Pension Portfolios Monthly Update

Pension Style Investing for All Canadians

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Uncertainty Has Returned

A few months ago, we published a monthly review entitled "Are We There Yet?" and at that time it seemed that seeds of optimism were beginning to create shoots of recovery. July and into August saw that optimism result in stocks rallying and even bond prices responded positively. At that time, it looked like the tide was turning. Unfortunately, September has not been as kind, and we are now seeing that optimism quickly fading. Gloom and fear grip capital markets once again.

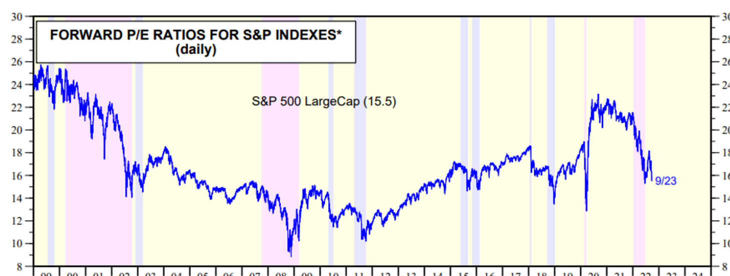
Investors are once again showing how quickly their attitudes can change. The triple threat of persistent inflation, aggressive central bank tightening and an all but certain global recession is driving prices lower in almost all capital markets. The situation in Ukraine also seems to be escalating negatively with Russia's call for conscription, a direction that might mean a protracted conflict. Further, a recent spike higher for the US dollar seems to underline the renewed uncertainty.

Due to ongoing volatility and continuing uncertainty, the NCM Pension Portfolio allocations remain in defensive mode. Our equity holdings in the funds remain tilted to lower beta stocks, meaning more investments in companies less sensitive to broad stock market prices. In our fixed income positions, a new tilt to shorter maturity investments is helping to avoid the volatility still impacting longer dated fixed income markets. Allocating to investments with less volatility still seems to be the right approach.

Market Values Are Improving

Even with the continuation of volatility, it is not lost on us that the valuation characteristics of equities has improved markedly since the market peaked late last year. One of our biggest concerns last year was the lofty market multiples that defined the market (particularly the S&P 500) at the peak. To give an example, the P/E ratio of the S&P 500 was over 20X before the weakness that has seen that index decline 23% since the beginning of the year.

CHART 1



Source: Yardeni.com

The current P/E of 15.5X seen in Chart 1 indicates that a significant amount of valuation risk has been wrung out of this index. Unfortunately, one would need a crystal ball to know if the P/E will continue to decline or not, but our view is that a much lower P/E means much of the damage is behind us. The action item resulting from this observation is to start looking for opportunities in the current market wreckage. Further to that, if the world enters a recession next year, the market in the U.S. may be a reasonable place to look for value. The combined effect of a recession and a protracted conflict in Europe has us favouring North American over European equities. We have recently been allocating accordingly, and our Non-North American allocations are now lower.

One of our strategies to lower volatility in our NCM funds has been to favour dividend paying companies. Dividend yield is the per-share cash paid to investors divided by the stock price. Higher dividend yields mean more money directly into investors' pockets. Historically, the dividend yield for the S&P 500 ranged between 3% and 5% with a 4.3% average. When considering the long-term average, the 1.27% yield at the market peak looked anemic, however, since the base of this calculation is the price, which is now much lower, this metric has also improved. The dividend yield now stands at about 1.7% and it might naturally start to move higher without further price erosion.

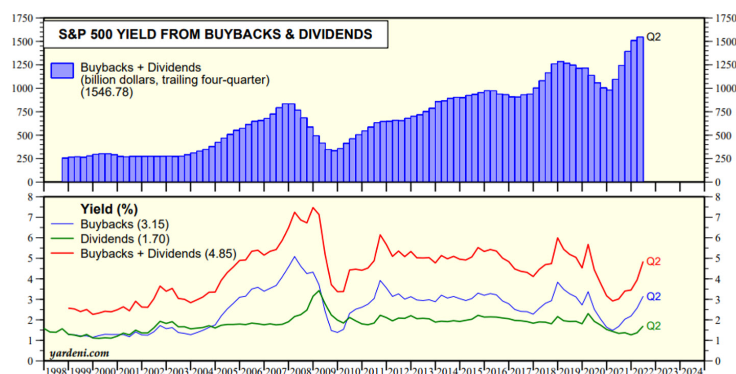
Dividend Yield PLUS Buybacks Tells a Different Story

The trend to low dividend yield over that past few years has a lot to do with stock buyback programs. When a company uses excess cashflow to purchase stock it is rewarding investors with higher earnings for each share outstanding. If the number of shares declines, each share still outstanding has a claim on more earnings.

There are two camps of investors when it comes to buybacks. Quite simply, some investors like them and some don't. The

reasons are investor-specific and are related to cashflow needs or differing tax treatments of the gains among others. Additionally, this corporate strategy is typical of growth companies. Recently, the S&P 500 has been dominated by a handful of fast growers, some with healthy buyback programs and no or low dividends being paid, hence the lower yield versus history. Chart 2 shows the result of combing dividends and buybacks. Based on this way of looking at value gleaned by stock owners, the low yield doesn't look as bad as the combination of buybacks and dividend yield creates a pretty attractive return.

CHART 2



Source: Yardeni.com

But...Market Prices Need to Cooperate

There is an issue with buyback, and this is the need for market price action to provide buyback value. Share buybacks are expected to boost the value of the stock in the market but this expectation becomes a little less certain when the market is in freefall. If shareholders start to take a "show-me-the-money" attitude, Chart 2 suggests the dividend yield could continue moving higher and that's a good thing. Using history as a guide, there is no doubt that there's room to move.

Either way, the lower portion of Chart 2 shows that both buyback yield and dividend yield got too low at the market's last peak. Both shareholder compensation programs are showing better valuation support today and when added together, the move from 3% at the market peak to 4.85% over the last 9 months is a big improvement. Just as P/Es have moved back towards the average, so too have buyback plus dividend yield percentages. That's a positive read for the market.

Fixed Income Remains Short-dated

Our fixed income strategy is predominantly split between short and medium term holdings. In each of the NCM Pension Portfolios, short and medium term fixed income represents over 85% of the total fixed income positions. This portion of the fixed income holdings has an average maturity of approximately 3.7 years.

NCM Pension Portfolios also hold a balance of credits. The Conservative Income Portfolio holds 10% of its fixed income positions in high yield investments. In the Balanced Income Portfolio, high yield accounts for 28% of its total fixed income and in the Growth and Income Portfolio, high yielding investments account for 40% of the fixed income securities. Each fund's high yield is predominantly held using a short-term high yield ETF. While this ETF has seen declines with the rest of the bond market, it is priced in $US, meaning the currency gain has seen its value in our portfolios remain virtually even. We don't typically count on currency as an active component to returns but in this market, we'll take the win.

We are in a holding patten once again. With markets making new lows we are content to be patient. We believe that the adjustments we made through the summer will provide both higher stability and attractive returns once markets return to normal. While the timing of getting back to normal is uncertain, taking a long-term view with a well-diversified portfolio has been a recipe for success.

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