

Qwest for Returns

JANUARY, 2010

ISSUE 5

Cam Hui, CFA

Board of Advisors

Qwest Investment Management Corp.

cam@hbhinvestments.com

Expected return, growth, risk and asset class relationships, or correlations, changed massively in the wake of the Great Recession.

Investors now walk a tightrope between the prospect of inflation and deflation, with little middle ground in between.

Under these circumstances, we believe in using dynamic asset allocation techniques that capture and profit from that uncertainty and volatility, such as our Inflation-Deflation Timer model.

Wealth management in an Age of Uncertainty

Both 2008 and 2009 were a real wake up call for many investors and wealth management specialists. Many long cherished principles of Modern Portfolio Theory seemed to crumble under the stress of the Great Recession. Even leading finance academic and Nobel laureate Robert Merton quipped that "My portfolio is almost perfect. You just need to short it."

When balanced funds failed

The standard wisdom in wealth management is to build a well-diversified portfolio with components that had uncorrelated returns. If anything went wrong, then the diversifying effects of the different investments helped to cushion the blow.

This approach failed abysmally in the fall of 2008 and into 2009, as many balanced funds failed to cushion the blows of the bear market. It was not unusual to see diversified portfolios down 30% or more in 2008 before starting to recover in 2009. Despite the rally in 2009, most portfolios have not recovered their lost value.

What happened?

Simplistically speaking, everything changed in the wake of the Great Recession. Expected growth, return, risk and the asset class relationships, or correlations, shifted massively virtually overnight.

In the wake of the Great Recession, investors now walk a tightrope between the prospect of inflation and deflation, with little middle ground in between. Under these circumstances, we believe in using dynamic asset allocation techniques that capture and profit from that uncertainty and volatility, such as our Inflation-Deflation Timer model.



Investors need to navigate the differential growth and inflationary paths and cycles of the developed and emerging markets.

We suggest investors employ more dynamic to address the new investment environment.

Dynamic asset allocation, not Buy & Hold

When investors apply Modern Portfolio Theory to build a diversified portfolio, they typically allocate their stock holdings mainly to home country equities. If they want to diversify further, they may wander aboard into broad developed market stocks and maybe put a small portion into the emerging markets.

The Great Recession threw a giant monkey wrench into the risk and return characteristics of most asset classes as the growth potential of developed and emerging markets diverged. Developed world real growth potential appears to have slowed from about 3% to 2% for North America and from 2% to 1% for Western Europe. The developed economies are facing a period of slow growth and deflation, though there is a longer term threat of inflation because of all the government spending and money printing. By contrast, emerging market growth potential (and inflationary expectations) remains high.

The trouble is that emerging markets go through big boom-bust cycles. Nevertheless, emerging market economies remain on a long-term growth path compared to the developed markets.

Investors need to navigate the differential growth and inflationary paths and boom-bust cycles of the developed and emerging markets. Under these circumstances, a standard buy and hold balanced fund approach is likely to yield sub-optimal results. We suggest investors use more dynamic techniques, which is the approach taken in our Inflation-Deflation Timer model. We described our model approach in our November 2009 Qwest for Returns newsletter (see http://www.qwestfunds.com/publications/newsletters_pdf/newsletter_october_2009.pdf.)

Where was diversification when you needed it the most?

Conventional wisdom of portfolio construction says that you don't put all your eggs in one basket. Add some of asset B to a portfolio of A. If the returns of two are uncorrelated, then if the price of A falls, B won't go down with it. Voila diversification! You get both returns and stability at the same time and that's the basis of Modern Portfolio Theory in plain English.

That theory was used to sell many asset classes over the years. For example, foreign stocks were said to be diversifying to a portfolio of domestic stocks. Add some foreign stocks to a domestic stock portfolio and you get lower overall risk and higher expected return. The same argument was used for emerging markets, real estate, alternatives such as venture capital and hedge funds.

A funny thing happened along the way to constructing diversified portfolios. Diversification failed when investors needed it the most. While uncorrelated assets served to stabilize returns during normal times, during crisis episodes, all asset classes tended to go down together and asset class return correlations had a nasty habit of converging to 1 during those times.

Diversification failed when investors needed it the most.

During crisis episodes, all asset classes tended to go down together.

The risk and return characteristics of different asset classes have changed in the wake of the Great Recession.

A basket of developed market stocks no longer has the same long-term growth potential as its emerging market counterpart.

We may be seeing the start of an emerging markets bubble.

The weaknesses of Modern Portfolio Theory

The weakness in the theory behind portfolio diversification was that the relationship between the returns of asset classes was statistical and not causal. In other words, stock returns were *seen* to be relatively uncorrelated with bond returns but high stock returns *did not cause* low bond returns and vice versa.

Statistical relationships can break down – and they often have during crisis episodes. Moreover, the expected risk and return profiles of many asset classes changed in the post-Lehman crisis era.

Investors traditionally allocate funds to equities for their characteristics of growth, partial inflation protection and higher return potential. Most of that allocation went into domestic stocks, a little into international stocks and perhaps a miniscule amount into the emerging markets.

The problem was that the growth potential of developed markets relative to emerging markets changed subtly as well. As the Great Recession took its toll, the economic growth potential of the developed markets was hobbled by debt overhang and excess capacity, which cause deflation. The policy response of fiscal and monetary stimulus also served to heighten long-term inflation risks.

By contrast, the emerging markets economies had largely learned its lesson during the Russian and Asian crisis of the 1990's. Their positions were much better relative to the developed economies and they came out of the Great Recession in much better shape. As a result, emerging markets have become the premier source of growth in the global economy.

As a result of these changes, a basket of developed market stocks no longer has the same long-term growth potential relative to its emerging market counterpart. The market has recognized these changes and re-priced these asset classes accordingly.

An emerging market bubble?

We may be seeing the start an emerging market bubble. Even legendary investor Jeremy Grantham, who serves as Chairman of Grantham, Mayo Van Otterloo (GMO), a firm with US\$86 billion in AUM, believes that there is an emerging markets bubble building. In the latest GMO quarterly letter, he wrote:

I believe we are well on the way to my “emerging bubble” described 18 months ago (1Q 2008 Quarterly Letter). I would recommend to institutional investors, including my colleagues, to give emerging equities the benefit of value doubts when you can. For once in my miserable life, I would like to participate in a bubble if only for a little piece of it instead of getting out two years too soon.

One of the challenges of emerging market investing is the lack of governmental, legal and regulatory framework that upholds property rights, as well as the low degree of openness in market structure. Consider the following exchange of an analyst with a CFO of a large Chinese construction equipment manufacturer:

Analyst: You and your competitors have very high margins, some are even higher than Caterpillar (NYSE: CAT) which is the global leader. Is there any risk that as you all add capacity those margins decline?

Chinese CFO (through translator): Uh so he says that there is no risk of a pricing war.

Analyst: Ok can you tell me why that is?

Chinese CFO: Uh so he says China has 5 main wheel loader companies. And all are good companies and will not start a price war. Also he says the 5 CEOs of the companies meet every month for a dinner and they all agree not to make a price war against each other.

We prefer to participate in the growth of emerging market economies indirectly through exposure to commodities and commodity producers.

Analyst (to the translator): Did he really say that?

Translator: Yes.

Source: <http://longorshortcapital.com/more-notes-from-china-lost-in-the-collusion.htm>

We prefer to participate in the growth of emerging market economies indirectly through exposure to commodities and commodity producers. As emerging market economies industrialize, their resource intensity and demand will inexorably rise. Millions of Chinese, Indians and Brazilians will want more cars, TVs, mobile phones and other consumer goods as they become more prosperous. As an example, 2009 was the year that Chinese consumers bought more cars than Americans. Moreover, there will be greater investment in capital goods capacity as a result of industrialization (e.g. more steel plants, etc). All these factors will serve to raise commodity demand as emerging market economies grow.

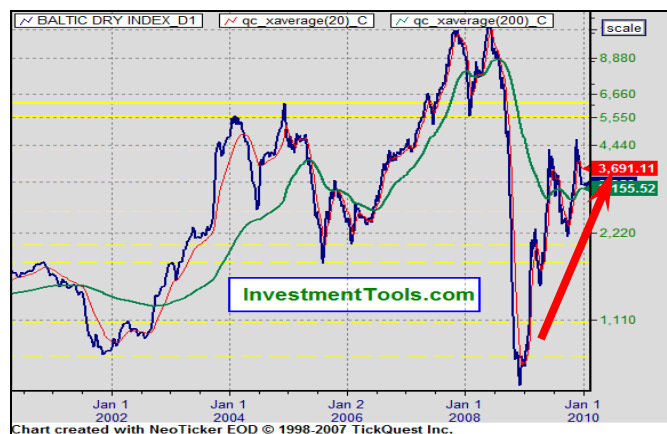
During the California gold rush, the people who made the real money weren't made by the miners as only a miniscule number ever struck the mother lode, but the ones who sold the picks and axes to the miners. Today, commodities represent the picks and axes of the emerging market boom.

The Inflation-Deflation lens

If we were to view the world through the macro-economic lens of inflation and deflation, we see that the character of inflation and deflation has changed. Deflationary forces are evident in the developed markets while inflation is seen in the emerging markets. This environment represents a drastic change from the one before the Great Recession.

The developed economies are burdened by debt overhang, excess capacity and deflation. Nevertheless, there is a longer term threat of inflation because of the policy response of government spending and money printing.

Emerging market growth potential remains high. By contrast, these economies face greater capacity constraints and rising demand for both capital and consumer goods, which would serve to raise commodity demand and therefore asset price inflation. The chart below of the Baltic Dry Index, an index of shipping costs as a proxy for emerging market trade, shows that it has recovered significantly from its lows:



When we view the world through an inflation-deflation lens, we see commodity price inflation in the emerging markets and incipient inflation in the developed markets. These indications make us long-term commodity bulls.

Deflation is evident in the developed markets while inflation is seen in the emerging markets – a drastic change in environment from the pre-Great Recession era.

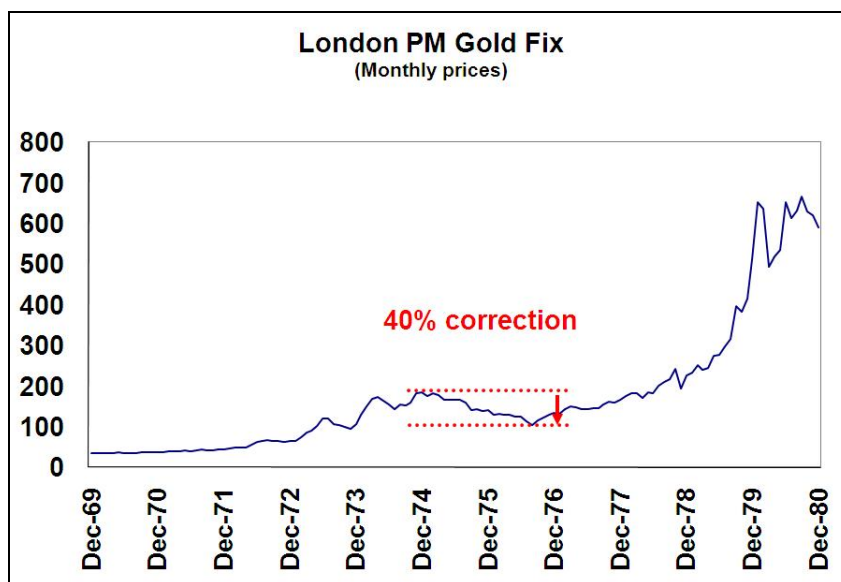
Emerging markets represent the growth markets for the foreseeable future. Their hunger for resources is what makes us long-term commodity bulls.

Even though we remain long-term commodity bulls, we are aware that emerging and commodity markets can undergo extremely volatile boom-bust cycles.

Navigating Inflation/Deflation volatility

While we remain long-term commodity bulls, we are aware that emerging and commodity markets can undergo extremely volatile boom-bust cycles.

As an example, the economic environment of the 1970's was somewhat similar to today as it was marked by slow growth and high inflation. The only difference being labor arbitrage was nonexistent then compared to today and that factor would serve to dampen the effects of any inflationary spiral. As a result, commodity prices soared. The chart below shows the monthly prices of the London PM Gold Fix from 1970 to its peak in 1980. While gold prices did move from \$35/oz. at the beginning of the period to a peak of \$850/oz. in early 1980, the corrections were brutal.



When gold price peaked in 1975, the subsequent pullback was about 40%. This episode illustrates the incredible volatility of commodity prices. You can get the long-term trend right, but investors need to be prepared to suffer through devastating corrections.

Given the volatility in commodity markets, simple buy and hold strategies may be overly volatile for investors seeking to preserve wealth.

A better way is to use models that capture and profit from volatility.

Using dynamic allocation to preserve wealth and raise returns

Despite our long-term bullish commodity outlook, we believe that an undiversified buy and hold long exposure to commodity and commodity producers is overly volatile for investors who are interested in preserving capital.

Investors who seek to better control risk and achieve higher expected returns can use dynamic allocation techniques to capture and profit from volatility.

*People are our strength.
Creating value is our
goal.*

About the Author

Cam Hui has been involved in the equity markets since 1980, both on the buy side and the sell side. Most recently, Cam was a Relative Value and Technical Research Analyst with Merrill Lynch in New York. He is currently living in Vancouver, British Columbia with his family. He maintains his interests in the markets through his investment blog:

<http://humblestudentofthemarkets.blogspot.com>

Cam serves as a member of Qwest Investment Management Corp.'s Board of Advisors.

Contact Qwest:

Maurice Levesque
Managing Director , President
604-601-5802 or
mlevesque@qwestfunds.com

Website:
www.qwestfunds.com

Qwest Investment Management Corp.

Qwest Investment Management Corp. ("Qwest") is an investment management firm which specializes in identifying, structuring and managing investment products. Qwest is currently focused on investments in the natural resource sector.

Qwest's executive management team has over 100 years of combined experience in corporate and financial product structuring and investment management which provides the team with the skills required to evaluate and profitably manage the risk and rewards inherent in the capital market industry.

Qwest is the parent company of Qwest Investment Fund Management Ltd., a company which provides investment advisory, portfolio management services and fund management services, and Heritage Bancorp Ltd., a company which provides administrative services.

Interesting Facts About Qwest

- Specialists in investing Canadian capital in the natural resource sector;
- Throughout their careers, members of the Qwest management team have completed hundreds of financings and have raised and/or invested billions of dollars of capital in the natural resource sector;
- Resource company flow-through specialists;
- Recognized for our experience in Canadian oil and gas sector;
- Top quartile oil and gas-weighted flow-through portfolio performance.

Calgary-Based Portfolio Management

From our Calgary, Alberta office, Qwest's portfolio management team is strategically situated to conduct in-depth research and analysis of Canada's oil and gas companies. Our portfolio management team is led by Ms. Jennifer Stevenson who brings over 20 years of oil and gas industry experience and a strong track record in financing and investments in oil and gas companies.

The portfolio management team's additional strengths include:

- first-hand knowledge and insight into the oil and gas sector (i.e. situated in the heart of the Canada's oil patch)
- years of experience working with management teams to finance their oil and gas companies
- specialization in the research and analysis of Canadian mining companies
- considered to be leading experts in the oil and gas sector by Canada's most reputable media outlets

IMPORTANT DISCLOSURES

This information is made available by Qwest Investment Management Corp. ("Qwest") for information purposes only. This information is not intended to be and should not to be construed as investment advice, and any recommendations that may be contained herein have not been based upon a consideration of the investment objectives, financial situation or particular needs of any specific recipient. In addition, this information is not to be construed as an offer to sell, or solicitation for, or an offer to buy, any securities.

The information is intended for residents of Canada only.

The opinions, estimates and projections contained herein are those of the author and not Qwest. Qwest makes no representation or warranty, express or implied, in respect thereof, takes no responsibility for any errors and omissions which may be contained herein and accepts no liability whatsoever for any damage or loss arising from any use of or reliance on this information. Qwest is under no obligation to update or keep current the information contained herein.

The information presented may not be discussed or reproduced without prior written consent.

Qwest, its affiliates and/or their respective officers, directors or employees may from time to time acquire, hold or sell securities mentioned herein as principal or agent.

Copyright © Qwest Investment Management Corp. 2010. All rights reserved.