

# Jockeys Grab Your Saddles—Not so Fast?

— JASON VINCENT, PFP, TEP, CHIEF OPERATING OFFICER AND VICE PRESIDENT, MULTI-FAMILY OFFICE

Mainstream media reports may have you believing that we're in the starting gate ready to break into another bull cycle. Only seven months ago the same media were proclaiming financial Armageddon. How can this be?

I believe it's important to reinforce my comments of last edition and here's why. I can't remember any time in my career when we've had such an intense full-cycle swing in investor sentiment. Investors' thinking may be able to shift, deny or massage reality, but sentiment can't reconstruct the fundamentals of how economic and market cycles work.

Let's be clear. We're in a period of volatility and turbulence and we think a unidirectional market is an unlikely scenario over the next two to three years. Although we believe markets will generally continue improving in the near and mid term, there are long-term challenges that can't be overlooked or ignored. For example, interest rates will rise; it's a matter of how much and over what period. Past experience tells us that more expensive money creates headwinds for sustainable economic growth.

For investors with the stomach for high-risk investing and, better yet, the financial position to potentially absorb dramatic losses, the current market environment is ripe with investing possibilities. The majority of investors, like us, prefer to put risk management ahead of return management. We're confident that from a risk-adjusted perspective and over longer periods of time this approach is successful.

We believe now's the time for investors to break away from the cycle of allowing greed and fear to drive investment decisions. There are other ways besides placing bungee-jumping bets. So, while a plethora of messages may have you believe we're off on another bull run, we say not so fast. We think it's prudent to move forward during such times with a strategy, and tactics guided by fundamental information. We think it's critical to have the discipline to do so. That's why for now, while others may be running for the next big thing, we're stock picking our way to successful long-term performance. ■



## MATCO FINANCIAL INC.

We are a wealth management office that believes a comprehensive approach to living well with money simply makes sense.

The result is strategies that help you shape what comes next, now and for generations. Strategies that integrate the investment portfolios, trust, estate and tax plans developed exclusively for you. Strategies that can be implemented seamlessly by our group or in concert with your advisors. Finally, consolidated reporting that gives you a comprehensive view of your wealth—raising hidden weaknesses and new opportunities. **This is what we do.**

As a private company, we have a personal stake in your success. We believe the most valued relationships are built one-on-one over time. We believe you judge risks and opportunities as much by the people involved as by the numbers on the page. **This is who we are.**

## Safeguarding Your Assets

Unfortunately, as we've seen recently, market corrections present investors with unforeseen risks, including questionable trading practices and even outright fraud. At Matco Financial, several safeguards, integral to our daily activities, are designed to "protect" your assets:

- **Registration:** Matco Financial is registered with the Alberta Securities Commission and our portfolio managers carry professional credentials, such as the Chartered Financial Analyst designation—a requirement for managing your funds.
- **Third party custody:** Your assets are held in separately registered accounts with a recognized financial institution such as TD Waterhouse Institutional Services and RBC Dexia. Such firms provide independent investment reporting as well as asset insurance through the Canadian Investor Protection Fund.
- **Compliance:** Matco and our custodians undergo regular, independent audits.
- **Process:** From the initial due diligence on investment objectives and the transparency of our documentation to the investment guidelines set in an Investment Policy statement and benchmarking of investment returns, we work to ensure our clients always have a clear understanding of where they stand with their Matco portfolio.

We believe recent events should motivate investors to review any investments that do not meet these basic criteria.

Let us know if we can be of assistance.



Matco Financial Inc.

# Waiting for the Other Shoe to Drop

— BILL K. DICKIE, CFA, PRESIDENT AND PORTFOLIO MANAGER

— JERRY A. OLYNUK, LLB, CFA, VICE PRESIDENT AND PORTFOLIO MANAGER

Investors breathed a sigh of relief in the spring as global financial markets avoided a meltdown. Sentiment improved further over the summer, as results were better than expected, and turned optimistic in the third quarter as signs of economic recovery appeared. Despite this shift in sentiment, Canadian investors remain firmly on the sidelines holding an astonishing \$1 trillion in cash and equivalents. Shaken investors fear the current rally may be nothing more than a head fake in a long-term bear market. History supports these concerns, but we need to examine all of the factors driving current events. On balance, they're telling us the economy is in the early stages of a recovery. We believe investors must continue to judge the nature and pace of the recovery to generate active returns for their portfolios.

The scope of the "Great Recession" does compare to the Great Depression. The conditions then of chronic unemployment, the instability of financial intermediaries that spread through the financial system, and the speculative stock market bubble are almost identical to today. The Dow Jones Industrial Average recovered most of the 1929 losses the following year, only to drop 50% in 1937, and employment levels never really recovered until the outbreak of World War II a decade later. However, the marked difference with past events lies in the actions of modern-day policy-makers. Since the 1930s, central banks have dealt with a series of financial crises—such as the Asian currency crisis in 1997—by injecting massive amounts of cash into financial markets to provide liquidity, and by taking rapid action to support investor confidence. This time, policy-makers rolled out the same playbook and, in the face of unprecedented challenges, introduced innovative techniques such as "quantitative easing" to provide the credit and capital required by individuals and businesses.

Despite Herculean efforts, the world's developed economies remain fragile. The recent spike and subsequent plunge in auto sales due to various "cash for clunkers" programs demonstrates how dependent activity is on government support. Commercial mortgage defaults, another round of housing devaluations and mounting consumer debt are all potential shoes that could yet drop. Despite these challenges, governments have marshalled sufficient fiscal reserves and policy tools to address them. G8 nations have been unusually cohesive in ensuring that monetary stimulus isn't withdrawn prematurely. Much of the promised stimulus spending has yet to hit the economy; at last report approximately \$100 billion of the \$800 billion U.S. stimulus package has been spent. We're perhaps halfway through the first phase of simply bridging the economy back to sustained growth. Going forward, rather than a long, linear recovery out of recession, we're likely to experience a rebalancing of world economic activity. The United States and United Kingdom face a prolonged period of spending cuts and currency devaluations to repair their economies, while the newly emerged economies of Asia and Latin America seek to invest their substantial savings at home and abroad. Fortunately, Canada is well-positioned in this global economic shuffle.



## Taking Action

Have financial markets gotten ahead of the recovery? Technical measures demonstrate the Canadian market has recovered an average of 31% one year after the initial rally from a correction. On a fundamental basis, the 1980 recession exhibited the same unemployment levels, but the Canadian stock market rallied 76% in the following two years. Currently, it's no coincidence that Canadian and BRIC country equity markets have outperformed the world this year due to strong economic fundamentals.

So, rather than waiting for another shoe to drop, we're affirming our investment footprint. Year-to-date returns support our bias toward equities over bonds. Even if the current recovery process stalls, investors run too great a risk sitting on the sidelines while events play out. Cash yields are still near zero and bonds have shown surprising resilience, while our focus on defensive dividend-paying equities is designed to handle the ongoing volatility of the recovery. Based on our long-term views of the global economy, markets such as Canada and Australia—tied to the rising fortunes of China and Brazil—will provide new opportunities for returns that don't fit the mould of a traditional recovery. ■

### OUR CURRENT INVESTMENT STRATEGY (for the period September 30, 2009 to December 31, 2009)

ASSET CLASS	STRATEGY (LONG-TERM)	TACTIC (SHORT-TERM)	ACTIVE BALANCED PORTFOLIO
Cash	Neutral	Unchanged	0.00%
Fixed Income	Underweight	Increasing	45.00%
Canadian Equity	Overweight	Decreasing	40.00%
U.S. Equity	Underweight	Unchanged	5.00%
International Equity	Overweight	Unchanged	10.00%

# Where Are We Right Now?

— LEE W. APPLETON, CFA, PORTFOLIO MANAGER

We're still in a topsy-turvy world as the Canadian market continues its upward climb, led by low-quality companies from across the market capitalization spectrum. While that term may sound flippant, the current stage of the market cycle is far from frivolous and not a first.

Low-quality companies are defined by attributes such as negative earnings, continued deterioration in earnings, low profitability and poor balance sheets. Such companies, many of which had questionable futures and were most severely trounced during the market crisis, have left high-quality stocks in their wake rebounding the most since the bottom set March 9, 2009. As the graph below shows, Canadian investors have experienced four prior low-quality leadership cycles since 1980. Following further analysis, our clear conclusion is twofold: the low-quality trade happens rarely and when it does the duration is typically between five and 18 months. We believe the glow on this current low-quality affair is already starting to fade as valuations for higher-risk companies are outpacing true fundamentals such as price-to-earnings multiples, bottom line growth and profitability. Investors are paying more to “get less.” They're paying more to get less quality as measured by investment fundamentals. They're paying more to buy higher risk. We expect as this trend continues to evolve, the focus will begin shifting to higher-quality opportunities with the necessary basics to both survive and grow in a longer term economic and market environment that is currently tinged with uncertainty. We believe such companies have the staying power necessary for these times and anticipate the market focus will likely right itself over the next three to six months.

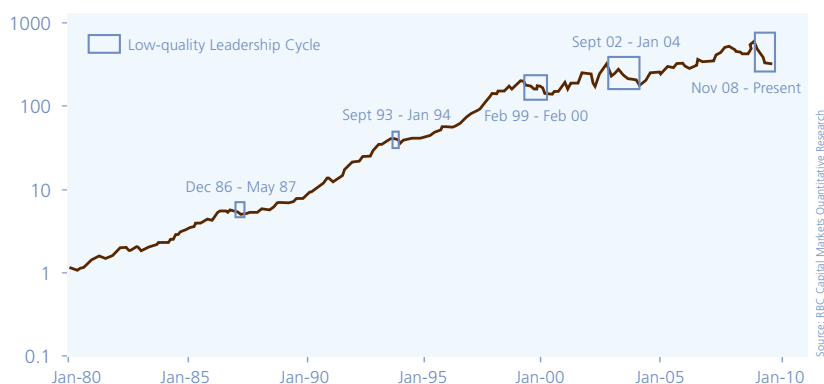
In the meantime, we recognize how, at first blush, investors may be attracted to the gains posted by the low-quality trade. Though the market numbers may be tempting, we're not shifting our discipline for what is a temporary stage fuelled by the extreme pendulum swing of investor sentiment. Instead, we continue to focus on companies that are:

- profitable enough to produce higher dividends than the market;
- present a lower price-to-earnings multiple than the market; and
- deliver lower risk than the benchmark.

We prefer to pay less to “get more” in terms of better quality, higher growth potential and higher dividend yields. Given all the recent investor attention to the opposite higher-risk, low-quality companies that have led the market's recent resurgence, one might think our portfolios would be well behind. We're pleased to say that despite the trends of the past six months, the Matco Equity Income portfolio, for instance, has matched the S&P/TSX Composite Index. As the markets move out of this topsy-turvy world, and investors focus on those companies that are healthy and strong enough to succeed over the long term, our portfolios will be well-positioned to capture the renewed attention and to continue building gains well into the future. ■



## A VIEW OF HIGH- VERSUS LOW-QUALITY PERFORMANCE



As RBC's QuaDS model shows, high-quality equities outperform low-quality equities over the long term. Their research indicates “Canadian investors have experienced four prior low-quality leadership cycles since 1980” and such periods have been generally short in nature.

# Unlocking Present and Future Gains

— DANIEL S. CHENG, CFA, PORTFOLIO MANAGER

If you're unfamiliar with hydraulic fracturing (fracing) and horizontal drilling, we believe now's the time to know a bit about them as these technologies and associated techniques are key to unlocking oil and gas performance in North America. With the majority of "low-hanging fruit" already discovered and drilled, fracing and horizontal drilling stand behind most of the major oil and gas resources that have emerged in Canada and the United States over the last few years. For instance, we've spoken of unconventional plays such as Montney, Horn River and Bakken in Canada, as well as Barnett, Woodford, Fayetteville, Marcellus, Haynesville and Eagleford in the United States. These new plays have been made physically and economically viable by the application of one or both of these technologies. In addition, fracing and horizontal drilling are credited for leveraging more performance from older assets or previously uneconomic ones.

Briefly, this is what each entails. Designed to free oil and gas from rock strata, fracing involves pumping fracturing fluid under very high pressure into, for example, a highly impermeable shale formation. As a result, trapped oil and/or natural gas are allowed to flow more freely. Horizontal drilling is best described as drilling down vertically, and then sideways. This is a simplistic explanation of a complex process that can involve wells spanning 1,000 to 5,000 feet or more sideways through rock. The goal: Expose more reservoir rock to the well bore surface than can be achieved through a traditional vertical well. Horizontal drilling is credited with increasing well productivity and having the potential to prolong the commercial life of a well.

We believe the impact of these technologies is linked to long-term themes that will influence opportunities and the performance of oil and gas equities. For example:

- The anticipated natural gas shortages of years ago and the need to import liquid natural gas (LNG) have been deferred indefinitely. In Canada, construction of the necessary terminal infrastructure to enable LNG exports is starting. Estimates suggest current Canadian and U.S. natural gas reserves can supply 50 to 100+ years of production.
- In the United States, particularly, we believe concerns about secure energy sources will support a further focus on demand for natural gas as a home and auto energy source. Over time, we believe this will have an impact on demand for natural gas supplies both within the United States and from Canada.

We incorporate such themes in our energy investment strategies. For example, our MFi Energy Fund portfolio includes CalFrac Well Services, a premier Canadian oilfield services company, providing fracing capabilities in key unconventional resource plays. We're also invested in companies that are participating in the majority of North American resource plays and are applying fracing and horizontal drilling to do so—companies such as Crescent Point, Progress Energy, Southwestern Energy and Petrohawk Energy, to name a few.

Innovations will continue to influence the development of the oil and gas sector in Canada and the United States. Tapping our exclusive relationship with Ross Smith Energy Group, and using our own research, we'll continue to make the connections between such developments and solid, long-term investment opportunities for our clients. ■



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