



Q3 2012 Investment Commentary

Equity markets moved ahead in the third quarter despite continued macroeconomic headwinds and political uncertainty in the U.S.

The relatively strong performance of most stock markets over the quarter caught many by surprise as return expectations were low given the sluggish economy. Our view, however, is that it is very difficult to predict the short term direction of equity markets based on current macroeconomic factors. This obviously contradicts today's accepted market wisdom which is that investors should attempt to move "in" or "out" of the market based on a current read of the economy.

Interest rate levels and bond yields seem to move more predictably with the health of the economy and there is little doubt that yields cannot go much lower. The yield to maturity on both US and Canadian ten-year government bonds currently stands at an unprecedentedly low level (in the range of 1.8%).

The hunt for income is driving some investors toward increasingly leveraged and overpriced investments in real estate, risky corporate bonds and dividend-paying stocks. As we approach Halloween, it would seem that investors' nearly insatiable appetite for current yield would make even the thirstiest of vampires blush! For our part, we continue to believe that it is important to invest cautiously and focus on credit quality in order to avoid losses down the road.

The current low interest rate environment puts us in an awkward position as we are generally in favour investing in stocks which pay dividends. As we have written many times before, dividend stocks are attractive as one gets paid while waiting for capital appreciation and, indeed, most academic studies indicate that dividend-oriented stock portfolios generate superior performance over the long term. That being said, we believe many investors are now chasing stocks with high dividend yields at the expense of valuation.

For example, investing in a stock that pays a 4% dividend yield is obviously attractive given today's low interest rates, but it is a terrible investment if the stock ends up declining by 30% because it is overvalued on a fundamental earnings basis. It takes a long time for a 4% dividend yield to compensate for a 30% loss in value.

It is thus critical to avoid buying dividend-paying common shares which have been bid up unreasonably by investors in search of yield. In this vein, we have recently added several positions to our equity and income portfolios which we believe are attractively priced for the long term.

Becton Dickinson develops, manufactures and sells medical products around the world. The company has almost \$8 billion of annual revenue and was founded over 100 years ago. It has a current dividend yield over 2% and is priced at less than 8x operating earnings. We expect the company's business will hold up relatively well in the event of an economic downturn.

Guardian Capital Group is an investment management company which was founded in 1962. It manages and administers over \$26 billion of capital on behalf of institutions and individuals. The company also has its own investment portfolio, comprised mainly of shares of Bank of Montreal.

We invested in Guardian because we like its recurring revenue business model and its shares are priced in the market such that we are effectively buying its entire investment management business for free after accounting for the value of the company's investment portfolio. Guardian's shares have a dividend yield of about 1.5%.

Lastly, Thomson Reuters is a company that may be familiar to many of you. It provides information to businesses and professionals across the globe. Thomson generates annual revenue in excess of \$13 billion and produces substantial cash flow. The company's share price has been depressed for some time and we expect the business to recover as global economic conditions improve. Thomson's shares have a dividend yield of approximately 4.5%.

We wish you all the best for the fall and the upcoming holiday season. As always, please feel free to call should you have any questions about your portfolio.

Yours truly,



John Fisher, CPA, CFA