Seymour Investment Management

January 9, 2012

Global equity markets generated disappointing returns in 2011 as macroeconomic uncertainty weighed heavily on investor sentiment. The S&P/TSX Composite Total Return Index fell 8.7% while the S&P 500 Total Return Index generated a positive but meagre 2.1% return. The macroeconomic issues that continue to weigh on sentiment include the European debt and political crisis, the jobless recovery, mounting debt and political deadlock in the U.S., and a slowdown in Chinese growth.

While there are no easy or obvious resolutions to most of these issues, the history and track record of capitalism suggests that they are likely to be resolved – eventually. The pace of recovery from the 2007-2009 recession has been markedly slower than in almost any recovery in the past century. However, with investor sentiment at extremely low levels, it is easy to overlook the concrete evidence that a recovery is, in fact, taking place. In the United States, the unemployment rate fell to 8.5% in December, its lowest level in more than 2 ½ years, while the housing market has begun to show signs of stabilizing. Manufacturing activity is improving and the U.S. ISM manufacturing PMI rose to 53.9 in December, its highest level in six months. Recent data would indicate a similar improvement in manufacturing activity in other key countries including Canada, China and India.

What is most relevant about the current macro environment to equity investors is that the issues and challenges are well understood and documented. Most Americans are aware that there is a growing fiscal imbalance in their nation and that there are potentially damaging consequences if it is not dealt with (i.e. debt downgrades by rating agencies, higher debt costs, inflation). There is clearly no consensus on how to deal with the growing debt issue, but not much debate that it exists. More importantly, there is little doubt that macroeconomic issues are widely known and factored into, or discounted in, current equity valuations.

Over the last century, returns from stocks have averaged around 7%. When stocks are expensive, subsequent returns (for several years or even a decade) tend to be lower than normal and when stocks are inexpensive, subsequent returns tend to be higher than 7%. We believe we are in a period of inexpensive valuation which generally leads to several years of higher than normal returns for stocks. The S&P/TSX Composite Index is trading at 12.5 times 2012 earnings compared to a long-term average of 15.2 times (source: TD Securities). While our expectations for overall equity market returns are quite positive, there are inevitably some sectors of the market that are more attractive than others.

Sectors with high dividend payouts such as utilities, telecommunications, real estate and financials have all outperformed the broader market over the past several years, as illustrated in Exhibit 1 below.

Suite 1000 | 1285 West Pender Street | Vancouver, B.C. | V6E 4B1
Main: 604-659-1722 | Fax: 1-877-778-3770
www.seymourinvest.ca

Exhibit 1: S&P/TSX Composite GICS Sector Total Returns

	Weight on Composite	1 Year	3 Yr Cpd Ann	5 Yr Cpd Ann	10 Yr Cpd Ann
S&P/TSX Composite Index		**-8.7%**	**13.2%**	**1.3%**	**7.0%**
GICS Industry Sector Total Returns:					
Energy	27.1%	-9.9%	12.5%	0.4%	12.6%
Materials	21.1%	-21.2%	13.0%	6.7%	12.5%
Industrials	5.8%	4.2%	15.6%	5.1%	4.1%
Consumer Discretionary	4.0%	-15.5%	6.9%	-3.9%	1.0%
Consumer Staples	2.8%	6.8%	8.4%	2.5%	4.8%
Health Care	1.4%	50.4%	47.0%	10.9%	-2.3%
Financials	29.3%	-2.9%	16.0%	-0.5%	8.0%
Real Estate	3.5%	5.3%	25.9%	1.0%	10.7%
Information Technology	1.3%	-52.5%	-15.4%	-16.3%	-11.7%
Telecom Services	5.2%	24.9%	17.7%	8.0%	7.9%
Utilities	2.0%	6.5%	14.5%	5.9%	11.1%

Source: RBC Capital Markets Quantitative Research

We believe this outperformance can be explained by two factors:

1. These industries are generally viewed as defensive, so earnings are not impacted as much by weaker economic growth and,

2. Investors have an increasing desire for income with alternate investments such as fixed income generating historically low yields.

In times of economic uncertainty, it isn't surprising that defensive stocks such as utilities, telecommunications, and real estate equities attract fund flows and demonstrate market leadership. Moreover, these companies tend to carry higher debt loads and as such their earnings benefit disproportionately during periods of low interest rates because they can use leverage to increase their returns. What is somewhat unusual, however, is the magnitude of the outperformance that we have witnessed by high dividend paying stocks and the valuation discrepancy which has developed.

Exhibit 2: S&P/TSX Comp Sector Valuation – 2011F vs. Historical Relative Median P/E

	A	B	C	D	D-B
	20-Year Median P/E	as a % TSX P/E	P/E on 2011F	as a % TSX P/E	
S&P/TSX Composite Index	**19.1**		**13.8**		
Information Technology	40.3	211%	6.1	44%	-167%
Energy	22.1	116%	8.9	65%	-51%
Consumer Discretionary	23.1	121%	12.7	92%	-29%
Industrials	20.6	108%	13.5	98%	-10%
Materials	27.6	145%	19.3	140%	-5%
Telecom Services	19.0	99%	15.2	111%	11%
Consumer Staples	18.8	99%	15.3	111%	13%
Financials	14.3	75%	15.2	110%	35%
Utilities	16.3	85%	24.3	176%	91%
Health Care	45.0	236%	55.0	400%	164%

Source: TSX, BMO Capital Markets

The sectors of the market that have demonstrated market leadership for several years (utilities, telecommunications, financials) are all trading at price earnings multiples which are higher than historical norms (column C vs. A in Exhibit 2) and at much higher multiples relative to the overall market (column D).

Investors have become so enamoured with dividend income that many high yielding stocks have been bid up to relatively lofty valuations. At the same time, pessimism over the course of the economy has resulted in the overall market, and low dividend yielding stocks, trading at very low multiples. As a result, we think the potential for outsized returns is generally greater in lower yielding stocks.

Historically, on average, about half of the total return from owning stocks has come from dividends and half from capital appreciation. During periods of economic uncertainty when defensive sectors outperform, a greater proportion of total return has been comprised of dividends. In more robust economic times when growth stocks tend to lead, a greater proportion of total return has come from capital appreciation. We encourage investors to focus on total return, which is comprised of both dividend income and capital appreciation from earnings growth and valuation shifts. We expect total returns over the next year for higher yielding stocks will be comprised only of returns earnings growth and dividends. In the case of lower yielding stocks that are trading at historically low valuation metrics, total returns may also benefit from an increase in valuation multiples, which may allow for outsized returns.

Given the uncertainty in the timing and magnitude of the global economic recovery, it is important that equity investors retain a long-term investment horizon. Of course, not all low payout ratio stocks are created equal, just as quality differs among high-yielding equities. We have not ignored the high dividend paying sectors that have led the market recently.

Diversification across industries and companies is a cornerstone of good investment management and we are not abandoning high dividend paying sectors across the board. However, we are generally finding more attractive investment opportunities in lower dividend paying industries and companies, where we see numerous investment opportunities in well capitalized companies and industries that are trading at very attractive valuation levels.

We thank our clients for their support and look forward to meeting with you in the near future.

Regards

The Seymour team