



## **Why Is Everyone Calling It the New Normal If Its Not Normal?**

### **Hillsdale Investment Management**

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# Discussion Points

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- A Short Digression on Normative vs Positive Economics
- The New Normal Is...
- The World As We Knew It
- Is This the New Normal?
- What Was Normal About the New Normal?
- Investment Implications for Institutional Investors

# The New Normal Is...

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- “The New Normal Means Slower *Growth in the Years Ahead*... There Are Three Reasons for This. No. 1 is Deleveraging...No. 2 Is Re-Regulation... and No.3 is De-globalization.
- Various Countries Around the World Will Produce Slower Growth Than What We’ve Grown Used To, and *This Leads to Lower Returns on Assets*”
- *This Is a Normative Look at the Economy and Markets*

# We Are Concerned With...

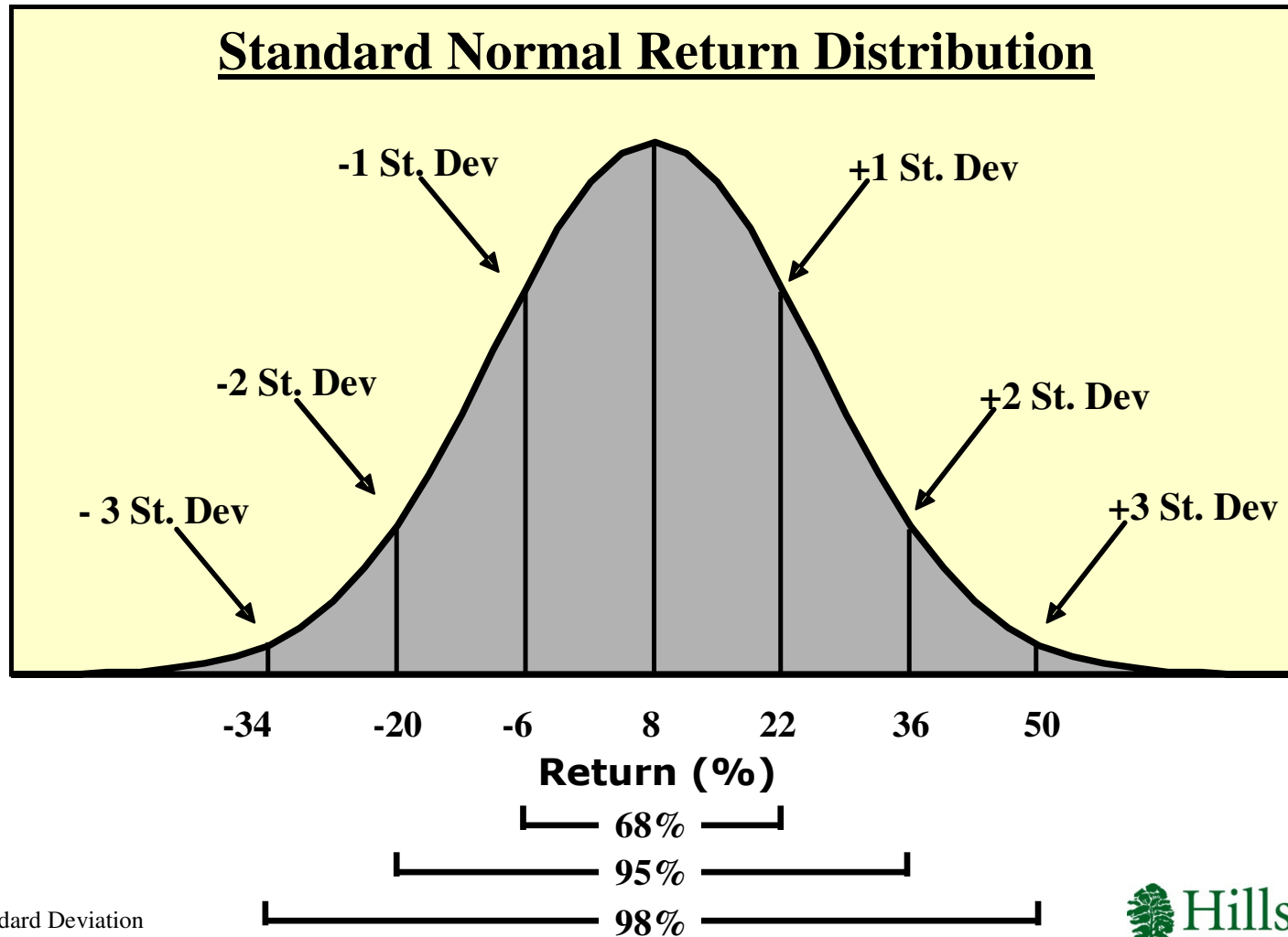
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- Theories That Are Not Working In Reality
- Market Experiences That We Have Never Experienced Before
- Events Leading Up the New Normal Were Not Normal
- We Are Not Trying to Forecast What the Economy **Should Do** or What Asset Classes Returns **Should be**
- Instead, **We Are Concerned With What Markets Are Doing**
- What Are The Implications for Investors?
- *This is a Positive Look At the Economy and Markets*

# The World As We Think Of It...

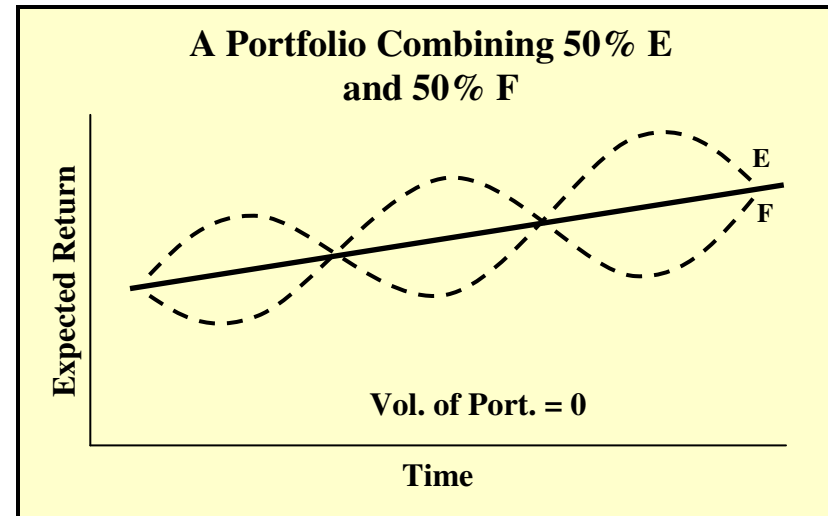
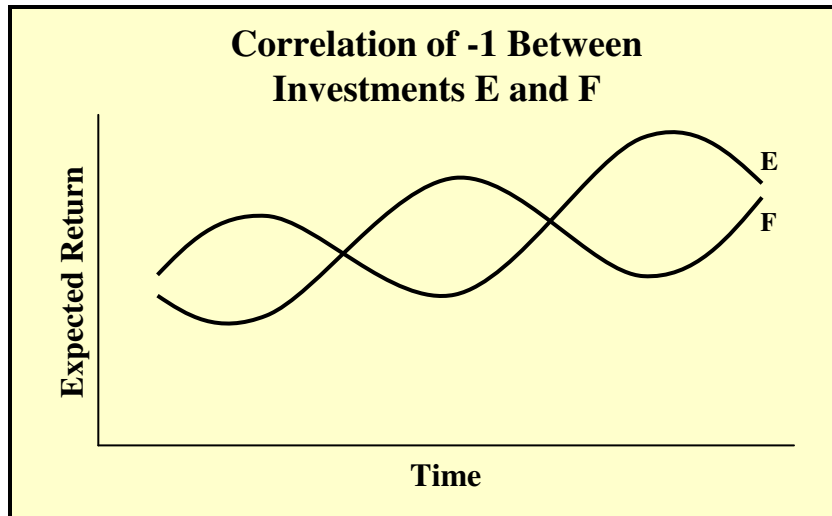
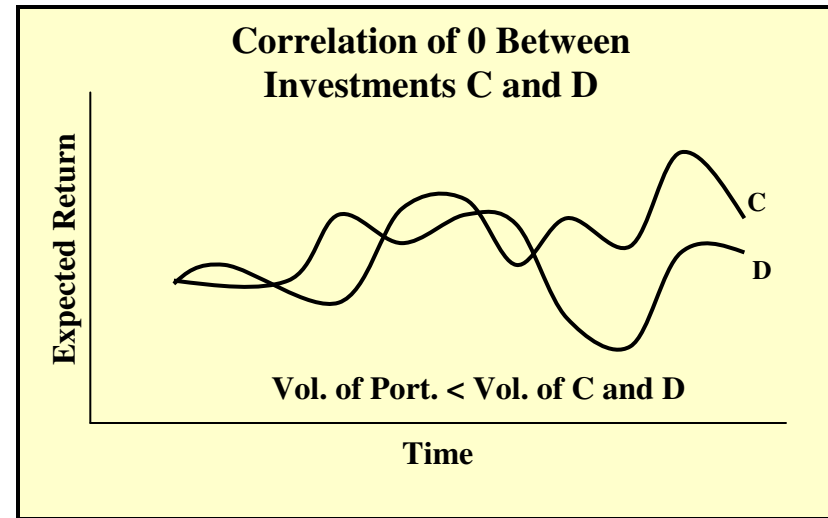
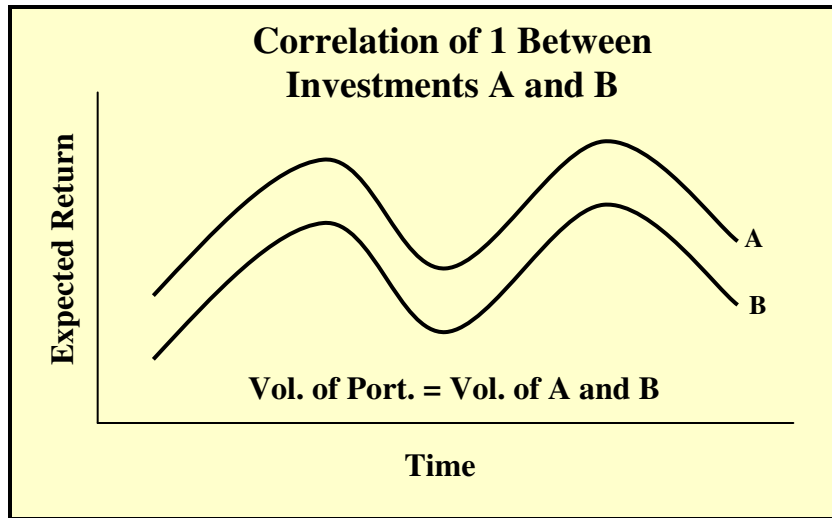
Equity Market Return = 8%

Equity Market Standard Deviation of Returns = 14%



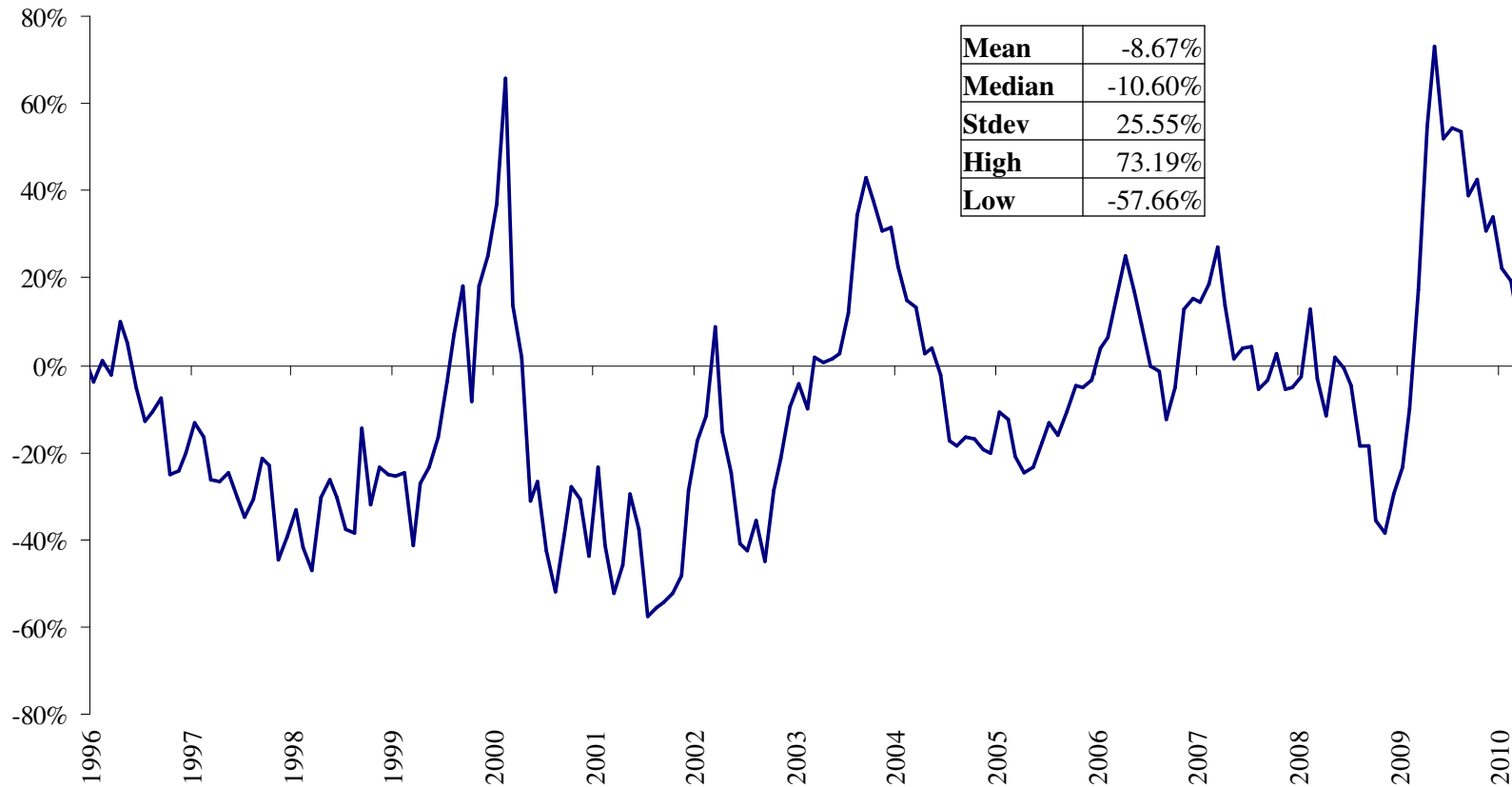
5 St. Dev = Standard Deviation

# Diversification As We Have Been Taught



# Is This The New Normal? Idiosyncratic Risk Factor

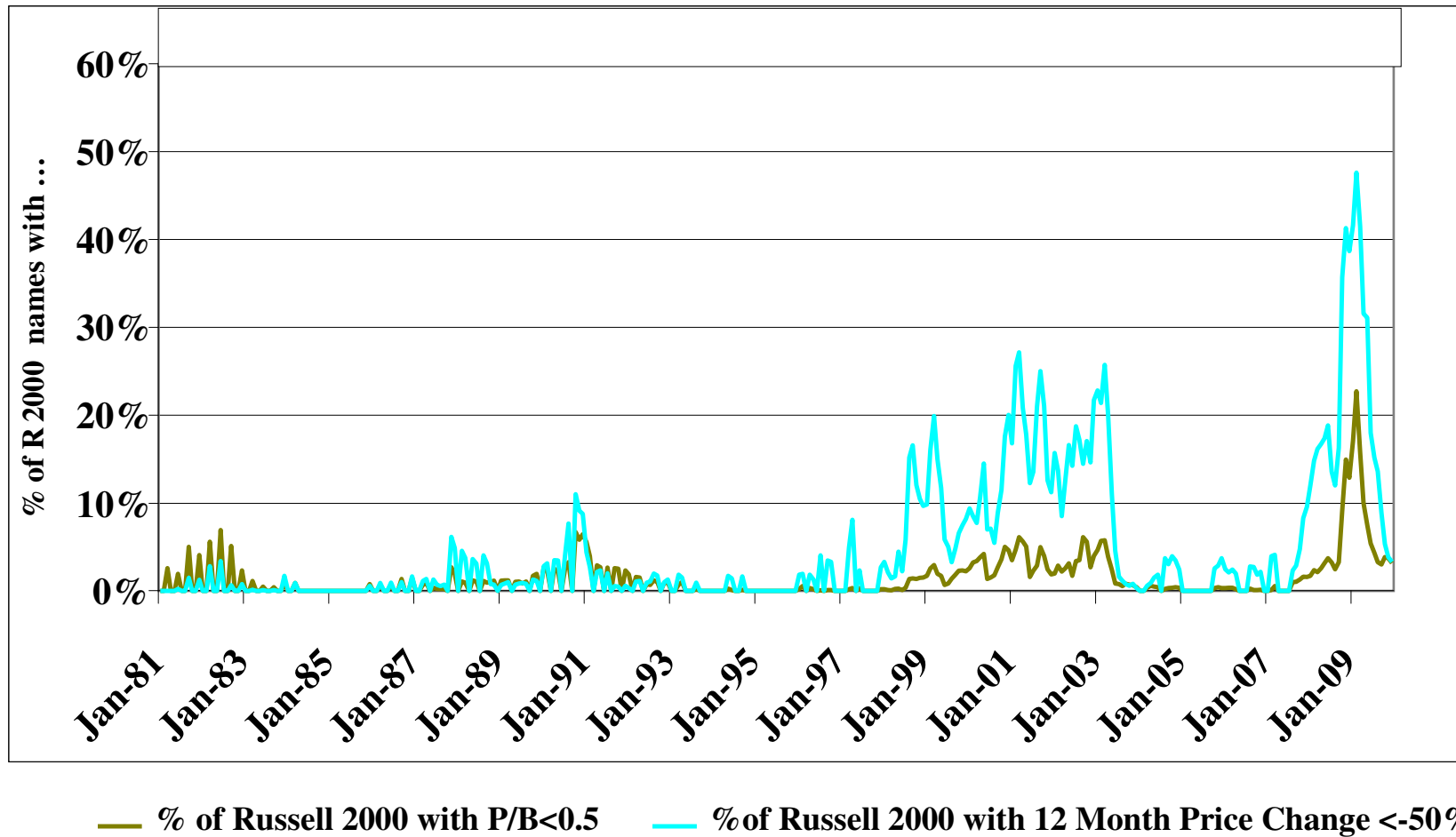
**120 Day Standard Error**  
Top 30 Stocks – Bottom 30 Stocks, 6 Months Rolling



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Stock Universe is the TSX Composite Index. Top 30 stocks are the largest or highest. Bottom 30 Stocks are the Smallest or Lowest. Portfolios are Equally Weighted. Data as of March 31, 2010

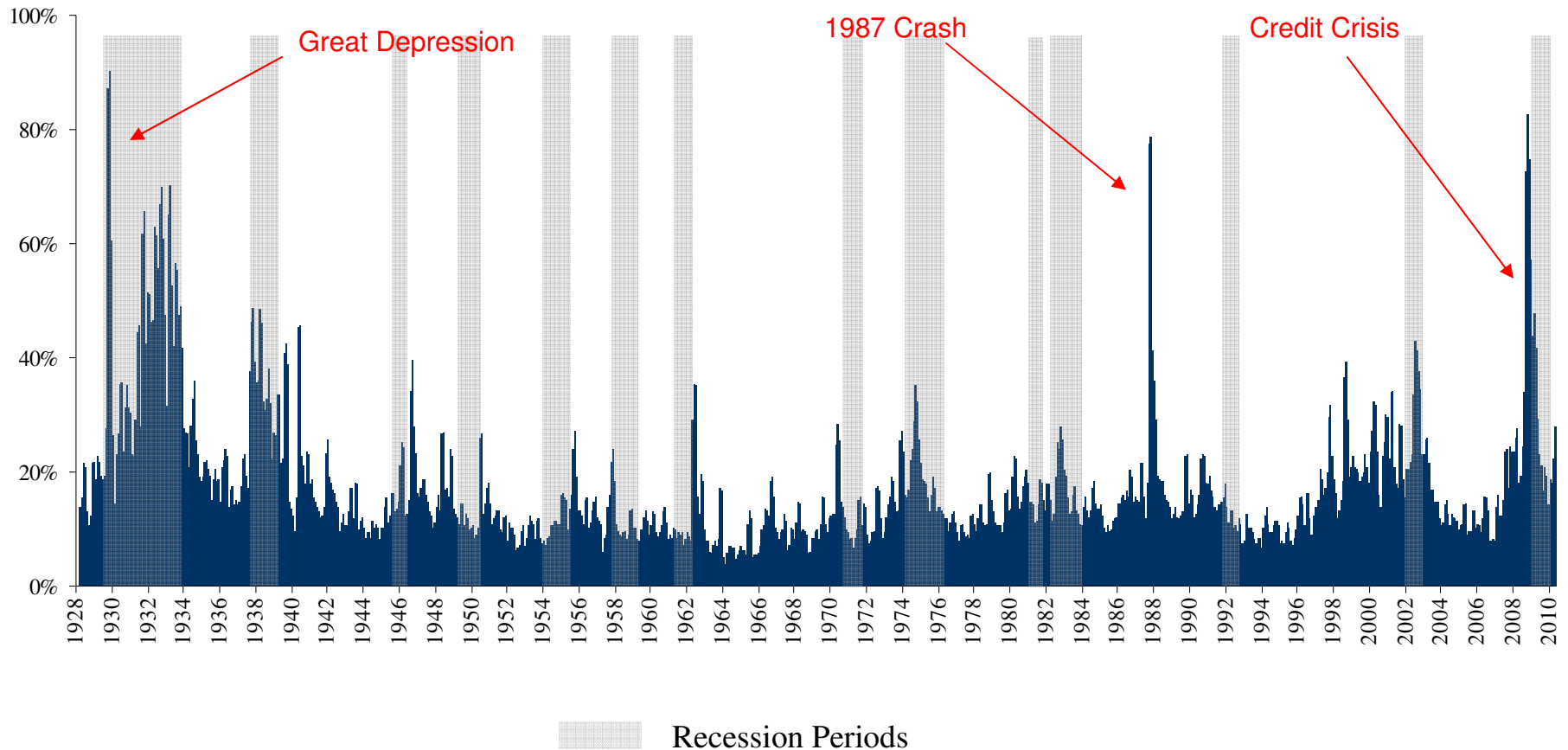
# Is This The New Normal?



Source: Hillsdale Investment Management

# With Hindsight, Nothing Was (Is?) Normal - Look At the Risk Level Investors Lived Through...

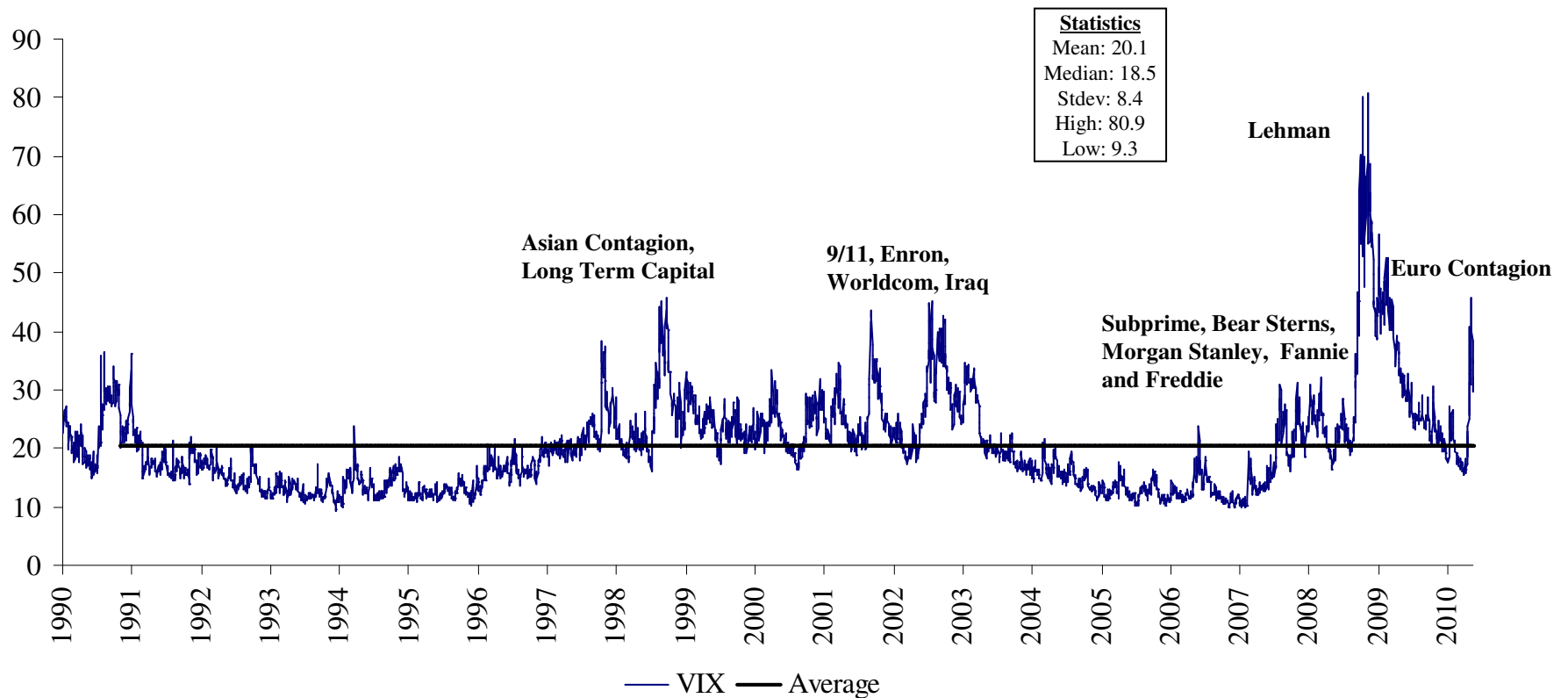
S&P 500 30 Day Rolling Volatility (Jan 1928 – May 28, 2010)



# In The New Normal, the “Investors Fear Gauge” Has Been on a Rollercoaster Ride

## Chicago Board Options Exchange Volatility Index (VIX)

*Daily, Ending May 28, 2010*



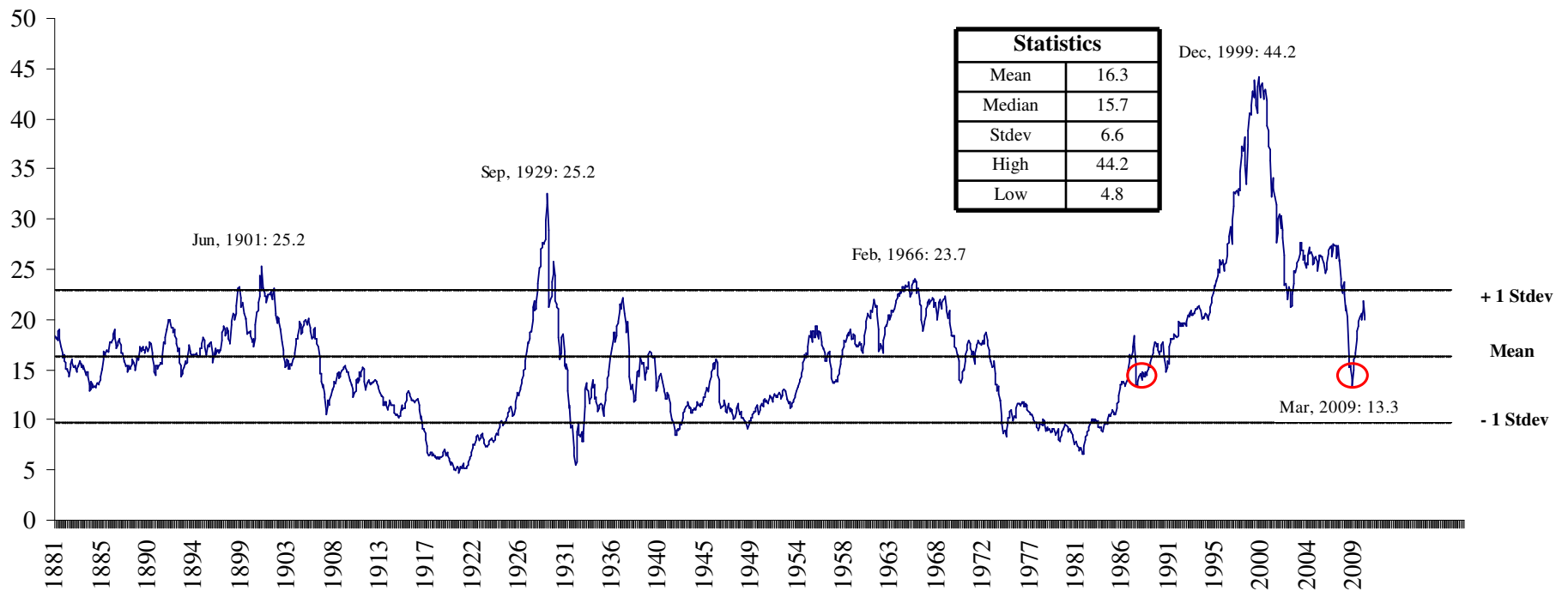
**VIX Definition:** An implied volatility index that measures the market’s expectation of 30-day S&P 500® volatility implicit in the prices of near-term S&P 500 options. VIX is quoted in percentage points, just like the standard deviation of a rate of return.

Source: Chicago Board Options Exchange



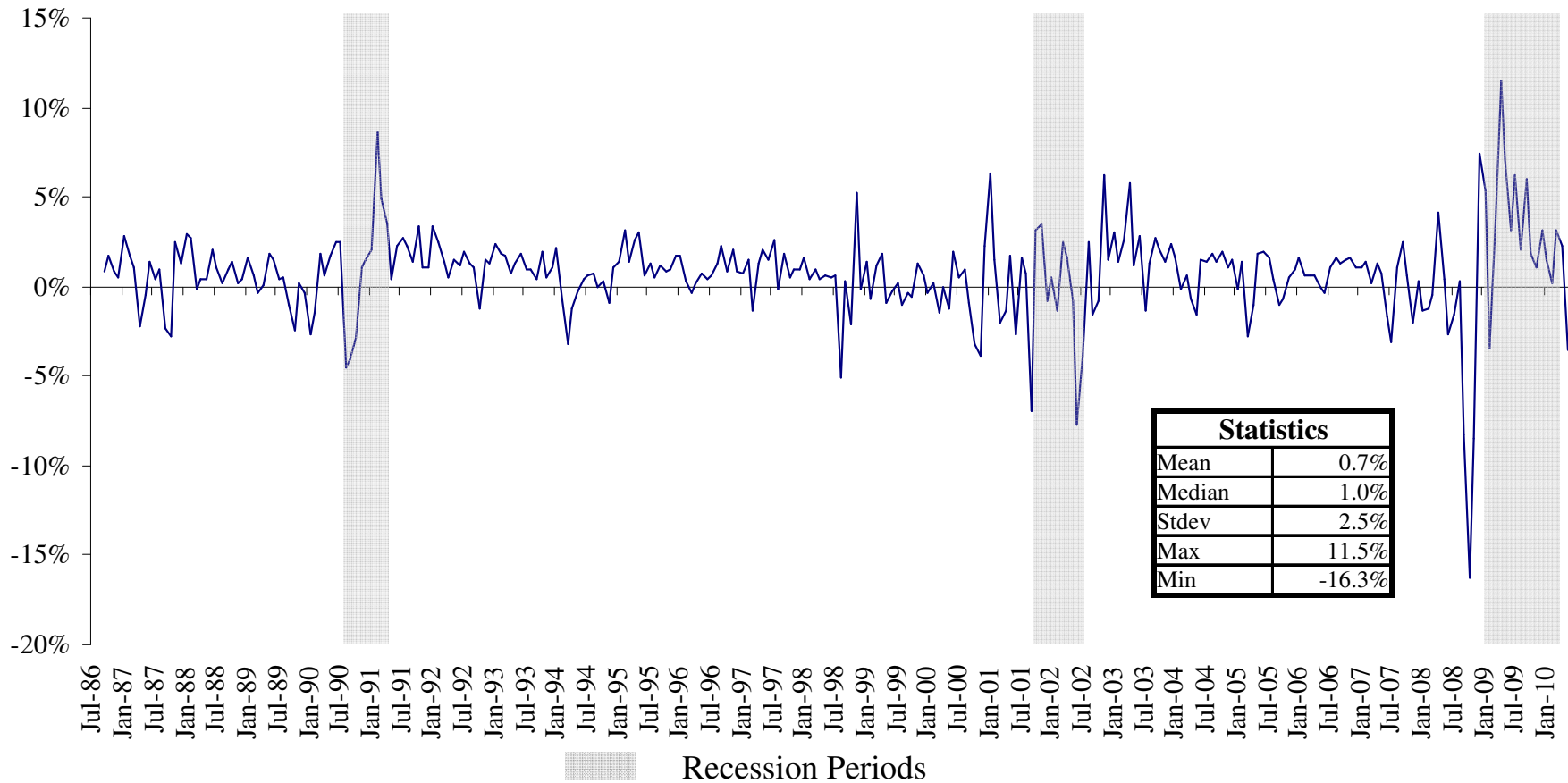
# As Well, We Had Equity Valuations That Occur Maybe Once A Decade

**Shiller P/E: S&P 500 Price/10 Year Real Earnings Average (Jan 1871 – June 2010)**



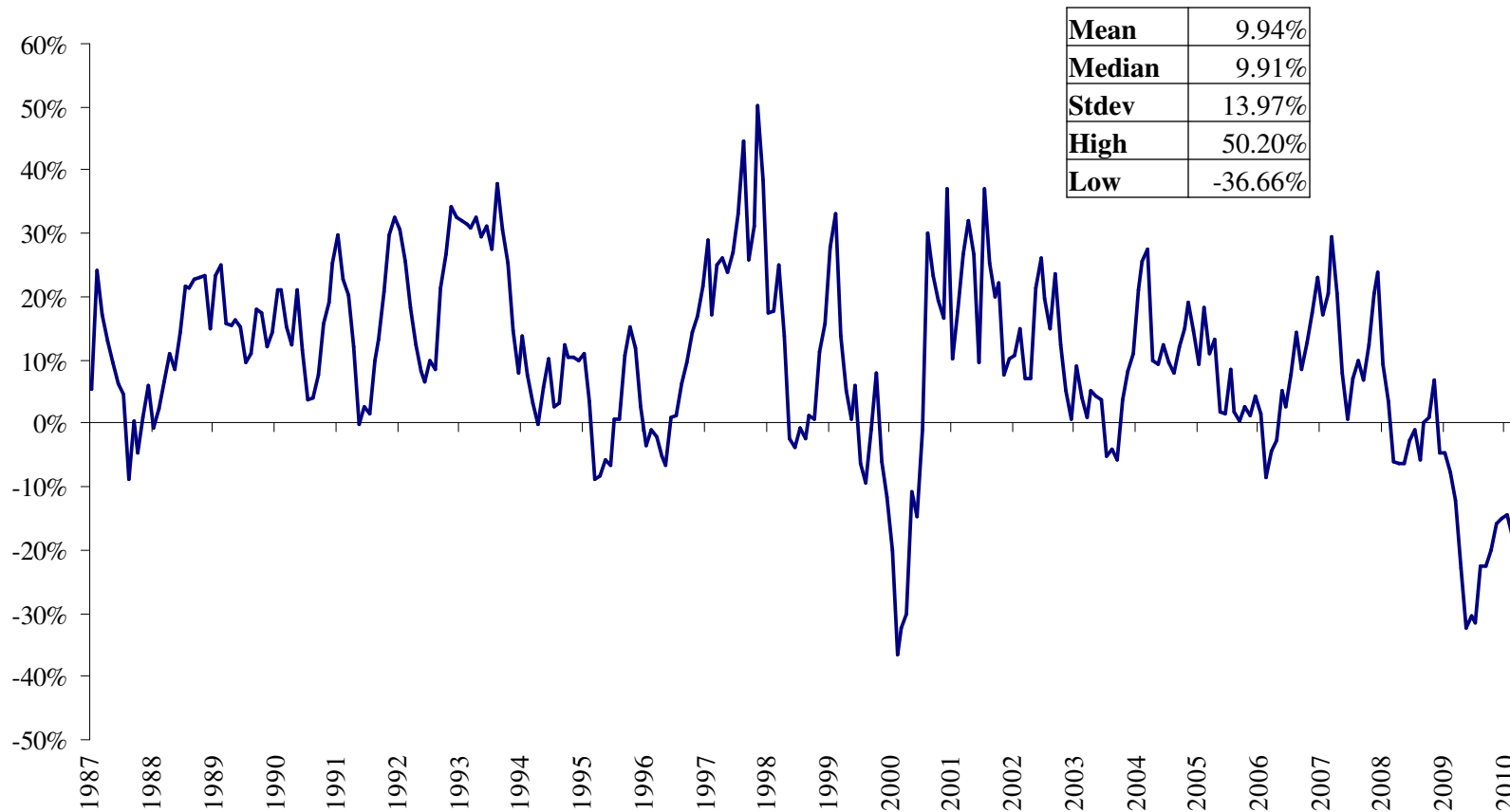
# And, In The Bond Market, Credit Risk Never Experienced

**Bank of America Merrill Lynch High Yield Master II Monthly Returns Sep 1986 – May 2010**



# Typical Fundamental Factors Were Not Rewarded

**Quarterly Earnings Growth (Trailing)**  
 Top 30 Stocks – Bottom 30 Stocks, 6 Months Rolling

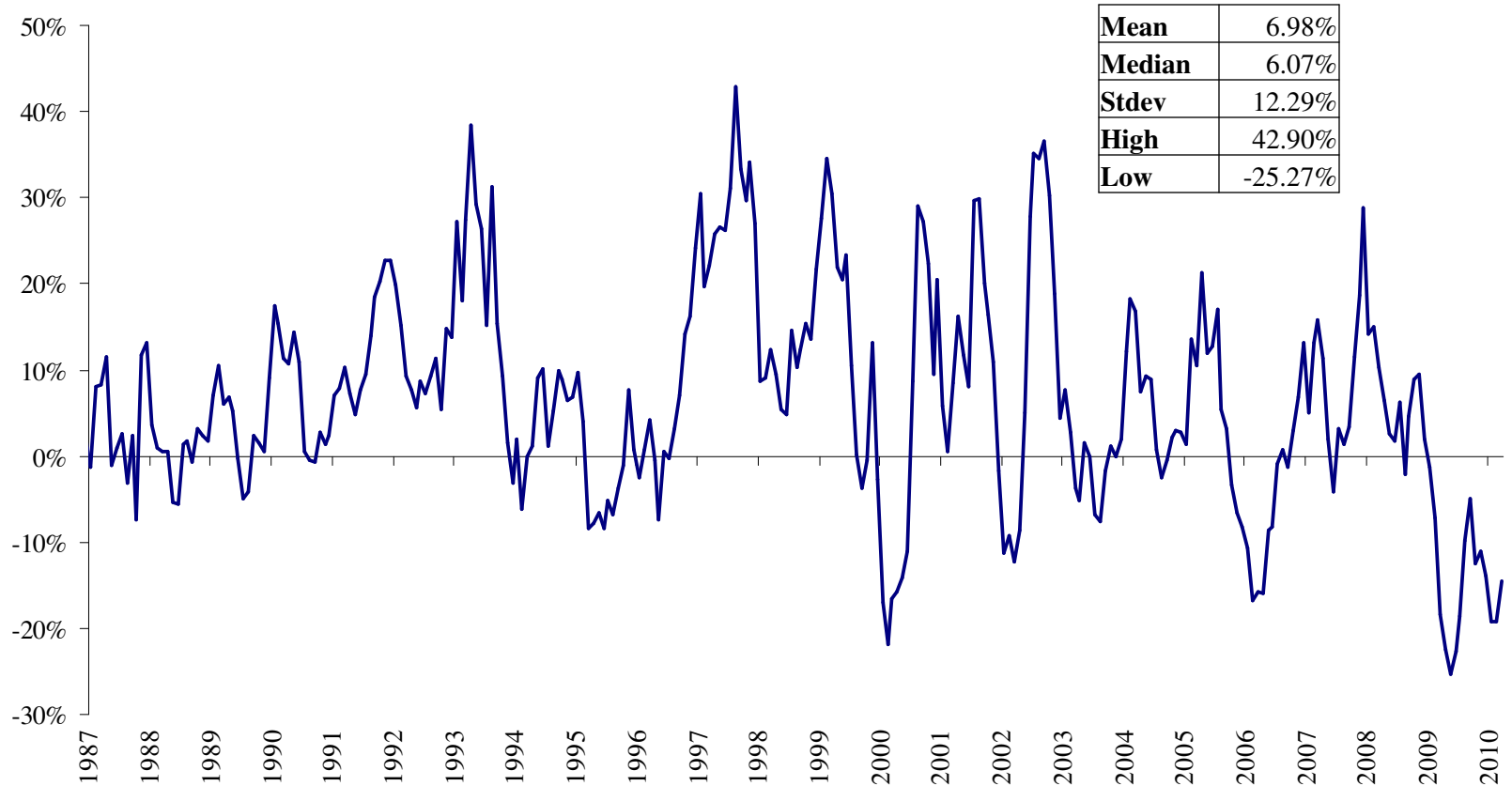


**13** Stock Universe is the TSX Composite Index. Top 30 stocks are the largest or highest. Bottom 30 Stocks are the Smallest or Lowest. Portfolios are Equally Weighted. Data as of March 31, 2010

# Typical Fundamental Factors Were Not Rewarded

## Quarterly Cash Flow Growth

Top 30 Stocks – Bottom 30 Stocks, 6 Months Rolling



14 Stock Universe is the TSX Composite Index. Top 30 stocks are the largest or highest. Bottom 30 Stocks are the Smallest or Lowest. Portfolios are Equally Weighted. Data as of March 31, 2010

# But, Core Long Term Fundamental Strategies Do Work

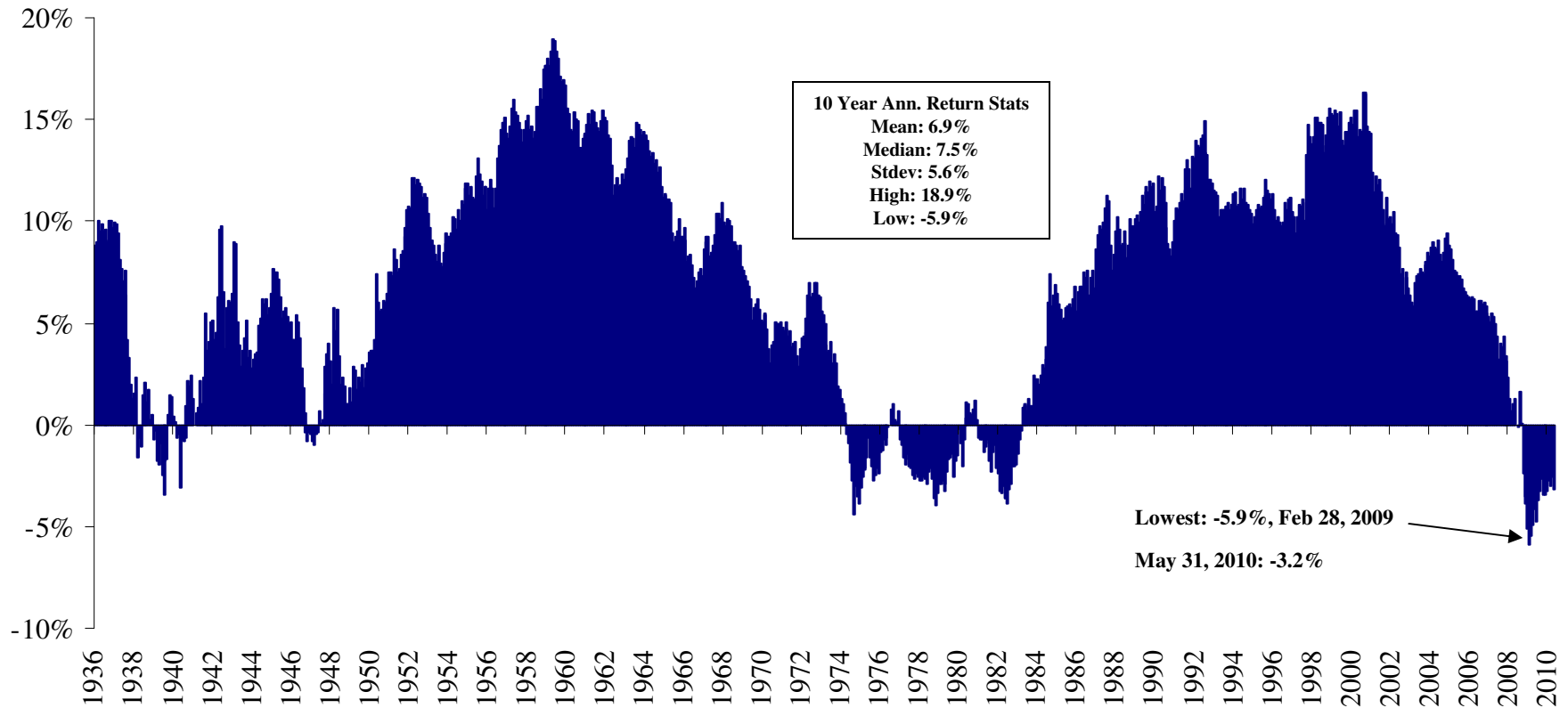
## Return/Risk of Factor Strategies

Simulation Period between December 1985 – December 2009



# And, Having Invested Through The Worst Decade Yet For Stocks in Real Terms

**S&P 500 TRI 10 Year Annualized Returns Adjusted for Inflation (1931- May, 2010)**



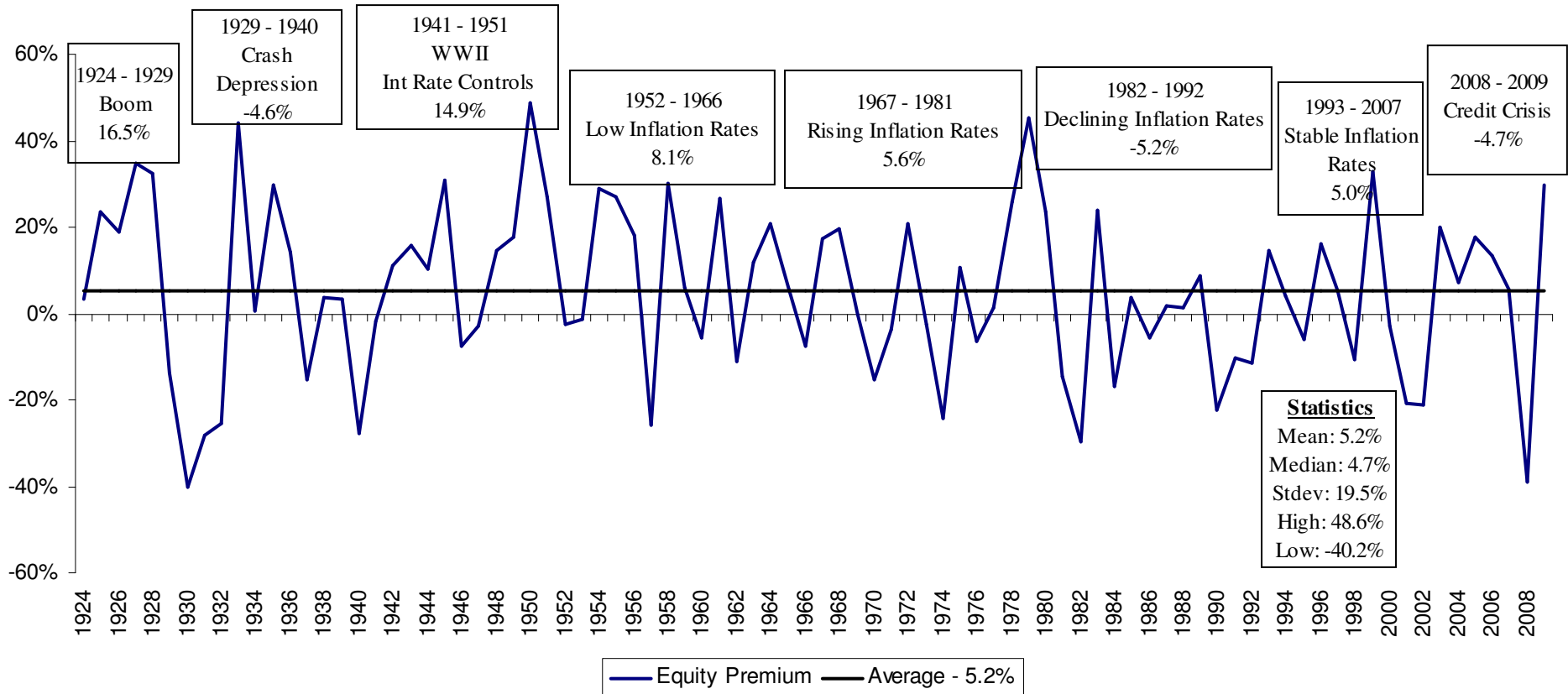
## The Icing on the Cake: Over the Past Decade, There Has Been Huge Theoretical Disconnect Between Return and Risk as the Risks Lined Up But Not the Rewards

### 10 Year Return and Risk Data – Ending December 31, 2009

	Return	Risk	Return to Risk
Cdn CPI	2.2%	0.3%	7.4
Cdn 91 Day T Bills	3.1%	0.4%	7.5
DEX Bond Universe	6.7%	3.6%	1.9
DEX Long Bonds	7.8%	6.7%	1.2
TSX Composite	5.6%	16.3%	0.3
TSX Small Cap	2.8%	19.4%	0.1
S&P 500 (USD)	-0.9%	16.1%	-0.1
Russell 2000 (USD)	3.5%	21.5%	0.2
MSCI World (USD)	0.2%	16.6%	0.0
MSCI EAFE (USD)	1.6%	17.9%	0.1
MSCI Emerging Markets (USD)	10.1%	24.9%	0.4
HFRX Equity Hedge(USD)	4.2%	7.5%	0.6
Cdn Equity Min Risk	10.3%	12.0%	0.9

# Another Theoretical Failure Was The Disastrous Cdn Equity Risk Premium

## Average Equity Risk Premium (S&P/TSX – DEX Bond Universe)



## So What Did Canadian Institutional Investors Do?

Asset Mix	2008	2009	Change (2009 – 2008)
Total Canadian Equities	18.7%	16.7%	-2.0%
Total International Equities	27.4%	25.2%	-2.2%
Total Fixed Income	30.8%	36.0%	5.2%
Real Estate	9.0%	9.3%	0.3%
Private Equity	5.9%	4.2%	-1.7%
Hedge Funds	2.5%	2.2%	-0.3%
Infrastructure	1.6%	2.0%	0.4%

# What Are the Top Challenges For DB Plans

	<b>Ranks As One Of The Top 3 Challenges</b>	<b>More Severe Than Before The 2008 Financial Crisis</b>
<b>Volatility Of Funding Contributions/Accounting Expenses</b>	<b>91%</b>	<b>77%</b>
<b>Cost Of Maintaining/Funding DB Plans</b>	<b>88%</b>	<b>80%</b>
<b>Imbalance Between Funding Risk and Reward (Asymmetry)</b>	<b>48%</b>	<b>37%</b>
<b>Complying With Fiduciary And Governance Responsibilities And Disclosure Guidelines</b>	<b>28%</b>	<b>37%</b>
<b>The Move To International Accounting Standards By The Canadian Institute Of Chartered Accountants (CICA)</b>	<b>22%</b>	<b>51%</b>

## Guess What...It's Time To Change Investment Strategies

	Taken In Past 12 Months	Implementing In Next 12 Months	Considering For The Future
<b>Changes Unrelated To Cost And/Or Volatility</b>	9%	15%	14%
<b>Actions Targeted At Containing Cost And/Or Volatility</b>	37%	33%	52%
• <b>Switching/Converting To CAP/DC</b>	4%	6%	13%
• <b>Plan Design Changes Excluding Move To CAP/DC<sup>1</sup></b>	9%	7%	23%
• <b>Investment Strategies<sup>2</sup></b>	27%	25%	34%

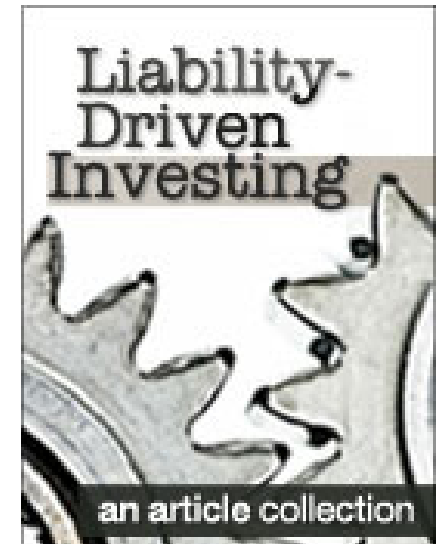
1 Changes include reduction in ancillary benefits and primary retirement benefits for current employees and increase in required employee contributions.

2 Changes include increasing fixed income weighting, lengthening fixed income duration, employing cash flow matching strategies, annuitizing liabilities and other liability-driven strategies.

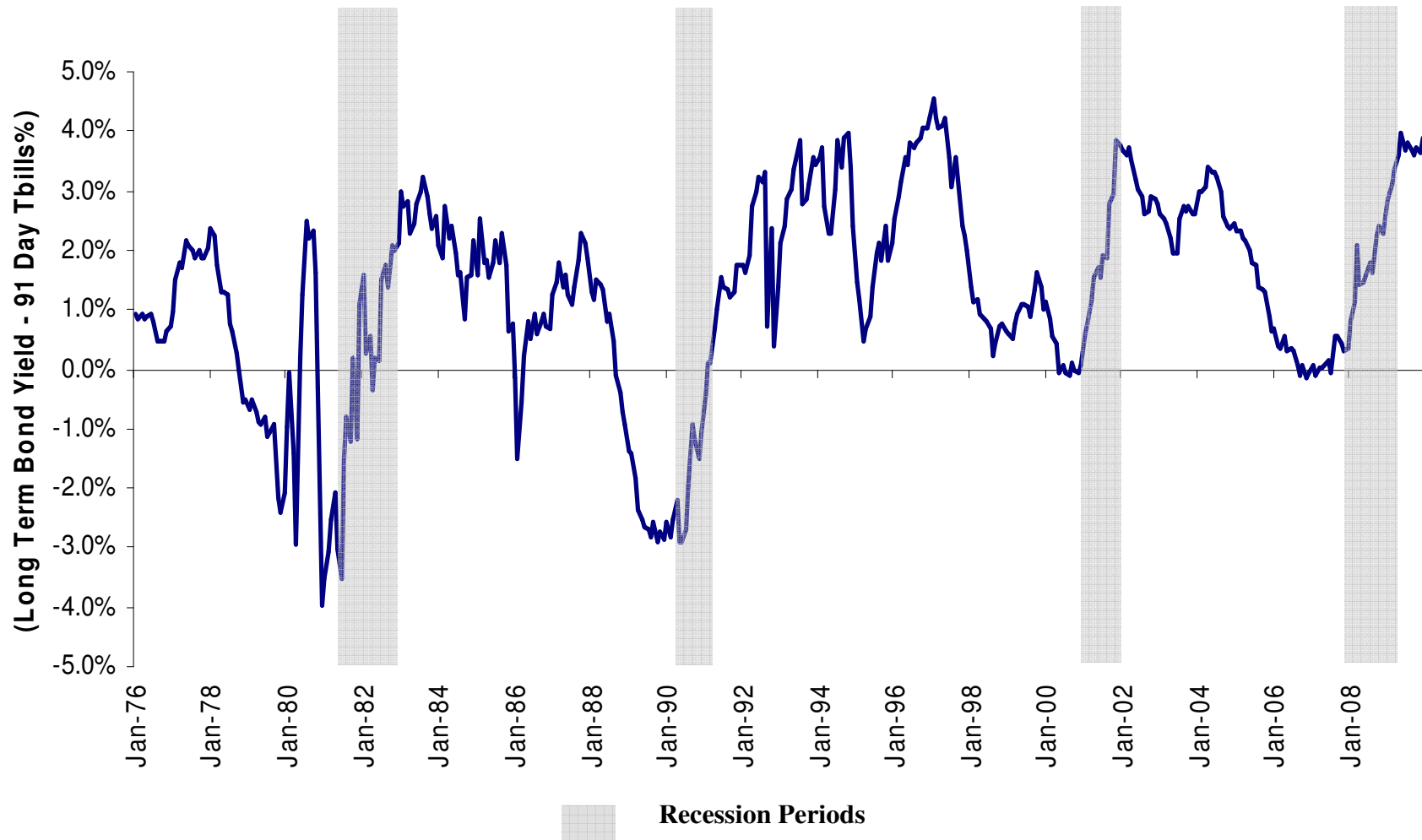
# Everyone Is Doing The LDI Dance

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- Corporate Plans Jumping to LDI (Pension and Investments, March 22, 2010)
- Opportunity Comes Knocking for Consultants (Pension and Investments, March 22, 2010)
- Managers Prep Marketing for Looming LDI Wave (Fundfire, March 10, 2010)
- Pension De-Risking (Federated Press Conference, June 17, 2010)
- The Business of Re-Risking Defined Benefit Plans (Pension Trends, May 2010)
- Dynamic De-Risking (Canadian Investment Review, March 5, 2010)
- Growth Sparks Consultant Hiring Spree (Fundfire, March 22, 2010)



# However, With The Slope of the Yield Curve at Peak – Is Now the Time Consider LDI?

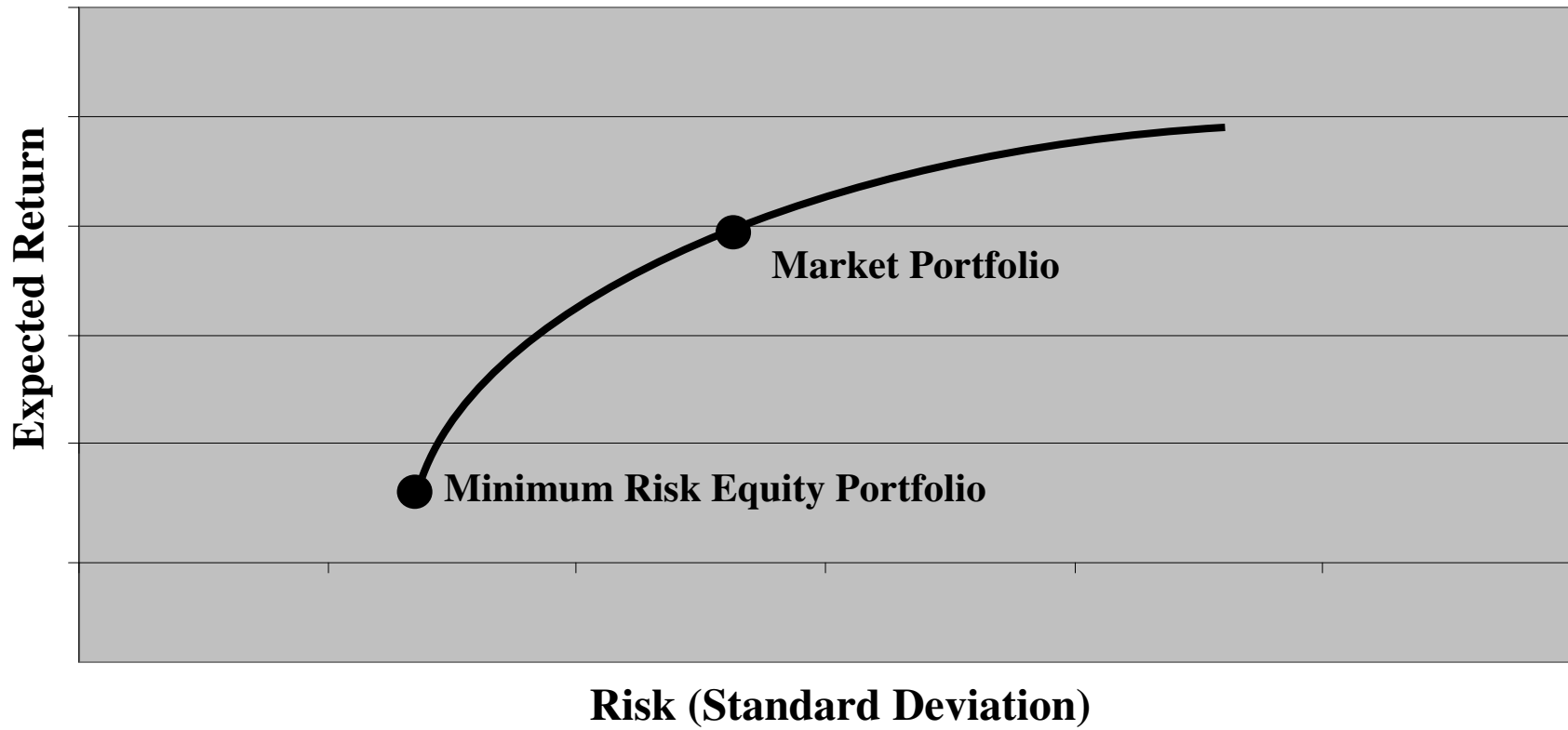


23 \*Selected Government Of Canada Benchmark Bond Yields – Long Term  
([http://www.banqueducanada.ca/pdf/annual\\_page14.pdf](http://www.banqueducanada.ca/pdf/annual_page14.pdf))

# What Modern Portfolio Theory (MPT) Tells Us

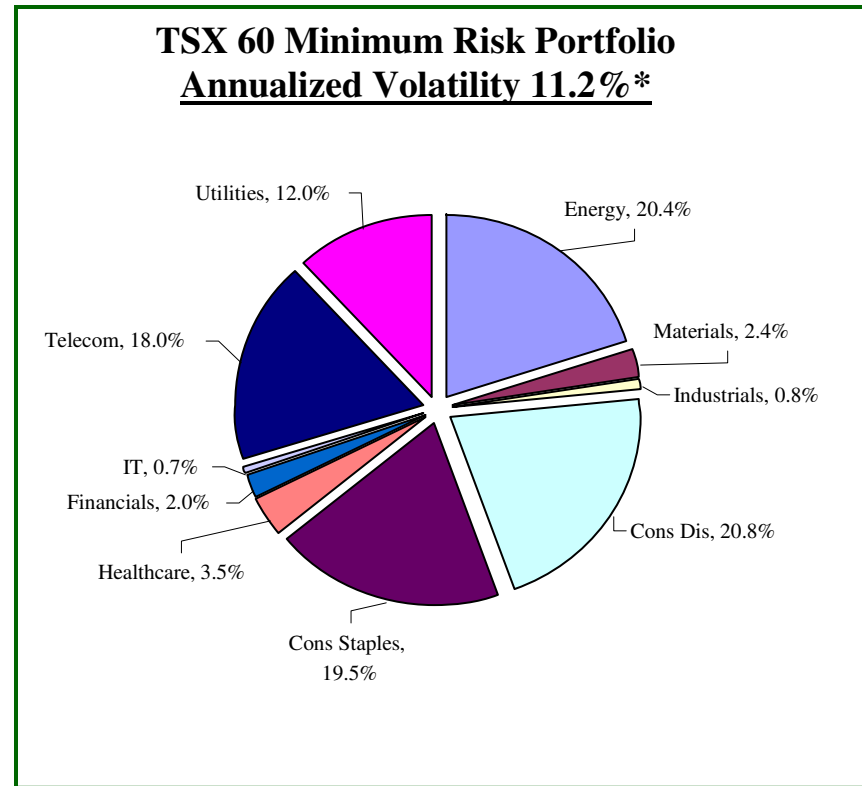
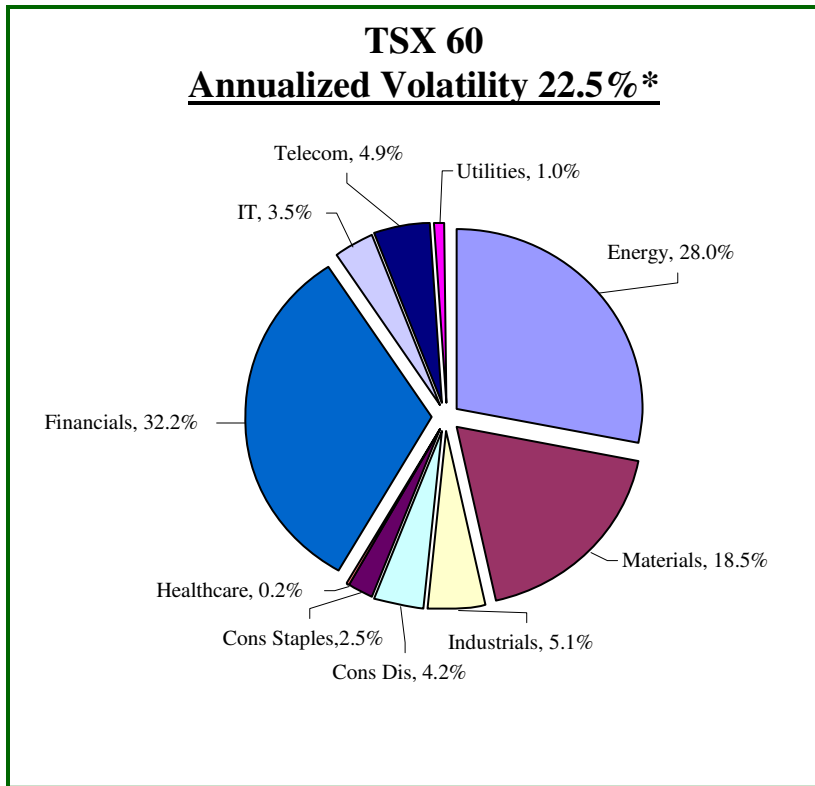
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## Theoretical Efficient Frontier



# The Risk of The Market Portfolio Can Be Significantly Reduced By Building A Minimum Equity Risk Portfolio As of Dec 31, 2009

*Risk of Market Portfolio: 22.5%. Minimum Risk Portfolio: 11.2%*



25 \* Based on 180 Day Rolling Volatility as of Dec 31, 2009. The Minimum Variance portfolio is comprised of the 60 Stocks in the TSX 60 Index, optimized to create a portfolio with the lowest volatility. Stock Weights range from 20 – 600 Basis points

# The Portfolio Holdings Of The Market and Minimum Equity Risk Portfolio Are Mirror Images

## *TSX 60 Index*

<u>Stocks</u>	<u>Sector</u>	<u>Percentage</u>
<i>Royal Bank of Canada</i>	<i>Financials</i>	<i>7.9%</i>
<i>Suncor Energy Inc.</i>	<i>Energy</i>	<i>5.7%</i>
<i>Toronto-Dominion Bank</i>	<i>Financials</i>	<i>5.6%</i>
<i>Bank of Nova Scotia</i>	<i>Financials</i>	<i>5.0%</i>
<i>Cdn. Natural Resources</i>	<i>Energy</i>	<i>4.1%</i>
<i>Barrick Gold Corp</i>	<i>Materials</i>	<i>4.0%</i>
<i>Research in Motion Ltd</i>	<i>Technology</i>	<i>3.5%</i>
<i>Manulife Financial Corp</i>	<i>Financials</i>	<i>3.4%</i>
<i>Potash Corp. of Sask.</i>	<i>Materials</i>	<i>3.3%</i>
<i>Bank of Montreal</i>	<i>Financials</i>	<i>3.0%</i>

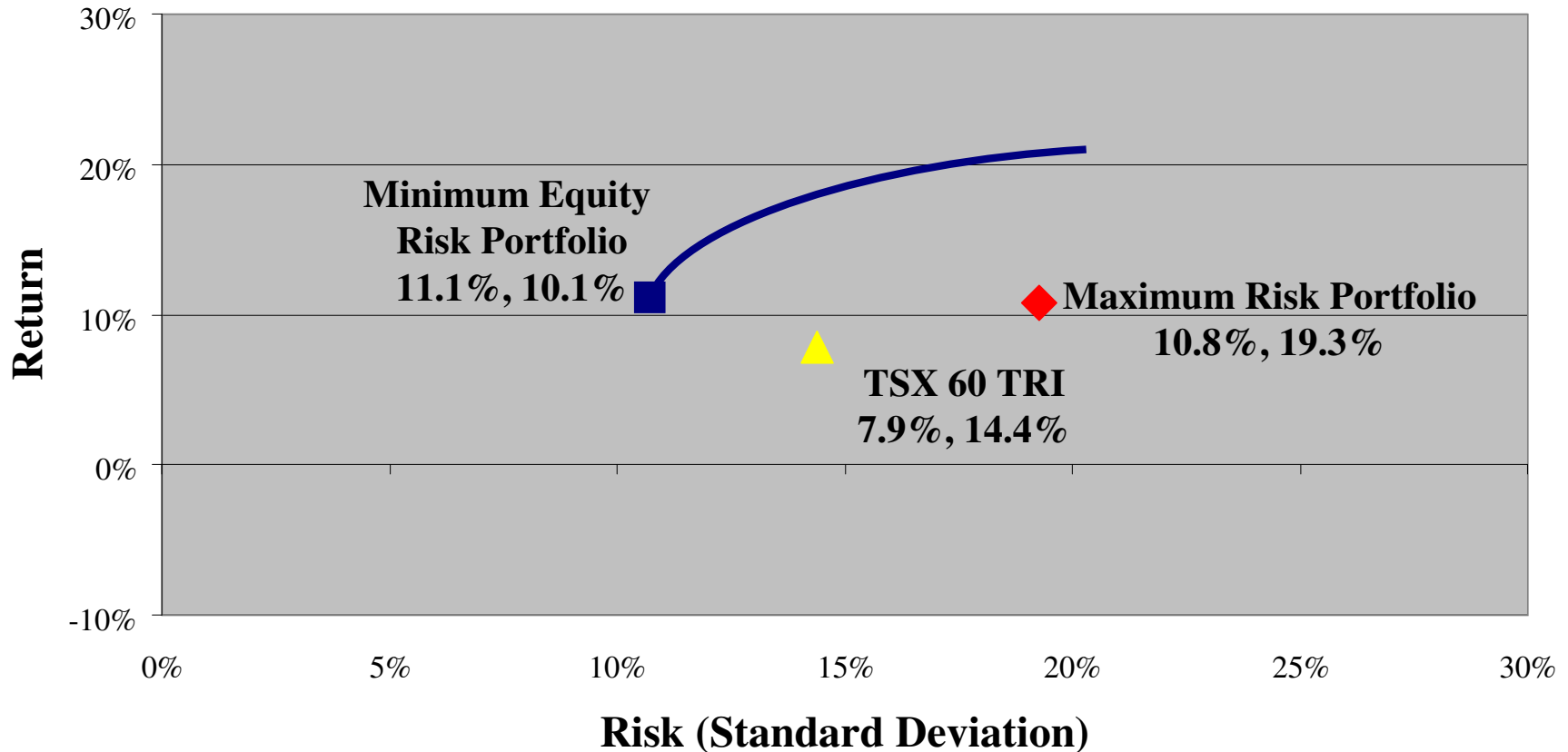
## *TSX 60 Minimum Risk Portfolio*

<u>Stocks</u>	<u>Sector</u>	<u>Percentage</u>
<i>BCE Inc.</i>	<i>Telecom</i>	<i>6.0%</i>
<i>Cenovus Energy Inc.</i>	<i>Energy</i>	<i>5.9%</i>
<i>Enbridge Inc.</i>	<i>Energy</i>	<i>5.7%</i>
<i>Fortis Inc.</i>	<i>Telecom</i>	<i>5.5%</i>
<i>Metro Inc.,A</i>	<i>Staples</i>	<i>5.3%</i>
<i>Rogers Communicat.,B</i>	<i>Telecom</i>	<i>5.3%</i>
<i>Shoppers Drug Mart Corp</i>	<i>Staples</i>	<i>5.2%</i>
<i>Shaw Communications, B</i>	<i>Discretionary</i>	<i>5.1%</i>
<i>TELUS Corporation</i>	<i>Telecom</i>	<i>5.1%</i>
<i>Tim Hortons Inc.</i>	<i>Discretionary</i>	<i>5.0%</i>

# In Reality...Why Bother With An Inefficient Market Portfolio?

## Return and Risk In An Optimized Framework

Average 3 Year Monthly, Jan 1999 - Dec 2009



# Attractive Fundamentals, Half the Risk

Ending Dec 31, 2009

	<u>Hillsdale Cdn Equity</u> <u>Min Var Portfolio</u>	<u>S&amp;P/TSX 60</u>
	<b><u>Size</u></b>	
	Market Capital (\$ Millions)	12,786
Higher Earnings Quality	<b><u>Governance/Management Quality</u></b>	
	Earnings Variability (%)	10.2
Higher Return on Equity	<b><u>Fundamental/Capital Efficiency</u></b>	
	Cash Flow to Debt	0.3
	Return on Equity trl. (%)	14.4
Lower Valuations and Higher Dividend Yield	<b><u>Fundamental/Valuation</u></b>	
	Price/Book	1.7
	Price/Earnings (Est.)	13.1
	Price/Cash Flow	6.5
	Divident Yield (%)	4.0
Higher current Sales and Earnings growth	<b><u>Fundamental/Growth</u></b>	
	Quarterly Sales Growth (%)	-1.0
	Quarterly Earnings Growth (%)	-2.5
	Annual Est. Earnings Growth (%)	9.9
Positive Earnings surprises	<b><u>Consensus/Technical</u></b>	
	Quarterly Earnings Surprise (%)	1.3
	Quarterly Estimate Revision (%)	-0.4
Much Lower Risk	<b><u>Risk</u></b>	
	5 Year Beta vs. TSX	0.5
	1 Year Ann. Daily Std. Deviation (%)	28.3
		32,636
		10.8
		0.4
		12.9
		2.0
		14.5
		7.7
		2.6
		-1.5
		-12.0
		25.1
		-1.1
		0.2
		1.0
		44.2

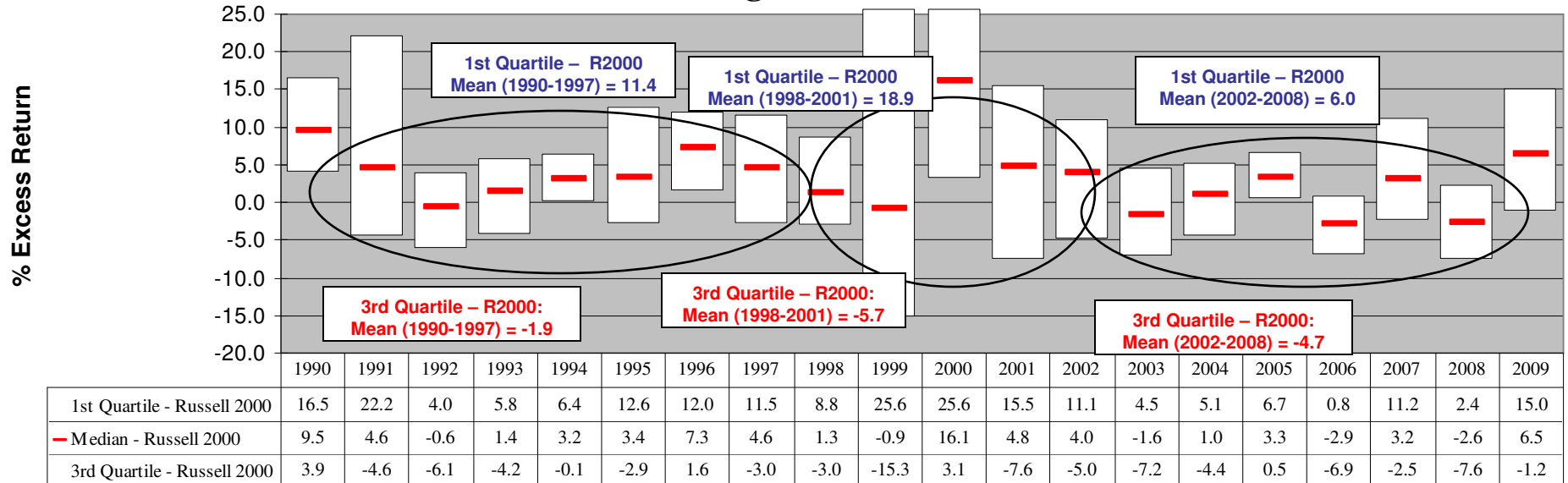
# Conclusions On Minimum Risk Portfolios

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- Large Scale Optimization for Risk Reduction Works
  - Variance and Covariance Risk are Persistent
- The Market Portfolio is “Inefficient” or “Suboptimal”
- Low “Risk” Stocks have Superior Returns adjusted for “Risk”
- A Long/Short Strategy Is The Next Progression in Managing Equity Volatility Involving the Potential for Both Alpha and Risk Reduction
- Additional Reduction in Risk is Available as Holdings from Multiple Countries are Blended and Further Optimized

# U.S. Small Cap Alpha Potential 600 – 1000bps

Annual % Excess Returns of 1st Quartile, Median and 3rd Quartile Managers vs. Russell 2000



Statistics			
	1st Quartile – Russell 2000	Median – Russell 2000	3rd Quartile – Russell 2000
Mean	11.0	3.41	-3.7
Median	11.1	3.2	-4.2
Stdev	7.4	4.5	4.5
High	25.6	16.1	3.9
Low	0.8	-2.9	-15.3

# As Good As Private Equity

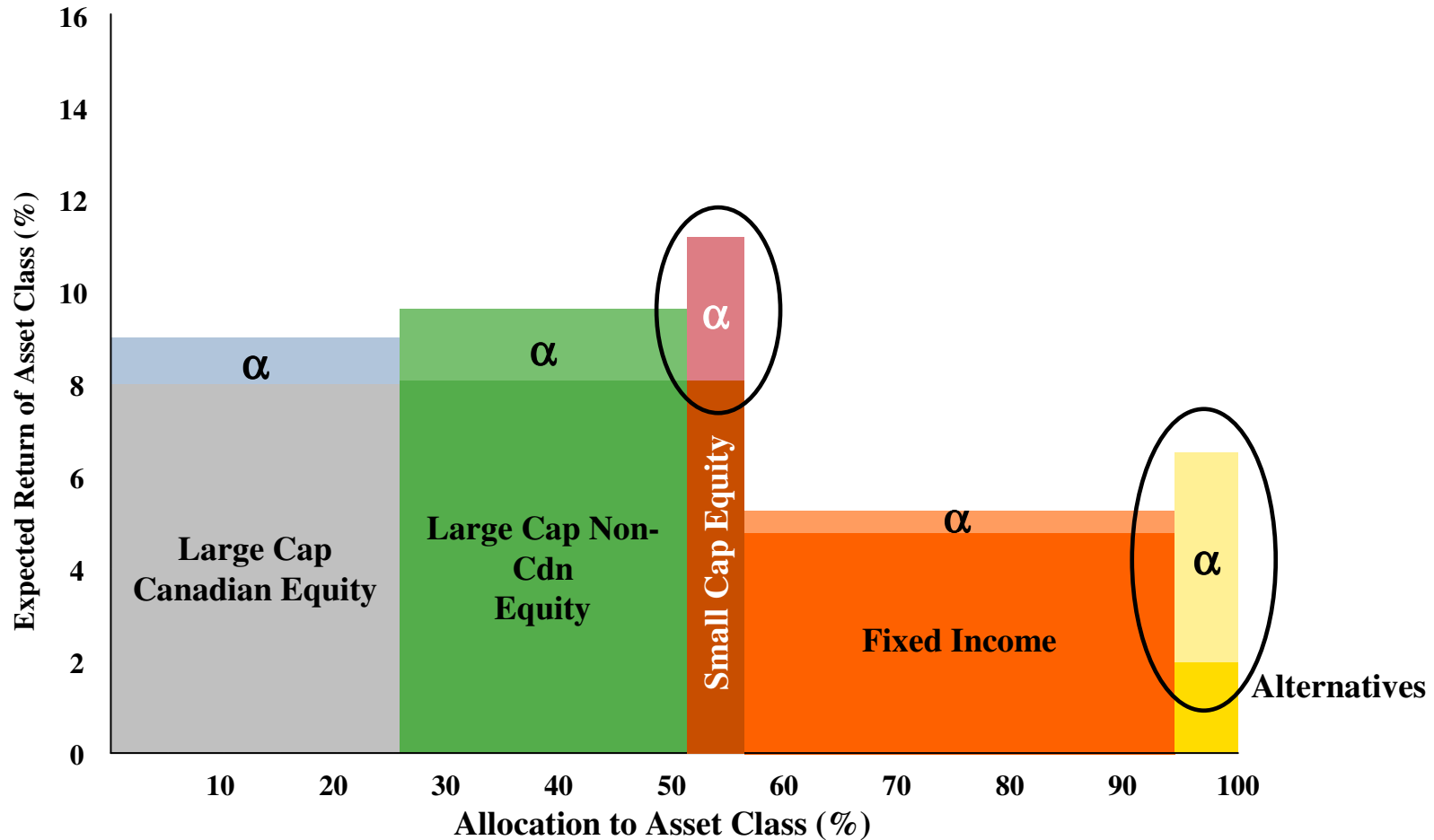
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## Average Annual Excess Return (%)

	1st Quartile	3rd Quartile
<b>US Small Cap</b>	11.0%	-3.7%
<b>Venture Capital</b>	9.7%	-8.2%
<b>Buyouts</b>	6.4%	-4.2%
<b>All Private Equity</b>	8.9%	-7.5%

31 Source: Evestment Alliance, Thompson Reuters and “Is U.S. Small Cap a Viable Alternative to U.S. Private Equity” By Bruce Grantier. April 2009 \* US Small Cap is 1990 – 2008 while Venture Capital, Buyouts and all Private Equity are from 1987-2007

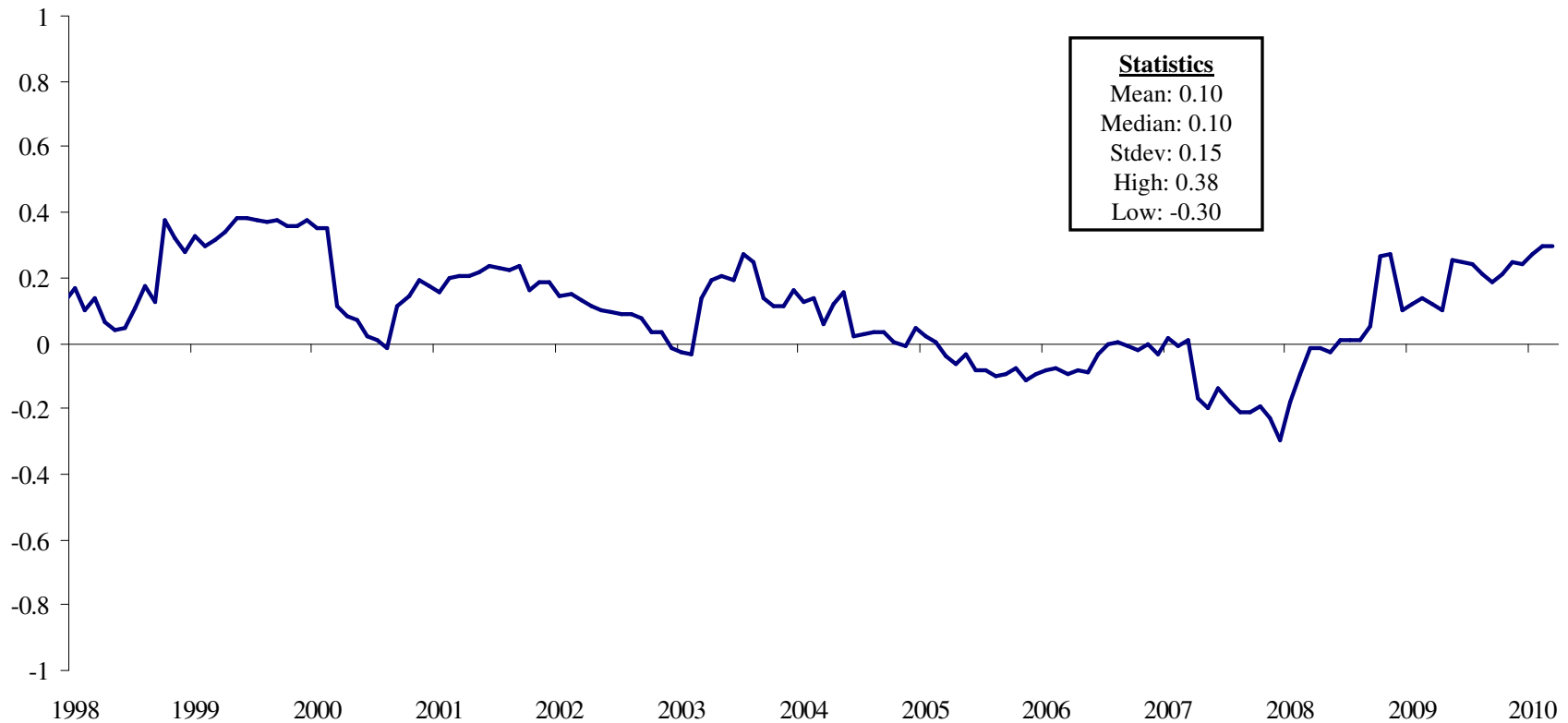
# We Tend To Miss The Small Cap Opportunity As Our Focus is On Beta At The Cost of Alpha



# Small Cap Managers Complement Large Cap Managers Diversifying Your Sources of Excess Returns

## Correlations Between Large Cap And Small Cap Managers

*3 Year Monthly Excess Return Correlations Between the Median Cdn Small Cap Equity Manager and the Median Cdn Large Cap Equity Manager*



# Current Market Outlook is Good as the Concentration of Large Cap Stocks in the TSX Has Peaked

## Top 50 Names in the S&P/TSX Composite by Float as a % of the Total Composite

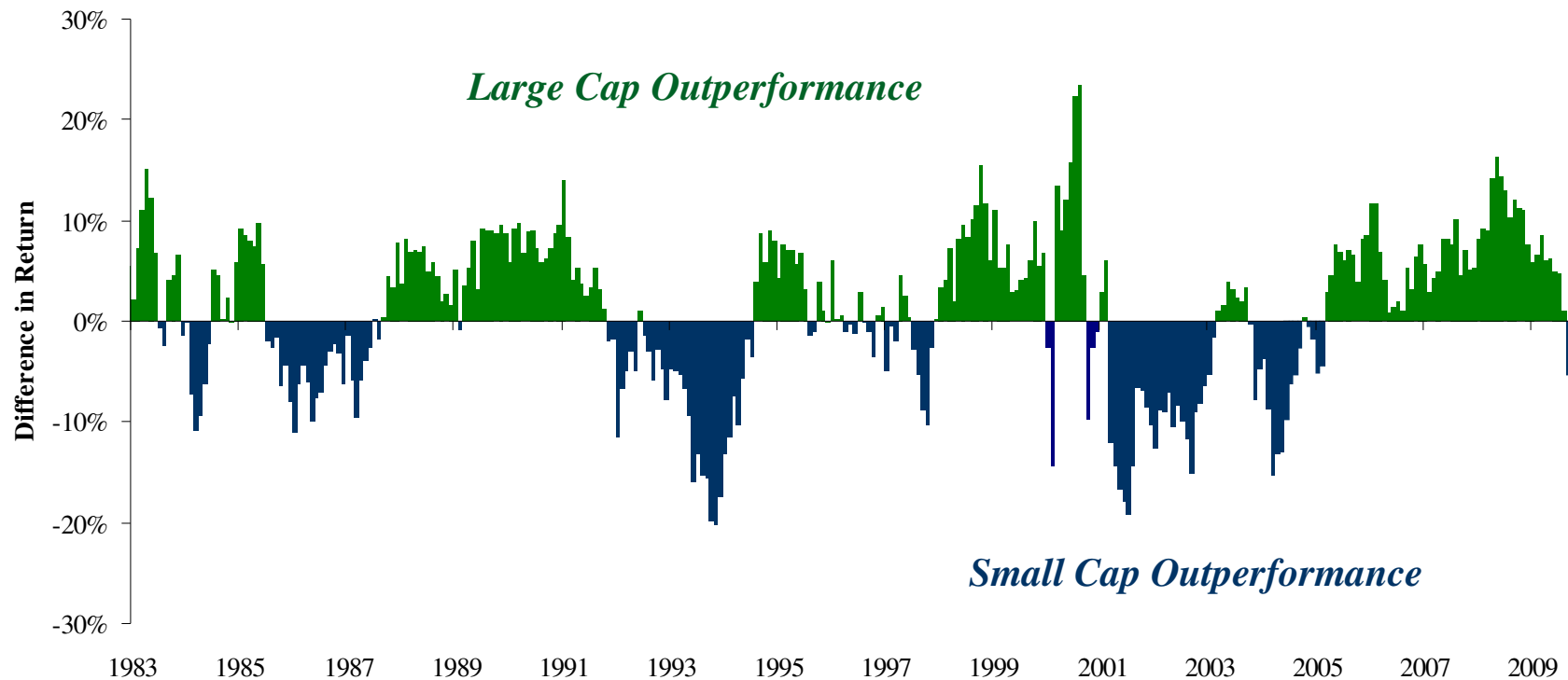
Monthly, Ending December 31, 2009



# In Canada, for the First Time in 5 Years, Completion and Small Cap are Outperforming

## TSX Large Cap vs. TSX Completion

12 Month Rolling, Ending March 31, 2010



Source: S&P/TSX Index Services/Hillsdale. "TSX Large Cap" is a composite of TSX 60 TRI (since Jan 1999) and TSX 100 TRI (prior to 1999). "TSX Small Completion" is a composite of TSX Completion TRI (since April 2007), Hillsdale Completion Index (Jan 1999 – Mar 2007) and TSX 200 TRI (prior to 1999)

# Concluding Thoughts

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- The “New Normal” Is Not Normal
- Is This The Time to Move Into LDI?
- Instead, Consider Min Risk Equity Portfolios
- The Next Evolution In This Investment Continuum is Long/Short
- Why Not Consider “A Regular” Strategy – Small Cap
  - Compelling Case For Alpha and Its Persistence in Small Cap Space
  - Small Cap Is As Good, If Not Better, Than Private Equity
  - Small Cap Managers are an Excellent Complement to Large Cap Managers

Turbulent Times Require Thoughtful Strategies...

”You’ve Got To be Very Careful If You Don’t Know Where You’re Going, Because You May Not Get There”, Yogi Berra – PAUL – PLS GET YOGI’S PICTURE