

OCTOBER 2011



President's Perspective

Davee Gunn, President & CEO
dgunn@hahninvest.com

HAHN Investment Stewards is pleased to bring you the Fall 2011 edition of Global Wealth Perspectives.

In this issue our Chief Investment Officer, Wilfred Hahn, provides examples of eight trends or anomalous developments observed around the world that he describes as “peculiar, new, or perverse when viewed against historical patterns”. Deeply depressed interest rates and investor fears are contributing to erratic markets that are dysfunctional opposite traditional theory.

Wilfred emphasizes that as global investment managers we overtly seek to profit from these dysfunctions. Opportunistic investment themes developed to take advantage of these distortions are best described by the title of his October issue of *Global Spin* – “Profiting from Bungles in the Jungle”. A number of these themes are outlined in our [Current Portfolio Strategy](#) on page 4, along with our outlook for investment markets and summary of our current viewpoints.

This issue also includes an excerpt from an article authored by our Director of Research, Tyler Mordy, titled “Workers of the World Untied: Has Capitalism Come Undone?”, which will be published in the November/December 2011 issue of the *Journal of Indexes*. Tyler prefaces his comments by saying that while political economy is not the normal domain of portfolio managers, these trends are inextricably linked with sustainable wealth creation so need to be examined and understood. Importantly, Tyler reminds the reader that “our goal is the pragmatic stewardship of client capital ... focusing on the world as it is, not as it should be.”

We hope that you enjoy the issue of Global Wealth Perspectives and as always, welcome your comments and feedback.

What's New at HAHN

→ It is our pleasure to welcome Ken Hawkins to our investment team in the position of Research Manager. Ken has over 25 years experience in the investment management industry. Prior joining HAHN, Ken was Chief Investment Strategist at Weigh House Investor Services. Earlier, Ken was a portfolio manager with Ontario Teachers' Pension Plan and was also a top-ranked quantitative analyst/strategist with Scotia Capital and Deutsche Morgan Grenfell.

→ On July 15, 2011 Jovian Capital Corporation (TSX:JOV) announced the sale of its exchange traded fund business to Mirae Asset Global Investments, South Korea's largest mutual fund manager. As a global wealth manager of ETF portfolios for private and institutional investors, our business is separate and distinct from the exchange traded fund business purchased by Mirae. Our firm is not part of this transaction. To signify this we are now displaying the new logo for HAHN Investment Stewards.

Last Quarter's Highlights

- Economic growth fears and European debt concerns have dominated trends in global financial markets. All investment markets have experienced above-average volatility.
- Diversified portfolios have fared best as these have comprised significant fixed-income allocations. While equity markets domestically and around the globe have declined significantly since March of this year, bonds have soared
- Several major and unprecedented influences are at play, from European debt crisis, potentially large shifts in U.S. budget policy and the continuing multi-legacies of the Global Financial Crisis.
- Global diversification in equity markets has been of benefit as Canadian equities were amongst the worst performing again this past quarter.
- A sharply weaker Canadian dollar versus the U.S. dollar, as anticipated, has served to improve performance of international holdings. A lower Canadian dollar is beneficial for the Canadian economy.
- For an expanded review of the investment outlook and current strategies, please see Portfolio Strategy Update (pg. 4)

HAHN Global Insight

Wilfred J. Hahn, CIO & Chairman
whahn@hahninvest.com



Uncommon Global Voyage

The international financial environment remains in uncharted waters. Financial markets are not functioning normally. Indeed, trends and conditions are being observed that are entirely new to the current generation of investors and professional investment managers. More than ever, a grounded perspective, rooted in causal theory, and a knowledge of history is necessary. As such, we find that an increasing portion of our diversified strategies are being triggered by various financial and economic dysfunctions. Add to this the behavioural dynamics of desperate financial institutions and private investors; what emerges is a rich mix of both risks and opportunities.

To date this year, our risk-averse posture has been rewarded. Not all of our strategies have worked out as expected. They rarely do. Nevertheless, that is why we emphasize a “balanced, risk-averse approach.” And on balance, we have done a good job of preserving capital this year to date. It was the right time to do so. Now, we are gradually beginning to turn to new opportunities even as overall consternation with current world trends remains high. We will need to tread carefully, ensuring that our longer-term viewpoints are being validated by actual trends and events.

A key dynamic that has changed in recent months, has been consensus expectations. Whereas we were lonely analysts anticipating growing challenges and were calling for caution earlier this year (*see the*

March 2011 *Global Spin*, titled “50 Whys to Leave Your (Risk) Lower”, a general sense of foreboding is now almost universal. This is justified and market prices have at least partially adjusted to these perceived realities — meaning equities prices have fallen and bond prices soared.

The past few months, a massive re-rating of the world economic outlook has occurred. This has indeed vindicated our earlier view that a sustained economic slowdown was again around the corner. Yet, the speed of this expectational adjustment has been virtually unprecedented, causing long-term interest rates to fall by as much as one-third in a time span as short as 10 weeks. These are epochal shifts ... and they have produced large gains in fixed income positions.

Where No One Has Gone Before

Around the world, we observe a large number of trends and developments that are either peculiar, new, or perverse when viewed against historical patterns. Financial markets are not functioning normally, but rather are dysfunctional and often performing perverse to traditional theory. For example:

1. Currency wars are back ... and this time, instigated by the strong countries not the weak ones. Basically, all central banks (lately also including that of Brazil, which recently instituted a bizarre rate cut) are opting for “money printing” rather than bear the consequences of slumping demand.

2. The Swiss National Bank (SNB) — the central bank for the nation with the world’s strongest balance sheet and with one of the highest external surpluses— as of September 5th is now offering 0% loans and, effectively, debasing its currency by accepting lower quality collateral.

3. Rising commodities prices today are more deflationary than inflationary. Why? Because, when real income growth is low any increase in prices causes higher household living costs, thus crimping room for other spending.

4. For the first time, emerging countries (their economies and bond markets) are outperforming those of the advanced nations in a period of economic downturn, though this may not continue indefinitely.

5. The bonds of some large companies are outperforming (*trading through*) government yields of their home countries. Currently, no less than 70 large U.S. companies are considered a better credit than the American government (*according to credit derivative markets reported by Markit*).

6. Some commodity prices are much less cyclically sensitive than in past cycles. Why? This may be due to capital flight from currency debasement institutional activity in futures markets.

7. The best investment for many corporations is their own shares. Even Warren Buffet, the legendary billionaire investor, is buying back the stock of his company, Berkshire Hathaway.

8. The wide-spread popularity of gold bullion and its widely-promoted role of a “safe currency” (*though this is no longer true*) has elevated the gold bullion price far above production costs. As such, gold producers, as in the 1930s, will again outperform and are now inexpensive.

9. Rather than focus on the long-term, money managers are forced to maintain active and dynamic strategies and to pursue niche opportunities that are born of global systemic dysfunctions.

Indeed, global financial markets are dysfunctional at present.

However, it is nonetheless a characteristic that can be diagnosed, against which behavioural adjustments can be made. As such, we are overtly seeking to take advantage of these dysfunctions. These have led to profitable distortions and opportunistic investment themes. We describe 8 of these in the October issue of the *Global Spin*, titled “Profiting from Bungles in the Global Jungle”. Some of the “dysfunctional” realities that we may have identified can be arbitrated for gainful opportunity. Zero interest rate policies which are clearly signalled to continue for some years, are a strong stimulus to corporate equity buybacks. As such, the equities of large global companies (*provided that there is not a big earnings drop*) are likely to be a good store of value.

The Force field of Low Interest Rates

Most of the market dysfunctions that are now playing out around the world stem from ultra-low interest rates; and investor’s quest for safety. The most distorting of these are ultra-low interest rates (*and deeply negative real interest rates*). Most advanced nations are experiencing very low or zero-bound interest rates levels that are being guaranteed for some years.

Ultra-low rates are unhealthy for several reasons. Firstly, it warps investor behaviour, pushing them dangerously to take on higher risk in order to achieve higher yields; encourages speculation; artificially pushes up asset values which might be valued relative to interest rate levels, and most unfortunately, causes an income crisis for those dependent upon interest income (*this also including all future retirees who are participants in a pension fund*).

Viewed philosophically, depressed interest rates reward borrowers for their profligate behaviour and punish wise savers. None of these symptoms are at all conducive to restoring stable financial markets or a favourable economic situation over the longer-term. The by-product of these conditions is high financial market volatility — prices surging and crashing alternately — all of this aggravated by desperation, fear, confusion and brinkmanship.

Given this current reality, people may then be asking: “Why invest savings in asset markets? Why not deposit retirement savings in a bank account or an annuity?” This indeed might appear to be an attractive alternative in view of the buffeting and volatility being experienced in financial markets. Yes, investors should all arrange their affairs to accommodate their “sleep zone.” However, we would alert investors to consider these two balancing perspectives:

1. Focus Only on What is Unseen. Financial asset markets consist of many more asset types than just stocks. Yet, it is primarily the gyrations of stock markets that attracts the emotion-mongering propaganda of the media — whether fear or unfounded optimism. The reason that our portfolios have not succumbed to the losses of equity-heavy balanced portfolios this year is that while various stock markets may have fallen by as much as 20% and more, long-term bonds (*an investment position that we had emphasized*) have returned 25% and more! These two asset classes have offset each other. Yet, the steep upwardly-sloping volatility of the bond markets has not met the same hyped attention of the media. A diversified portfolio that can tactically participate in many asset types around the world — from securities to hard assets — and that is not limited to just one environment is absolutely necessary. Unusual times call for innovative approaches.

2. High Volatility Breeds Opportunities. While the harried reactions of globalized financial markets and economies may indeed be very confusing to the layperson, to the professional global investor these offer tactical opportunities. While no one will be guaranteed to make the correct decisions every time (that being the main reason for diversified portfolios), an active tactical approach remains one of the few ways to outperform cash returns in the next few years.

Client Perspective

Workers of the World *Untied*: Has Capitalism Come Undone?

(Following is an excerpt from a provocatively-titled article recently submitted by Tyler Mordy (Director of Research) to the global publication of *Index Universe, Journal of Indexes*. Tyler is also an advisory board member of IndexUniverse's ETF Analytics platform, a leading independent authority on ETF analysis. The full article is forthcoming in the November/December 2011 issue of *Journal of Indexes*.)

***"In the long run the workman may be as necessary to his master as his master is to him; but the necessity is not so immediate."* — Adam Smith, *The Wealth of Nations* (Book 1, Chapter 8)**

Admittedly, political economy is not normally the target domain of portfolio managers such as this author. We pledge no allegiance to any long-dead philosophers or other academic scribblers. Rather, our goal is the pragmatic stewardship of client capital ... focusing on the world as it is, not as it should be. Yet, trends in returns on capital versus returns on labour—the central battleground of many of these ideological debates — are inextricably linked with sustainable wealth creation. Even passive indexers and ETF enthusiasts must rely on a minimum level of balanced economic growth, and indeed a functioning capitalistic system, to tap into the other well-known benefits of indexing.

For investors and political economists alike, these developments need to be examined and understood. Can these trends continue? Or, is the capitalistic model broken? After all, classical economic theory — indeed, the very underpinnings of capitalism itself — asserts that higher profits and productivity should translate into higher wages. During boom times, margins should eventually be under pressure as workers gain bargaining power and competition drives up other cost inputs. And, as Henry Ford learned almost 100 years ago, the health of the corporate sector is ultimately tied to the health of its customer. Therefore, the combination of rising profits and stagnant income growth (and thus weak aggregate demand) cannot possibly last forever.

Or can it? In a globalized era, a new investment class has emerged — the multinational corporation. Rising out of a more interconnected world, these companies transcend the restrictions of individual nation states, roving the globe for arbitrage and profit opportunities. They can seamlessly shift production from country to country, accessing better tax regimes and, importantly, cheaper labour. The same advantages are now also available to global portfolio managers, as

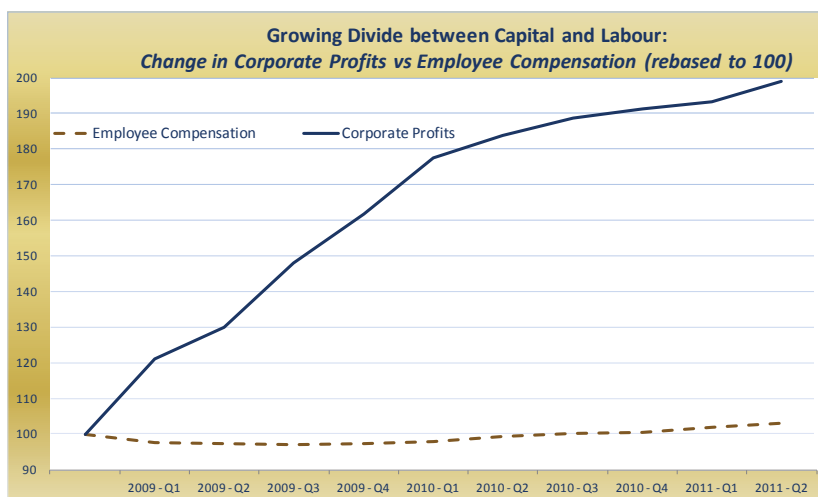
client capital can be invested in profitable economies or enterprises anywhere around the world.

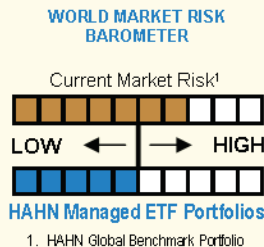
Shareholder Driven Capitalism. Restrained wage growth has not been the only corporate cost-cutting measure supporting record margins. In fact, other structural trends, in place for some time now, have acted to bolster short-term profits while simultaneously undermining both labour growth and longer-term profits. Importantly, maximizing shareholder value has often been placed ahead of productive wealth accumulation. This is primarily an outgrowth of changing incentive structures since the early 1980s. Facing short-term quarterly earnings pressures, option-laden managers (whether consciously or not) favour measures that immediately boost share prices rather than securing long-term profit growth. For example, since the late 1990s, spending on capital equipment and software has significantly lagged earnings growth (see chart). Over time, these actions deplete productive capital formation, reduce macroeconomic growth (and, ultimately contribute to a reduction in employment).

[...] Undoubtedly, however, corporations will remain focused on cost control and productivity gains. As part of that equation, financial engineering will remain key. Consider that companies have a number of options when utilizing their capital; they can reinvest back in the underlying business, retire debt, buy back shares, or pay out dividends. Why would corporate executives pursue the first two options when aggregate demand is weak and interest rates are at historic lows (and pledged to remain there until at least mid-2013)?

A more rational approach, even if not beneficial to labour, attempts to boost stock prices by reducing share count or increasing dividends. That has been the observable case, as corporations have been actively increasing

dividends or share buybacks. For the first half of 2011, the net domestic common stock dividend increase of \$30.2 billion already surpasses all of 2010, representing an 11.1% increase (4.1% for Q2 and 6.7% Q1). From a capital allocation standpoint, these trends are completely logical and likely to continue for some time.





Current Portfolio Strategy

We remain fundamentally and secularly cautious (as investment risk remains above average over the longer-term) however, are reducing our extreme defensive bias. A large degree of economic “down-rating” has already occurred over recent months... the consensus moving sharply to a deep defensive position. However, it remains premature to take an aggressive stance as no indicators yet validate a strong fundamental outlook.

Most crucially, our outlook for global investment markets continues to be framed by the following seven major secular trends:

- 1. Debt Deleveraging:** A private sector “balance sheet” adjustment is limiting overall demand and economic growth, a process that typically unfolds over a period of years, rather than quarters.
- 2. Resource Geopolitics:** Food supply, arable land aggregation, access to water and energy supply will continue to define the geopolitical policies of many nations.
- 3. Grey Demographics:** A rapidly aging population in many Western countries has created an urgent requirement for increased saving.
- 4. Wide Wealth Skew:** Wealth stratification has become extreme, imposing credit instability and impediments to economic growth.
- 5. Imbalanced Global Trade/Capital Flows:** These have yet to adjust to a sustainable pattern. Trade and savings imbalances between surplus and deficit nations remain acute ... and are worsening. Both Europe and the U.S. remain in the crosshairs.
- 6. Keynesian Endpoint Reached:** This means that unprecedentedly high government debt levels now limit policy options in advanced nations, should future financial crises or economic slowdowns occur. Interest rates remain very low, generating income crises.
- 7. Global Convergence:** The living standards of selected non-advanced nations are expected to continue to converge with that of the high-income countries.

Additional investment initiatives arise from shorter-term opportunities that may arise due to various policy actions, geopolitical developments and financial market over reactions. Our current tactics and viewpoints are summarized below:

A Risk-Wary Stance Continued, But Modulated. We have moved back to a more neutral stance increasing equities and have removed an underweight in European equities to modestly overweight. Though “euro” troubles persist, equity market valuations in this region are extremely depressed.

A Focus on Quality and Diversification. Worldwide, the prospect of instabilities remains above average. Sovereign debt defaults are a likelihood at this point. As such, HAHN portfolios are emphasizing “quality”, “yield” and broad diversification. We have sought investments in opportunity assets that offer both stability and the prospect of untethering from a global “slow growth” outlook.

Fixed Income Markets Now Overvalued. Interest rates have fallen dramatically over the past half year. We anticipated this outcome, having maintained an over-weight in fixed-income markets as well as maintaining exposure to long-dated bonds. However, now with large gains, we are faced with significant overvaluation. We have reduced our exposure to fixed income markets to modestly underweight. Asian bond exposures have also been reduced.

Income, Income, Income. Wherever possible, income is being emphasized. We remain cautious of higher-yield assets as credit spreads appear to have begun a widening cycle.

Companies With No Country. Over the long-term, we favour large, globally-diversified multinational firms that can best retain pricing power, seek opportunities internationally, and deliver better value and solid dividend yields. Recently, equity markets have begun to factor in slowing profit growth. Given the low, low level of interest rates, we expect that equity markets will remain underpinned by high corporate take-over and buy-back activity.

Gold and Inflation Hedges. We continue to hold a large overweighted exposure to gold equities, though we do not expect high inflation in the future (other than a late stage, cyclical spike). Gold is held primarily as a “crisis hedge” and not an inflation hedge. Gold equities particularly are reasonably valued at the present time.

Sectors: Non Cyclical Focus. Globally, we maintain a sector emphasis upon health care — a sector that we believe will offer enduring growth, given aging societies — and have re-initiated an overweight in energy. An overweight in utilities has been removed in line with our more cautious fixed-income strategies.

Opportunity Investments. Investments in this special category of our portfolios are selected to boost growth and/or achieve “shock absorber” qualities, enabling portfolios to better weather unstable markets. Currently, this portion of portfolios also carries a raised emphasis upon high-yield assets including government-guaranteed mortgages and Asian fixed income. For the near-term, the outlook for emerging markets overall calls for continuing caution. We continue to hold a core holding in India. We will be adding to this category several selected investments as opportunities arise.

Safe Country Focus. Due to rising prospects of sovereign debt defaults and high government budget deficits, we expect that a preference for “safe countries” will increase. For Canadians, this is best achieved by a higher weighting in Canadian bonds.

Currencies. All foreign currency exposures remain unhedged at this time against the Canadian dollar, with the exception of investment holdings in the Eurozone. The euro is vulnerable to a decline versus the Canadian dollar.

Quarter 4, 2011 Investment Stance

Net Asset Mix	Versus benchmark		Change from previous quarter
	under	over	
Cash			▲ Increased
Total Equity	■	■	▲ Increased
Total Fixed Income	■		Unchanged
Opportunity		■	Unchanged
CDN Investments			
Bonds		■	Unchanged
Stocks	■		Unchanged
US Investments			
Bonds		■	▼ Decreased
Stocks		■	▲ Increased
INTL Investments			
Bonds	■		▼ Decreased
Stocks		■	▲ Increased

Global Wealth Perspectives is published by HAHN Investment Stewards & Company Inc., a manager of global, diversified portfolios for private clients and institutions in Canada, the U.S. and offshore primarily using Exchange Traded Funds (ETFs). This document is being made available for educational purposes only and should not be used for any other purpose. The information contained herein does not constitute and should not be construed as an offering of advisory services or an offer to sell or solicitation to buy any securities or related financial instruments in any jurisdiction. Certain information contained herein concerning financial and economic trends are based on or derived from information provided by independent third-party sources. HAHN believes that the sources from which such information has been obtained are reliable; however, it cannot guarantee the accuracy of such information and has not independently verified the accuracy or completeness of such information or the assumptions on which such information is based. Any opinions expressed in this document are based on current analysis of market events and circumstances and are subject to change.