

## Easy Money, Hard Times

Our panel of experts offers some ideas about how best to allocate your investments

BY PAUL DELEAN JANUARY 2, 2009



Quebec investment professionals (left to right) Jeff Tory, Bill Kovalchuk and Hugues Dubeau discuss the year that was in business and what lies ahead.

**Photograph by :** MARCOS TOWNSEND THE GAZETTE

Equity markets slammed into reverse in 2008 as credit crises erupted around the world, rattling the nest eggs of small investors and huge pension funds alike. To put the year in perspective, and discuss prospects for 2009, Gazette reporter Paul Delean met recently with investment professionals Bill Kovalchuk of Claret Asset Management, Jeff Tory of Pembroke Management Ltd. and Hugues Dubeau of Dubeau Capital. Here's an edited transcript of their discussion.

Gazette: "We have almost made it through what will go down as one of the worst years ever for stock-market investors around the globe. How foreseeable was any of this?"

Tory: "There certainly was a pocket of investment thinkers who were very alarmed about what they perceived as the deterioration of credit quality in the credit markets, but I don't think anybody had built this credit crisis into their models. Looking back, we didn't realize the degree to which the system was geared to availability of credit. The rapidity of the decline has been very surprising. One example was the resource sector in Canada. It was so incredibly virtuous six or seven months ago and now it's basically become a highly challenged investment sector. People should have been cautious. Some of

the red flags were there. Looking at the price chart for commodities, that had mania written all over it. In our business, our job isn't to get out, it's to pull back, reallocate and rebalance. That's where a lot of people fail in bull markets. They don't rebalance."

Dubeau: "There was talk for many, many years about household debt, especially in the U.S. We heard it a lot. Debt is a necessary ingredient in the economy, especially for durable goods, and obviously housing and cars, but it went out of line. There was too much of it available. There has to be some sort of mechanism, or discipline, by institutions, to curtail credit."

Tory: "Over the last two or three generations, there's been a complete shift in how people view debt. Our parents financed when they had to. What happened in America, and to a lesser degree in Canada, is that credit was fuelling everything, and it was no longer borrow and pay back, borrow and pay back. The borrowing was ongoing. One thing I missed was how many industries depended upon, and were boosted by, unlimited access to probably unrealistic credit levels. I think part of what you'll see is a return now to old-fashioned saving and investing."

Dubeau: "Away from all these structured products, which I always disliked. The more layers you have, the more potential danger you're in."

Kovalchuk: "I don't think anyone foresaw the extent to which the credit crisis was going to impact the markets. Availability of credit to the wrong people became the issue. Boards of directors weren't doing their jobs, either, in remunerating people properly. If you pay somebody to be a cowboy, you're going to get a cowboy. There was a lack of governance and oversight."

Dubeau: "It comes back to confidence ... in a financial manager, a bank, a system. Confidence is extremely important in this, for all the participants."

Gazette: "What do you see ahead next year? All we've been hearing about is government deficits, bailouts and massive infrastructure spending."

Kovalchuk: "2008 is the year when you had a stock-market crash, 2009 is the year when you'll have an economic crash, which is a very different animal. The stock market being a leading indicator tells you a bit of what will happen in 2009. The unemployment rate in Canada and the U.S. is between 6 and 7 per cent. To have it go back to 11 per cent, as it was in 1981-82, might not be unreasonable, and that would be quite an economic downturn. There'll be a large decline in consumption. Prices in the market already reflect that."

Gazette: "So who takes us out of this?"

Kovalchuk: "It starts with government deficit-financing, infrastructure projects, then corporate takes over, and I think you'll see the consumer come in maybe 18 months out. Consumers are repairing

themselves now, and more importantly, the banks are repairing themselves now. Then they can go back to lending."

Dubeau: "I'm not pessimistic. It's obvious the economy will slow down for sure next year. I'm building a cottage and I asked my builder, a big operator in Quebec, 'how's business?' He said we're busy as hell until next summer, but the phone has stopped ringing for new orders. This is an indicator, I think, of the kind of slowdown we'll see next year. But a good chunk of that is showing in the market already. After a 40-per-cent drop, more or less, we've probably seen the bottom, although we've still got to get through January, with the new earnings, big layoffs, and a new president."

Tory: "I think the jobless numbers will get worse. People don't fire people before Christmas."

Kovalchuk: "I'm of the view we're 75 per cent to 85 per cent of the way down. The bottoming-out process probably will continue for another six to nine months, then you'll be off to races. Markets will be going up even with unemployment rising and negative earnings, because it's a leading indicator. It'll be turning around while you still have an economic crisis going on. But you've still got the automakers issue to settle. Do you bail them out or not? I'd prefer to see them have the outcome of a bankruptcy without having to go through the actual bankruptcy. The risk there is to the suppliers. They've been squeezed for years, and they're efficient and lean. Now it's time to restructure the main companies, GM, Ford and Chrysler. It's completely a cost issue. Honda and Toyota have very efficient plants in the U.S., working smoothly, making cars desirable to consumers, at half the wages."

Dubeau: "The only way to get rid of these (labour) contracts is bankruptcy."

Kovalchuk: "Either you go through the bankruptcy, or you negotiate new terms. Air Canada went bankrupt, wiping out shareholders and most bondholders, and kept flying the whole period."

Tory: "We're not really market prognosticators. All I know is that (stock) valuations now are unbelievable. Earnings are uncertain, of course, but you're protected at many levels by the valuations."

Kovalchuk: "There are companies trading at cash levels, or close to it, so the business is free. I find comfort in that. If you think this will be over in three or four years, what level will they be at? They won't be at this level. They'll be higher than the current nine or 10 times earnings on the indexes."

Tory: "One of the amazing things, if you look at America historically, is that they do somehow tend to deal with their problems, clear things out, and then the system starts anew."

Kovalchuk: "That's why it's different from Japan, which took 17 years for the economy to come back."

Gazette: "For many Canadian investors, the biggest plus this year was having U.S. investments, because of the turnaround in the U.S. dollar. What do you anticipate for the U.S. dollar in 2009?"

Tory: "The unexpected rise in the U.S. dollar vs. the Canadian dollar was a bit of a dividend for being diversified. The dollar rising is a reminder that, in a crisis, logic doesn't always prevail. If you'd interviewed people last year, they would have said the U.S. dollar was going down the drain. Once the panic subsides, I don't see it staying high. But we need a dollar in the range of 85 cents (U.S.) for our manufacturers."

Kovalchuk: "The U.S. dollar right now, because there's a crisis, has safe-haven status. It's a reserve currency. The U.S. at least will protect your capital, unlike the Kremlin, which will take it. So that's the place you run. Once you get over this crisis, and people feel more comfortable, I think the U.S. dollar will devalue. People will wake up to the debt issues and all the deficits they're running. I think that'll be beneficial for the Canadian dollar."

Dubeau: "I can't put a number on it, but I think it'll be higher (the Canadian dollar)."

Gazette: "What are the market sectors you expect to perform best in the coming year?"

Dubeau: "Our best bet next year will be not equity, but corporate bonds. That's where there's a lot of value right now. If you do your homework, are comfortable the business and believe they'll be there to honour their debts, there are good pickings there. Among stocks, I'd say to focus on the leaders in whatever industry you're looking at."

Kovalchuk: "We like companies with low debt levels. I have an allergy to debt. I don't need companies that have huge debt they'll have to refinance in the next three years."

Tory: "Clearly, companies that can grow through this strategically, taking market share from competitors, raising their dividends, irrespective of industry, will be rewarded. There'll be major opportunity in companies where there is leverage and sustainability of the business. They can't be overly defensive, though, in a financial sense. If you're in a position to grow and access capital markets, there's amazing strategic opportunities."

Gazette: "A lot of investors stuck with buy-and-hold through the downturn and got killed. Is that still a valid approach?"

Tory: "Stocks are down globally, so even the most conservative equity investors have been hurt, but I do believe it was asset mix that killed a lot of people. They were probably overexposed to resources, like they were overexposed to tech in 2001. They had a six-year run in the Canadian stock market and hadn't rebalanced. But now is not the time to give up on stocks. The smart pension fund would be reallocating to stocks now. This is a great moment to do the cleanup, re-evaluate your managers and what you own, and ask for accountability from your investment adviser. Have explained to you what you own and why you own it. If you have comfort what you own is of quality, the normal path out from here should be quite positive over a multi-year period. T-bills and cash could be the worst asset over

the next five years."

Kovalchuk: 'Especially if there's significant inflation coming along. If you believe there's an equity premium, you should make it up over the next five to seven years.'

Dubeau: "But you need guts to buy in these times.'

Gazette: "What are some of the stocks you find attractive now?"

Dubeau: "One I've always liked is Bombardier, in the theme of infrastructure, leadership. Obviously, there's some risk in the business jet part of the business, but it's an interesting play. Financially, they've made a lot of progress in the last few years. TMX Group is another. It's a nice toll booth, especially if you believe the Canadian market will eventually come back. Volumes have been quite good even in these difficult times. It's highly profitable, the whole options/derivatives side is very interesting, and there's a nice big dividend. BCE is another I like. We got out at \$40 in 2007 and now we're getting back in. They've got some work cut out for them, but financially, I think they're fine. Canadian insurance companies also are poised to go if Canadian markets move up. We have some worldwide leaders in Canada - Manulife and Sun Life are obvious ones."

Kovalchuk: On the large-cap side, Johnson & Johnson and Wal-Mart are easy choices. No matter what happens, people still will be buying Band-Aids and going to Wal-Mart. Super-cheap these days is Dorel (Industries), currently trading at four times earnings. It has very manageable debt levels. Parkland (Income Fund) pays out a huge, predictable distribution. Paladin Labs is a good local story, very well managed, lots of cash, just put together a fabulous quarter, and were not affected in this downturn."

Tory: "One I've been close to a long time, and in this stock storm got very cheap, is Cogeco Inc., a family-controlled holding company. For whatever reason, a large discount has appeared in Cogeco Inc., the parent of Cogeco Cable. It's very conservatively financed and has been doing strategic things to keep growing. The results in the past three years have been spectacular. You get almost one whole Cogeco Cable share for free in Cogeco Inc. Another one we're quite excited about is Atrium Innovations, which is in the health supplement/nutraceutical business. It made a big acquisition last year. The stock is in single-digit P/Es. Income trusts also are getting interesting. The looming conversion has caused investors to back away from the sector, creating a disconnect between valuations of some of these interesting business trusts, which are really small-cap stocks. It's been a very maligned sector and I haven't been a big fan, historically, but within the universe, there are six, eight or 10 of them that are really nice businesses, and some now have yields as high as 20 per cent. Valuations have morphed into the absurd."

Gazette: "As professional money managers, what single lesson, if any, have the events of the past year brought home or reinforced?"

Dubeau: "We always stayed away from leverage, and that served us well. On the investment side and in your personal life, I'd recommend staying away, as much as possible, from leverage and debt. If you need money for a trip, or a house, don't have it in the market. Put money aside."

Kovalchuk: "It's helped confirm my allergy to debt, and my like of cash flow. The concept of diversification in globalized markets is also somewhat fictitious. There's a lot of interconnection. As more parts become interrelated, volatility goes up. The concept of diversification isn't what it was once."

Tory: "We also learned a lot of these new-age investment strategies were driven by easy access to money. At the end of the day, the real truth in investing is buying things well, and backing good people who earn a return on capital and grind it out over a long period of time. You get rich slowly, not quickly. For me, the eye-opener was recently going through the Forbes 400, which is the 400 richest families in America. Guess what? Most of really rich people are old. Why? Because it takes a long time to get rich. It's compounding over a long period of time. To me, it reinforced what investing is really all about."

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