

THE MONEYLETTER®

STRATEGIES FOR SUCCESSFUL INVESTING

STRATEGY

A 2012 portfolio approach that calls for a mix of capital preservation and...

RELIABLE INCOME

David Graham, CFA

AS THE END OF THE YEAR approaches, we are thinking about 2012 and how best to invest the funds in our portfolios for the upcoming year.

Our clients want income to live on. They would also like capital appreciation. What they don't want is another 2008/2009, where the stock market fell almost 50 per cent. So let's look at some of the factors that might impact 2012, and how we are investing the money in the **CIBC Monthly Income Fund**.

The Canadian economy looks reasonably stable going into



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2012. Our debt/GDP, at about 34 per cent, is better than most countries. Our Federal Government deficit is low and foreign investors prefer our Government bonds to their own.

There has been some concern about rising consumer debt and house prices, but moral suasion from the Bank of Canada seems to have slowed the pace of the increases.

The U.S. economy will likely slow in 2012, but still show a modestly positive rate of growth. The economy is still in rehab, as consumers continue to reduce debt and foreclosures continue to put pressure on the housing market.

Recent economic data has perhaps been better than investors expected, but the recovery is too slow to put a dint in the stub-

bornly high unemployment rate. The Federal Reserve has promised to keep interest rates low until 2013, and would probably provide more stimulus if it is needed.

The main problem in the U.S. has been the inability of politicians to instill confidence or take decisive action. As we enter an election year in the U.S., we expect a lot of campaigning but little action, and the economy may suffer as a result.

Throughout 2012 various tax and unemployment benefits will expire, reducing personal income by about \$200 billion or 1.35 per cent of GDP.

And by the fall of 2012, investors will be weighing the consequences of the new automatic spending cuts passed by Congress (automatically triggered by the "Super Committee's" failure to agree on a deficit reduction package), and the need to once again increase the U.S. debt ceiling in early 2013.

Turning to Europe, we see a recession looming in 2012 because the 17 countries in the European Union, the European Central Bank (ECB) and the International Monetary Fund continually fail to agree on a plan of action.

While each of its neighbours has faced difficulties refinancing its debt, Germany has demanded more austerity for ECB support. It has become a

game among bond investors deciding which country will get into trouble next.

On the positive side, Greece, Italy and Spain all have new leaders who appear to have greater fiscal discipline.

The ECB also has a new leader, who, after announcing a rate cut on his first day, may lower rates further and take other actions similar to the Federal Reserve, convincing investors there is a workable solution.

At CIBC Global Asset Management, our base case calls for a sluggish global expansion of about 2 per cent well into 2013. Next year, we believe Canada will grow by 1.6 per cent, the U.S. 1.7 per cent and Europe 0.5 per cent.

However, we see a 35 per cent chance of a global recession, mainly due to policymakers doing too little too late.

BOND OUTLOOK

In our view, both bonds and stocks are discounting many of the concerns we have discussed above. In late 2008, when Canada was clearly in a recession, 10-year Government of Canada bond yields dipped to 2.7 per cent.

We continue to have about 28 per cent of our portfolio in bonds because we don't see a dramatic move in interest rates in the next twelve months, and they should help preserve capital.

Within the bond component of our portfolio, however, we have increased our exposure to corporate bonds from 48 per cent to about 51 per cent.

Most corporate balance sheets are in much better shape than they were in 2008, so we think this widening is warranted unless we

slip into recession.

Also, the spread between corporate bond yields and Government yields has widened since January 2011, from about 1.75 per cent to over 2.0 per cent, due to the economic slowdown fears.

Stocks look more attractive than bonds today. If we can buy a stock with a three to five per cent dividend yield, we should get 30 to 50 per cent of our investment back in dividends over the next ten years (this assumes no dividend increases).

This compares to the yield on a 10-year bond of about 2.1 per cent a year, or about 21 per cent over 10 years. In addition, the shareholders will get the dividend tax credit.

Since our portfolio is all "blue-chip" companies that have weathered many recessions, we ask ourselves how likely are these stocks to perform so badly that they give up that yield difference?

STOCKS WE LIKE

Canadian Apartment Properties REIT (TSX-CAR.UN, \$21.06) is an example of a name we've added as a bond substitute. It owns 29,000 apartments across Canada, of which 2,467 are recent acquisitions. About two-thirds are in Ontario, with a mix of 37 per cent luxury, 54 per cent mid-tier and 9 per cent other.

Apartments are generally the most stable of all REITs because people pay their rents. The REIT may get above-average rent increases in 2012 as it catches up with HST.

Management is continually looking for ancillary revenues such as allowing cellphone towers on the buildings, renting extra parking spaces and using inde-

pendent hydro meters. We see this helping to maintain margins.

CAR.UN has a distribution yield of 5.3 per cent which we think is quite stable. The main risk in our view is rental competition from condominiums, but thus far condo rents are more expensive than apartments.

AltaGas Ltd. (TSX-ALA, \$30.90) is another stock we favour. It has three businesses: gas processing and liquids extraction, power and distribution. It has six extraction facilities that process gas for producers to remove the liquids. Most of this is done on a cost-of-service basis, and the company tries to hedge a good proportion of the remaining exposure to commodity prices.

The exciting part of the company's story is on the power side. It is building a run-of-river hydro facility (called Forrest Kerr) in BC for about \$725 million and has a 60-year sales agreement with BC Hydro.

This facility will come on-stream in 2014 and should make a significant contribution to earnings. Two smaller facilities (McLymont & Volcano) are also in the works for 2015 and 2016.

AltaGas currently pays a \$1.32 dividend per share and yields 4.6 per cent. We expect dividend growth of about five per cent a year.

There are still construction risks with these projects, but so far everything is on-time and on-budget, and the company has contingencies.

When we look at equities, there is a choice between value and yield. Most investors have been looking for more income, and so many stocks with good

dividend yields no longer have great value.

Ideally we want a company that has a combination of both, along with the prospect for earnings and dividend growth.

That winning combination today, in our view, can be found in Canadian banks. Bank stocks are at 9-10 times 2012 earnings estimates and yield between 3.9 per cent and 5.0 per cent. They look expensive relative to global peers, but are in better financial shape.

All of the Canadian banks are much stronger financially today than in 2008. Our banks survived the Great Depression and the 2008 recession, and we expect they will survive the next

few years.

There are concerns about consumer debt and house prices in Canada, and that may impact loan growth and earnings, but we don't see it jeopardizing the dividends.

Our favourites are **Toronto-Dominion Bank** (TSX-TD, \$72.63) and **Canadian Imperial Bank of Commerce** (TSX-CM, \$72.55).

We continue to believe that a balance of government bonds, corporate bonds and high yielding dividend stocks provides investors with the appropriate combination of capital preservation and a reliable income stream.

Given the expected continuing uncertainty and slowing of growth

in 2012, we believe this strategy is prudent and reliable. ▼

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