Investment markets:

a review of the past year; expectations for 2005

by John G. Ambrose, CFA

As the new year begins, many investors want to know what they can expect in the financial markets over the next 12 months, and how to take advantage of future opportunities.

Why are expectations important?

Longer-term retirement and estate plans must take into account an investor's current portfolio, expected investment returns, and future expected living expenses.

Having reasonable expectations is important. Using unrealistic projected investment returns in retirement and estate plans will almost certainly mean a reduced standard of living at retirement, or perhaps require spending capital that will diminish, or even deplete, the estate for heirs.

Very good returns for Canadian investors in 2004

Canadian markets performed well last year. The Canadian bond index returned 7.2 per cent for the year ended December 31, 2004.

Falling interest rates gave bonds an extra gain of three per cent, as well as the interest yield of 4.2 per cent. Steadier interest rates will likely keep bond returns limited to about five per cent.

For 2004, the Canadian Standard & Poor/Toronto Stock Exchange (S&P/TSX) equity index returned 14.5 per cent, with extra gains from the energy and materials industrial sectors (a result of "cyclical" or temporarily high oil and commodity prices). This return is well above the long-term average of about eight per cent per year.

Also in 2004, the S&P 500 Composite Index returned 10.9 per cent in U.S. dollars, but only 2.8 per cent in Canadian dollars, due to the strengthening of the latter.

U.S. equity returns about 10 per cent to 12 per cent per year over the long term in Canadian dollars. It is expected that U.S. equity returns will recover to traditional levels, and this offers an opportunity to those who can anticipate the turnaround on the U.S. dollar.

Many investors have balanced portfolios containing portions of Canadian bonds and equities, and U.S. and non-North American equities. A reasonable long-term return is seven per cent per year for a balanced portfolio.

Assuming a portfolio containing two per cent cash or treasury bills, 38 per cent Canadian bonds, 30 per cent Canadian equities, 20 per cent U.S. equities, 10 per cent international equities, and no management fees, the blended return of these classes, using indices, was nine per cent in 2004.

If an investor had purchased the median performing mutual fund from each asset class, and blended them in the proportions noted above, the blended return would have been 6.6 per cent. This means that the return of the blended mutual fund was 2.7 per cent below the market, which is about equal to the average management fee. Although disappointing, this median mutual fund relative performance is typical of other time periods.

Stable equity markets with average multiples today

The markets seem to have stabilized since the technology bubble burst in March 2000.

The blue-chip Dow Jones Index fell by 20 per cent from its peak of 11,000, and has recovered. The S&P/TSX Index has fallen by 20 per cent from its peak of 10,000, and has recovered. The S&P 500 Composite and tech-heavy NASDAQ indices have stabilized.

Company valuations as measured by today's market price per share divided by next year's expected company earnings (known as the P/E ratio) have stabilized as well.

The P/E multiple based on 2005 earnings for the S&P 500 Composite Index rests at 18 times, or near the 50-

year average. Similarly, the Canadian S&P/TSX Composite is at its 50-year average of 17 times.

The dividend yield for both indices is about 1.8 per cent. Therefore, investors still must buy equities for capital gains to achieve their retirement and estate goals.

Economic conditions expected for 2005

Oil prices are expected to be about US$35 per barrel, and there will be moderate economic growth and limited inflation, which should keep interest rates generally stable in 2005.

However, U.S. interest rates may rise as a result of higher U.S. government borrowing. This may cause equity P/E multiples to reduce, offsetting earnings growth. U.S. bonds should provide returns limited to the coupon yield.

With a slightly contracted multiple and earnings growth, the U.S. equity markets overall may not grow significantly in 2005.

In Canada, returns for bonds should follow a similar course, but with flat interest rates.

Investment forecasts for 2005

Returns in all areas will be moderate in 2005. The Canadian long-bond market index is expected to return approximately five per cent, Canadian equity returns will reach seven per cent to nine per cent, U.S. equities will return six per cent to seven per cent in U.S. dollars, and the Canadian dollar will stay in the US$0.80-$0.85 range.

Major risk factors for financial markets include a world-scale terrorist calamity, disruption in a major energy supply, or increased global warming, with a short-term social effect. Events such as these could trigger a recession with higher interest rates, slower growth, and a decline in consumer confidence and spending.

Objectives for investors

Based on the above expectations, investors with short-term investment horizons should consider the following financial strategies: increase Canadian equities; reduce U.S. equities; and prepare to switch back to long-term weightings at a later time.

Long-term investors may wish to invest at their long-term weighting in U.S. equities now, in anticipation of future recovery of the U.S. currency.

For long-term retirement and estate plans, it is always important to invest for the long term, and to diversify risk using a blend of bonds and equities to suit the individual investor's risk tolerance and investment horizon. OMR

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