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Q3 2011 Investment Commentary

Equity markets continued their downward slide in the third quarter. Declines were driven by investors' continued concern over weak economic growth and fears that a Greek bond default would cripple Europe's financial institutions and take down the Eurozone.

On a year to date basis through September 30, the S&P 500 has declined 10% and the TSX Composite has dropped by more than 13%. Energy stocks have performed particularly poorly this year with the S&P/TSX Energy Index losing more than 40% of its value from its peak in March to its low in early October.

Stock prices have rebounded to some extent since early October on more encouraging economic news and a potential deal in Europe. Although there is no easy short term solution to bringing down debt levels in developed economies, we are much less pessimistic than others about publicly traded equities given the financial strength of corporate balance sheets and attractive equity valuations compared to other asset classes.

Our view is based on the fact that many blue chip equities (particularly in the US) are trading at low earnings multiples. For example, well capitalized companies with strong, long term growth prospects such as Disney, 3M, AmerisourceBergen, CGI Group and Johnson & Johnson were all trading at the end of the quarter for multiples of enterprise value to operating earnings of approximately 7x to 8x.

After accounting for fixed asset replacement, these valuations imply that if an investor purchased 100% ownership in any of these companies, repaid all of their debt and withdrew annually their pre-tax cash flow, they could earn about a 10% cash-on-cash return on investment (before personal taxes). We view this theoretical rate of return as attractive as it does not consider that corporate earnings will likely grow significantly over the long term, offering further upside.

We believe other investment alternatives may offer lower returns going forward based on current asset values. For example, commercial and multi-unit residential real estate is currently a very popular asset class, but offers cash returns that are extremely low. It is not unheard of for investors to purchase quality buildings in the current environment for pre-tax cash rates of return of less than 5%. These investment yields are at historic lows as purchase price multiples for buildings have soared as a result of the availability of inexpensive mortgage financing. When interest rates inevitably rise and financing is more expensive, investors will undoubtedly demand greater rates of return on investment, causing prices to decline.

Arguably, the same situation exists in the world of private company investment. Our discussions with private equity groups indicate that these investors are increasingly acquiring smaller, more volatile businesses for earnings multiples which exceed those paid for much stronger and safer publicly traded companies.

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Despite investor fatigue after the recent rollercoaster ride of the last five years, we expect that stocks will outperform most asset classes over the next decade given current depressed valuations. This is not to say that the short term, which is ruled more by investor emotion than fundamentals, won't be bumpy, but we believe that patient investors will be rewarded over the long term.

As always, please feel free to call us should you have any questions or wish to chat about your portfolio.

Yours truly,

John Fisher, CPA, CFA