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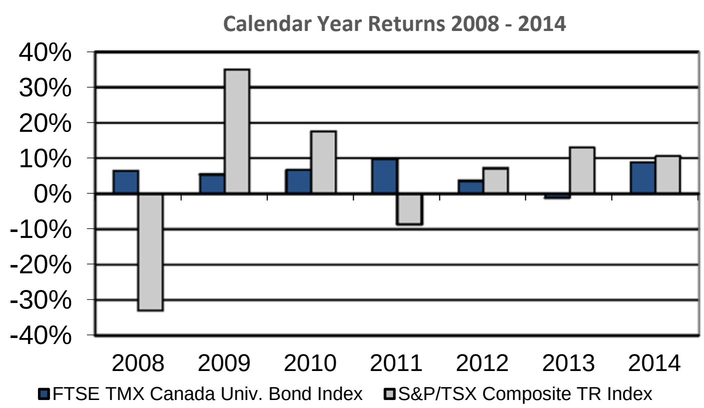
It is all relative

As noted in our QV Update on January 30th, we recently lowered our target equity commitment in our balanced strategy to 55%, and increased our allocation to cash and short-term bonds. With yields so low, one may ask why hold bonds?

The Government of Canada 10-year bond yield, adjusted for inflation, is now negative for the second time in three years. Inflation, a bond's worst enemy, erodes the purchasing power of a bond's future cash flows. With negative real rates, one could argue that bond investors are actually paying to assume risk, and must increasingly rely on price gains to offset these low yields.

Since February 28, 2009, the FTSE-TMX Bond Universe Index has gained 6.3% annually. Over the same time period, the S&P/TSX Composite Equity Index has gained 14.3% annually, more than double that of the bond index. We note this six year period as this week marked the 6th anniversary of the current equity bull market. This also covers a period of unprecedented central bank stimulus programmes, anchored by near zero per cent interest rate policies aimed at curbing deflation following the financial crisis in 2008.

Both bonds and equities have benefitted from this era of extraordinary monetary stimulus. Bond yields have been in a perpetual state of decline with nearly every central bank policy announcement. Equities, in contrast, offer an attractive relative earnings yield, and potential for dividend growth over the rate of inflation. However, as the annual performance chart below highlights, one must accept greater volatility to achieve these higher equity returns.



Following six years of double digit returns, the Canadian equity market trades at an earnings yield of 5.5%, or 18x earnings, versus a yield of 8.3% or 12x earnings in 2009. The US market shows a similar advance in multiples and decline in yields. Historically, long-term average earnings multiples are closer to 15 times. Earnings in the US have supported some of this multiple expansion, growing 11.5% annually. Canadian earnings growth has been more muted, given the fluctuations in commodity prices. The relative yield advantage, while still in equities favour, today carries more downside risk.

Our risk management process is the backbone of our investment strategy. Simply, it is how we manage the risk of permanent capital loss through our investment in the public markets. Our valuation analysis considers different economic cycles, historical valuation multiples, and conservative estimates for growth. When we must stretch growth estimates to justify valuations, when relative, not absolute, valuations become the case for holding a security, or when we must "accept" negative yields to meet benchmark returns, we know that we risk greater losses by not adhering to our risk management discipline.

The recently announced bond purchasing program in Europe, combined with the Bank of Canada's surprise rate cut, has the potential to fuel bond and equity gains even further. Chasing higher relative yields has worked for six years, why not more? Managing downside risks associated with the return to even average valuation multiples is why we have become more defensive. We expect our relative performance to lag the benchmarks if this market momentum continues unabated.

Our defensive strategy encompasses shorter maturities in our bond portfolios, thus mitigating negative price movements if bond yields do rise in anticipation of tighter monetary policy. It also encompasses higher than normal cash balances in our equity mandates, a function of the opportunity set when employing our stock selection process. We have been and will continue to slowly deploy our cash reserves when expected returns more than compensate us for the risk. Valuation, or the price we pay, is crucial to minimising this downside risk.