

Asset Allocation Thoughts

"Let every man divide his money into three parts, and invest a third in land, a third in business, and a third let him keep in reserve."

-Talmud, circa 1200 BC - 500 AD¹

This letter is the start of a process we will, in the future, develop into a more useful and practical asset allocation framework for investors' portfolios that reflects our macro view, concerns about the general riskiness of the financial world and a variety of issues that go into the asset allocation process.

As a starting point, it is important to understand what real long-run rates of return have been for different assets.² Good data exists on developed country equity markets by sector and on real estate. For example, most people know that the real long-run return on U.S. equities is about 6.5%. Small-cap stocks outperform large companies by a wide margin, value stocks outperform growth stocks, also by a wide margin, and small value stocks easily outperform small growth stocks. However, small companies have much greater volatility and business risk.

It is also well known that the real return on bonds lags the real return on stocks, but risk is much less. In a portfolio, the inclusion of some bonds along with stocks lowers risk faster than it lowers returns up to a point.

¹ Asset allocation to manage risk and return has a long history. Since land was considered equity, the ratio of 2/3 equity and 1/3 fixed income is consistent with the typical pension fund asset allocation in the post World War II era.

² See *The Great Reflation*, Part II for a general discussion; also Ibbotson & Associates, *Stocks, Bonds, Bills and Inflation*; Jeremy Siegel, *Stocks for the Long Run*; Elroy Dimson et al., *Triumph of the Optimists: 101 Years of Global Investment Returns*.

Real estate is another major asset that is widely held. Real returns have been significantly lower than stocks: roughly ½ % on residential property and about 5% on income-producing commercial property. And the swings can be wild when easy access to mortgage credit fuels leveraged speculation. Consequently, perceptions of risk in real estate have shifted dramatically over the last few years.

Emerging markets and gold can also be very attractive additions to portfolios. However, the history of emerging markets is short and these markets are evolving quickly. Gold has been free to fluctuate in the market only since 1971 and there have been just two major bull markets.

The asset allocation process is highly complex. Different investors have very different time horizons and risk aversions. The experience of the past three years has shown that historical correlations can be extraordinarily misleading. Various asset classes unexpectedly became highly correlated and much more volatile than the historical pattern. Understanding future correlations is the critical issue. In the midst of a crisis, liquidity can evaporate as trading volumes dry up, hedge funds close to redemptions and private equity may accelerate capital calls and halt distributions with unfortunate timing. Hidden leverage comes to the fore, exacerbating illiquidity.

Our approach to asset allocation is focused on wealth preservation by controlling the overall exposure to risk assets in relation to macro conditions, valuation and market psychology. We are not attempting to forecast the specific performance of various asset classes as a means of facilitating market timing decisions, as history has shown that this is rarely a winning strategy. Rather, we will attempt to provide analysis that will help investors play a more active form of defence and offense with their portfolios.

In order to achieve these goals, we favour a dynamic approach to asset allocation, reviewing the portfolio and making adjustments on a quarterly basis or as conditions evolve,

rather than sticking with fixed allocations come “hell or high water”. Systemic risk in the global economy is far higher than in the previous post-World War II years, volatility promises to remain extraordinarily high and the financial system may be subject to major shocks. This is a major theme running through The Great Reflation. In such an environment, a buy and hold approach to asset allocation will carry a lot more embedded risk than most people expect.

In practice, the execution of dynamic asset allocation is subjective and highly complex for global investors. Many attempts have been made to create models or algorithms that rely on indicators to calculate an optimum asset allocation. However, this sort of quantitative approach inevitably breaks down as the assumptions that underpin the model cannot fit every set of economic conditions. We use indicators selectively to inform decision-making, but at its core, asset allocation is an art, involving equal measures of analysis, intuition and common sense. Above all, investors must have a clear idea of their tolerance for risk, exercise discipline and stick to a plan. Some prefer one of rigid allocations and the literature tends to support this approach. We favour a dynamic allocation process which allows for some flexibility in order to better control risk at important market junctures (e.g. stocks in 1999, housing in 2006-2007).

In future issues, we will explore these issues in much more detail and try to develop a framework and process for asset allocation for investors with the objective of being relatively simple, and hopefully, useful. For now, we will review our main macro views and investment conclusions.

Macro Outlook

One of the essential macro themes in the U.S. and Canada for the rest of 2010 will be a relatively strong corporate sector, characterized by good balance sheet liquidity, rising profits

and capital spending (Charts 1-3). This will continue to be offset, in part, by a weak housing market, consumer spending, employment and fiscal retrenchment. A continuation of highly accommodative monetary policy is assured. The recovery is intact, but will slow significantly and remain uneven, with risks to the downside.

Chart 1



Chart 2

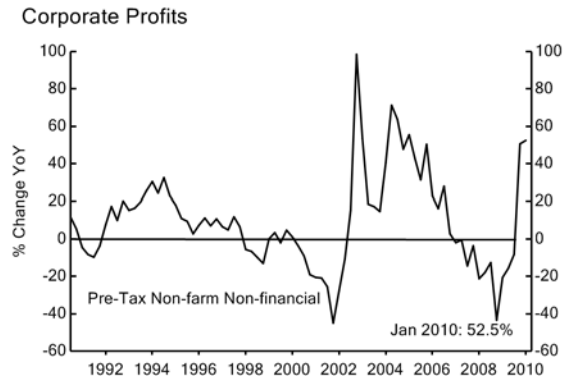


Chart 3



Ideally, as the business cycle moves through the expansion phase and valuations become stretched, conservative investors should be taking money off the table, moving assets into cash and bonds. However, in the aftermath of a global financial crisis, the usual assumptions about business cycle dynamics and timing are often different. This recession was not triggered by a

policy response to overheating as is the case in a typical recession, but by a burst credit and asset bubble. Consequently, economic expansion depends on much more than a monetary policy response.

The few historical parallels where recessions are triggered by excess debt and financial crises can be misleading, as these have tended to be localized, regional affairs which were often resolved in part through currency devaluation, making fiscal consolidation less painful. In the current scenario, both public and private debt levels are extremely high and the problems are common to almost every developed nation. The great irony is that most of the important emerging market economies have the best fiscal dynamics, the freest markets and strongest growth prospects, reversing position with the so-called “developed” economies. Competitive devaluation in a globally fragile situation is not an available solution to everyone. Perhaps the lone benefit of such a coordinated crisis is that it’s hard to tell whose sovereign debt smells worse. However, with so many G20 countries with unsustainable fiscal positions, the risk of contagion is high.

The bottom line is that this is an untested economic environment with a highly uncertain outcome. Monetization of vast amounts of debt is well underway and set to continue as policymakers desperately try to reflate sick economies. However, as Japan can testify, central bank reflation and zero interest rates don’t necessarily create a sustainable recovery. Despite the concerted effort of central banks to reflate their economies, deflation remains a greater risk than inflation for the foreseeable future. The key determinant of investment returns over the next ten years will probably be dependent on getting the inflation/deflation forecast right (i.e. when the deflation risk shifts to an inflation risk). We do not see that happening any time soon.

Money, Credit and Liquidity

Money supply and credit expansion are generally positive for risk assets but only if price inflation remains stable. The U.S. Federal Reserve (along with most other developed nations) expanded its balance sheet dramatically in 2008-2009. However, money supply growth remained subdued in 2009 as banks have been working through write-downs and have sharply increased their reserve holdings. The private sector has been deleveraging, but this may be changing (see Charts 4-6). If the Fed's aggressive policy does result in a significant expansion of money and credit, it will, at some point, have to start taking action or risk a spike in inflation expectations.

The key question is: When should we expect this to occur? The lag between recovery and price pressure is much longer in the aftermath of a financial crisis than it is after a typical recession. This is because banks remain conservative for a very long time and consumers and businesses focus on balance sheet strength. Indeed, the level of commercial and industrial loans has been declining steadily since mid-2008, although the rate of decline has slowed sharply (Chart 7). Housing markets, consumer demand and employment data are still negative, ensuring that inflationary pressures will be long delayed.

The implications of this view are:

1. Extraordinarily loose monetary policy and near-zero interest rates will persist for at least another 6-12 months.
2. General price inflation in the U.S. and other developed nations will continue to be tame.
3. Asset inflation in emerging markets will continue to put pressure on their domestic monetary policies to tighten and allow their currencies to rise, particularly the RMB.

Chart 4

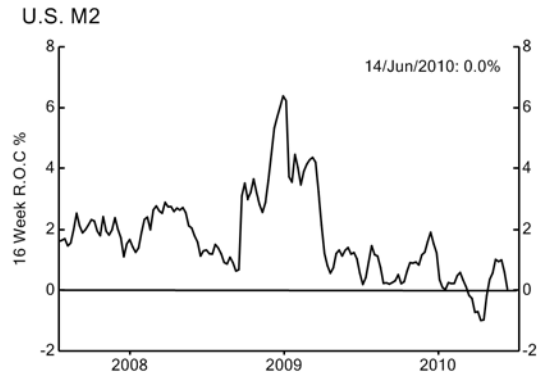


Chart 5

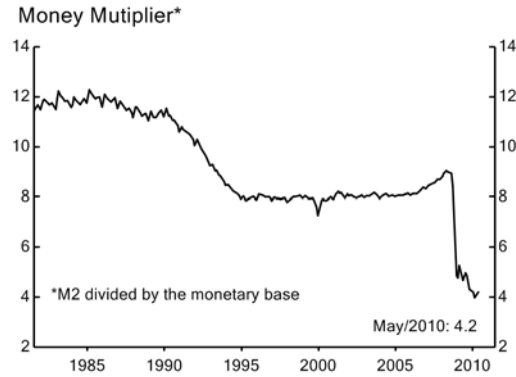


Chart 6

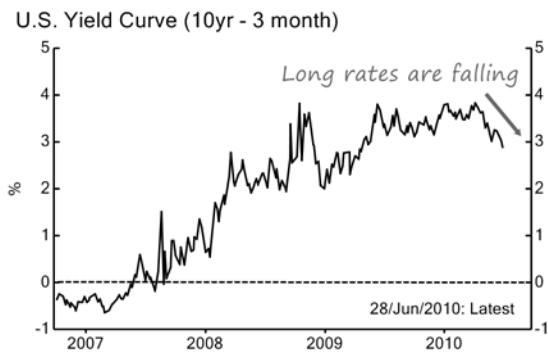
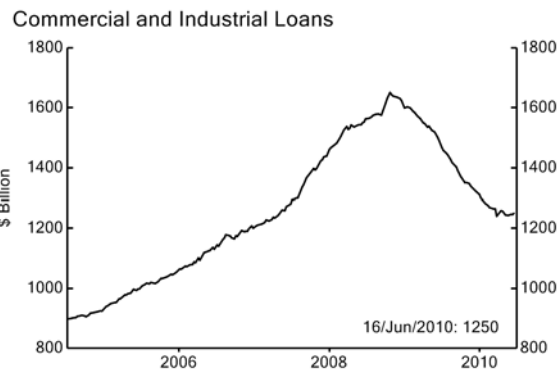


Chart 7



Equities: Maintain Exposure

There are two main reasons to maintain exposure to equities despite the murky economic outlook. First, the corporate sector in many developed nations is in relatively good shape as a result of low debt levels and high productivity. Valuations are still reasonable. Second, there are few other good options for investors seeking decent returns. However, we continue to believe benchmark exposure should be less than in previous periods because of the continued high level of systemic risk.

Some Thoughts on Geographic Diversification

Valuations in most markets are close to long-term average levels (Charts 8 & 9). These conditions exist in much of Europe as well. We expect to see healthy gains in both European and North American markets over the next six to nine months, (Charts 10 & 11). China, and broadly speaking other emerging markets, have different dynamics. Monetary policy will

continue in a somewhat restrictive direction, but capital inflows and interest rates far below growth rates will ensure excess liquidity and a tendency for asset markets to be buoyant, in spite of valuations. Chinese equities, in particular, should perform well, given the 15-20% correction over the past year against a backdrop of continued strong growth (Charts 12 & 13). The fear of a big China slowdown due to tightening of monetary policy is way overdone. A bit of moderation in China's growth is a welcome development from overheated conditions and will not derail the North American recovery. However, it could soften some commodity markets further.

Chart 8

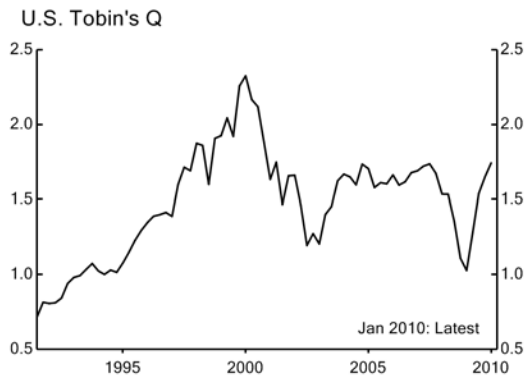


Chart 9

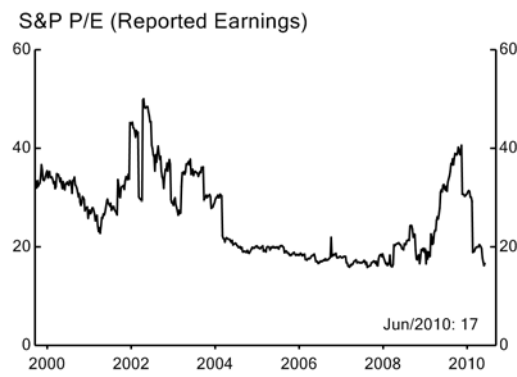


Chart 10

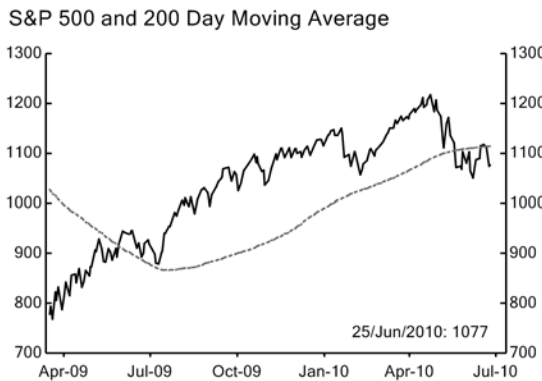


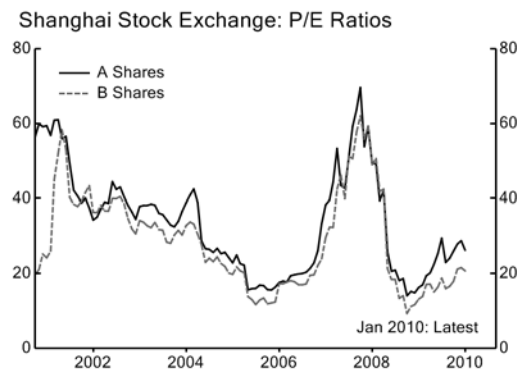
Chart 11



Chart 12



Chart 13



Commodities

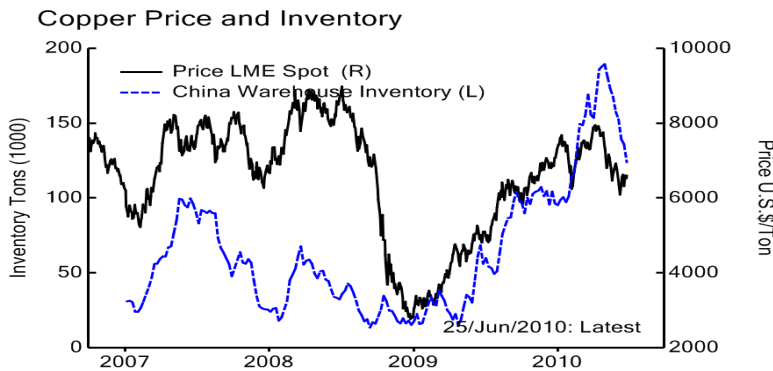
The last decade has seen a continuous commodity bull market driven by emerging market demand. We don't believe that the thesis underlying this trend has changed. However, it is important to note that the investment landscape in the commodity sector has changed dramatically in the last few years. The consideration of direct commodity investments as an asset for inclusion in retail and institutional portfolios is a new phenomenon. This revolution has created a corresponding explosion of financial products that make leveraged bets on commodity futures a simple matter. Currently we are seeing an increasing share of purely financial (speculative) demand, with obvious implications for volatility in the sector. We are uneasy with the decoupling of commodity prices from fundamental supply and demand, particularly given that we disagree with the inflationary concerns that underlie much of this financial demand. We recommend investors plan for increasing levels of volatility in this sector over the next few years, with downside risk, should the world economy be weaker than we are assuming.

In the shorter term, we expect commodity prices to remain range bound over the next few quarters. The Chinese leading economic indicator has started to roll over, which has been a fair predictor of commodity prices (Chart 14). Changing gears to slower growth may cause some inventory reduction, but this may well have already been discounted in the short term (Chart 15).

Chart 14



Chart 15



Precious Metals

It is difficult to have confidence in fiat currencies or sovereign debt while fiscal positions are clearly unsustainable. Precious metals are a logical hedge, but gold is impossible to value when the bulk of demand is financial. At this point, gold is a crowded trade but could easily become a lot more crowded if fears of another European banking and sovereign debt crisis heat up again.

Greece has spooked policymakers of indebted nations around the world. They are now talking tough on budgets. The recent G20 meeting seemed to result in a commitment to halve deficits within three years and stabilize debt levels in six years, Japan excluded. However,

President Sarkozy was careful to point out that these targets are “voluntary”. There is hope but let’s see what governments actually do. In the short term, we can’t ignore the possibility that the European recovery goes off the rails, forcing another round of bailouts and delays in expenditure cuts and tax increases. Some allocation to precious metals, as a contingency plan for a worst case scenario, is advisable. From a technical perspective, the bull market is intact and the path of least resistance is up (Chart 16). However, our sense is that speculating in precious metals is a highly risky strategy.

Chart 16



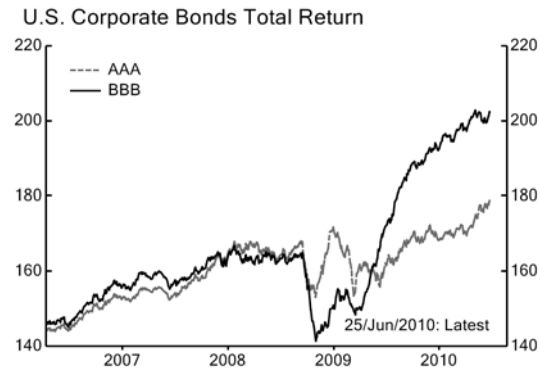
Corporate Bonds

Corporate bonds have been one of the best performing asset classes over the past decade, providing a compound annual return close to 8% in the U.S. (Chart 17). The past 15 months has seen exceptional returns in lower quality debt, as spreads have tightened from crisis levels (Chart 18). Corporate bond returns will be substantially less over the next few years, as the cycle of credit-spread narrowing has largely played out. Nevertheless, settling for the roughly 5% yield on investment grade corporate bonds is a reasonable position, given unstable economies and benign inflation prospects. And for those who understand the complexity of the high-yield market, opportunities still exist there.

Chart 17



Chart 18



Treasuries

Over the past 18 months, the Federal Reserve increased its balance sheet by \$1.7 trillion which largely represents purchases of U.S. Treasuries and mortgage bonds. The quantitative easing program supposedly ended in March, yet Federal Reserve assets continue to grow (Chart 19). Central bank intervention is suppressing yields well below what the market would determine, particularly given the new found appreciation of risk in sovereign debt (Chart 20). We expect heavy intervention in sovereign bond markets to continue. But this is clearly an unsustainable situation and conservative investors, who want to minimize risk, should focus on the sovereign debt issued by countries with relatively sustainable fiscal situations³ (Chart 21).

Chart 19

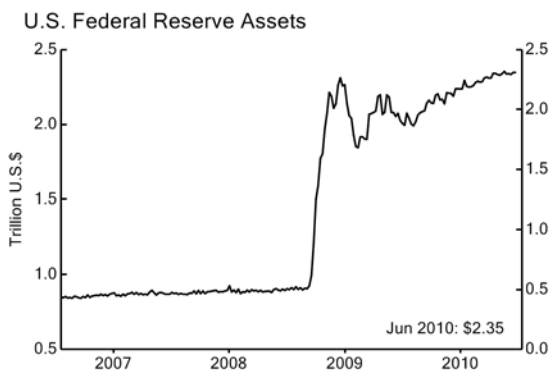
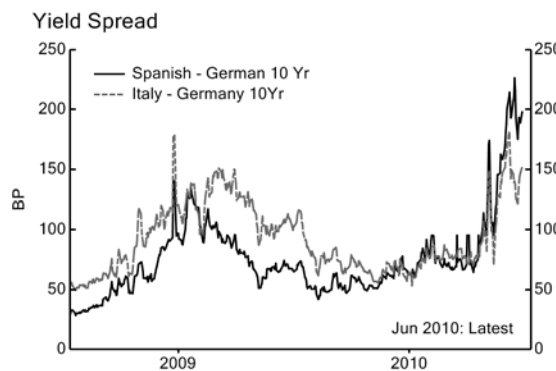


Chart 20



³ This would include Canada, Norway, China, Korea, New Zealand, Sweden, Switzerland, among others.

Chart 21



Investment Conclusions

In general, we continue to be positive on risks assets in the context of our continuing focus on wealth preservation and diversification. Probabilities favour a recovery in stock and commodity prices rather than an extended bear market. Since our last letter dated June 1st, there has been a halting recovery in markets. However, the severe breakdown in markets today and the fact that the S&P could not get above its 200-day moving average suggest that, in the near term, new lows will be reached before a significant rally develops. We continue to like natural gas (see our June letter) and the price is up about 10% over the past month. Oil prices, which we will cover soon in some detail in one of our letters, are likely to remain in the \$70-80 range, barring the unlikely event of a double dip recession.

In particular, we like small-cap companies in the U.S. and Canada and equities of quality European countries. The recent panic has created exceptional value in Germany, for example, whose export machine will benefit from the sharp devaluation of the euro. We continue to like emerging market equities in general, based on long-term growth prospects and sound financial systems vis-à-vis the declining West.

Quality corporate and government bonds provide good diversification and a hedge against deflation.

Gold remains in a bull market. It is a good hedge against another European debt and banking crisis, which would certainly trigger a further European rush to gold as protection against a falling euro and banking insolvencies.

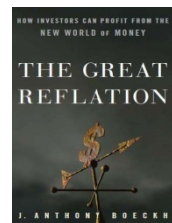
The currency game is clouded by the fact that all the majors – euro, U.S. dollar, sterling and yen are all “basket cases”. However, they can only devalue temporarily against each other. Therefore, long-term investors should maintain a portfolio approach if they must hold those currencies. Better bets are the commodity currencies with strong national balance sheets and sound banking systems—Canada, Norway, China, Korea, New Zealand, Sweden and Switzerland come to mind. The Chinese RMB stands out as being enormously undervalued. It is a one-way bet with the only uncertainty being in the timing.

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