global real estate.

To see the top 15 holdings of the individual United Pools or of the United equity Alpha mandates, please visit the United Financial web page by right clicking on this link and selecting “open web link in browser”:
<http://www.assante.com/wp/optima/financials.jsp#united15>.

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