

The investment chase: Where all the smart money is going

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Just about anybody who invested in real estate, stocks or bonds over the past five years has done exceptionally well – and that's a problem.

A half decade of impressive gains in every major asset class has created a landscape in which next to nothing looks cheap. Unlike previous booms, this outburst of exuberance hasn't focused on a particular industry or a specific region. It's a worldwide, all-encompassing buying binge that has driven up the prices for nearly anything that might interest a potential investor.

On Vancouver's west side, the epicentre of the Canadian real estate frenzy, the average price for a detached home has surged to an unprecedented $2.3-million. On Wall Street, the S&P 500 benchmark for U.S. stocks has smashed through one record after another this year, and advanced to yet another fresh high this week.

In the fixed-income market, bond prices have soared as investors display a touching eagerness to ante up their cash for next to no return – a trend highlighted by Apple Inc.'s €2.8-billion ($3.9-billion) bond offering this week, which offered some of the lowest yields on record for corporate debt. (A paltry 1.082 per cent for eight years, for those keeping score at home.) Even such non-mainstream investments as art and Canadian farmland have seen prices jump in recent years.

Today's situation amounts to a near total inversion of the markets of a generation ago. "If you look back to, say, 1981, stocks, bonds and real estate were all cheap," says Jim Giles, chief investment officer at Foresters, a Toronto-based financial services provider with more than $20-billion in assets under management. "Now, the exact opposite is true."

For investors, this poses a daunting challenge: What do you buy when there's nothing left to buy – or at least nothing that appears to be a bargain?

The answer hinges on your outlook for interest rates, the key driver in this global boom. Some money managers believe that rates will remain modest and we're only midway through an epic bull market; others see ample reason to be highly cautious. The common thread is the belief that tomorrow's gains are likelier to be spottier and more treacherous than the broad surge of the past five years, when an

investor could have thrown his or her money into just about any investable asset with outstanding results.

From 2009 until now, the Toronto Stock Exchange's S&P/TSX index produced a total return of 49.8 per cent. The S&P 500 index rewarded Canadian investors with an even more impressive 120-per-cent return during the same period.

Meanwhile, despite a near blow-up of the euro zone, European blue chips chugged ahead, producing a 22.6-per-cent return since 2009. Even Japanese stocks, the sad sacks of the investing world for decades, performed superbly, churning out a 54.8-per-cent return.

Supersafe government bonds crowded into the winners' circle, too, with the Bloomberg Canadian Sovereign Index gaining 22.6 per cent over the past five years. And, of course, Canadian real estate continued to burst past all historical markers, with the MLS Home Price Index advancing nearly 24 per cent since 2009, continuing a decade-long run that has propelled prices in cities such as Vancouver and Toronto to Everest-like highs.

There's no great mystery as to what has fuelled the "everything boom," as The New York Times termed it earlier this year. It's the direct result of central bank policies in the wake of the financial crisis that dragged key interest rates down to near zero as a way of providing stimulus to the battered global economy.

"That resulted in an amazing reflation of asset prices," says Jim Harrison of K.J. Harrison & Partners Co., a money manager in Toronto that serves high-net-worth individuals. "Clearly the agenda of the Federal Reserve was to drive down interest rates and force investors out the risk curve" into assets like stocks and real estate.

The question now is what will happen as the Fed backs off its more exotic easy-money policies, such as quantitative easing, and begins the long process of returning interest rates to more normal levels. Mr. Harrison sees the market's recent dip as a harbinger of the turbulence that is to come, as prices for stocks and bonds come to grips with the risk that accompanies a move back to more conventional interest rates.

He thinks stocks may produce 4- to 6-per-cent annual returns over the next few years, substantially less than they have in the recent past. As a result, he's growing increasingly selective about potential investments and is not afraid to hold cash while he awaits outstanding opportunities – which he believes now may be emerging in the Canadian oil patch. Rather than just throwing money into the market, "in this environment, you have to invest by exception," he said in an interview.

Tim McElvaine, one of Canada's best-known value investors, has a similar viewpoint. The head of McElvaine Investment Management Ltd. in Victoria is holding about 25 per cent of his fund's assets in cash, considerably higher than the normal level, as he awaits buying opportunities.

"People will tell you they don't want to hold cash because it doesn't yield anything," he said in an interview. "But the real value of cash is its ability to buy

things when prices become attractive."

Among the reasons to worry about today's market is that near-zero interest rates have failed to spark any widespread global recovery. The Organization for Economic Co-operation and Development trimmed its global growth forecast this week to 3.3 per cent for this year, reflecting the euro zone's continuing woes and a slowing Chinese economy.

Rather than galvanizing the world's real economy, cheap money has had its greatest impact in financial markets. Bond prices, which move in the opposite direction to rates, have soared. Thanks to cheap debt, companies can borrow more money to buy back stock and boost their share prices.

By at least one important measure, U.S. stocks are well into frothy territory. The cyclically adjusted price-to-earnings ratio, or CAPE, compares the prices of shares to their past decade of real earnings. It shows that U.S. stocks are trading at about 25 times those past earnings, far above their 16.5 historical average. The implication is that stocks would have to tumble by roughly a third to return to more conventional valuations.

GMO, a Boston-based money manager with a strong track record of predicting market returns, is one of the most outspoken skeptics about today's market. It predicts that U.S. large-capitalization stocks will lose an average of 1.5 per cent a year after inflation over the next seven years.

Its outlook for international large-cap stocks is only slightly more positive: It foresees them gaining a mere 0.8 per cent a year after inflation between now and 2021. Bonds, meanwhile, are forecast to lose about 0.2 per cent a year in real terms.

But not everyone is so pessimistic, especially about the next year or two. Richard Bernstein of Richard Bernstein Advisors in New York isn't afraid to say that he thinks "we could be in one of the biggest bull markets of our career."

The long-time Wall Street strategist believes U.S. stocks are still in the middle of the investing cycle and have room to rise as the U.S. recovery gathers strength. He's particularly enthusiastic about small U.S. manufacturers and other companies that can cash in on an improving outlook for the American economy, where unemployment this week hit its lowest level since 2008.

The Fed will raise interest rates only if the nominal economy – that is, the sum of both real growth and inflation – is expanding, he said in an interview. Since such an increase in the nominal economy would also be good for corporate profits, and hence share prices, he sees little reason to worry about the impact of higher rates.

While he acknowledges worries about emerging markets and other areas, he predicts stronger-than-average returns for U.S. stocks over the next three to five years. And as for that troubling CAPE ratio? "If you adjust it for interest rates, you conclude that stocks are fairly priced right now," he said.

Mr. Bernstein and other bulls argue that any investment has to be weighed against the potential alternatives. Professional investors price stocks on the basis of their ability to generate a premium to the risk-free rates provided by government bonds.

So long as bond yields and interest rates remain near generational lows, stocks – even at elevated prices – remain the only game in town for those seeking better-than-dismal returns.

It's not a sure bet that rates will climb back to anywhere near their historical norms, says Mr. Giles of Foresters. He points to the greying population of much of the developed world, as well as still high debt levels, as reasons to think that economic growth may well be modest in coming years.

That suggests there will be little upward pressure on borrowing costs. "If interest rates remain as low as they are now, stock returns may not have to be as high as they have traditionally been to attract investors," he said in an interview.

David Rosenberg, chief economist and strategist at Gluskin Sheff + Associates in Toronto, notes that the Fed might not raise rates until 2016. If so, stocks are likely to continue their run until at least then.

"You can't look at valuations in a vacuum," he said in an interview. "You have to look at them in the context of where the risk-free rate is. So that means an expensive market probably gets more expensive."

With files from reporter David Berman.



An oil pump jack outside of Calgary. TODD KOROL/REUTERS

THE ENERGY SECTOR

Garey Aitken, chief investment officer and portfolio manager at Franklin Bissett Investment Management

Mr. Aitken sees an abundance of investing opportunities in Canada, thanks to low interest rates, a falling Canadian dollar and a domestic economy that's in decent shape.

But the sector that has him jumping for joy? Canadian energy stocks.

Sure, they have been hit hard in recent months as the price of crude oil fell about 25 per cent, sliding below $80 (U.S.) in November. Investors have grown concerned about a rising global supply, weaker demand and a potential price war being waged by Saudi Arabia.

“It doesn’t faze us,” Mr. Aitken said. “In fact, I’m much more excited about the energy sector now than I was in June, when oil traded for more than $100 a barrel.”

He’s not betting on a resurgent oil price – forecasting where commodities are going is a tough business, he said – but rather that the negative shock from cheaper oil is more than reflected in tumbling stock prices.

Energy stocks within the S&P/TSX composite index have racked up losses totalling 17 per cent since the start of September, in a virtual freefall.

However, the decline looks too harsh when you factor in the lower Canadian dollar relative to the U.S. dollar, which makes Canadian energy firms more competitive.

What’s more, volatile oil prices can make lower-cost producers with strong balance sheets stand out among their peers. They are better able to withstand downturns and even expand their operations, positioning them for better days ahead.

Although Mr. Aitken can’t comment on stocks he has been snapping up for his fund, he noted that Canadian Natural Resources Ltd. is the sector’s bellwether name, able to survive on the way down and thrive on the way up.

But buying opportunities can be found among smaller players, too, such as energy services firms, exploration and production companies and even independent natural gas firms such as Keyera Corp.

In a world where just about everything has been enjoying a remarkable run, Canadian energy stocks stand out as potential bargains. ***David Berman***



A welder for custom manufacturer Fox Co. Inc. in Philadelphia. MATT ROURKE/AP

INDUSTRIALS

Richard Bernstein, Richard Bernstein Advisors LLC

Markets? Mr. Bernstein has seen a few – and the 30-year veteran of Wall Street exudes enthusiasm as he discusses today's outlook for U.S. stocks.

"We think we're in mid-cycle now and equities are fairly valued," the New York-based strategist says. Late in the cycle, people lose perspective and want equities at just about any price – but we're not there yet, he adds.

As Mr. Bernstein awaits that happy moment, he is recommending a higher-than-average tilt toward stocks, especially small and mid-sized U.S. industrial companies that will benefit from the American economic recovery. The former chief investment strategist at Merrill Lynch sees "higher-than-average" returns ahead for U.S. stocks, which suggests annual gains in excess of 8 per cent a year.

He's much more cautious when looking around the globe. Emerging markets, for instance, are poised to disappoint, he says. As the prime beneficiaries of the "global credit bubble" that central banks inflated in the wake of the financial crisis, countries like Brazil, Russia, India and China have the most to lose from any gradual tightening in interest rates.

In Europe, he recommends that investors focus on "very defensive" exporters, such as makers of consumer products, that can do well despite the euro zone's continuing woes. In Japan, he likes large exporters that can tap into markets outside Asia and benefit both from the U.S. recovery and the deep depreciation of the yen he sees ahead.

Mr. Bernstein disagrees strongly with those who think that the ultra-low interest rates of the past few years have merely benefited financial assets. He argues that they have also helped spur activity in areas such as oil fracking and laid the foundation for more robust growth in North America.

While he won't name individual stocks, he mentions that one area to avoid is gold. He notes that the time to buy precious metals is when currency is depreciating and inflationary expectations are growing. Precisely the opposite is true in the U.S. right now, he says.

The recent tumble in oil prices, and Saudi Arabia's fight to maintain market share, is ultimately a deflationary phenomenon, he argues, and therefore an added negative for gold. "We've been saying for a while that gold is going below $1,000 (U.S.) an ounce and we're sticking to that call." I***an McGugan***



A Bank of America branch in New York's Times Square. CRAIG RUTTLE/AP

U.S. BANKS

Jim Harrison, K.J. Harrison & Partners Inc.

Mr. Harrison believes managing volatility can be just as important as managing returns. The chief executive officer of K.J. Harrison & Partners Inc., a discretionary money manager in Toronto that oversees about $900-million for wealthy individuals and families, likes to remember the marching orders he received decades ago from a client: "Be just as careful with my money as I would be if I knew what I was doing."

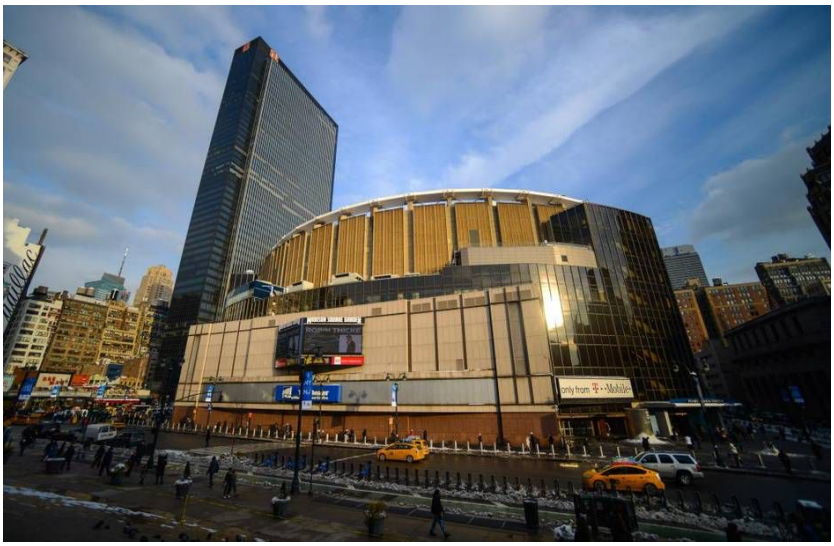
For Mr. Harrison, now is not a time to be taking unusual risk. With both bonds and stocks looking expensive, he believes investors should have the courage to hold more cash than usual and wait for the opportunity to buy market-leading companies at historically cheap prices.

The market serves up such opportunities on a regular basis, he notes. Right now, for instance, he's upbeat about the potential of large U.S. banks. The sector is increasingly dominated by five large players and some are exceptionally cheap. Bank of America Corp. and Citigroup Inc., for instance, both sell for less than book value.

Another area he's intrigued by is the Canadian oil patch. Until recently, his company's energy fund had more than half its assets in cash, awaiting a chance to buy at the right price. Those opportunities are finally emerging in the wake of the recent selloff. "The [Canadian energy] sector has been effectively de-risked," he says, and his firm recently bought a position in Suncor Energy Inc. after the stock tumbled from $46 to $36.

Investors will need a selective eye to navigate the economy's grinding, painful readjustment to more normal levels of interest rates, he says. He acknowledges the possibility of serious disruption if monetary policy ultimately proves ineffective at reviving the real economy. But even in the more likely event of a global recovery, he believes that wise investors should be wary, patient and willing to hold cash.

Many people hate holding cash because of today's low yields, but that's the wrong way to view the situation, he says. "The value of cash has nothing to do with what you earn on it. Its value lies in your ability to transform it into stocks or other securities at some point in the future when prices are better than they are right now." ***Ian McGugan***



Madison Square Garden in New York. RON ANTONELLI/BLOOMBERG

THE U.S. ECONOMY

David Rosenberg, chief economist and strategist

at Gluskin Sheff + Associates

You can hunt for bargains among beaten-up, out-of-favour sectors, but the best investment opportunities can be found within one winner: the U.S. economy.

David Rosenberg, chief economist and strategist at Gluskin Sheff + Associates, believes the U.S. economy will continue to lead the world, helped by low interest rates, falling borrowing costs, lower energy prices and a resurgent housing market – and that translates into a bullish bet on the U.S. consumer.

"The broad theme is tapping into the part of the world where domestic demand growth is positive and firm, and that happens to be in the United States," he said, adding that lower gas prices alone should pad consumers' pockets by about $50-billion (U.S.).

U.S. companies that get a significant chunk of their sales from domestic spending fit the theme. But there are other opportunities here, too. For example, Canadian companies exporting to the United States will also benefit, and they get an additional boost from the weaker Canadian dollar.

"They can range from transportation companies, to auto parts, to forest products and even to banks that have a strong presence south of the border," Mr. Rosenberg said.

His colleague Peter Mann, a portfolio manager at Gluskin Sheff, mentioned a couple

of U.S. stocks that fit the theme particularly well.

Delta Air Lines Inc. has retired $10-billion worth of debt over the past five years and is generating plenty of free cash flow, buying back shares and paying a dividend. Even though the stock has risen more than 50 per cent this year, it trades at just 13-times trailing earnings. “We still think people look at the airlines and say, ‘that’s just a terrible business,’ ” Mr. Mann said. “But the business has changed a lot,” he added, pointing out that there are fewer players exerting more control over pricing.

Madison Square Garden Co. owns not only an iconic arena, the New York Knicks and the New York Rangers, but the crown jewel is the sports networks that televise the Knicks and Rangers games locally.

“We think the value of those networks alone is pretty much the market capitalization of the business – so you get the two sports teams for free,” Mr. Mann said. That’s a nice feature if the company divides itself into two parts, which Mr. Mann expects. ***David Berman***

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