

Costs, Consequences and Opportunity

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“Phew, it worked”, exclaimed Eric Bushell, Morningstar’s Equity Fund Manager of the Year in 2009, and Chief Investment Officer of Signature Global Advisors, a Toronto-based investment manager with over \$24 billion in assets under management. Mr. Bushell’s comments are a reference to the powerful cocktail of coordinated government intervention that was designed to save the world from an uncontrolled deflationary spiral in late 2008 and early 2009. While Bushell and his team of award winning investment professionals are convinced that the worst of the financial crisis is behind us, they are equally sure that we will be faced with a range of consequences for years to come. These consequences will have wide ranging implications and will shape security selection and asset allocation for years to come. Below, Mr. Bushell and Signature share their views on what has transpired over the last year and a half along with the team’s thoughts and positioning going forward.

The fix:

Signature is highly complimentary of key government officials who orchestrated a range of government intervention, including U.S. Federal Reserve Chairman, Ben Bernanke, whom he describes as doing a “tremendous job”. They see the decision of foreign governments to socialize bank losses as necessary and applauded their efforts to force arranged marriages of weak institutions and extend blanket guarantees in an effort to stabilize the system. Signature was equally supportive of government decisions to take interest rates to zero, engage in quantitative easing by expanding their balance sheets and introducing a wide range of spending measures that were intended to stimulate the world economy and replace the temporary drop in private sector consumption. Signature does not think that these measures went too far, but also feel that we cannot do it again.

The consequences:

Signature expects the consequences will take three forms: financial reform, an adjustment to the public service model and a gradual withdrawal of monetary stimulus. They argue that we are already beginning to see the early stages of financial institution reform and barring some sort of irrational populace backlash, expect moderate improvements that will strengthen the global financial systems. Fiscal adjustments are also beginning to take hold, with the most obvious example being Greece, who has become the poster child for government spending gone wrong. However, in recent weeks we need to look no further than Canada to see a series of austerity budgets in Ontario, Quebec and Ottawa. In the long run, Signature expects to see a reduction in the size of government and increased taxes. Lastly, Signature sees a variety of stimulus measures being withdrawn. This includes higher bank capital requirements in China (which are designed to reduce stimulative lending and cool an overheated property market) and the withdrawal of a range of emergency stimulus measures in developed markets.

The Signature team anticipates that the emergence of these consequences will be largely incremental, giving the private sector time to adjust, and ultimately constructive to the economy and capital markets.

The opportunity:

In late winter, as the world watched with great anticipation to see if Greece would be overcome by crushing debt levels and skyrocketing borrowing costs, Signature saw the development as ultimately constructive. For one thing, on a reasonably small and manageable basis, it demonstrated clearly to foreign governments the consequences of prolonged fiscal mismanagement. It also put significant pressure on the Euro currency, and increased demand for U.S. dollar denominated assets, which will prove to keep borrowing costs down for the U.S. government and nurture the nascent recovery. Going forward, the Signature team expects that moderately low interest rates, coupled with modest global economic growth, will translate to a broadly constructive market for equity investors. While their view is generally positive, they also recognize that the economic recovery is built on a far less stable base than has been the case in previous cycles.

Based on this outlook, their award winning balanced strategies remain overweight equities but with a more defensive orientation and have an underweight in government bonds. After having been fully invested for much of the past year, they recently raised their cash position to about 10%. With the Canadian dollar trading close to par, their level of foreign holdings remains high at close to 45% of the equity component and they have a bias toward U.S. equities. Signature sees good value in high quality U.S. banks and pharmaceutical stocks and carries an overweight in Technology names that should benefit as companies begin to spend on high-return investments to boost productivity. The team also likes select telecom companies and maintain a bias towards established companies with strong-proven cash flows and attractive dividend yields. The Signature team is underweight utility stocks, arguing that the stubbornly high level of unemployment will make it difficult to increase rates as a means to maintain their operating margins.

“2010 will be a battle in markets between economic recovery and the consequences of the crisis. We’re positioning our portfolios based on the former being more powerful in the near term.” – Eric Bushell.