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DISASTER IN WAITING

By Gordon Pape, Editor and Publisher

"It would be a disaster if we leave the euro." That wasn't a Greek speaking – it was an Italian tour guide in Turin. Concern is growing that the entire eurozone might collapse. It is no longer just a disorderly Greek exit that's feared – in fact that has almost been accepted as inevitable. Now the overriding concern is that we could see a complete meltdown that would lead to the return of drachmas, lira, pesetas, francs – the old Babel of European currencies.

If that seems unlikely, keep in mind that this whole crisis could not have been imagined just four years ago. Then the collapse of Lehman Brothers set in motion a cascading spiral of financial failures that have brought us to this point.

Many Europeans are frightened and fear the future. A lot of them were opposed to the idea of a common currency when the euro was launched but now they are terrified to think what the economic consequences would be without it. Even the overwhelming majority of Greeks want to keep the euro, according to the polls. They just don't want to pay the price for it.

And it's a high price. The austerity plan demanded by the European community for continued financial support is gutting Greece economically and pushing unemployment to depression levels. That in turn has driven political support to extremist parties that promise to roll back the cuts and restore prosperity – all while keeping the euro. Dream on! At least the Irish were smart enough to grasp the reality facing their country and voted overwhelmingly in a May 31 referendum to support the European Fiscal Stability Treaty.

The harsh reality is that without domestic monetary control, countries like Greece and Spain are in an impossible position. Power over fiscal policy lies outside their borders and they have little influence over the course of events. In fact, their fate is being decided in Berlin and the government of Angela Merkel seems to be showing little sympathy to their plight.

It's increasingly obvious that the only way to preserve the eurozone is through much tighter fiscal integration, which would include the introduction of eurobonds and a multi-national deposit insurance program to ward off destabilizing bank runs in troubled countries. But Germany's resistance to such measures, which it sees as rewarding the profligacy of the PIIGS, has prevented any action that might ease the pressure.

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Disaster – continued from page 1…

Prime Minister Stephen Harper's comment that Europe is "running out of runway" is right on the mark. Western leaders are increasingly frustrated with the inability of the Europeans (read Germany) to take decisive action. So is European Central Bank president Mario Draghi, who has practically been on his knees pleading with the politicians to get off the pot. No wonder he's alarmed. Spain's banks are going down the tube, Italy's borrowing costs are approaching unsustainable levels, and even France is starting to crack but no one is doing anything. It is uncomfortably reminiscent of the 1930s when politicians turned a recession into a depression by pursuing narrow self-interest policies such as the erection of trade barriers. We're well down that same road.

The investment implications are clear. Stocks need to be selected with great care, with an emphasis on dividend-paying companies with good cash flow and strong balance sheets. With a few exceptions, such as Switzerland, European securities should be avoided. Emerging markets must be treated with caution until such time as the extent of the slowdowns in China and India become clearer. Bonds should continue to have a key position in your portfolio (see accompanying story). In short, play turtle and focus on preserving assets while generating some cash flow.

This could be a long haul. The U.S. Federal Reserve Board has already pledging to keep interest rates at record low levels through 2014. That suggests we are unlikely to see a return to strong growth until at least the middle of this decade.

There are ways to make money, even in this kind of environment, as our IWB model portfolios have demonstrated. We will continue to identify appropriate securities for you. But financial success in this situation also requires discipline, constant monitoring, and careful risk management on your part. There will come a time to take some flyers and go bargain hunting but this is not it.

BONDS WON'T GO AWAY

How quickly things change. Last January it appeared as through the long-term bond bull market was finally over. The U.S. economy seemed to be slowly getting back on track, the European sovereign debt crisis looked to be contained, and stock markets were gearing up for a comeback.

At the start of the year, I commented that it was hard to see where bond profits might come from this year, with interest rates already at record lows and apparently poised to rise. My prediction was a return of about 4% from the DEX Universe Bond Index in 2012. By comparison, the 2011 gain was about 10%.

We're on track to coming close to that 4% mark. As of Thursday's close, the Index was ahead by 1.52% year to date. That's not a lot but in the light of what has happened to the stock markets in recent weeks, a 4% return in 2012 now looks very attractive. As of the June 7 close, the S&P/TSX Composite Index was down 3% for the year and 12.1% over the past 12 months. Despite the mid-week rally, I don't expect that situation to change materially over the next few months. In fact, I think the gap between stock and bond performance will widen unless European politicians pull off the equivalent of a Hail Mary pass in football.

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YOUR QUESTIONS

Exempt securities

Q – A friend of mine is dissatisfied with the performance of his current investments and is looking at something called an "Exempt Market Product". I've never heard of this before and I wondered if you could tell me a little about them and if they would be suitable for a more conservative investor, someone with a growing family.

Thank you very much, and please keep on writing your excellent IWB newsletter! – Greg E.

A – No, these would not be suitable for a conservative investor. In fact, they are highly risky. The word "exempt" tells all – these securities are not subject to the usual scrutiny that is required of any investment that is publicly traded. They do not trade on any exchange and the companies are not required to provide investors with regular financial disclosures. Investors must be "accredited" or family, friends, or associates of the company.

The lack of regulatory approval means that anyone considering investing in such a security must perform a lot of due diligence – something most people are ill-equipped to do. The bottom line is that this is a market that is suited only to very sophisticated investors who are willing to risk money on companies that cannot meet the qualifications for an approved initial public offering. – G.P.

Passing on money

Q – My wife's parents (in their 80s) sold their house earlier this year and are living off the proceeds from these funds. They are likely to head to a care facility shortly due to health issues. They want to put the

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Bonds – continued from page 2…

Therefore, it's useful to take a closer look at the bond market to see where the profits are to be found. So far, government bonds have underperformed in 2012 despite the recent inflow of cash into U.S. Treasuries and, to a lesser extent, Government of Canada issues. The DEX Universe Federal Bond Index is only up 1.10% so far this year. Provincial bonds have not fared much better at 1.12%.

The real action has been in corporate bonds, especially those with lower ratings. The DEX Universe All Corporate Bond Index shows a year-to-date gain of 2.84%. The leading performers have been the BBB rated bonds, which are ahead 3.51% so far.

But for big profits, you have to look at a segment of the bond market that most people know little about: "maple bonds". These are bonds denominated in Canadian dollars that are issued by foreign financial institutions and companies and sold in this country. The idea is to give Canadians an option to invest in offshore interest-bearing securities without exposure to currency risk.

The DEX Maple Bond Index is up an astonishing 9.5% year-to-date, with most of that advance occurring within the past month. One mutual fund that has benefitted is the Pembroke Corporate Bond Fund, which has about 40% of its holdings in maple bonds. It is ahead by 7.65% so far this year. However, there are two problems with it. First, many of its maple bonds are issued by European financial institutions which raises the risk factor of the fund. Second, the minimum initial investment is $150,000 which puts the fund out of the price range of most investors.

A less expensive alternative is the new iShares DEX Short Term Corporate Universe + Maple Bond Index Fund (TSX: XSH). Launched last September, it invests in a portfolio of 174 short-term Canadian issues and foreign maple bonds, 84% of which are rated BBB or higher (about 16% of the issues are unrated). About 86% of the holdings mature within five years. Another 9% have 5-10 year maturities while just under 3% are long-term (25+ years) positions.

This is an unusual combination of fixed-income assets but the short-term nature and high quality of the portfolio limits risk while the maple bonds portion boosts return potential. It's worth a look if that combination appeals to you but don't expect big gains. The fund is ahead only 0.35% year-to-date because of its short-term nature.

Note that I am not formally recommending this fund and will not be tracking it. My preferred short-term bond fund continues to be XSB, which is updated elsewhere in this issue. But XSH can be used as an alternative if you prefer some foreign exposure. – G.P.

THE CASE FOR ANALYSTS

Contributing editor Tom Slee is with us this week with some thoughts on the Facebook fiasco and the role played by analysts in the whole mess. He also has a new pick for us. Tom managed millions of dollars in pension money during his career and is a fundamentalist when it comes to stock picking. Here is his report.

Tom Slee writes:

Who would want to be a securities analyst these days? They haven't a friend in the place. On one hand an increasing number of pundits think that research departments have become redundant and their opinions are irrelevant. On the other hand a lot of commentators believe that analysts are important but downright incompetent. There is certainly not very much respect for the work being done.

Take the recent Facebook initial public offering (IPO) for example. According to the *Boston Globe* the company specified that 25% of the shares had to be allocated to

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retail clients to broaden public participation. As a result, when the stock opened at US$38 and promptly plummeted 18%, these people were left with losses totaling US$630 million. What was their reaction? They promptly sued the underwriters' analysts for a misleading forecast.

In fairness, these investors are also suing the bankers and I can understand why they are upset, in many cases hopping mad. A major IPO should be reasonably priced – perhaps slightly below market in order to distribute the new supply. To have the shares immediately plunge reeks of stupidity. That being said, I should point out that several independent analysts had already reduced their forecasts after seeing the initial prospectus. There were plenty of warnings that Facebook was a high-risk investment. There is no suggestion that the prospectus was fraudulent, only that the underwriters' analyst subsequently reduced his projections and the banks disclosed this to preferred clients.

An investigation has been launched but at first glance it's difficult to see what the analyst did wrong. He or she was hired to forecast earnings using various sources, including the company's guidance, and provide this information to the employer's clients. The general public was given adequate information about Facebook's IPO in the prospectus. After all, the so-called revisions that have caused all the fuss were minor and amounted to a reduction of about 7.3% in the company's estimated 2013 revenues (not profit). The trouble is that all of the forecasted numbers were highly leveraged. At US$38, Facebook was priced at 100 times its last 12 months' earnings compared to a 14 multiple for the S&P 500 index. Consequently, tampering with any of the assumptions produced a magnified effect on the issue price.

Let's face it! Facebook at US$38 was extremely expensive. It was floated on hype. As one wag put it: "From now on IPO means 'It's probably overpriced.'"

What intrigues me about the entire affair is that the analyst or analysts are suddenly regarded as crucial players and to blame for the fiasco. This comes at a time when they are being dismissed as irrelevant. There has been a wave of criticism and suggestions that analysts are no longer needed. Dr. Eric Jackson, founder of hedge fund Ironfire Capital, maintains that stock analysts are clueless: "They love analysis paralysis, heck that's part of the job description". Equity Research CEO Barry Ritholtz thinks analysts are often wrong, in fact most of them are usually wrong. Most scathing of all is financial advisor Joshua Brown in his new book *Backstage Wall Street*. He believes that analysts are a waste of time, an endangered species.

Are analysts becoming less important? Well, certainly some money managers think so because of the rapidly changing markets. Brokers' research is aimed at accurately forecasting profits and identifying industries that are likely to prosper. Recently, however, this approach has not been rewarding. These days there seems to be little connection between earnings growth and stock performance.

Surveys show that in 2011 daily activity in stocks was dictated more by breaking news than fundamentals. Earnings beat expectations in many cases but the shares failed to respond. It's also apparent that with increased computer trading and hedge fund operations, similar stocks are no longer moving in unison. Sophisticated traders monitor correlations – how individual stocks move vis-à-vis the market and each other. According to Marko Kolanovic, head of derivative equities at JPMorgan Chase: "We are currently witnessing the largest drop in realized correlation in recent years". Not only are the markets erratic but there is also turmoil within the various sectors. It's a tough time for fundamentalists trying to provide recommendations based on value.

There is another important factor at work. As the respected magazine *The Economist* has pointed out, we no longer enjoy a constant flood of new public companies. American-listed companies reached an all-time high of 7,888 in 1997. Since then the number has actually fallen by about 38%. The number of major IPOs dropped from an average of 311 per annum during the period from 1980 to 2000 to just 81 in 2011. Entrepreneurs are now more inclined to expand through private financing because of the complex regulations governing public companies. There is continual pressure on their executives, as Mark Zuckerberg is discovering at Facebook. As a result, partnerships are increasingly popular. This makes it difficult for analysts to identify and cover new stocks.

My feeling, though, is that good analysts are more important than ever. Of course, we are inundated with information and opinion through the Internet and the media so it's unlikely that an analyst is going to provide much fresh insight into a company. The days of a research department cozying up to executives and getting some unpublished numbers are long gone. However, following an industry properly still involves a huge amount of grunt work in studying financial statements and trying to spot trends. Most important, analysts provide a sounding board for your leads and ideas as well as on-going coverage. Always keep in mind that buying a stock is primarily an investment in a company, not the market, which sends conflicting signals. Moreover, buying a stock is just the start of the process. From then on you need to track its progress according to its plan.

I have taken a look at this recent wave of criticism and most of it seems to boil down to the old complaint that analysts are

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poor stock pickers. Well, they were never meant to provide tip sheets. Research analysts are specialists who usually operate within one or two industries. They are supposed to identify good value in their sectors, not cover the entire market and try to choose short-term winners. Moreover, they are not privy to inside information. I am not surprised that a hedge fund manager like Eric Jackson learns little from research reports. He presumably studies stocks all day, every day and has in-house advisors. For the small investor, though, analysts' reports are invaluable.

Keep in mind too that North American investors are becoming disillusioned about the hunt for capital gains and want dividends as well. That means boring cash flow projections will become much more important than European breaking news. It's something that good analysts do well. When you are reading a report, take a moment to see how much time and space has been devoted to this aspect. Here at Internet Wealth Builder we will continue to provide you with recommendations that have already been vetted but it always helps to have more input.

As to the markets, one company that I think looks particularly attractive at the moment is TransForce. The stock has had a good run already this year but still has a lot of upside potential. There is also the possibility of a dividend increase. Priced at $17.49, TFI is my top pick for June. Details follow.

TOM SLEE PICKS TRANSFORCE

Founded in 1957 as a junior Quebec trucking service, TransForce (TSX: TFI, OTC: TFIFF) has grown rapidly through diversification and acquisitions, especially in recent years. As a matter of fact, TransForce has acquired 35 companies since 1992 and now operates Canada's largest trucking fleet. Revenues amounted to $2.7 billion in 2011 and generated an operating profit of $312 million.

The big story here is that TransForce is no longer just a trucking company. It has diversified into four business units. Package and Courier accounts for about 35% of sales; Less-Than-Truckload represents 18% and falling; Truckload at 23% is also declining; while Specialized Services, such as oil rig moving and waste management, generates 24% of the revenues. The thrust is into energy services and in April the company acquired certain assets of Peck USA Energy, an oil field services operation in Texas. There have even been discussions about whether management will sell its Truckload unit, now regarded as "a keeper, but not a grower" in order to finance future acquisitions.

What I find exciting about TFI is the willingness to vacate its traditional long distance trucking business where the future largely belongs to the railways. Management has plans to close 50 terminals in the trucking unit during the next three years. Expansions into waste management, parcels, and the energy sector look much more promising. At the same time, acquisition of Dynamex has given the company a foothold in the lucrative and fragmented U.S. same-day courier business, a sector that CEO Alain Bedard says "keeps on growing".

The company's first-quarter 2012 results were recently released and adjusted earnings of $0.25 a share were in line with expectations and more than double the 2011 profit of $0.12. A great deal of this improvement resulted from acquisitions but there was also a broad-based increase in profit margins.

Going forward, management is committed to reducing debt in 2012 although there is the possibility of more acquisitions in the oil fields. An expected free cash flow of $240 million will allow for expansion, some balance sheet improvement, and perhaps another dividend increase from the current $0.52 per year. The yield based on the current price is just under 3%.

Earnings of about $1.50 a share are expected in 2012, up from $1.06 last year, with a further increase to the $1.80 range in 2013. This is a company on the move.

Action now: Buy TransForce at C$17.49, US$17.06 with an initial target of $24. I will revisit the stock if it dips to $14.

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funds into the hands of their children. Is the money coming from them taxable to the children according to Revenue Canada's rules as per current legislation? – Wendell M.

A – No. There is no gift tax in Canada so gifts of cash can be made to adult children on a tax-free basis. However, if the assets are being held in investments such as stocks or mutual funds, transferring ownership would be a deemed sale which would trigger a capital gain (or loss). Any tax due would be the responsibility of the parents. – G.P.

TOM SLEE'S UPDATES

Peabody Energy (NYSE: BTU)

Originally recommended on Aug. 15/11 (IWB #21129) at $48.23. Closed Friday at $24.27. (All figures in U.S. dollars)

Peabody reported adjusted first-quarter earnings of $0.67 a share, well above Wall Street's $0.54 estimate. Cost cutting and slightly better than expected coal prices more than offset lower sales volumes in Australia and domestic markets. The outlook, however, has deteriorated.

BTU, the world's largest publicly traded coal company, started 2012 at $36 and looked extremely cheap. That is why I chose it as one of my four picks for the year. At that time it looked as though the $5 billion acquisition of Australian producer Macarthur Coal was temporarily weighing on the stock. In fact, the weakness was because industry fundamentals were deteriorating as we entered the warmest winter since 1895 and a natural gas glut drove most energy prices lower. At the same time European steel production slumped and demand for higher grade coals fell away.

The net result is that after two years of rising profits the U.S. coal industry is facing flat revenues in 2012. Next year, where many of the contracts remain unpriced, is a big question mark.

Given its huge operation and international diversification, I think that Peabody will continue to do reasonably well and report respectable numbers. Wall Street is expecting earnings of about $2.50 a share this year and an improvement to the $3.50 range in 2013. Now priced at $24.27, the shares represent good value but the industry is out of favour and there is little chance of growth over the short term. I am sorry that Peabody has not worked out so far but it would be wise to postpone any purchases until the fundamentals improve.

Action now: Peabody becomes a Hold at $24.27. More aggressive investors may wish to liquidate at least some of their position. There are more attractive opportunities.

Power Financial Preferreds (TSX: PWF.PR.E)

Originally recommended on April 4/05 (IWB #2513) at $25.85. Closed Friday at $25.39.

In April 2005 we recommended the Power Financial 5.5% Series D Preferred Shares (TSX: PWF.PA.E) for reliable, above average income. Since then, through a worldwide financial collapse and a prolonged recession, they have met our expectations. Currently trading at $25.39, the shares yield 5.42%, which is equal to about 7.7% from a bond in an unregistered account. The dividend of $1.375 remains safe.

As the majority owner of Great West Life and IGM Financial, Power Financial continues to generate steady earnings growth and is expected to report a profit of $2.50 a share this year with an increase to about $2.75 in 2013. The common stock pays a dividend of $1.40 and trading at $25.43 the yield is 5.5%. The preferred shares are well protected.

Action now: PWF.PR.E is a Buy for investors seeking safe, steady income. One word of caution: Power can redeem these straight (perpetual) shares at a price of $25 after Jan. 31, 2013, so do not chase them up and become exposed to a possible capital loss. The call feature will also cap any capital gains. – T.S.

GORDON PAPE'S ETF UPDATES

iShares 1-5 Year Laddered Government Bond Index Fund (TSX: CLF)

Originally recommended on July 5/10 (IWB #20124) at $20.32. Closed Friday at $20.06.

This ETF, which used to be part of the Claymore group, was originally recommended as a low-risk alternative to a money market fund. We have lost a little in terms of market value but that has been more than offset by the distributions of $0.79 per unit we have received. The net result is a modest gain of 2.6% in 11 months. That's not a princely return but compared to the 12-month average of 0.32% for the Canadian Money Market fund category (to April 30) it looks pretty good.

However, corporate bonds are performing better at this stage so I suggest a shift to the companion iShares 1-5 Year Laddered Corporate Bond Index Fund (TSX: CBO). Like CLF, it invests in a short-term bond ladder but in this case the securities are high-grade issues from major Canadian companies. Distributions are paid at a current monthly rate of $0.076 per unit ($0.912 annually) and are normally adjusted at the start of each year. The MER is a low 0.28%. The ETF gained about 4% over the 12 months to May 31. Closing price on Friday was $20.24.

Action now: Sell CLF and switch to CBO.

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ETF Updates – continued from page 6…

iShares DEX Short Term Bond Index Fund (TSX: XSB)

Originally recommended on Aug. 12/02 (IWB #2230) at $28.20. Closed Friday at $29.00.

This dependable ETF has been on our Recommended List for almost 10 years and only once has it lost money over a 12-month period: a decline of 0.52% in the year ending June 30/06. So far in 2012, the fund has not fared well, losing 0.16% (to June 6). However, I still regard it as a safe place for conservative money and the 10-year average annual compound rate of return of 4.88% is much better than average for the category. Monthly distributions vary but are usually around $0.07 per unit. The management fee is 0.25%.

Action now: This ETF is a Buy for conservative investors.

iShares DEX Universe Bond Index Fund (TSX: XBB)

Originally recommended on March 5/07 (IWB #2709) at $29.44. Closed Friday at $31.47.

This ETF covers the broad spectrum of the Canadian bond market including both government and corporate issues. If you only have one bond ETF in your portfolio, this should be it. The fund has never been in the red over a 12-month period since it was recommended more than five years ago. It was especially strong over the year to May 31, gaining 9.27%. But don't expect that to continue – the year-to-date return of 0.61% (to June 6) is more reflective of current market conditions.

Action now: Buy. This fund continues to be a core holding in our IWB Defensive and Very Conservative Portfolios.

iShares Gold Bullion Fund (TSX: CGL)

Originally recommended on Aug. 15/11 (IWB #21119) at $15.72. Closed Friday at $14.23.

Since this fund invests exclusively in gold bullion, its price rises and falls in line with the broad gold market. When bullion tumbled, it did too dropping as low as $13.74 in mid-May. Lately, it has staged a modest comeback in line with the rally in the gold price. This ETF has paid no distributions and is not expected to ever do so. The only reason to hold it is to gain low-cost exposure to the gold market (the MER is 0.55%). If you think the price of bullion is likely to rise (I do) then take a position at the current price.

Action now: This ETF is a Buy for those who want to own a security that invests exclusively in physical gold.

iShares Oil Sands Index Fund (TSX: CLO)

Originally recommended on May 5/08 (IWB #2817) at $26.56. Closed Friday at $14.07.

These are tough times for the oil sands. Despite being one of the richest petroleum deposits in the world, they are under attack from all sides. Environmentalists view them as an unmitigated disaster. NDP leader Thomas Mulcair blames them for hollowing out Canadian manufacturing by artificially forcing up the value of the loonie. Lack of pipeline capacity and the rapid growth of shale oil production in the U.S. have led to discount prices for Canadian oil. To compound all these woes, the world price of oil has been falling as economic fears grow. All of this has resulted in a sharp decline in the value of this ETF, which focuses on oil sands companies such as Imperial Oil, Suncor, and Cenovus. And things could get worse before they get better. Therefore, I suggest you liquidate your positions and book the capital loss. We'll consider re-entering once the outlook improves.

Action now: Sell.

iShares S&P/TSX Canadian Aristocrats Dividend Index Fund (TSX: CDZ)

Originally recommended on April 9/12 (IWB #21214) at $22.29. Closed Friday at $21.42.

This fund held up reasonably well during the market turbulence. We have a small capital loss which has been partially offset by two monthly distributions of $0.06 per unit. The ETF invests in companies with a market cap of at least $300 million which have increased their dividends for a minimum of five consecutive years. Most of the largest positions are small-cap companies such as Atlantic Power, Ag Growth International, Exchange Income Fund, AGF Management, and Bird Construction. So despite the "Aristocrats" name, this is by no means a blue-chip stock fund. The portfolio is very well balanced by sectors with no group dominating. Financials have the largest position at 19.5% of total assets followed by consumer services (18.6%), industrials (17.4%), energy (16.3%), and utilities (11.7%). The year-to-date gain based on market price is 2.5%. That may not seem impressive but it is a lot better than the TSX which was off 3% as of the close of trading on June 7. The MER is 0.67%.

Action now: Buy. If you want to hold an equity ETF during this rough period, this is a good choice and the regular monthly payout ensures decent cash flow.

SPDR S&P Dividend ETF (NYSE: SDY)

Originally recommended on April 9/12 (IWB #21214) at $56.33. Closed Friday at $55.35. (All figures in U.S. dollars.)

This is the U.S. equivalent of the Canadian Aristocrats ETF and it has performed in a similar way. However, there is more blue-chip representation in the top holdings such as Pitney Bowes, AT&T, Consolidated Edison, and Johnson & Johnson. Distributions are paid quarterly. The last one was at the end of March and amounted to $0.40 a share. The next payment is due later this month. The MER is 0.35%.

Action now: This ETF is a Buy for those who want broad exposure to U.S. dividend stocks. – G.P.