

# BARBELL STRATEGY

How to use one for your portfolio in 2012

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## DISCUSSION POINTS

- Barbell Strategy for Equities?
- Present Environment
- Market Outlook
- Implementing a Barbell Strategy

## What is a Barbell Strategy?

- Historically used in reference to bonds
- Strategy seeks to balance safe, very-short term bonds with higher-risk, very long-term bonds



## Equity Barbell Strategy

- In general terms, barbell strategy refers to a portfolio approach that combines low risk and high risk investments
- In equities, the term refers to a combination of low-risk blue-chip equities, and high-beta, relatively aggressive stocks

# Risk vs. Return



- Low risk = low returns
- Higher potential returns => going further out on “risk curve”
- Barbell strategy = combines conservative and aggressive stocks to provide downside protection and improve potential returns

# Stock Characteristics

## Conservative

- Defensive sectors – healthcare, utilities, telecom
- Stable businesses with low growth rates
- Earnings predictability
- Above-average dividend yields
- Low beta
- Mid- to large-caps

## Aggressive

- Cyclical sectors – energy, commodities, technology, financial
- Growing businesses with high growth rates
- Volatile earnings
- Low dividend yields (except financial sector & ex-energy trusts)
- High beta

## Why a barbell strategy in 2012?

- Surging volatility implies markets are at a turning point...but which way will they turn? Upwards or downwards?
- Consider these facts –
  - On July 7, the S&P 500 and DJIA were only about 1% away from their 3-year highs reached on May 2
  - On July 7, the Nasdaq Composite was less than 10 points or 0.3% away from its 10½-year high (also reached May 2)
  - On March 7, the TSX Composite was only 825 points or about 5% away from its record high set in June 2008

## Why a barbell strategy in 2012?

- At their May peaks, the S&P 500 was up 105% from its 2008 low and the TSX was up 90%,
- This was a stunning rebound by any measure....
- .... but especially in light of 2008's savage bear market & global recession (US\$36 trillion or 60% of global market cap wiped out in 17 months)
- Our early 2009 thesis that equities would be range-bound after the chaos of 2008 may now be coming to pass – finally.....

## Why a barbell strategy in 2012?

- Having consistently traded in the top half of their trading range since 2009, equities may be poised to test the bottom half....
- .... which means that global equities may drift lower in 2012
- No shortage of headwinds going into 2012, but there are mitigating factors

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## Trading Ranges since 2009

TSX Composite

S&P 500



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## The Bad News Bears

|                       | Our assessment of risk |                    |
|-----------------------|------------------------|--------------------|
|                       | First half of '11      | Second half of '11 |
| ■ Sovereign debt risk | ↓                      | ↑                  |
| ■ US economy          | ↓                      | ↑                  |
| ■ Currency turmoil    | ↓                      | ↑                  |
| ■ China               | ↑                      | ↓                  |
| ■ Complacency         | ↑                      | ↓                  |
| ■ Geopolitical risk   | ↑                      | ↓                  |

## The Good News Bulls

- Corporate balance sheets are strong
  - Example – US non-financials had almost \$2 trillion in cash at end-2010
  - Cash = 7.4% of total assets for these companies, highest ratio in over 50 years
- Monetary policy is stimulative
  - Fed on hold until 2013, Bank of Canada until 2012?

## The Good News Bulls

- Energy and commodity costs have fallen
  - Crude oil is down 23%, CRB index is down 11%, giving some relief to cash-strapped consumers
- Valuations are attractive
  - S&P 500 at 12.2x FY12 EPS, TSX at 13.4x
- Most importantly, consensus estimates still call for healthy earnings growth
  - Average annual projected EPS growth over next two years: TSX 12.5%, S&P 500 11.2%

## The billion \$ question - are EPS estimates for 2012 too optimistic?

- Not if –
  - global growth resumes apace
  - the Eurozone issues are resolved
  - the US skirts recession
  - there are no more macro shocks
- Current 2012 EPS estimates are predicated on too many “ifs”
- Ergo, earnings estimates are too high and are at significant risk of being lowered

## 2012 Outlook

- Fourth year of US presidential cycle
- Fourth year of market rebound
- While we foresee modest declines in global equity markets....
- If risk appetite returns, we may have another up year

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## Big swings in risk appetite



- “Risky” asset classes like commodities and equities are moving in tandem
- Risk pendulum gyrations
  - “Risk on” - 2003-07, most of 2009-2011
  - “Risk off” – 2008, May-June 2010, May 2011 to present
- C\$ great proxy for risk appetite

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## How will the global economy fare in 2012?

- US – 1-in-3 chance of recession (WSJ Survey)
- Europe – Turmoil may take toll on growth
- Canada – Surprise contraction in Q2; what next?
- China – Some concerns about growth
- Japan – Still coping with earthquake aftermath
- India – Near 10% inflation, interest rates up 3.50% since March 2010

## So why invest in equities?....

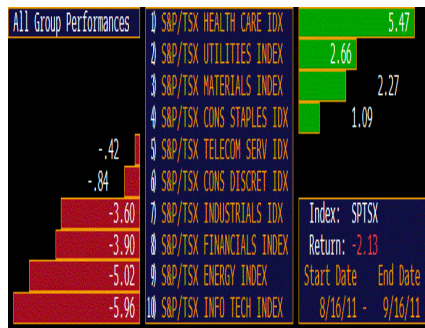
- Disproportionate sell-off in some sectors (energy, commodities, financials)
- Opportunity to add best-of-breed stocks
- Improved valuations
- Suitable entry point for long-term investors

## ... especially aggressive stocks?

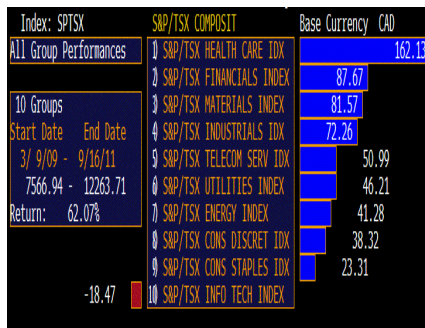
- Aggressive stocks outperform during market rallies
- Staying wholly defensive all the time will lead to portfolio under-performance over long term
- Improves portfolio diversification

## Eschewing risk does not always pay

TSX Group returns – Aug.  
16, 2009 to Sept. 16, 2011



TSX Group returns – March  
9, 2009 to Sept. 6, 2011



## ..and sometimes takes time to work out

- **Portfolio Foundation Stocks**
  - We picked five diversified stocks in Feb. 2009
  - Criteria - Dividend sustainability, financial stability, low beta
  - Stocks that made the cut - ADP, BMO, ENB, JNJ, and THI
- **Relative Performance**
  - Average stock gain (Feb.26, '09 to Sept. 16, '11) = 60.1%
  - Blended benchmark performance = 56.3%
  - Portfolio outperformance = 3.8%
- **Notable points**
  - This five-stock portfolio underperformed for most of the time
  - Only began outperforming when risk appetite waned
  - Portfolio beta at inception = 0.76; Current beta = 0.71

## Implementing barbell strategy

- We advocate ongoing adjustment in the proportion of conservative to aggressive stocks, depending on the stage of the economic cycle
- During strong bull markets, portfolio beta should be well above 1
- During neutral to bearish markets, portfolio beta should be below 1

## What we look for in our stocks

### Conservative

- Blue-chip large-caps
- Sustainable, growing dividends
- Strong cash flows
- Manageable debt loads
- Attractive valuations

### Aggressive

- Mid- to large-cap (not necessarily blue-chips)
- Dividends not a priority
- Projects or products that can boost earnings
- Attractive valuations

## Barbell Strategy Stocks - Examples

### Conservative

- Rogers Communications  
(\$37.22, div.yld.3.8%, beta 0.48)
- Johnson & Johnson  
(\$64.59, div.yld.3.5%, beta 0.62)
- TransAlta\*  
(\$22.00, div.yld.5.3%, beta 0.74)
- Duke Energy  
(\$19.57, div.yld.5.1%, beta 0.60)

### Aggressive

- Suncor Energy\*  
(\$29.63, div.yld.1.5%, beta 1.40)
- Sherritt International  
(\$5.00, div.yld.3.0%, beta 1.62)
- MEMC Electronic Mat.  
(\$7.06, div.yld.0%, beta 1.72)
- Kinross Gold  
(\$16.99, div.yld.0.7%, beta 1.11)

\* Presenter or family member owns shares

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## Why the barbell strategy is worth considering

**Yamana Gold**  
(+50% in 18 months)



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**Savanna Energy Services**  
(+62% in 2 ½ months)



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## In Conclusion

- Surging volatility implies that markets are at a turning point – the question is which way will they turn?
- Our early 2009 thesis that equities would be range-bound after the chaos of 2008 may finally be coming to pass
- Although global equities may drift lower in 2012 – given the headwinds going into next year – there are mitigating factors
- While there have been huge swings in the risk pendulum recently, we may have another up year in 2012 if risk appetite returns
- Why invest in aggressive stocks at all? Because they outperform during market rallies, improve diversification, and if avoided all the time will lead to portfolio underperformance
- It is important to adjust the proportion of conservative to aggressive stocks in the portfolio on an ongoing basis, depending on the stage of the economic cycle

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## Global Research Products

- Daily “Morning News Call”
- Weekly Market Bulletin
- Weekly Options Bulletin
- Quarterly Strategy Reports
- Reports on Portfolio Stocks
- In-depth Reports on Stocks

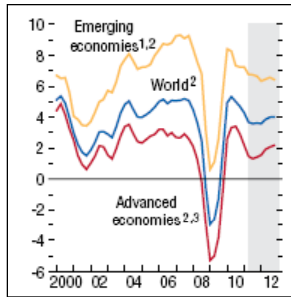
## THANK YOU!

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# Addendum 1 – This just in.....

## IMF cuts global growth forecast



## Canada feels the pinch as well

|            | GDP Growth Estimates<br>(percent change) |        |        | Difference from June<br>2011 Projections |      |
|------------|--|--------|--------|--|------|
|            | 2010 A                                   | 2011 E | 2012 E | 2011                                     | 2012 |
| World      | 5.1                                      | 4.0    | 4.0    | -0.3                                     | -0.5 |
| Adv.Econ.  | 3.1                                      | 1.6    | 1.9    | -0.6                                     | -0.7 |
| Em. & Dev. | 7.3                                      | 6.4    | 6.1    | -0.2                                     | -0.3 |
| Canada     | 3.2                                      | 2.1    | 1.9    | -0.8                                     | -0.7 |
| US         | 3.0                                      | 1.5    | 1.8    | -1.0                                     | -0.9 |
| Euro Area  | 1.8                                      | 1.6    | 1.1    | -0.4                                     | -0.6 |
| Japan      | 4.0                                      | -0.5   | 2.3    | 0.2                                      | -0.6 |
| China      | 10.3                                     | 9.5    | 9.0    | -0.1                                     | -0.5 |
| India      | 10.1                                     | 7.8    | 7.5    | -0.4                                     | -0.3 |

Source: IMF WEO September 2011

# Addendum 2 – Strategy Example

## Scenario 1

- Strong economic growth, rising earnings
- Within equity portfolio, Conservative stocks = **45%** (Average Beta 0.8)  
Aggressive stocks = **55%** (Average Beta 1.25)
- **Overall Portfolio Beta = 1.05**

## Scenario 2

- Slowing economic growth, falling earnings
- Within equity portfolio, Conservative stocks = **70%** (Average Beta 0.8)  
Aggressive stocks = **30%** (Average Beta 1.25)
- **Overall Portfolio Beta = 0.94**