CUMBERLAND

Strategy Review
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The Trend is Your Friend...But for How Much Longer?

Equity markets picked up where they left off in December as major averages continued to power higher through the month of January. The S&P 500 climbed 2.3% in U.S. dollar terms last month and is up about 20% since January of 2010. The Canadian equity market had a more modest start to 2011, climbing "just" 0.8%, although the TSX is now up over 22% from last year. Gold certainly didn't help the Canadian equity market as the price of bullion slid by just over 6% to US$1,333 per ounce on the back of a stronger U.S. dollar, and a fledgling view that stronger U.S. growth could mean less quantitative easing from the Federal Reserve (possible, but in our view not likely). The Canadian dollar fell slightly against the Greenback, dropping 0.3% last month, but continues to be among the very best performing global currencies relative to the U.S. dollar. The price of oil remained relatively flat, holding above the US$90 level on concerns recent tensions in Egypt could prove destabilizing in the Middle East and threaten the supply of oil out of the region.

Treasury yields have continued to move higher as the 10 year U.S Treasury has climbed all the way back from 2.4% in August to about 3.6% as of this writing, and it is now within striking distance of the recovery high (around 4%) established just before the Euro crisis erupted last May. Credit spreads have remained relatively flat on investment grade bonds, but have continued to tighten on high yield bonds as the improving economic outlook lessens perceived credit risk. Generally, recent trends have continued to hold: equities and bond yields move higher, while gold and government bond prices move lower.

We spent the better part of last summer arguing that both bond and equity markets were discounting far too pessimistic of a view on future growth for the U.S. economy. In our view, equity markets offered a much more compelling trade-off for risk relative to reward than was available in the bond market. Clearly, results since August have shown that to be the right call. North American equity markets have gone on a tear for the past 6 months, while government bond yields have moved sharply higher. As a result, our clients' capital appreciation portfolios have benefited from both a large equity allocation and successful stock selection while our income accounts were well prepared for higher government bond yields by being diversified into higher yielding securities and holding selected floating rate notes.

So why do we feel so uncomfortable now that equity markets are moving higher week after week? Shouldn't we feel vindicated now that popular opinion seems to have switched so quickly to discounting good times ahead for U.S. economic growth? After all, markets don't react to some sort of gravitational pull, counterbalancing upward moves with some unseen downward force. Why not just sit back and enjoy the ride?

Believe me, it is tempting to sit back and further enjoy the strong upward move in our clients' portfolio values. However, decades of managing risk and opportunity through many cycles has taught our firm a few things about getting complacent in the investment game. Just check out the definition of the word:

Com-pla-cen-cy: noun. A feeling of quiet pleasure or security, often while unaware of some potential danger, defect, or the like;

If there is one thing we strive to understand on a daily basis, it is potential risks embedded in our asset allocation, security selection or in the consensus view. Fundamental to our investment philosophy is that we must believe the reward

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offered by an investment opportunity far outweighs the risks we are taking. The way we see things at the moment, if anything feels complacent it is this market. The S&P 500 has climbed almost 30% since last August with barely any pullback along the way. Since the start of December, the S&P is up 13% which annualizes,as we write this letter, to a return of over 60%. Perhaps even more worrisome is that the market has traded higher on 70% of the trading days over that span. Equity markets also appear to have stopped paying attention to Europe, where credit default protection for peripheral countries are still at crisis levels and, as we highlighted last month, serious refinancing for the largest of these countries (Spain) is required by this spring.

Finally, although we still feel equities offer better risk/reward relative to bonds at current levels, the gap between the two has closed considerably over the past few months. As noted earlier, the 10 year Treasury now yields 3.6%, not 2.4%. The S&P 500 now has a forward earnings yield of 7% not 8.5% and the dividend yield has fallen below 2%. Our response has been to stick with our plan: gradually lower our target allocation to equities and gradually transition to more defensive names within our client portfolios. The trend has been our friend so far, but we know markets are never our BFF (that's Best Friend Forever for those of you who don't text). Should events unfold over the next few months in a manner which makes our fears appear unfounded, we would be more than happy to reverse course and increase our exposure to equities once again.

John Wilson
Chief Investment Officer
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