

# Weekly Trend Watch

February 19, 2010



## Inflation/Deflation Timer - Current Indication:

# Neutral

**The Inflation-Deflation Timer is a trend-following model, and this class of model is incapable of calling tops or bottoms, and therefore its value is in the ability to spot trends. The trends we are looking for are: inflation, deflation and neutral.**

This publication is an ongoing monitor of the Inflation-Deflation Timer model, for more information on the model, see:

[http://www.qwestfunds.com/publications/newsletters\\_pdf/newsletter\\_november\\_2009.pdf](http://www.qwestfunds.com/publications/newsletters_pdf/newsletter_november_2009.pdf); and  
[http://www.qwestfunds.com/publications/newsletters\\_pdf/newsletter\\_february\\_2010.pdf](http://www.qwestfunds.com/publications/newsletters_pdf/newsletter_february_2010.pdf)

Cam Hui, Board of Advisors, Qwest Investment Management Corp.

## Qwest Commentary

### How much of a portfolio should go to dynamic asset allocation?

Over the past few months, we have been asked the question, "Given the excellent past returns of the Inflation-Deflation Timer model (see [http://www.qwestfunds.com/publications/trend\\_watchpdf/january\\_8\\_issue.pdf](http://www.qwestfunds.com/publications/trend_watchpdf/january_8_issue.pdf)), what would an appropriate allocation to such a dynamic asset allocation portfolio?"

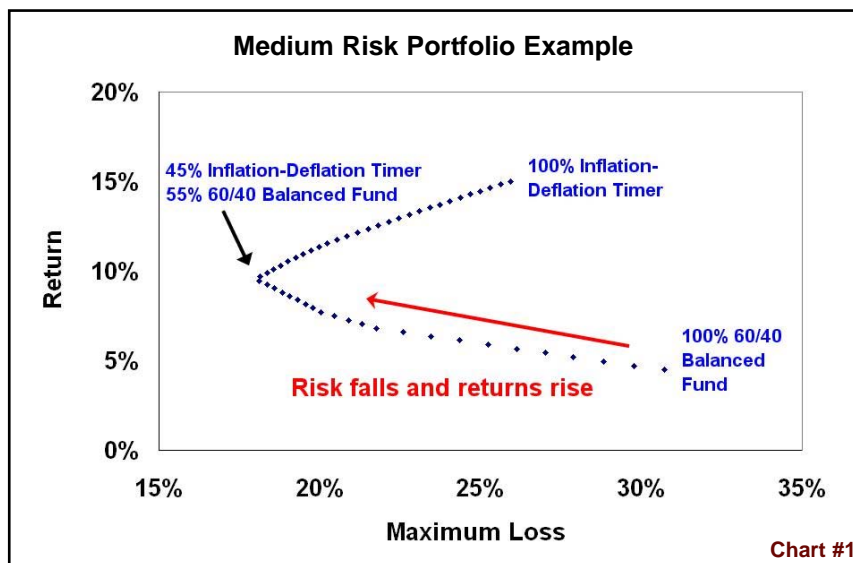
Every portfolio is different and allocation depends on an individual's risk and return preferences. However, we will try to give some guidance using the following three examples.

#### Example #1: Medium Risk Portfolio

For illustrative purposes, we first look at the risk and return tradeoffs involved with a medium risk portfolio. **Chart #1** plots the risk (i.e. as measured by maximum loss) and the return of different allocations to a 60% stock and 40% bond portfolio and the Inflation-Deflation Timer model. At the bottom right hand corner, the dots near the words "100% 60/40 Balanced Fund", show the risk and return characteristics of a 60/40 Balanced Fund over the test time period of December 2000 to December 2009. Each dot moving to the left of the

	Risk and Return (Dec 2000 to Dec 2009)						Inception (Dec 2000)	Return/ Std Dev	Max Loss
	2009	2008	2007	3 years	5 years				
Inflation-Deflation Timer model	18.1%	71.2%	21.7%	35.0%	23.6%	15.3%	0.9	26.0%	
60 stocks/40 bonds*	21.4%	-16.5%	8.2%	3.1%	7.6%	4.9%	0.5	30.7%	
S&P/TSX 60	31.4%	-31.1%	10.9%	0.1%	8.4%	4.6%	0.3	47.9%	
DEX Bond Universe	5.2%	6.2%	3.4%	4.9%	4.6%	3.9%	0.7	8.5%	

\* 60% S&P/TSX 60/40% DEX Bond Universe



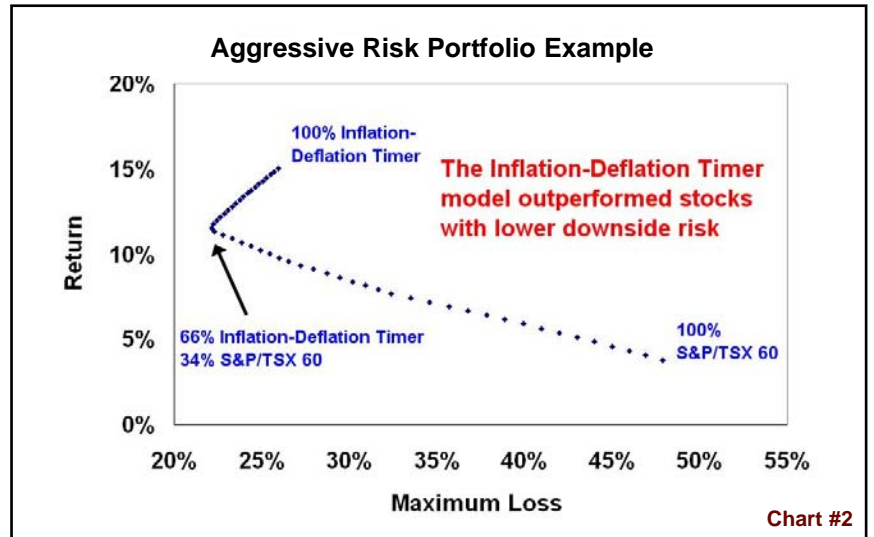
100% 60/40 Balanced Fund starting point represents progressively higher allocations to the Inflation-Deflation Timer model. The allocation eventually becomes 100% to the Inflation-Deflation Timer model and 0% for the 60/40 Balanced Fund.

As a hypothetical investor allocates more and more to the Inflation-Deflation Timer model, the chart shows that downside risk falls and returns increase. The point for minimum risk, or the point for the most efficient portfolio, turned out to be a 45% allocation to the Inflation-Deflation Timer model and a 55% allocation to a 60/40 Balanced Fund. From the minimum risk point onward, risk increases but so does the potential return.

### Example #2: Aggressive Risk Portfolio

**Chart #2** shows the risk and return characteristics of an aggressive portfolio where an investor has allocated 100% of his portfolio to equities. This investor would be fully exposed to the risk of deflation.

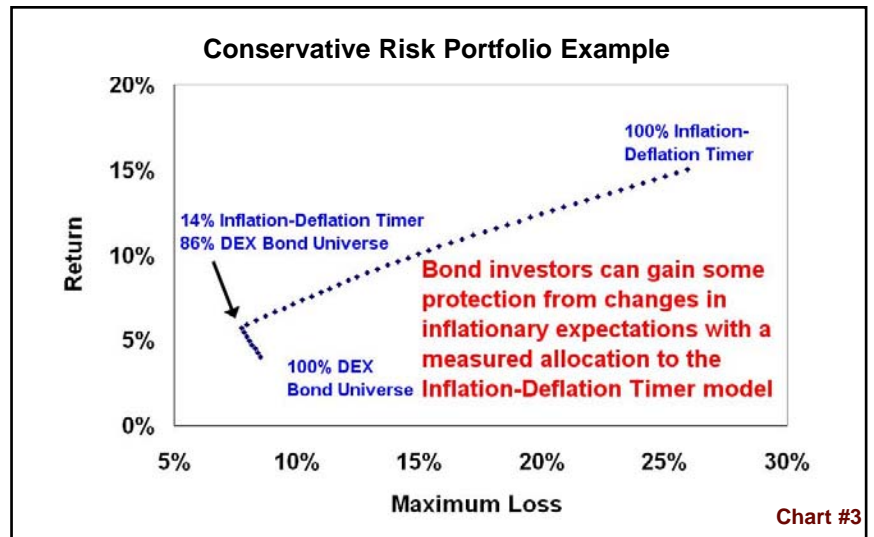
As the chart shows, the Inflation-Deflation Timer model outperformed stocks and did so with a lower risk profile. The point of minimum risk, or the point for the most efficient portfolio, is a 66% allocation to the Inflation-Deflation Timer model and 34% allocation to equities, as defined by the S&P/TSX 60 Index. Investors who are more comfortable with a higher risk and return scenario should allocate greater amounts to the Inflation-Deflation Timer model. The Inflation-Deflation Timer model would provide some measure of protection against deflation depending on the allocation of the Inflation-Deflation Timer model.



### Example #3: Conservative Risk Portfolio

**Chart #3** shows the risk and return characteristics of a conservative portfolio, where an investor has allocated 100% of his portfolio to bonds. This investor would be fully exposed to the risks from inflation.

The point of minimum risk, or point for the most efficient portfolio, is a 14% allocation to the Inflation-Deflation Timer model and 86% allocation to bonds, as defined by the DEX Bond Universe. The Inflation-Deflation Timer model would provide some measure of protection against inflation depending on the allocation of the Inflation-Deflation Timer model.



### Targeting risk levels

Some investors prefer to target a certain risk level rather than specify their risk preferences as conservative, aggressive or somewhere in between. The table on the next page shows suggested allocations to a portfolio of stocks, bonds and the Inflation-Deflation Timer model for a given level of downside risk tolerance.

We would note that stock allocations are relatively stable in this study at the 20-26% level. As risk and return rises, bond allocations fall and Inflation-Deflation Timer model allocations rise.

## Your mileage will vary

The question, "what is an appropriate allocation to the Inflation-Deflation Timer model" depends on risk and return preferences. We have tried to show a number of scenarios that can guide an investor to making allocation decisions.

The results of these scenario based examples are dependent on many variables, such as the choice of asset classes, the behavior of those asset classes as well as the specifics of the implementation of an Inflation-Deflation Timer model.

Your own mileage will vary.

## Risk targets and allocations

<u>Max Loss</u>	<u>Stocks</u>	<u>Bonds</u>	<u>Infl-Defl Timer</u>	<u>Return</u>
10%	20%	66%	14%	6.2%
15	26	38	36	8.8
20	23	15	62	11.7

Stocks: S&P/TSX 60

Bonds: DEX Bond Universe

Return: Simulated return, Dec 2000 to Dec 2009

## DEFINITIONS (as defined in the American Heritage Dictionary)

### Inflation

A persistent increase in the level of consumer prices or a persistent decline in the purchasing power of money, caused by an increase in available currency and credit beyond the proportion of available goods and services.

### Deflation

A persistent decrease in the level of consumer prices or a persistent increase in the purchasing power of money because of a reduction in available currency and credit.

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