



A COMPUTER LOOKS AT CANADA

CANADA'S STOCK AND BOND MARKETS HAVE DELIVERED OUTSTANDING PERFORMANCE IN THE LAST FEW YEARS, ESPECIALLY COMPARED WITH OTHER INTERNATIONAL MARKETS WHOSE RETURNS SUFFERED WHEN VIEWED THROUGH THE LENS OF THE SUPER-STRONG CANADIAN DOLLAR.

As a recent article in *The Globe and Mail* put it, investors who put \$1,000 in the Canadian stock market three years ago have nearly doubled their money, while those who put money in the World stock market have barely made enough to buy a couple of tickets to a Leafs game (see Table 1).

Not surprisingly, the home-ice advantage has prompted Canadian investors to increasingly put all of their new savings into Canadian income and balanced funds and to shun global markets. That can be seen in recent data from the Investment Funds Institute of Canada that show fund flows into Canadian income and balanced products accounted for 125% of net fund flows last year. Not surprisingly, U.S. and foreign stock funds suffered net outflows, although interestingly enough so did pure Canadian equity funds (see Table 2).

Will Canada Keep Going?

If history is any guide, the popularity of different categories of funds is no guarantee that they will deliver superior performance in the future. As shown in Table 2, income funds were unpopular in 2000, but subsequently delivered strong returns. In contrast, foreign funds were highly popular and delivered disappointing returns. Hence, the need for broad diversification across asset classes and for periodic portfolio rebalancing aimed at trimming positions that have significantly outperformed while adding to those that have

recently underperformed. (For more on the case for portfolio rebalancing, see our September 2005 World Report, "Meet the Fuggers.")

With the Canadian stock market having started off the year with a strong 6% gain in January, can we expect the Canadian market to continue to perform like the Energizer bunny? Or is this a good time to rebalance into foreign equity markets? To a large extent we think that depends on what happens to oil prices. As we showed in our research last year, almost 70% of the long-term variation in Canada's stock market performance versus world markets can be explained by oil prices. If oil prices go up, Canada is likely to outperform and vice versa.

O Canada!
MSCI Stock Market Indices Net Returns in Canadian Dollars (%)

Description	2003	2004	2005	YTD 1/31/2006	Cumulative Since 12/31/2002
Canada	26.5	13.3	25.1	6.5	90.8
Europe	13.3	12.1	6.7	4.3	41.3
Japan	11.2	7.4	22.4	2.8	50.3
USA	5.0	2.1	2.5	0.5	10.5
Far East	11.3	8.1	21.0	2.8	49.8
Emerging Markets	55.8	25.6	34.0	11.2	191.4
EAFE (Europe, Australia, Far East)	13.4	11.5	10.7	3.9	45.3
World	8.9	6.4	6.7	2.2	26.4

Source: FactSet and MSCI

Table 1: Investors in Canada's stock market have nearly doubled their money since the end of 2002, while returns in other developed markets have lagged significantly.



Fund Flows and Subsequent Performance

Fund type	2000 Net Sales*	5 Yr Return**	2005 Net Sales*	5 Yr Return
Income	-13%	5.9%	79%	?
Balanced	6%	3.0%	45%	?
Canadian Equity	16%	6.8%	-5%	?
Foreign Equity	73%	-2.0%	-13%	?
U.S. Equity	18%	-4.8%	-6%	?

*Source: IFIC, Jan-Dec 2000 & Jan-Dec 2005 (Net Fund Flows per category, excluding Money Market)

**Source: Morningstar Averages; Dec. 00 - Dec. 05

Table 2: More than 100% of recent fund flows have been toward Canadian income and balanced products, but popularity is no guarantee of future performance.

The trouble is, it is very difficult to predict what will happen to oil prices over the next few years. Many seasoned oil analysts dismiss the currently popular “peak oil” theory. Instead, they believe that oil prices remain subject to cyclical fluctuations and should eventually “revert to the mean,” which would imply a return toward the \$40 US per barrel level. For the time being, however, Iran is busy stirring up a nuclear hornets’ nest and has threatened to withhold supplies from global markets if it is sanctioned by the United Nations. That threat helped oil to rally again and has been a major plus for the Canadian market.

Ranking Markets: Just the Facts, Ma’am

Unfortunately, none of us has access to a perfect crystal ball to tell us what will happen to oil prices over the next few years. At the same time, there are many other factors that could affect the relative performance of the Canadian stock market. So we thought it would be helpful to take a look at the factors *we can actually measure now* that might have a bearing on the Canadian stock market’s future prospects relative to other global markets. In other words, instead of simply speculating on the future of oil prices (which if we had to guess will be lower in a few years’ time), we want to focus on things we can actually know with confidence are likely to influence future returns.

With that in mind, we recently took a close look at the work of Leila Heckman, who is a specialist on global asset allocation affiliated with Bear Stearns (www.heckmanglobal.com). A statistician by training, Ms. Heckman spent many years developing methods for ranking global stock markets strictly by the numbers, using monthly data on market valuations, growth expectations, risk factors, and momentum.

By design, her method is intended to take all emotion out of the process of comparing markets. Most importantly, she uses straightforward statistical measures that have proved to be useful in the past for predicting future market performance patterns. Each individual measure has been tested to assure that it would have helped in making favourable country allocations in the past. Then the measures are combined into one score for overall market attractiveness based on assigning 40% weight to value scores, 15% to growth scores, 15% to risk measures and 30% to momentum scores. Ms. Heckman has used this computer-aided scoring technique to rank markets for more than a decade with consistently favourable results.

How does Canada’s stock market rank currently based on Heckman’s computerized scorecard? The answer is somewhat surprising: close to the bottom of the pack. Of the 23 developed country stock markets that she ranks by this method, Canada ranked 21 – and that was up from a rank of 22 out of 23 in the previous month (see Table 3).

Since Canada’s stock market did quite well in January, so much for the model’s one-month track record! Indeed, it is not quite fair to Heckman’s statistical framework to put too much emphasis on how the market does in predicting the relative performance of one individual country. The key is whether the method makes more good calls than bad calls, month after month. However, a review of the model can also give insight into why investors shouldn’t put all their

eggs in one basket, even though they may feel very good about the basket.

Why the Low Score for Canada?

Ranking exercises like this can be fraught with difficulty, as is evident to anyone who has ever followed the reactions to various other types of rankings of countries or cities: "How dare you rank our city in the bottom tier! Aren't you aware of the recent drop in our crime rate!" So for those who might observe that this method fails to take into account Canada's strong resource base, low inflation, strong government finances, etc., the response is: guilty as charged. It is simply based on a set of indicators that have been helpful in ranking markets in the past and does not make any pretense of being all-inclusive or omniscient. In fact, as they say in the software world, that's a feature, not a bug.

Something else to keep in mind is that the ranking is not intended to predict whether any country's market will go up or down *in absolute terms* in the months ahead, but is meant only to indicate how it will perform *in relative terms* compared with other markets.

With those caveats in mind, why does Canada's stock market currently rank so low by this method? Without going into every single detail of the rankings, here are a few facts that illustrate what goes into Canada's current low ranking:

Valuation (40% weight). On this measure, Canada currently ranks 22 out of 23. With a price-to-book value of 2.8, only six other nations' markets are currently more expensive. With a price-to-trailing earnings ratio of 20 times, only two other nations are more expensive. And while Canada's P/E ratio is actually lower than its 10-year average of 22 times, most other nations P/E ratios are far lower relative to their own history. Also, a comparison of

the earnings yield of Canada's market to the nation's short-term interest rates shows Canada to be fourth from the bottom on that measure.

Growth (15% weight). Thanks to the buoyant consensus outlook for resources, Canada's forecast 2006 earnings growth of 14% is second highest among the 23 nations. In contrast, however, many other nations have seen strong year-on-year gains in their index of leading indicators (as calculated by the Organization for Economic Cooperation and Development), while Canada's leading index has been relatively stagnant. That is due to the depressing effect of the strong Canadian dollar on Canada's manufacturing industry and the effect of rising interest rates in both Canada and in the economy of its friendly neighbour to the south. Overall, however, Canada's growth rank is a solid four out of 23.

Risk (15% weight). On this measure, Canada currently ranks 18 out of 23. The risk measure is based on two different inputs. One is based on the relative volatility ("beta") of each nation's stock market over the past 18 months, with low volatility being preferred to high volatility. By that measure, Canada is at the middle of the pack. The second risk measure looks at how much a country's exchange rate has moved versus its long-term trend. Countries with

Oh, Oh, Canada!

Developed Stock Market Ranking Out of 23 Countries - January 2006

Factor	Weight	Canada's Rank	Comment
Valuation	40%	22	Canada's done very well; most other markets are cheaper
Growth	15%	4	Growth outlook looks solid; depends on commodity cycle
Risk	15%	18	Drastic appreciation of Canadian dollar poses risk to earnings
Momentum	30%	16	Relatively few upward earnings revisions by companies
Overall Rank	100%	21	Rosy growth outlook doesn't offset other negatives

Source: Heckman Global Advisors

Table 3: A computer-based scorecard for ranking the relative attractiveness of developed countries' stock markets surprisingly places Canada near the bottom of its list.



currencies that seem cheap by that measure are preferred to those that have experienced a huge surge in their currency's value. The reason is that a huge currency appreciation can depress earnings (ask business people in Ontario) and thereby set the stage for a currency reversal in the future. On the exchange rate risk measure, Canada ranks 22 out of 23, with only New Zealand having experienced an even more drastic exchange rate appreciation.

Momentum (30% weight). As Sir Isaac Newton observed, "a body in motion tends to stay in motion." The momentum ranking is also based on two different inputs. One is the ratio of companies' earnings estimates that have recently been revised up, which has ranged from 35% to 40% in recent months. In contrast, the average upward revision ratio around the world has been 54% and Canada ranks 22 out of 23 on this measure. New Zealand also ranks last by this measure, so it appears that the strong currency effect is hitting both nations. The other momentum category is simply the year-on-year price momentum for the overall stock market measured in local currency terms. Surprisingly, Canada ranks in the middle of the pack on this measure, despite its stellar performance over the last year. The reason is that many other nations – notably most European nations and Japan as well – posted even stronger gains in local currency terms. So Canada's overall momentum rank is a ho-hum 16 out of 23.

Japan is Number One

Does all this mean that Canada's market is set to perform poorly? No, the method is not aimed at predicting absolute market performance. What it does mean, however, is that other markets are not only cheaper, but also have better earnings momentum, more buoyant leading economic indicators, and are not contending with the shock of a huge currency appreciation.

Those are all simply facts – the type of facts that have been associated with underperforming markets over the years. If it is any consolation, the United States does not fare much better in this ranking, having an overall attractiveness ranking of 18 out of 23.

Who is at the top of the list? Japan is currently number one, with the rest of the top 10 nations being European. This squares with our thinking, based largely on fundamental company research, that the non-U.S. equity markets (represented by the MSCI EAFE Index) are likely to outperform the U.S. once again in the year ahead.

Does this make a strong case for bailing out of Canadian markets? Of course not – especially since Iran, Venezuela and other friendly OPEC nations seem to be trying as hard as they can to position Canada as a relatively attractive place to invest in the world's future energy needs. However, is there a case for rebalancing portfolios away from Canada and toward global and particularly non-U.S. markets?

Leila Heckman's computer says yes.

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