Insights & Strategies

PRIVATE CLIENT SOLUTIONS

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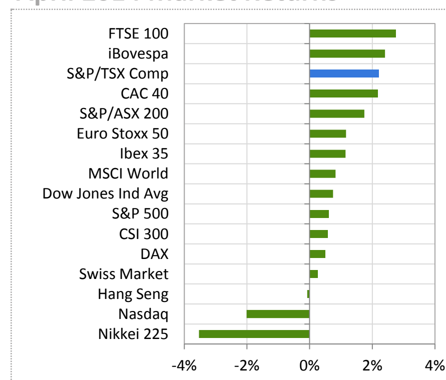
Spring is in the Air

We had a long, hard winter, but the market received further confirmation last week that the US economic recovery is on solid footing, as the US Nonfarm Payroll number came in much better than expected. The US added 288,000 new jobs in April, well ahead of the consensus expectation of 215,000. It was the third straight month above 200,000, signalling a nice recovery from the anemic 84,000 December figure. Overall, it was the best performance in more than two years. The unemployment rate also fell to 6.3%, its lowest level since 2008.

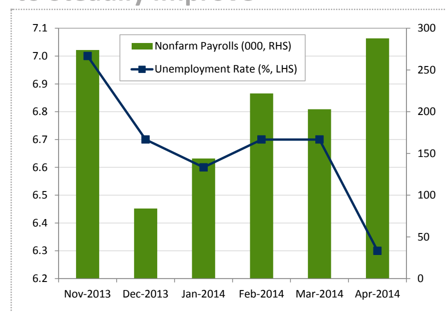
April 2014 Market Returns



Source: Bloomberg, Raymond James Ltd.

However, the market reaction was relatively muted, as some analysts viewed the report to be a weather-related rebound and also noted that the fall in the unemployment rate was driven in part by a fall in the participation rate. Regardless, the number still paints a picture of an economy continuing to grow strongly and leaves little doubt that the US Federal Reserve will continue tapering its asset buying program. At the end of April, the Fed announced that it was tapering its asset purchases by an additional US$10 bln per month, bringing its monthly purchases down to US$45 bln. Last year, the Fed was purchasing US$85 bln per month. The Fed also stated that "economic activity will expand at a moderate pace and labor market conditions will continue to improve gradually." This is about as close as the Fed gets to being outright bullish.

US Unemployment Rate Continues to Steadily Improve



Source: Bloomberg, Raymond James Ltd.

One of the main issues overhanging the market has been whether the subdued economic data in recent months was a result of a genuine slowdown in fundamentals or simply an effect of the abnormally harsh winter. The April Nonfarm Payroll number helps confirm that it likely was only a temporary effect of the weather. For the US economy, the snow's gone and spring most definitely has sprung.

Doug Rowat
VP, Research & Strategy

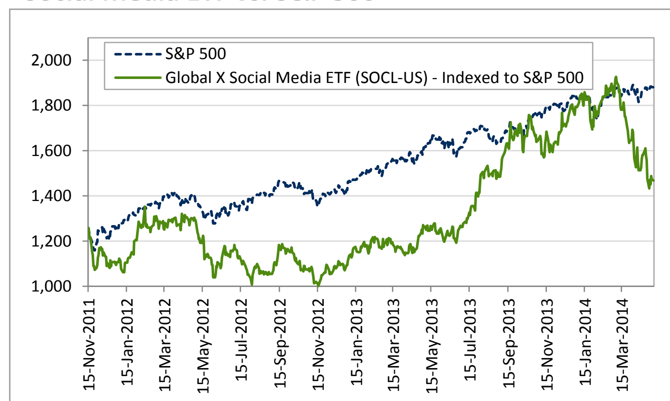
Time to "Like" Social Media Stocks?

For more than two years, the social media story has been playing out exactly as investors had hoped with high-profile IPOs, strong user-base growth and increased adoption across the corporate sector fuelling a remarkable bull-run. The Solactive Social Media TR Index went on a tear, gaining roughly 80% from the start of 2012 to its March 2014 highs. Unfortunately, at this point, social media started to lose steam and the Index has since plunged almost 24%, marking a bear market for this once red-hot sector. Lacklustre recent earnings results from several key social media players, including LinkedIn (LNKD-US), is certainly one reason for the sell-off, but the general market skittishness to start 2014 is also a factor, as the first area to get punished when investors get anxious is often momentum stocks.

An Entry Point?

However, what we know for certain is that social media will not disappear anytime soon (earlier this year, Facebook celebrated its *10th* anniversary) and that, in all likelihood, the space will continue to grow strongly. (For the largest US social media stocks, consensus expects 36% revenue growth this year followed by 30% growth in 2015—see table below.) The questions to ask, of course, are: **are investors paying too much for this growth and does the current weakness mark an attractive entry point?**

Social Media ETF vs. S&P 500



Source: Bloomberg, Raymond James Ltd.

Viewed from a strict price-to-earnings perspective, social media stocks are not cheap versus the broader market; however, taken in context with their potential earnings growth by using a forward price-to-earnings-growth ratio (PEG), a more rational valuation picture emerges. A PEG ratio is the price-to-earnings ratio divided by the earnings growth rate, the lower number the better. A PEG ratio, in short, helps put P/E into perspective by letting investors know that it might be worth paying for a stock with a higher P/E because you're being compensated with higher earnings growth. Quite simply, if things go according to plan, stocks that are expensive now may not be expensive for long. The largest US-listed social media stocks trade at a 2014 consensus PEG ratio

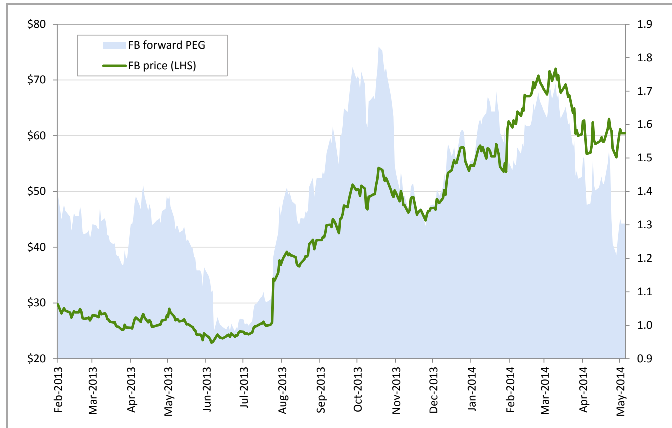
Largest US-Domiciled Social Media Stocks

Company	Ticker	Price (US$)	Mkt Cap (US$ bln)	Y-t-d Rtn (%)	2015 EPS Grth (%)	2014 PEG	2015 PEG	Total Debt/ Total Equity (%)	2013 Rev (US$ bln)	2014 Rev (US$ bln)	2015 Rev (US$ bln)
Google Inc	GOOGL	533.87	357.9	-4.8	17.7	1.1	0.9	6.0	47.6	52.4	62.0
								y-o-y growth (%)	*19.0*	*10.1*	*18.3*
Facebook Inc	FB	60.46	155.2	10.6	27.9	1.3	1.0	3.1	7.9	11.8	15.6
								y-o-y growth (%)	*54.9*	*49.4*	*32.2*
Twitter Inc	TWTR	39.02	22.1	-38.7	546.2	10.0	1.5	6.7	0.7	1.3	2.0
								y-o-y growth (%)	*109.8*	*95.5*	*53.8*
LinkedIn Corp	LNKD	147.73	18.0	-31.9	55.7	2.2	1.4	0.0	1.5	2.1	2.8
								y-o-y growth (%)	*54.3*	*40.0*	*33.3*
Pandora Media Inc	P	24.31	5.0	-8.6	192.6	1.1	0.4	0.0	0.7	0.9	1.2
								y-o-y growth (%)	*145.9*	*34.1*	*32.6*
Groupon Inc	GRPN	7.09	4.8	-39.7	140.2	2.5	1.0	N/A	2.6	3.2	3.6
								y-o-y growth (%)	*13.0*	*23.1*	*12.5*
Yelp Inc	YELP	59.76	4.3	-13.3	74.2	2.5	1.4	0.0	0.2	0.4	0.5
								y-o-y growth (%)	*69.3*	*56.8*	*43.3*
Zynga Inc	ZNGA	3.86	3.4	1.6	204.5	7.5	2.4	0.0	0.9	0.7	0.9
								y-o-y growth (%)	*-32.8*	*-14.5*	*22.5*
Angie's List Inc	ANGI	11.24	0.7	-25.8	N/M	N/A	1.4	N/A	0.2	0.3	0.4
								y-o-y growth (%)	*57.6*	*34.2*	*25.1*
Group Average				***-16.7***	***157.4***	***3.5***	***1.3***	***2.3***	***54.6***	***36.5***	***30.4***
Avg S&P 500 Company					***15.4***	***2.2***	***1.9***				

Source: Bloomberg, Raymond James Ltd. Priced May 2, 2014. 2014 and 2015 values are consensus forecasts.

of 3.5, which is higher than the average S&P 500 stock at 2.2. However, by 2015 this PEG ratio is expected to drop significantly to only 1.3, a significant discount to the S&P 500 average constituent of 1.9.

Facebook PEG at a Low Level



Source: Bloomberg, Raymond James Ltd.

It's also worth noting that social media stocks have real earnings, billions in revenue and real utility—unlike many of the Internet stocks of the late 1990s and early 2000s. For instance, teenagers actually use Twitter (a lot); and few people would look for a job today without a LinkedIn profile. Further, the largest social media stocks have clean balance sheets with little debt. This was a reality before the recent sell-off and it certainly hasn't changed in just the past few months. The average debt-to-equity ratio of social media stocks listed above is only 2.3% and cash and equivalents per share as a percentage of their overall share price is a high 13.5%. Google (GOOGL-US) (which is not normally thought of as a social media company, but has 1.1 bln Google+ users) even has a AA credit rating from S&P.

As Warren Buffett has regularly pointed out, and put into practice with his own money, profit can be made when you invest against the consensus view. There are now, for instance, almost 4x more hold and sell ratings on Twitter than buys. Risk-tolerant investors might want to take a look at the social media space. This share price weakness is a rarity and it may not last.

Doug Rowat
VP, Research & Strategy

Concentration: The Double-Edged Sword

Hedge fund manager Seth Klarman said that “one’s very best ideas are likely to generate higher returns for a given level of risk than one’s hundredth or thousandth best idea.” Klarman and other successful investors abide by the premise that running concentrated portfolios comprised of high-conviction ideas will generate better returns than diversified portfolios. There is evidence to support this belief. Several studies have shown that concentrated funds, both equity and fixed income, perform better after adjusting for risk and style differences over the long term.

A number of funds on the Raymond James Mutual Fund Focus List are concentrated portfolios with strong long-term track records relative to their peers and benchmark. Global equity fund EdgePoint Global Portfolio is a case-in-point. Abiding by a high-quality value approach, EdgePoint’s investment team invests with conviction, top ideas regularly representing over 6% of the portfolio. To put that in perspective, the largest position of the fund’s benchmark, MSCI World Index, carries a mere 1.6% weighting. The fund maintains a tight portfolio of 24 stocks, while the Index is comprised of over 1,100 securities. Management echoes Klarman’s belief that a concentrated approach allows the team to have in-depth knowledge about the companies it invests in compared to a portfolio manager who runs a mandate with over 200 positions.

EdgePoint Global Portfolio Top 10 Holdings

Name	Ticker	Wt %
Alere Inc	ALR	5.4
Wells Fargo & Co	WFC	5.2
TE Connectivity Ltd	TEL	5.1
Microsoft Corp	MSFT	4.8
American International Group Inc	AIG	4.1
Ryanair Holdings PLC ADR	RYAAY	3.9
JPMorgan Chase & Co	JPM	3.9
Wabco Holdings Inc	WBC	3.0
Altera Corp	ALTR	3.0
International Rectifier	IRF	3.0
Total		**41.3**

Source: Morningstar Inc., As of January 31, 2014

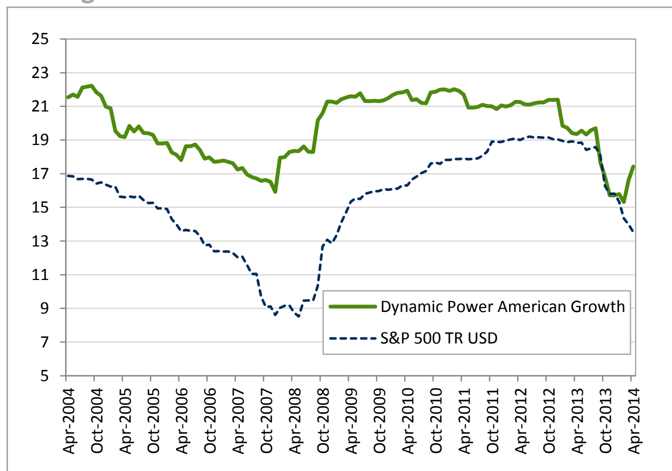
This high conviction investment process has led to strong results. Since its October 2008 inception, the fund has produced an annualized return of 16.4% while the benchmark and peer group returned 13.0% and 11.7%, respectively. EdgePoint Global Portfolio’s risk metrics are also attractive. In particular, the fund’s medium to long-term Sharpe and Sortino ratios (the higher the better) rank above its respective category average.

The Dark Side of Concentration

It's not always sunshine and roses. Concentrated investing can lead to extended periods of underperformance and high volatility, testing investors' patience. Take, for example, US equity fund **Dynamic Power American Growth**, a longstanding member of the Focus List. Managed by Noah Blackstein, the fund maintains a portfolio of 20-25 growth stocks with a heavy emphasis on info tech. Top 10 holdings have represented as much as 72.7% of the portfolio.

This strategy has served investors well. Since its July 1998 inception, Dynamic Power American Growth has produced an annualized return of 7.3%, while the S&P 500 Index returned 3.2% as of March 31, 2014. However, the fund has experienced significant swings in performance along the way. Such was the case in 2008 when the fund dropped 44.1%, almost double that of the Index (CAD). In March alone, the fund declined 12.6%, as core holdings Netflix (NFLX-US) and Alexion Pharmaceuticals Inc. (ALXN-US) plummeted 21.0% and 14.0%, respectively. The S&P 500 index was up 0.8% for the month.

Rolling Five Year Standard Deviation



Source: Morningstar. As at April 30, 2014.

ETFs Bear the Same Risks

Despite the widely-held belief that ETFs provide diversification at a low cost, many are very concentrated, even more so than actively managed mutual funds. The top 10 holdings of iShares S&P/TSX Capped REIT Index ETF (XRE-T) represent 84.13% of the portfolio with Riocan REIT (REI.UN-T) and H&R REIT (HR.UN-T) representing 19.8% and 15.2%, respectively. In contrast, the top ten holdings of the median REIT mutual fund total approximately 43.2%.

ETFs are also not immune to the dark side of concentration. Highly-concentrated BMO Equal Weight Utilities Index ETF (ZUT-T) has undergone a series of distribution cuts, declining from $0.069/month in January 2013 to $0.056/month in April 2014. Over the same period, its distribution yield has dropped from 5.25% to 4.54%.

ZUT's distribution cuts were due in part to dividend cuts of key holdings such as Atlantic Power (ATP-T) and Just Energy (JE-T). We believe a decrease in ZUT's monthly distribution would have been less or even possibly avoided if ZUT was diversified into more names, reducing the impact of a dividend cut. However, ZUT has become more concentrated. Its number of holdings has declined from 14 in January 2013 to 11 as of the end of April 2014. Should another holding cut its dividend, that holding's higher weighting will have a greater impact on ZUT's ability to sustain its current distribution.

Concentration risk is exacerbated by ZUT's equal-weight approach. That's because companies that cut their dividends and experience subsequent price declines will be assigned the same weighting as stocks that have increased their dividends at rebalancing, assuming they have not been booted out of the Index first.

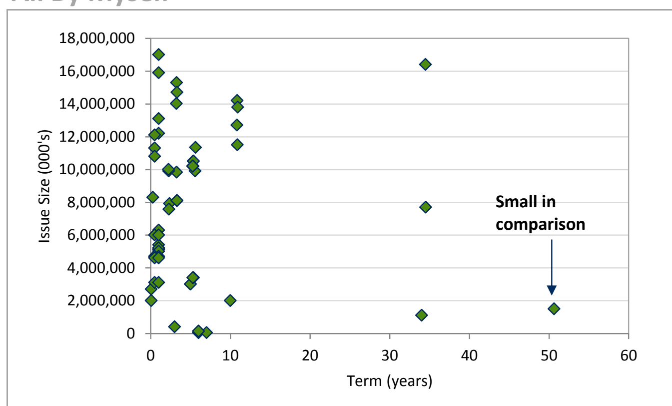
Unfortunately, a suitable utilities alternative to ZUT does not exist. The closest alternative is iShares S&P/TSX Capped Utilities (XUT-T), but it is also too concentrated for our liking with top holdings Fortis (FTS-T) and Canadian Utilities (CU-T) representing 19.1% and 13.8% of the portfolio, respectively. For those interested in ZUT for its dividend and income characteristics, consider iShares Dow Jones Canada Select Dividend ETF (XDV-T) as an option. XDV yields 4.0% and pays monthly ($.08406 in April). A key differentiator of XDV is that it runs quality screens to weed out lower quality stocks. For instance, potential candidates must have positive five-year dividend-per-share growth and a dividend-payout ratio of less than 80%. Another differentiator: XDV is more diversified by holdings as it is comprised of 30 stocks. XDV is also diversified by sector.

Jordan Benincasa, LL.B, MBA
Mutual Fund & ETF Research

Going Further

Last month, the Bank of Canada issued a new, ultra long, 50-year bond – the Gov't of Canada 2.75% Dec 1, 2064. This is part of a larger ongoing tactical strategy that has been in place since 2012, reallocating short-term issuance to long-term bonds. An attractive low interest rate environment and strong demand for longer-term products motivated this shift. Prior to this deal, the longest-dated issue was the Gov't of Canada 3.50% Dec 1, 2045, making the 2064's around 19 years longer than the former titleholder. This new issuance has allowed the Government of Canada to lock in a portion of their financing requirements for 50 years at a yield to maturity of 2.96%. Comparatively, a typical 5-year fixed-rate mortgage would be offered in a similar range (around 3.00%), but the Government of Canada will be able to use the funds for a period 10 times longer. Some believe that such a move is fiscally responsible and a clear benefit to Canadian taxpayers as this ultra-long bond reduces future refinancing risk.

All By Myself



Source: Bloomberg. Raymond James Ltd.

More often than not, retail investors do not lock in their money for such long periods, so who would be driving demand for this type of product? This deal caters to institutional investors, specifically pension funds and insurance companies, looking to manage their future liabilities. With rates so low, large institutional buyers are seeking yield, but as they are often mandated to stay with higher quality issuers, such companies had to reach further and further out on the curve to lock in higher yields. In fact, there was so much demand that the government initially tried to bring $750 mln of this new 50-year bond, but ended up doubling the size to $1.5 bln. As illustrated in the graph above, this is a loner in the ultra-long space and is relatively small compared to other Canada bonds issued in recent times. If this was a single event, the 50-year bond issuance may not be noteworthy; however, we believe that the environment will continue to be accommodative and that more issuers may take a good look at the ultra-long space for their future funding requirements.

Longer Maturities = Higher Risk

Two of the most obvious risks for any bond buyer are **interest rate** and **inflation risk**, and these risks increase as time to maturity increases – a bond maturing in 30 years will carry higher levels of risk than a 5-year issue.

Interest rate risk is when a bondholder experiences an unrealized capital loss on their holding when interest rates rise - we realize that the likelihood of the Government of Canada defaulting is low, but bonds with longer maturities are more likely to see price fluctuation, which may impact investors who look to sell early. Recall that bond yields and prices have an inverse relationship. The 50-year issue's current modified duration is around 26.54. Duration is a measure of price sensitivity to a change in interest rates. In this case, the approximate percentage price change from a 25 basis point rise in yield is a 6.635% decrease in the price of the bond and if yields rose 1%, the price of the bond would drop by 26.54%.

Inflation risk is when purchasing power is eroded by rising prices. For example, the cost of a "Big Mac" has doubled over the last 10 years and will most likely continue this trend. Although inflation readings in the current environment are very benign, one would expect that inflation will rise over the next 50 years. The coupon payment to the bond holder is fixed at 2.75%, so if inflation occurred, the bondholder would be worse off since their fixed payments would buy fewer goods.

Though this new Government of Canada ultra-long issue may be ideal for pension funds looking to manage their exposure, we feel that typical buy-and-hold retail investors should not target products with such high duration due to the risks involved. Currently, we recommend investing in the shorter end of the curve in bonds with 3 to 5 years to maturity, or using a laddered bond portfolio approach.

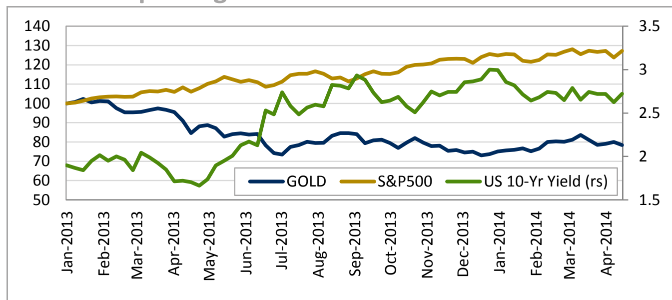
Harvey Libby
Fixed Income

BoC Weighing on Loonie

The loonie has been the worst performing currency against the USD (-2.45%), EUR (-3.74%) and GBP (-4.81%) in the G10 year-to-date. Looking specifically against the USD, a considerate amount of the Canadian dollar's underperformance looks to have been primarily driven by domestic factors, as well as a slowly improving US economy.

Globally, USD performance year-to-date has been mixed relative to a basket of the majors, with the exception of the commodity currencies which outperformed. Both AUD and NZD (commodity currency status) are both stronger against the USD this year, and the Canadian dollar has not benefited from the semi-commodity status lift it has experienced historically (see last month's *Insights & Strategies*). Additionally, the DXY Index (a relative measure of the value of USD against a basket of major currencies) is also essentially flat this year (-0.67% YTD), suggesting that broad-based moves and global appetite for the USD has not been the major driver of USD outperformance against the loonie.

Factors Impacting USD



Source: Bloomberg, Raymond James Ltd. Gold and S&P 500 indexed to 100

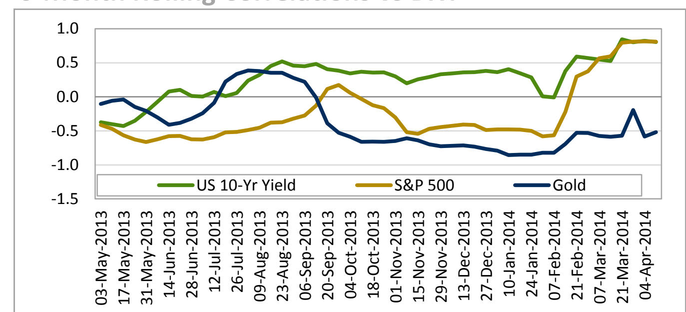
Over the past year, frequently used terms to describe investor sentiment have been "risk-on" / "risk-off". During recent times of positive US stock market performance (risk-on), fixed income products and gold (USD denominated commodity) tend to underperform (see chart above). A change in the trend of 6-month performance correlations over the past year has seen the DXY/S&P 500 and the DXY/US 10-Yr Treasury yield correlations trend positive, as well as the DXY/Gold correlation trend into negative territory (see chart right). This in combination with the "risk-on"/"risk-off" performance behaviour seen between asset classes lately, may have created a balance between USD buying and selling pressure that has contributed to the DXY's moderately flat trading range year-to-date.

With USD relatively flat globally, Canadian domestic factors must be playing an important part in the loonie's underperformance.

Looking to the Canadian economy, there has been a considerable shift in the Bank of Canada's tone since Stephen Poloz took over Mark Carney's position as governor, as well as a slight deterioration in domestic data.

When Mark Carney left the BoC for the lead job at the Bank of England, market consensus was that Canada was going to be the first major developed economy to raise interest rates. Since Poloz took the reins, consensus median for rate hikes has been pushed back, and now estimates are for both Canada and the US to increase rates in Q3 2015. This is a considerably different median forecast from mid-2013 which saw a Canadian rate hike as early as the end of this year. This is the result of a slowdown in domestic inflation and GDP which has caused the Bank to maintain its neutral outlook and shift its verbiage towards a more dovish bias with comments such as "rate cuts cannot be taken off the table". Additionally, Governor Stephen Poloz has been aiming recent policy talk at the need for export growth in an effort to spur inflation and a GDP recovery. Talk of export growth is often generally associated with a softer currency as it allows foreign importers to buy Canadian products at a lower cost.

6-Month Rolling Correlations vs DXY



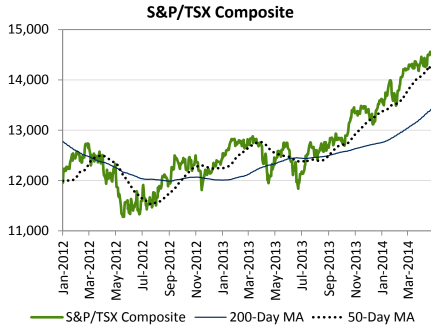
Source: Bloomberg, Raymond James Ltd.

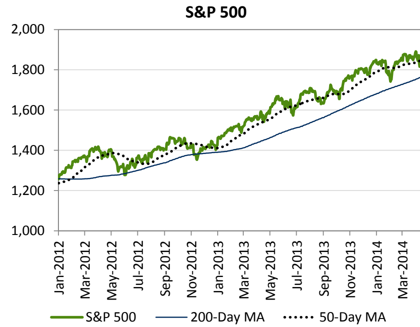
With the DXY trading flat year-to-date and what looks to be a slowly and steadily improving US economy, the Bank of Canada's monetary policy and domestic data will play an integral role in the direction of the Canadian dollar over the next 6 months. An outperforming TSX has been supportive of the loonie, but if Canadian economic data continues to be stagnant, the US wraps up its QE program, and chatter starts about an eventual rate hike there, the loonie could face further pressure until the BoC takes a more optimistic tone or policy.

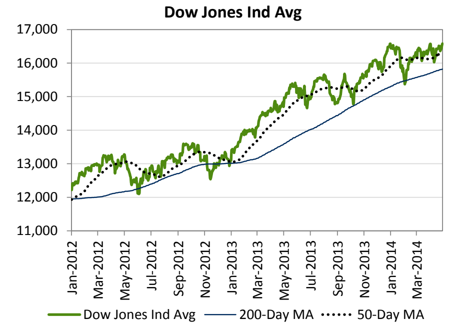
Andrew Clee
Foreign Exchange

Charts of Interest

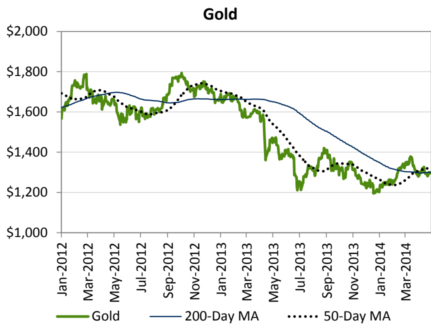
Markets

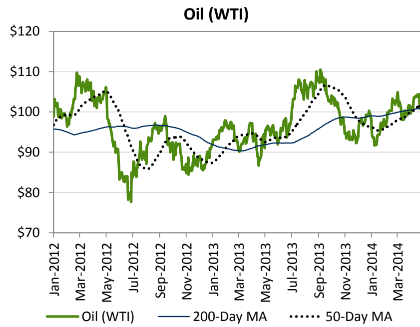


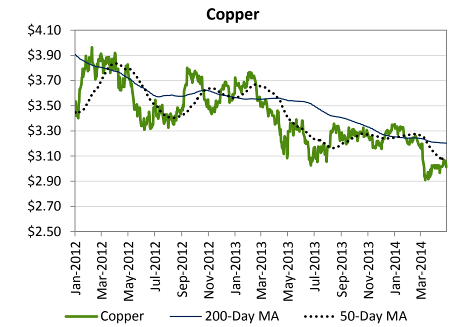




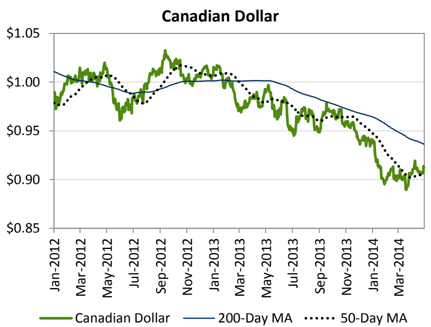
Commodities

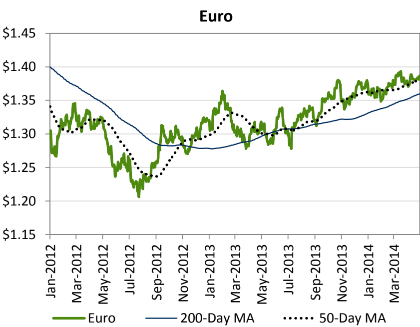


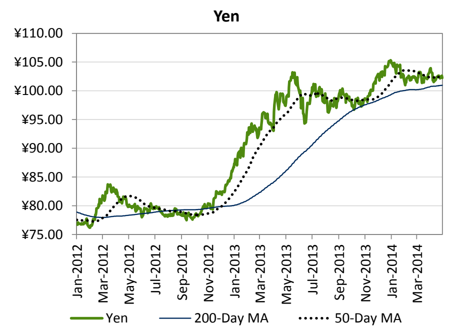




Currencies







Source: Bloomberg, Raymond James Ltd. Performance as at April 30, 2014.

Asset Class Weightings

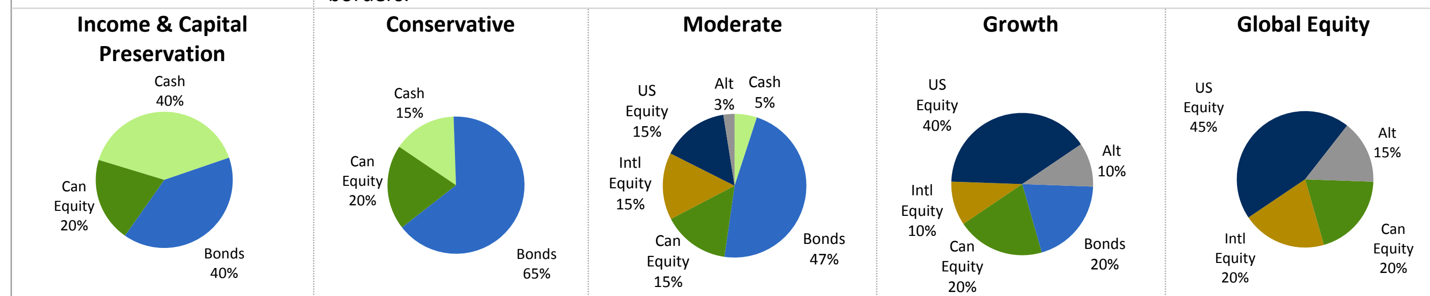
Profile	Cash	Bond	Can. Equity	Intl. Equity	US Equity	Alternative
Income & Capital Preservation	40%	40%	20%	0%	0%	0%
Conservative	15%	65%	20%	0%	0%	0%
Moderate	5%	47%	15%	15%	15%	3%
Growth	0%	20%	20%	10%	40%	10%
Global Equity	0%	0%	20%	20%	45%	15%

General Asset Class Ranges

	Cash	Bonds	Equities	Alternative
Income & Capital Preservation	40 – 75	15 – 40	0 – 20	0
Conservative	15 – 30	60 – 65	10 – 20	0
Moderate	5 – 10	45 – 65	25 – 45	0 – 5
Growth	0 – 5	15 – 40	50 – 70	10 – 15
Global Equity	0	0	80 – 85	15 – 20

Profile Descriptions

	Description
Income & Capital Preservation	Virtually any loss is unacceptable. Investors' primary objective is to achieve a return that keeps pace with inflation. Fixed income and cash make up the largest portion of holdings.
Conservative	Losses can be tolerated, but erosion of regular income payments cannot. Stability of coupon or dividend is the primary concern as many investors will employ this income for cost-of-living expenses. Bonds tend to make up the largest proportion of holdings.
Moderate	Some higher risk positions tolerated but these are typically offset with blue-chip dividend paying equities or low-risk bonds.
Growth	Willingness to take speculative bond and equity positions though growth portfolios are typically biased towards equities. Strong earnings growth or high yields usually take preference over valuations. Some defensive constraints may be employed, but even these may be removed for highly risk-tolerant investors.
Global Equity	A willingness to ignore 'home-country bias' and allocate holdings internationally. International equities typically receive weightings equivalent to or greater than domestic securities. These investors recognize that Canada represents only ~3% of global equity markets and are willing to source investment opportunities outside our borders.



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