

Daniel Hulak's

RandomComments...

Views and opinions
for the clients and friends of
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It's been nearly two and a half years since I authored the last edition of Dan's Random Comments on April 22nd, 2009...44 days after the markets bottomed and the recovery began (marking the end of the second worst bear market in history). Although much has changed in the world since then (and much has not), the investment principles that I tried to instill at that time prevailed yet again like they have on every single occasion since the beginning of capital markets history. In light of recent market uncertainty, I thought I would put together another collection of random comments...

October 6, 2011

Where does the current backdrop leave us?

The epicentre of fear today is no doubt the Eurozone and the potential for contagion if debt problems in the PIIGS nations (Portugal, Italy, Ireland, Greece, and Spain) are handled improperly. In my opinion, Greece's default is not a matter of if, but instead a matter of when, and most importantly a matter of how. Greece's economy is approximately the same size (in terms of GDP) as that of Washington State, so although not insignificant, it's not really that big of a risk on its own (even in the event of a default, restructuring, or whatever other terminology policy makers may use).

The fear however, is the potential for contagion (or the domino effects) if policymakers don't handle the restructuring appropriately. And having the fate of the European economy, especially in a time of ever increasing global interdependence, in the hands of politicians and policy makers is rightfully causing much concern. Layer on top of that US and global budget deficits and debt woes, a slowing Chinese economy, stubbornly high unemployment figures, very poor consumer confidence and now we've got ourselves some headlines.

It's most certainly true that there is cause for concern. One thing I would like to point out however is that there is ALWAYS cause for concern, and there are ALWAYS negative headlines. Consider the below article:



The Awful Uncertainty of the Future

It is a gloomy moment in history. Not in the lifetime of any man who reads his paper has there been so much grave and deep apprehension; never has the future seemed so dark and incalculable. In France the political cauldron seethes and bubbles with uncertainty. England and the British Empire is being sorely tried and exhausted in a social and economic struggle, with turmoil at home and uprising of her teeming million in her far flung Empire. The United States is beset with racial, industrial and commercial chaos, drifting we know not where. Russia hangs like a storm cloud on the horizon of Europe – dark, menacing and foreboding. It is a solemn moment, and no man can feel indifference, which happily, no man pretends to feel in the issue of the events. Of our own troubles, no man can see the end...

This editorial sounds pretty gloomy, doesn't it? The writer evidently was weighed down by present problems and quite ready to sell himself and our Nation short. Did I say 'present problems?' Excuse me please. No, far from it. This editorial appeared before World War II, before the Depression of 1929; before the First World War in 1919; before the panic of 1891; before the Civil War in 1865. It was an editorial in Harpers' Magazine dated October 10, 1847. Yes, pessimism is the scarecrow that fear erects in the watermelon patch of the future to frighten away the timid souls so the feast may be the richer for the few who are not afraid.

I would now like to point out that the first paragraph above was in fact published on October 10, 1847...almost exactly 164 years ago. The second paragraph was added on May 23rd, 1974...well before the European sovereign debt crisis we face today, well before the credit crisis of 2008, well before the tech bubble burst of 2002, well before the recession in 1990, well before the crash of '87, and well before the recessions of 1980 and 1982. That paragraph was added during the depths of a major recession and bear market that saw a peak to trough decline of 48.2% (markets bottomed in October 1974 – approximately five months after that paragraph was added). On that date - May 23rd, 1974 – sentiment was low, negative headlines were the order of the day, and anything remotely resembling optimism drew sneers and scepticism.

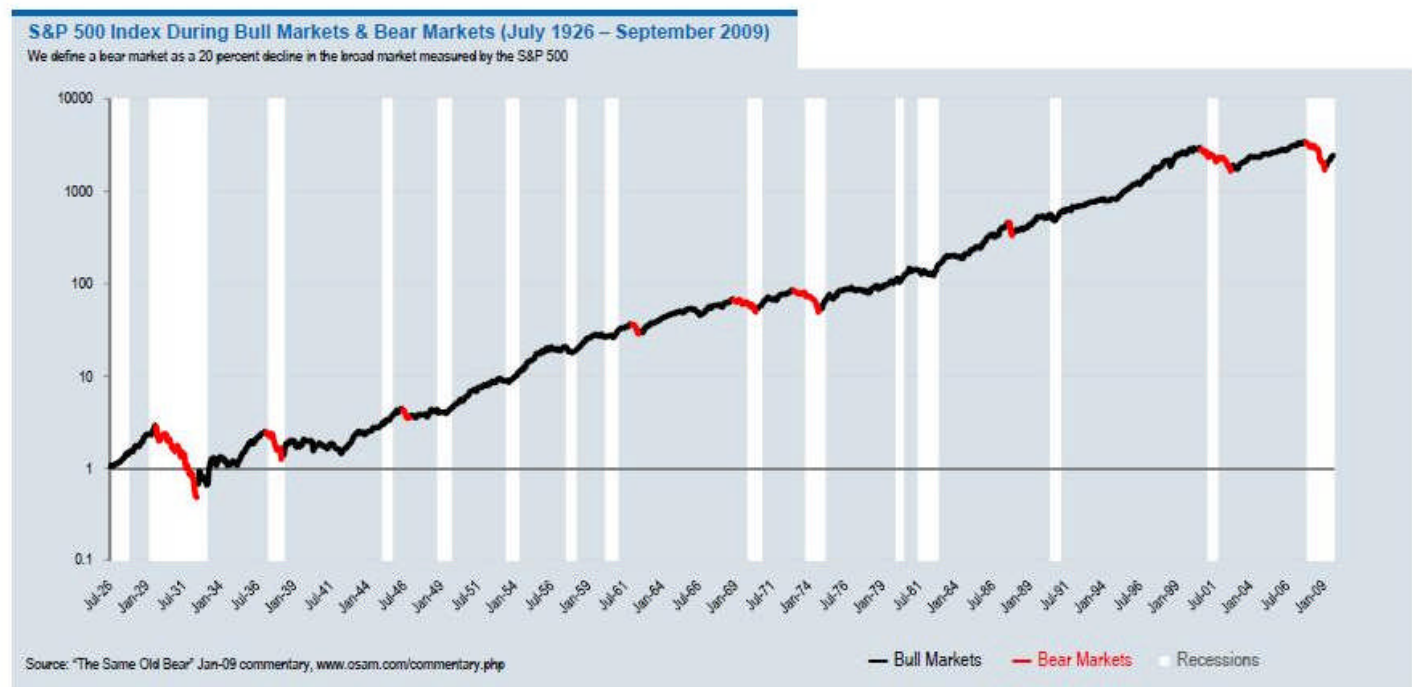
Why be optimistic when the outlook is so bleak? What could possibly turn this economy around? Questions heard time and time again over the course of history. But remember...it's always darkest before the dawn. The S&P500 closed at 87.29 on May 23rd, 1974. As I write this, keeping in mind we may now dip our toes into our third bear market within the past ten years, we're nowhere near our 2007/2008 highs, and after all of the major crisis' that have occurred since 1974, the S&P500 is trading at approximately 1,150. Not a bad performance considering how certain everyone was that 'this time is different' and that stock markets were doomed back in 1974...just like back in 1847...just like back in 1990 (see below)...just like back in 2008...just like at each and every pause in the relentless climb of stock markets since capital markets began.

In my January 2009 'Random Comments' I included an article that appeared in the Seattle Times on December 16th, 1990 that was entitled 'Bank Crisis Risks Turning Recession into Depression'. I'd encourage you to go back and re-read that article again. If you changed the date and perhaps a few names, you could easily re-print the article again today and no one would know the difference. It, like so many others, also painted a horribly bleak picture and made very valid points for why investors should simply pull all of their money out of capital markets and safely stash it under the mattress. After directing readers to that news article attached in the appendix, I wrote:

Did you read it? Now note the date on the top of the page...this article appeared in the Seattle Times on Sunday, December 16th, 1990! Does the content within sound familiar? Now note the following: On that date the S&P500 in the United States was at 326 points. About a month later it bottomed at 312 points and has never been that cheap since! As I write this, even after the massive sell-offs we've seen recently, the S&P500 is trading around 850...nearly triple where it sat in 1990!

As the chart below clearly indicates...declines are temporary, the advance is permanent.

Bear Markets Since 1926



- Economic contractions and bear markets do not always overlap
- Since 1926, there have been 15 recessions, but only nine bear markets

Past performance is no guarantee of future results. Please see important disclosure information at the end of this presentation.

Even though markets have always increased in value over time, it's also very true that they do not go up in a straight line. With all of the gloom and doom in the media, and especially with the advent of high frequency traders (HFTs) in recent years contributing to extreme volatility (it's now estimated that 60-70% of daily liquidity is driven by HFTs), the yearly, monthly, weekly, daily, even intra-daily swings can be nauseating.

But let's just assume for a minute that you were sleeping beauty, and for the past 60 years or so you decided to wake up only once every five years on the first trading day of the year, and on that particular day you checked the level of the S&P500 index. Here is what you would have found:

1952	23.80
1957	46.20
1962	70.96
1967	80.38
1972	102.09
1977	107.46
1982	122.74
1987	246.45
1992	417.26
1997	737.01
2002	1,154.67
2007	1,416.60
2012	?
2017	?

Over the past 60 years sleeping beauty would have slept like a baby...from her vantage point there really wouldn't be any cause for concern. No media, no stress, no irrational decision making, no sleepless nights; just a portfolio that increased roughly 60 fold over the past 60 years. Not a bad deal.

It's also quite clear that periods of extreme pessimism tend to reflect extraordinary opportunities. Where are our optimism/pessimism levels at today?

- Consumer confidence remains very low. The investor's Business Daily's Economic Optimism Index fell to an all time low of 35.8, and is down 31 percent for the year (source: OSAM Market Commentary August, 2011)
- Data provider EPFR Global reported that during the period immediately following Lehman's collapse (Sept 15, 2008) through to February 2009 (markets bottomed March 9th, 2009) investors pulled a record of approximately \$92 billion out of developed market equities. From May 2011 through the third week of September 2011 investors have pulled approximately \$117 billion – easily surpassing previous records!

It's obvious that the wounds are still fresh from the previous two bear markets, so investors are once again quick to panic and hit the sell button; which on the surface is understandable...but history shows us time and time again, that the retail investor is the perfect contrarian indicator, taking money out of the markets at exactly the wrong times:

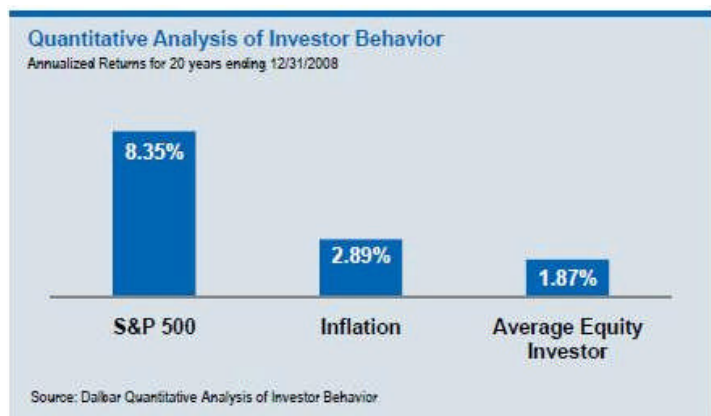
I Investor Behavior — Buy High, Sell Low

Investors routinely allocate to the wrong asset class at the wrong time...



AAI Asset Allocation Survey (1988 to Feb. 2010)			
	Stocks	Bonds	Cash
Average	60%	15%	25%
Maximum	77%	25%	45%
Date	Jan-00	Jul-09	Mar-09
Minimum	41%	7%	11%
Date	Mar-09	Nov-00	Mar-98

Source: American Association of Individual Investors Asset Allocation Survey



...and have done so consistently over the past twenty years.

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Another topic of discussion is alternatives. As I write, a ten year government of Canada bond yields 2.11% (1.85% in the US), and a thirty year government of Canada bond yields 2.71% (2.84% in the US). Savings accounts yield approximately 1.20% in Canada and 0.20% in the US. After factoring in taxes and inflation it's very difficult to see investors getting ahead at those rates. In fact, if you defined 'risk' as the loss of purchasing power over time, one could make a solid argument that investing in bonds and GICs is extremely 'risky' at these low rates.

Furthermore, once these low rates are locked in, the coupons/yields are fixed. Yes, market values of bonds can certainly vary (both positively and negatively) but the coupons are generally fixed. Dividends on the other hand have a tendency to change over time. If you purchased 1 common share of the Royal Bank back in January, 1980 you would have paid somewhere around \$2.81 per share and at that time agreed to receive 3.75 cents per share of dividend (which at the time represented about 1.33%). Today, a single common share of Royal Bank trades at about \$48.00 per share and pays \$2.16 per year in dividends. That \$2.16 dividend only represents about 4.5% of current market value today, but on your initial investment of \$2.81 you would be receiving approximately 77% of your original investment returned to you in dividends...annually! And that amount is likely to increase going forward. That is the power of dividends and equity markets over time.

Another comment that I hear regularly is "all that may be true, but my investments haven't gone anywhere in the past 10 or 12 years!" True. In most cases, that's very true. If you go back and re-read my comments from April '09 I make a clear argument that 10 or 12 years ago stock market prices (multiples) were extremely high. That may have been a significant factor in the underperformance of equity markets over the past decade. But you would be hard pressed to find anyone willing to argue that markets look overly expensive today. In fact quite the opposite appears to be true. With investors currently only willing to pay roughly 11 times next year's estimated earnings on the S&P500, valuations look extremely low and the risk/reward ratio seems very favourable. And when we look back at 'bad decades' over the course of history, we see that there is generally some significant reversion to the mean over the following 10 years. In fact, if we look at the fifty worst 10 year periods ever recorded, then take a look at the returns over the following 10 years, the numbers are quite interesting. The average 10 year return following the worst 10 year periods in history is 14.63% PER YEAR after inflation (real return).

I A Generational Opportunity

- After history's 50 worst 10-year periods prior to 2010, 161 out of 170 subsequent returns have been positive... a 95% base rate:

50 Worst Rolling 10-Year Equity Market Returns from 1871 through 2009¹

10 Years Ending	10-Year Real Average Annual Return (%)	Real Avg. Annual Return (%) over the Next:			
		1-Year	3-Years	5-Years	10-Years
May-1920	-6.09	16.04	17.63	17.40	20.64
Feb-2009	-5.86	50.31	—	—	—
Dec-1920	-5.72	24.33	18.06	21.33	16.05
Jun-1920	-5.72	13.26	16.81	17.46	18.77
Nov-1920	-5.55	21.17	16.94	20.18	16.68
Jan-1921	-5.49	21.75	16.79	19.92	16.11
Mar-2009	-5.43	46.71	—	—	—
Dec-1919	-5.35	-18.84	9.67	11.13	16.23
Jun-1921	-5.33	40.34	17.00	18.81	15.43
Feb-1921	-5.31	26.87	15.84	18.52	17.33
Jul-1920	-5.28	14.69	14.67	17.37	19.23
Mar-1921	-5.27	33.34	16.38	17.18	16.55
Aug-1920	-5.18	6.30	15.14	17.25	19.07
Apr-1920	-5.14	2.83	14.43	14.27	19.59
Jul-1921	-5.13	40.52	17.62	19.53	14.30
Oct-1920	-5.13	4.35	12.79	18.82	15.87
Feb-1920	-5.10	-4.92	14.33	14.25	18.25
Jan-2009	-5.06	30.25	—	—	—
Apr-1921	-5.00	33.72	15.38	16.79	15.11
Sep-1920	-5.00	7.48	13.14	17.58	16.91
Aug-1921	-4.97	55.48	20.04	21.29	15.03
May-1921	-4.94	33.85	13.88	16.65	13.34
Apr-2009	-4.88	35.74	—	—	—
Nov-1919	-4.79	-19.53	9.51	10.62	15.68
Jun-2009	-4.74	12.97	—	—	—

10 Years Ending	10-Year Real Average Annual Return (%)	Real Avg. Annual Return (%) over the Next:			
		1-Year	3-Years	5-Years	10-Years
Oct-1921	-4.74	48.84	19.39	20.30	11.81
Jan-1920	-4.70	-10.37	11.63	12.40	17.48
Nov-1921	-4.35	34.70	19.32	19.13	10.13
Sep-1921	-4.35	45.72	18.68	20.52	10.52
Dec-1921	-4.34	30.71	18.87	19.09	8.36
Sep-1974	-4.29	28.08	12.51	8.11	7.47
Mar-1920	-4.21	-12.04	10.30	10.97	18.28
May-2009	-4.16	18.33	—	—	—
Jan-1922	-4.11	27.47	18.02	17.93	7.88
Nov-1978	-3.82	4.85	3.86	8.62	9.76
Dec-2008	-3.81	22.80	—	—	—
Jul-1982	-3.80	55.63	22.98	25.79	14.94
Aug-1919	-3.80	-21.69	8.98	7.57	19.76
Dec-1974	-3.77	28.20	9.61	6.12	6.92
Sep-1919	-3.75	-19.87	7.86	7.56	19.00
Oct-1919	-3.71	-21.01	7.05	7.00	16.17
Jul-2009	-3.69	12.48	—	—	—
Oct-1978	-3.56	2.71	3.17	8.59	10.15
Jun-1982	-3.54	56.97	22.03	23.95	14.20
Feb-1922	-3.49	23.89	17.30	17.83	7.94
Nov-1974	-3.48	26.79	8.67	5.41	6.39
May-1982	-3.48	47.27	20.32	22.13	14.06
Nov-2008	-3.46	23.11	—	—	—
Oct-2009	-3.41	15.17	—	—	—
Apr-1919	-3.37	-15.58	5.10	5.92	17.67
Average	-4.57	19.64	14.29	15.53	14.63
Median	-4.74	22.96	15.26	17.38	15.78

¹ Source: Goetzmann NYSE price-weighted index (1871–1925), S&P 500 Total Return Index (1926–Present), Sahr inflation estimates (1871–1912), U.S. Bureau of Labor Statistics Consumer Price Index (1912–Present)

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Where will we be in 10 years from now? No one has the crystal ball, and by the time we can identify what the next catalyst that propels the markets is, we'll likely be well into the next leg of the uptrend.

OK, but what about the US debt problem? How many times have you heard the three words "US", "Debt", & "Problem" used in the same sentence? It seems like everywhere you turn, the media glamorizes this bottomless pit of fiscal imprudence, which is sure to bankrupt the country (insert sarcasm here)! Now certainly it's true that running federal deficits for extended periods of time is unsustainable, but it's also important to keep the numbers within the proper context. Hearing that the US has had more than a trillion dollars in deficits each year since '09 sounds extremely powerful and overwhelming...and it is...and it needs to be addressed. I fully concede that the situation is serious and can't be ignored. However, you never hear the media talk about that number in the context of the American Net National Assets...which are estimated at approximately \$150 trillion dollars! What makes up 'net national assets'? Monuments, museums, national parks, roadways, buildings, strategic reserves, etc. It's important to note that the \$150 trillion is an estimate since it's difficult to put an exact value on certain assets, but nevertheless the numbers are staggering. Perhaps using a scaled-down example might help to illustrate what I mean:

If you owned a business that generated about \$263,000 in revenues last year (and that happened to be the largest business in the world by far), but your costs were currently about \$373,000, you probably wouldn't be too satisfied with turning a negative profit of about \$110,000. You'd want to take steps to make that business profitable again (or at least break even), especially if you had a mortgage outstanding of about \$1.5 million (Wow - up to this point things sound pretty bleak...this is generally the point in the story at which the media stops). But what if that business had, over the years, accumulated a net worth - including real estate, investments, inventory, etc - of \$15 million dollars. Would bankruptcy be imminent if you had lost \$100,000, even taking into account your outstanding mortgage, when your net worth was over \$15 million? I realize that you couldn't lose money forever, otherwise your net worth would eventually dwindle away, but I hardly bet that many of your friends would dub your current situation 'doomed', 'dire', or 'destined for bankruptcy'.

The 2012 US Treasury estimate numbers are \$2.63 trillion in revenues, \$3.73 trillion in expenditures for a \$1.1 trillion deficit and a \$15 trillion national debt. This in the context of a \$15 trillion annual GDP and approximately \$150 trillion in net national assets. So in other words, the numbers I used in my example are fairly accurate - just scaled down by a factor of a few million.

I am not downplaying the seriousness of US federal deficits...there are significant issues that must be addressed, but I think it's important to keep things in the proper perspective. It's just unfortunate that the proper perspective doesn't make for a startling 'breaking news headline', nor does it sell as many newspapers as a 'doom and gloom' scenario. And the kicker to all of this is that the governments of the world may have balance sheet issues, but corporations around the world seem to be in extremely good shape. And yet the perception out there is that stocks are risky (ie - investing in good quality businesses), but bonds are safe (ie - lending money to governments running huge deficits). Food for thought.

As always, I urge Clients to 'shut off the noise' and focus on your own personal financial situation. Then, set the sails of your investment portfolio accordingly (see below) and trust that the wind will blow over time (like it always has).

So what should you do?

As I wrote in my first random comments, make sure that you've reviewed my **'5 Elements of Wealth Management'**:

1) Select an Asset Allocation that Makes You Most Comfortable

- I have clients that absolutely can not handle any volatility that is inherent in stock market investing. They literally lose sleep at night if their portfolio moves up or down by even 1%. These clients's have 100% of their portfolios invested in GICs, fixed income and cash. They understand that returns will likely be moderate, but they'll be consistent, and they do not have to worry about the day-to-day volatility of the stock markets. I fully support and encourage this investment strategy for these types of clients.

- On the opposite end of the spectrum, I have clients who understand many of the points I've made above and share my belief that stock markets do go up over time. They realize that if you strip out taxes and inflation from GIC rates, you're probably treading water at best (or even losing purchasing power over time). They realize that they require growth, protection of purchasing power, and most importantly, they don't worry about the day-to-day volatility - they're fine with sometimes 5% or even 7% daily swings in the value of their portfolio in exchange for the probability of greater long-term returns. (And history has proven that these types of investors are handsomely rewarded over time).

- The majority of my clients fit somewhere in-between these two extremes (50/50, 60/40, 70/30, etc). It's not my job to tell you where you should be, it's my job to help you decide what point along that continuum makes you the *most comfortable* with respect to your investment portfolio, then recommend top-quality securities that fit your profile.

- Bear markets are a great opportunity to review your current asset allocation to decide if it's still appropriate for you. If you'd like to make adjustments, make sure you're doing it for the right reasons – a permanent shift in asset allocation because your personal circumstances have changed is a very valid reason... a temporary shift in asset allocation because of emotion or because you're trying to time the market is NOT a valid reason.

- Another comment that I hear frequently is "I don't have 10 years...I'm retired now (or will be very soon)." To that I reply "extremely valid point, and that's where asset allocation becomes a huge component of portfolio management." Even for those in their retirement years, it's extremely rare that someone expects their entire portfolio to be spent within the next 3-5 years. If that's the case, then you likely shouldn't be in the equity markets at all. But if you're in the overwhelming majority, and you expect that a large portion (if not most) of your portfolio will not be spent within 5-10 years then a reasonably long-term view must not be ignored, and an appropriate asset allocation becomes crucial.

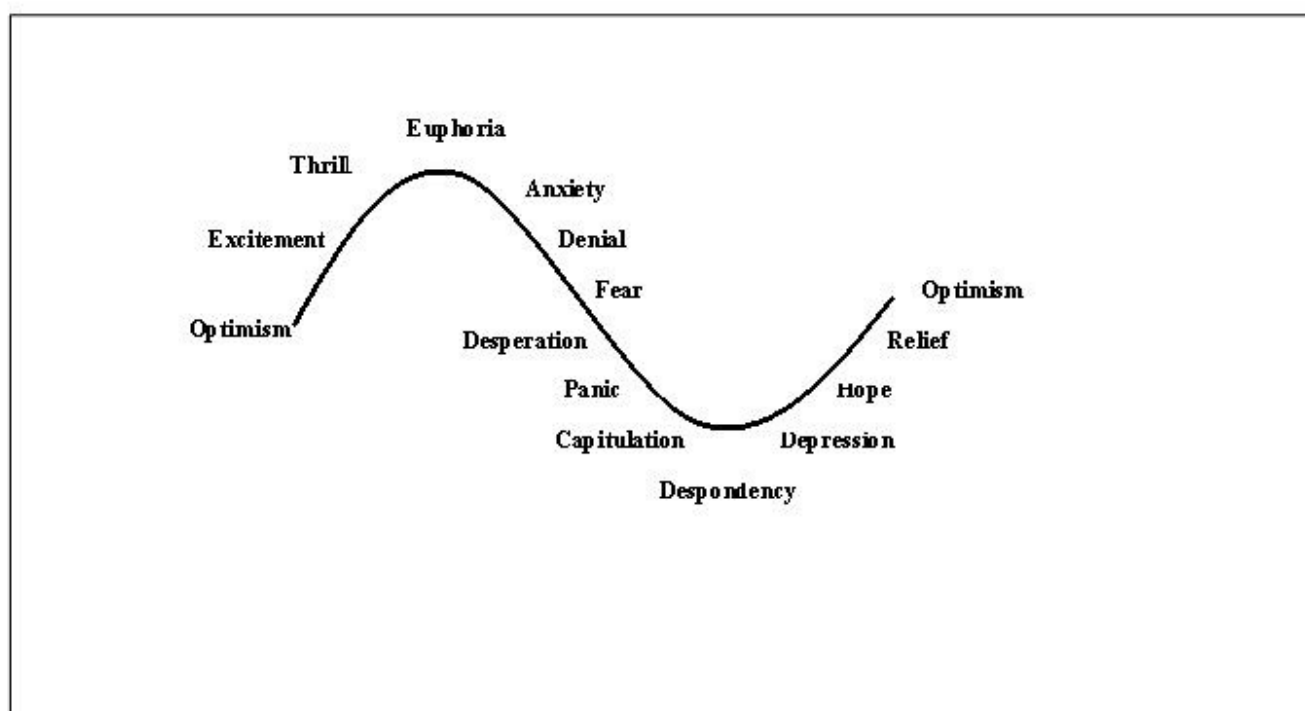
2) Stick to Quality

- Warren Buffet says that 'only when the tide goes out do you see who was swimming naked.' It's times of uncertainty that remind us that throughout all the ups and downs of the market, the best strategy is the simplest one... stick with large-cap, defensive, top-quality names with strong balance sheets. These types of companies can weather periods of market turmoil and usually come out the other end better positioned to capitalize during the inevitable recovery that follows. Furthermore, the dividends paid by solid businesses are as important as ever before. I've been preaching (for years now – to anyone that will listen) that high quality yield is prudent, and with interest rates as low as they currently are, the dividend theme continues to be extremely attractive.

3) Stick to a Disciplined Investment Process

- Separating emotions from logical portfolio theory is the most difficult part of investing. We must remind ourselves that no one is right all the time, but you can be right more than you're wrong if you use a time-tested, disciplined, investment process. And you must do this not just when markets are strong, but also when it's emotionally difficult to do it (aka during bear markets)! This provides you with the greatest chance of long-term success, and therefore the greatest chance of long-term positive performance. Please have a look at the following chart – it's one of the simplest, yet most useful and important charts in the investment world...

Market Emotions Chart



Although I don't ever profess to be a market timer, I do deal with Client's emotions on a daily basis. If you go back and re-read my previous comments from '08 and early '09, I made some general estimations on where we were at with respect to the market cycles emotions chart at those times, and with the benefit of hindsight I can now say that I wasn't too far off. If you asked me today where I thought we are my answer would be somewhat unconventional: I have yet to come across anyone who has experienced the thrill and euphoria that typically comes with a major market top in recent times, so instead I would guess that we've actually slipped backwards from hope, relief, and maybe even optimism back towards depression. If that's the case, then some solid footing is all we need to resume the uptrend. Time will tell.

4) Be Properly Diversified

- But not over diversified. There is a difference between having dozens of different mutual funds with thousands of underlying individual positions, and having a properly diversified portfolio focused on industry leading companies within a number of different sectors. The former is NOT proper diversification, the latter IS.

5) Concentrate on Your Financial Goals

- Remember that your personal goals and your comfort with volatility should dictate the composition of your portfolio – what the markets are doing should, for all intents and purposes, be irrelevant. If your personal goals on March 7th, 2011 (when the TSX traded at a post financial crisis high of 14,329) were the same as they are today, then your portfolio discipline shouldn't have changed either! I do, however, encourage you to take this opportunity to review your financial picture. RBC Dominion Securities offers the best wealth management resources in the country and I would be happy to help you in areas such as Business Succession Planning, Will & Estate Consulting, Insurance Solutions, and Comprehensive Financial Planning.

- With most of you, we've covered off the above "5 Elements of Wealth Management". For those that haven't, or for those whose personal circumstances have changed, please give me a call.

In Closing, I'd like to leave with some of my favourite Warren Buffet quotes:

- Only when you combine sound intellect with emotional discipline, will you get rational behaviour.
- Price is what you pay, value is what you get.
- I never attempt to make money on the stock market. I buy stocks on the assumption that they could close the market the next day and not reopen it again for five years.
- Great investment opportunities come around when excellent companies are surrounded by unusual circumstances that cause the stock to be misappraised.
- The most important quality for an investor is temperament, not intellect. You need a temperament that neither derives great pleasure from being with the crowd or against the crowd.
- I have no idea on timing. It's far easier to tell what will happen than when it will happen.
- In the short term, the market is a popularity contest...in the long term it is a weighing machine.
- Wild swings in share prices have more to do with the lemming-like behaviour of institutional investors than with the aggregate returns of the companies they own.
- The future is never clear, and you pay a very high price in the stock market for a cheery consensus. Uncertainty is the friend of the buyer of long term values.



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