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September 2010

Are Low Rates Leading to High Risk?

The past quarter continued the theme of conflicting economic data and government attempts to address the slow recovery. In this precarious climate, the market gyrations enabled us to purchase several companies at compelling valuations. We remain committed to our long-term value investment philosophy, and are focused on seeking attractively priced investment opportunities.

Economic overview – The slow pace of economic recovery

The economy remains in a fragile state. In its most recent meeting on September 21st - 22nd, the U.S. Federal Reserve Board indicated that "the pace of recovery in output and employment has slowed in recent months." William Dudley, president of the Federal Reserve Bank of New York, also noted in a recent speech that "the pace of growth has been disappointing even relative to our modest expectations at the start of the year." We remain of the view that the best case scenario is for subpar growth over the next several years.

The drivers of the economy – consumer spending and housing – remain weak. Although the banking system has stabilized, many risks that existed since the beginning of the financial crisis remain. The unemployment rate is stubbornly high despite stimulus spending and exceptionally low interest rates. The depressed housing sector, which has shown few signs of recovery, is now faced with legal issues related to foreclosures. Several major financial institutions have suspended these foreclosures due to "irregularities" in the process, impacting the housing market by keeping supply off the market. While this may result in a temporary rise in home prices, the overhang will return when the foreclosure process starts again. A scandal like this, occurring so soon after the sub-prime mortgage crisis, is a stark reminder of how deep the structural problems in the U.S. financial regulatory framework run.

The news is not much more encouraging elsewhere:

- Japan has cut short-term interest rates to virtually 0% in response to the rising yen and economic stagnation.
- Government debts are at levels usually seen only during wartime. Ireland is the most recent country to have its debt rating downgraded.
- A wave of anti-austerity strikes in Europe has taken place due to government mandated changes to the social contract.

- Canada and the U.S. have both been subject to a reduced growth outlook.
- Currency "wars" are under way – several countries are attempting to devalue their currencies to maintain export growth.
- U.S. – China currency peg: The House of Representatives passed a bill to allow for duties on Chinese imports if the yuan is not allowed to rise against the dollar.

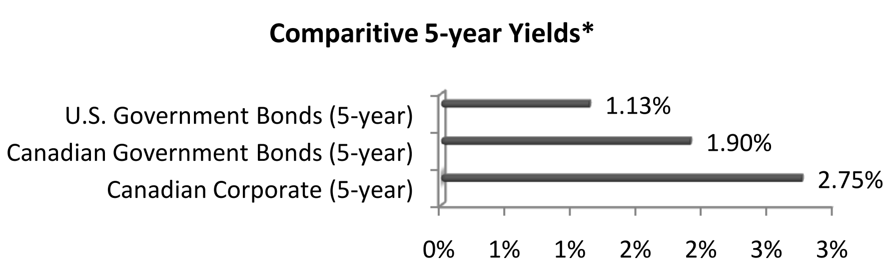
Perhaps the only positive news of late on the global economic front is that Asia and other emerging markets are still growing at a healthy pace. However, that growth is export-dependent and driven by consumer spending in the west. With consumers in a deleveraging mode, Asia's growth rate will likely slow; well-known economist Steven Roach makes a very good case for this in a recent Barron's article[1]. Since the financial crisis began, China's infrastructure spending has been making up for the weaker western demand, but there is only so long that this void can be filled.

Interest rate impacts of the current climate

Weak economic data led the Federal Reserve Board to pledge to keep interest rates at exceptionally low levels for an extended period. Faced with low bond yields, investors are buying equities in search of higher returns, creating a "bad news is good news" rally in the markets. The Fed is also strongly hinting at the prospect of another round of quantitative easing ("printing money" by purchasing government and agency bonds in the open market). Quantitative easing would have the impact of driving down bond yields to even lower levels (the current U.S. 10-year Treasury yield is 2.4%) and increasing the money supply in an effort to stimulate growth. The risks of this strategy are twofold: 1) keeping interest rates artificially low can lead to inflated asset prices, such as what occurred in the recent dot-com and housing bubbles, and 2) increasing the money supply also raises the risk of inflation, which so far has remained dormant.

At current interest rates, traditional bond investors cannot generate an adequate return on their investment. Thus, money is flowing into riskier assets. Individuals, pension funds and insurance companies are all confronted with this issue. Pension funds and insurance companies are facing long-term liabilities incurred through past rates of return assumptions in excess of what can be earned at present. If bond yields remain low for an extended period, corporations and governments will have to lower their return assumptions or take on more risk (probably a combination of both), which would have a negative impact on their finances.

As can be seen in the table below, bond yields are extremely low:



*As of October 18th, 2010.

[1] Kopin, Tan. (2020). A Better U.S. Fix for China Trade. Retrieved October 2, 2010, http://online.barrons.com/article/SB50001424052970204839304575520022191183034.html

These low yields put traditional fixed-income investors in a quandary – how to maintain adequate income levels without increasing equity exposure and the risks inherent in such a move. We at LSWM have, since June of this past year, been developing a diversified high-yield bond fund with the aim of providing higher returns for fixed income investors. Please see our enclosed letter, "A High Yield Opportunity in a Low Yield World" for more information on the logic of our high-yield bond fund strategy.

Equities

Our patience has been starting to pay off as we were able to purchase shares in the following companies at attractive prices during the past quarter:

- JC Penney
- Futaba
- Manulife
- Sun Life

All represent exceptional value and the prices we paid for the shares were at the lower end of their respective long-term trading ranges. Each investment also offers a dividend yield that is higher than the 10-year bond yield (in their respective home currencies). We maintain our discipline and stick to only buying companies whose share prices are trading at compelling valuations. The following are descriptions of the value each of these investments brings to our portfolio:

JC Penney

Established in 1902, JC Penney is a major U.S. retailer with over 1100 stores. The company has a long track record of earnings and free cash flow generation, as well as a strong balance sheet with a low level of debt. Unlike many other retailers who suffered significant losses during the downturn, JC Penney remained profitable throughout the recession. As consumer spending weakened, the share price fell from $87 (in 2007) to a low of $19.50. We patiently waited for the stock to hit a price level that we felt was a bargain. We were quite fortunate to make our purchase at virtually the *absolute low* – a price that was below tangible book value and offers a dividend yield of 4.1%. Since then, the company has begun to realize sales benefits from a number of initiatives, including the exclusive launch of Liz Claiborne (which has been off to a great start), a refocused promotional messaging and a reorganization of its home segment. At the time of writing, a major hedge fund (Pershing Square) has recently taken a major stake in the company and the shares are trading close to $34.

Futaba

It is not often that one can find companies with lengthy track records of profitability that are trading at less than working capital. Benjamin Graham (Warren Buffet's professor and the father of Value Investing) called these types of investments "golden opportunities" because based on his experience "practically all these bargain issues turned out to be profitable, and the average annual result proved much more remunerative than most other investments." As we mentioned in our previous letters, Japan currently offers a number of such opportunities, and we are identifying those that both meet our strict investment criteria and that can benefit from the growth in Asia. Futaba is one such company.

Founded in 1948 and based in Japan, Futaba manufactures and sells electronic displays and systems as well as machinery and tooling products. It has operations in the United States, Asia and Europe. It has no debt and trades at about net cash per share, meaning that the market does not ascribe any value to its business, offering a great deal of downside protection. At the price we paid, its shares were trading at less than half its tangible book value, with a dividend yield of 1.8%.

Manulife

Canada’s largest insurance company with significant Asian and U.S. operations, Manulife ran into trouble by selling products tied to the equity markets without hedging its exposure. The market decline resulted in large losses which forced the company to cut its dividend and issue equity. The shares fell from a high of $46 to about $12. At the price we paid, the dividend yield is 4.3%. Manulife is not out of the woods yet as its legacy products still leave it exposed to market risk. However, their core business is solidly profitable and all new business is appropriately hedged. At the price we paid, there is potential for a significant return over the next several years.

Sun Life

Sun Life proved itself to be more conservatively managed than most other North American insurers. Throughout the financial crisis it never had to cut its dividend or raise equity. Despite this, the shares suffered along with the rest of the industry. The company is building a growing presence in India and its prospects remain solid. At the price we paid for the shares the dividend yield is 5.7%.

Closing thoughts

Capital preservation implies holding a significant cash position when risks are too high. There have been two market shocks during the past decade – the dot-com collapse in 2000 and the financial crisis of 2008. Those who were fully invested learned an expensive lesson and suffered serious declines. We believe the best strategy is to wait patiently for those moments when the opportunity arises to purchase quality businesses at compelling valuations. We will continue to approach the market in this way, with patience, level-headed analysis and an eye towards long-term value.

As always, we would be pleased to speak with you about your investments.

Sincerely yours,

Lorne Steinberg