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Canadian Equities
The Double Digit Party Ends in 2007

After four years of double digit growth, fueled on the back of resources and a robust financial services sector, the Canadian equity market closed the year with a return of 9.83%. Although this return may disappoint those investors that have come to expect robust double-digit returns, it should be noted that the long term return for this Northern market is in the range of 8% and has historically delivered a number of years where no return was achieved at all.

A year in the financial markets always ushers in unexpected events that trigger market movements in both directions typically leaving investors euphoric, concerned, or frightened. Despite this range of emotions, this is indeed the normal course of business for investors with equity portfolios. Investment management firms such as Brownstone steer these portfolios through the maze of market emotions balanced against the factual data surfacing from the companies we invest in. Our job is to evaluate the best allocation of capital on a risk adjusted basis throughout the portfolios.

Over the past year the Canadian Equity market received a rather large dose of unexpected events, each impacting share price valuations and portfolio returns. To name a few; the new tax regime on income trusts, the price of crude oil reaching $100 per barrel, the soaring loonie hits parity, and most prevalent of all – the exposure of the U.S. based sub-prime credit disaster. While the year began with roses, the thorns of these problems sprouted and the market skidded downhill into the close of 2007.

While Canadian investors were comfortably resting (and making money) in safe havens such as our banks and insurance companies, they were also enjoying the fruits that were borne from our materials-based resource companies that explored, serviced and held resources in copper, nickel, zinc, uranium, etc to a hungry globe with China being the main customer for dinner. Not to rest in these sectors, Canadian investors also embraced the fundamentals of the energy industry which continued its unabated climb and seemed to surface not only as a function of energy earnings power, but truly a component to the solution plaguing the U.S. and its insatiable appetite for oil.

Yet in the midst of our summer holidays things began to change and change rapidly; the sub-prime crisis was exposed which meant our Canadian banks were exposed – the level of exposure was uncertain. Natural gas prices continued to decline while companies in this sector were paying record costs for drilling, human resources and cost of capital. The Canadian dollar soared putting further pressure on the revenue our energy companies receive for their product and fears of a U.S. recession caused raw material prices to recede.

At Brownstone we expect that most, but not all, of the impact of the sub-prime crisis is on the table. By June 2008 we would anticipate the damage from collateralized loan obligations and commercial mortgage-backed securities to be essentially complete. The fear of a global credit crunch has partially abated and, as is typical with financial markets, once the initial surprises and shocks are felt, the market is better able to handle the uncertainty.

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All the talk in the financial markets these days centre around the prospect of a U.S. recession, and we can anticipate market volatility with each economic statistic released and its contribution to determining the state of the U.S. economy.

Despite this mayhem, we grew the capital value of our portfolios this year and expect to do the same next year. Prices of many quality equities are down and in a range that raises our eyebrows. We have enough experience in these markets to know that the impact of clearing the slate of investment emotions can usher in strong market rebounds and profit to our investors. We will not sit on the sidelines, but instead intend to position portfolios in these market conditions to deliver returns both in the short, medium, and long term.

Brownstone Team

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