

THE MONEYLETTER®

STRATEGIES FOR SUCCESSFUL INVESTING

STRATEGY

How to invest for value or income in 2010

DEFINING STYLE

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AS WE ENTER 2010, THE PORTFOLIO management team I lead here at CIBC Global Asset Management has taken on some new responsibilities.

In addition to managing the **CIBC Monthly Income Fund** and the **CIBC Global Monthly Income Fund**, we will also be managing the **CIBC Canadian Equity Value Fund**, the **Renaissance Canadian Monthly Income Fund** and the **Renaissance Canadian Core Value Fund**.

Since some of the new funds focus on value, I decided to write about the different strategies used in managing a monthly income fund versus managing a value fund.



David Graham is Vice President of Canadian equities at CIBC Global Asset Management. He manages more than \$8 billion in assets for several CIBC and Renaissance mutual funds, including the CIBC Monthly Income Fund.

Also, and just as important, is our outlook for 2010 and how it will affect the two different investment styles.

First, let's talk about the similarities and differences.

The monthly income funds emphasize assets that provide current income, either on a monthly or quarterly basis, as well as capital appreciation.

The value funds hold stocks that are deemed to be undervalued in price and have greater potential for capital appreciation.

However, unlike the income funds, dividends are treated as a secondary consideration, and may be an important component when measuring the relative value of a holding.

All of our portfolios are value-oriented, we are not growth managers.

That said, we believe that the value funds should surpass the

monthly income funds in terms of total returns. That's because the companies held in these funds have lower levels of debt, lower price-to-earnings ratios, and lower price-to-book-value ratios.

Value, growth and momentum statistics provided to us measure the overall risk associated with specific stocks compared to the market and allow us to easily track and adjust each portfolio.

Most of the companies we hold in both types of portfolios will likely be similar but there are nuances in the composition of each portfolio.

The value funds hold only common equities (including income trusts), while the monthly income funds also have a fixed income and a preferred share component.

The overall goal in managing either kind of portfolio is total return. But in the monthly income funds we lean even more towards current income.

In our opinion, the main difference between monthly income funds and value funds is the balance between risk and return over time.

Although we expect our value funds to be less volatile than the Canadian equity market, pure common equity funds typically have higher volatility or risk – in line with the overall stock market, which should mean higher returns over longer periods.

Monthly income funds are usu-

ally less volatile because the bond and preferred shares in the portfolio offset the equity component, controlling the risk. Yet at the same time they restrain some of the long-term returns.

The exception was in 2008, when stock market declines were so severe that the ten-year return on bonds and bond-related funds ended up exceeding that of equity funds.

As the world returns to a more normal state however, we expect value funds to once again outperform monthly income funds.

Value funds have demonstrated excellent performance in down markets compared to both the overall stock market and to other equity funds. We call this downside capture.

The advantage of a monthly income fund is that the unit-holders do not have to decide what percentage of their money invested should be in bonds or stocks at different stages of the stock market cycle – we as portfolio managers make that decision for them.

We expect monthly income funds to have even better downside capture than value funds.

OUR OUTLOOK

So how does the market outlook affect the way we will manage the monthly income fund compared to the value fund?

In our view, the recession is ending and the recovery has started. But nobody is ready to predict how strong the recovery will be.

Consumer spending and house prices in the U.S. have been slowly rising. However, over 23 per cent of mortgages in the U.S. continue to be higher than the value of the house, and the unemployment rate is officially still at 10 per cent.

As a result American con-

sumers continue to be frugal and we expect this to persist.

U.S. Federal Reserve Chairman Ben Bernanke faces a dilemma as he assesses how to address this uncertain economy. Does he keep interest rates low to stimulate the economy? Or does he raise interest rates to avoid creating another economic bubble.

There are suggestions that the market is now much riskier after rising 50 per cent from its March lows earlier this year.

However, we believe that the nature of the risk has changed.

In March the risk was economic – with another Great Recession possibly on the horizon – few stocks were immune.

This has turned into an earnings risk with the possibility that certain companies won't be able to meet their earnings expectations in 2010 or 2011.

With that kind of risk you can at least be selective and choose companies with stable earnings and good dividends that should thrive.

The good news is that earnings estimates have stabilized, and earnings revisions by analysts have actually moved upward.

From a macro economic viewpoint, we are also encouraged. Most companies cut their costs very quickly in reaction to the recent recession, especially compared to their response during the 2001 recession.

Consequently, they have maintained a higher level of profitability and better balance sheets. As they gain confidence that their sales are improving, they are better positioned to hire workers and expand production, which will speed up the economic recovery.

Commodity prices have risen dramatically this year partly due to

the strong rebound in gross domestic product in both China and India and the weakness in the U.S. dollar.

The price of crude oil is up by more than 90 per cent, copper is up approximately 130 per cent, and gold is up more than 35 per cent.

FINDING BALANCE

To address the commodities surge, the big decision becomes how much to invest in energy and materials, the cyclical sectors, and how much to invest in the non-cyclical sectors, which in Canada is principally the financial sector, rather than the consumer staples sector.

In our portfolios, we have tried to maintain a balance between cyclical and non-cyclical sectors. In the value portfolios we hold more in the consumer staples sector. We like **Metro Inc.** (TSX-MRU.A, \$38.14) and **Empire Company Ltd.** (TSX-EMP.A, \$47.75) because of their low levels of debt, stable cash flows and inexpensive valuations.

In the monthly income fund portfolios we hold more energy companies like **Baytex Energy Trust** (TSX-BTE.UN, \$27.93) and **Crescent Point Energy** (TSX-CPG, \$39.38) for their combination of predictable production growth, conservative hedges and high distributions or dividend yields.

FINE-TUNING 2010

When economists, including those at CIBC Global Asset Management, consider the prospects for 2010 they often refer to a subdued, or a sluggish, recovery.

As we move through 2010 we should get a better sense of the shape of the recovery.

If it appears to be weaker than expected, we will shift the portfolio

lios, both value and monthly income, towards a more conservative stance. If the recovery is stronger than expected, we are also prepared to be more aggressive in our approach.

Those investors who are more comfortable with the risks and

potential rewards of equity markets should favour the value funds, while those seeking some income and less volatility should favour the monthly income funds. ▼

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