Credit Unions eye the big time *p.44* Top 2014 stock picks *p.37*

NIMBYism on Vancouver Island *p.17* Burnaby's Quantum Computing Revolution *p.14*

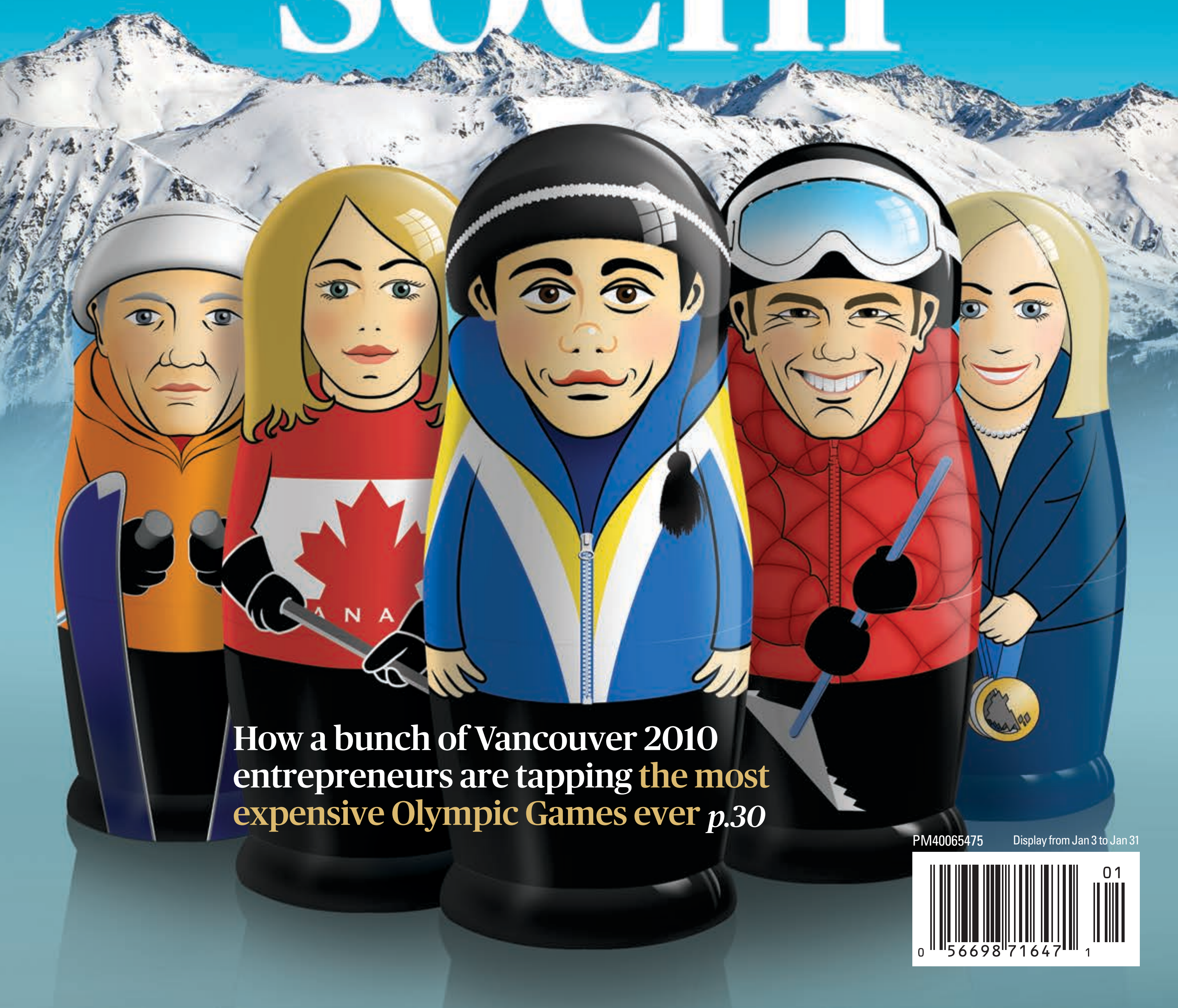
BCBUSINESS

JANUARY 2014 **$4.95**

MAKE IT HERE

Our year ahead in ENERGY *p.49*

The Money in SOCHI



How a bunch of Vancouver 2010 entrepreneurs are tapping the most expensive Olympic Games ever *p.30*

PM40065475 Display from Jan 3 to Jan 31

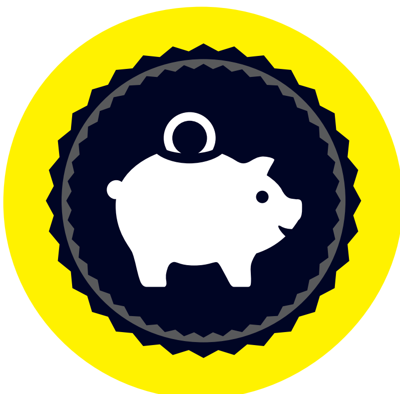
01

0 56698 71647 1

where should your money go

Investors have never faced more confounding markets: stocks defied traditional wisdom last year by soaring despite sluggish economic growth, and interest hovered near zero—for yet another year. To help make sense of the options available to investors today, we turned to local experts for some definitive direction

BY NICK ROCKEL



Murray Leith

Vice-President and Director, Investment Research, **Odlum Brown Ltd.**

- Large-cap stocks
- Look to the U.S. to capitalize on its improving economy
- One-year return, Odlum Brown Model Portfolio: 28.23%

Murray Leith is known for worrying about downside risk, but he didn't spend much time following last fall's budget battle in Washington. "The really important thing is that the U.S. deficit has gone from 10-and-a-half per cent of GDP at its worst in 2010 to four per cent today," says Leith, creator of the Odlum Brown Model Portfolio, a hypothetical equity portfolio whose holdings typically include between 40 and 50 large-cap stocks.

"The U.S. economy is making forward progress, and that's what matters," Leith asserts. "We've always been in the camp that the recovery is going to be long and drawn out," he says. "That's what we think we'll continue to have in 2014."

> "The U.S. deficit has gone from 10-and-a-half per cent of GDP at its worst in 2010 to four per cent today"

Leith has no time for what he calls today's obsession with macroeconomics. "You would think with that obsession that there's actually a strong correlation between the economy and the stock market," he says. But Leith argues that there's an inverse relationship between the two. He cites China, which has had one of the world's worst-performing stock markets over the past few years but also one of the fastest-growing economies. "The reality is that stocks can do just fine in a muddle-through economic environment, as they have ever since the bottom in March of 2009."

As of October 15, 2013, the Model Portfolio, which advisers and portfolio managers at $8-billion Odlum Brown might track closely or mine for investment ideas, had delivered a 15.3 per cent compound annual return since its 1994 inception. Over the previous year, it had gained 24.3 per cent, a performance that long-term investor Leith says was driven by decisions made before the 2008 financial crisis. Back then the portfolio diversified out of Canada by investing in U.S. multinationals at attractive prices.

Leith believes that if the Chinese economy loses steam, it could be positive for the U.S. and for stocks that Odlum Brown likes. "It's going to mean less inflation, and less inflation means a tax cut at the pump for consumers," Leith says. "It means less pressure on interest rates, which helps keep the recovery alive."

3 Recent investment picks

JPMorgan Chase & Co. NYSE:JPM

Despite its legal troubles, U.S. bank JPMorgan Chase was still the largest position in the Model Portfolio as of October. Year-to-date, its stock had gained 30 per cent, notes Leith, who thinks there's still plenty of upside.

"This is a company that's increased its book value from $36 [per share] pre-crisis to $53, despite $30 billion in legal costs that have been put through their income statement over that period," he says. "There's recovery upside in the U.S., and yet you have a bank like JPMorgan trading at half the price-to-book valuation of a Canadian bank."

Procter & Gamble Co. NYSE:PG

The Model Portfolio added 1,100 shares of U.S. consumer-goods giant Procter & Gamble and unloaded its entire position in London-based Diageo, which makes whisky and other alcoholic beverages. "What we've seen as we went through the Asian crisis in the '90s and other cyclical downturns in emerging markets is that Scotch is pretty discretionary," Leith says. The worry is that those economies might suffer a deeper-than-expected downturn this time around, he adds. A good alternative to Diageo was P&G, which has the same global reach and emerging-markets exposure. "There's also a turnaround element to the company, with some new management and a chance to manage the business better," Leith says.

Air Products and Chemicals Inc. NYSE:APD

"They sell industrial gases, and it's a very profitable industry, very concentrated; something like four players control about 80 per cent of the market," Leith says of Allentown, Pennsylvania-based Air Products. The company has under-performed, but Leith believes that will change, thanks to activist investor Bill Ackman, who took a stake of almost 10 per cent last September. The company announced it has appointed three independent directors and the current will retire in 2014. "This is an inherently good business," Leith says. "If we can improve the margins through better management, that will be a bonus. And if none of that works, the downside shouldn't be too bad because it's a good business that throws off a lot of cash flow."

ASSET CLASS STRATEGY PERFORMANCE

Jeff Guise

Vice-President and Chief Investment Officer,
Connor, Clark & Lunn Private Capital Ltd.

- Balanced portfolios
- Shift asset allocation from fixed income to international equities, small-cap stocks and infrastructure
- One-year return, CC&L Market Neutral Fund: 27.47%

As head of the high-net-worth investor platform at $46-billion Connor, Clark & Lunn Financial Group, Jeff Guise keeps a close eye on the global economy. "That sets the tone for us in terms of what we think is going to happen in markets," Guise says. "Is the economy accelerating, is it decelerating or is it contracting? We look at the overall trend in economic growth to determine whether we think stocks are going to perform well or fixed income is going to perform well."

Today, he sees encouraging signs in what he describes as a co-ordinated worldwide upswing in momentum. "That doesn't mean we're going back to the real strong economic growth days that we saw in the '90s and maybe even the early part of the 2000s, but it does mean that we think economic growth is going to be positive," says Guise, who oversees $3.7 billion in assets. "At the same time, inflation remains in check, so we would say against that backdrop, equities should perform pretty well and bonds will be on the back foot. Not to say that we expect really significant negative returns in bonds."

> "Inflation remains in check, so we would say against that backdrop, equities should perform pretty well and bonds will be on the back foot"

Looking ahead to 2014 and beyond, Guise says he's talking to clients about the risk-return tradeoff they face. He encourages them to define risk in three ways. The first: potential dollar loss in any given year. The second is not taking enough risk to generate sufficient returns over the long haul, and the third is investing in illiquid securities when you need access to capital.

Where it sees an opportunity to improve diversification and provide returns that aren't driven by the ebb and flow of the broader economy, CC&L recommends that private clients include alternative assets such as private equity, hedge funds, real estate and infrastructure in their portfolios.

For some investors, adding more equities could be another part of their shift away from fixed income, which won't match its historical returns over the next decade, Guise says. "Even within that, we think people are over-allocated to Canadian equities and they need to consider foreign assets."

2 Recent investment picks

Foreign small- and mid-cap stocks

"In 2013, we added foreign small- and mid-cap companies as a way to participate in the domestic recovery that we saw happening in the U.S.," says Guise, noting that the equities are mostly American but also include European and Japanese names. "We didn't think we could get it through the large-cap index, which has a high proportion of foreign earnings." Clients gained access to those stocks through a dedicated portfolio of about 50 companies.

Grand Renewable Solar Project

Connor, Clark & Lunn Infrastructure recently closed an equity investment in this new project in Haldimand County, Ontario, with partners Samsung Renewable Energy Inc. and the Six Nations. The largest ground-mount solar facility in North America, the $550-million plant will produce 100 megawatts, Guise says. "It's a 20-year investment, and we participate at the late-development, early-construction stage." (CC&L clients can participate in the firm's infrastructure plays through a trust that invests in internally managed limited partnerships with exposure to different areas of the market.)

Once the project starts operating, investors such as pension funds could take an ownership stake through a direct investment, Guise says. "But at the construction stage, there isn't as much interest, so we think it's an attractive risk-return balance for us."

Jim Gilliland

President, CEO and Head of Fixed Income,
Leith Wheeler Investment Counsel Ltd.

- Income-generating investments
- Shorter-term bonds and stocks with dividend-growth potential
- One-year return, Leith Wheeler Canadian Equity Fund B: 21.27%

Although Jim Gilliland is excited about the opportunities that lie ahead in 2014, he thinks it's a stock-picker's market that calls for deep fundamental analysis and a willingness to span multiple asset classes. "A lot of mandates are overly constrained," says Gilliland, whose firm manages $14.7 billion in assets for private and institutional clients.

Leith Wheeler likes to build portfolios that include investment-grade debt, preferred stock and equities with value characteristics but also dividend-growth potential, Gilliland says. "That combination and having the flexibility to reallocate capital and look at the portfolio as a whole provides a much better outcome for our clients than overly specified mandates that focus on just one narrow part of the market."

> "The flexibility to reallocate capital and look at the portfolio as a whole provides a much better outcome"

His message to clients: there's no magic cure for income portfolios' depressed returns due to low interest rates. "The only way of effectively building income is to step back and look at total returns rather than just headline yields, and to develop a portfolio that has some exposure to the stock market to effectively provide growth on top of the lower income requirement," Gilliland says.

Low interest rates have pushed investors to "fixed-income surrogates" such as high-dividend-paying stocks and preferred shares, he notes. But given current valuations, Gilliland believes price declines could eat away at yields. "Our approach as we look into 2014 is to barbell it by having a portfolio that combines shorter-term, as in three- to five-year–in some cases even five- to seven-year–investment-grade credit with a stock portfolio that has some dividend growth."

Leith Wheeler puts these ideas to work in its Income Advantage Fund. As of September 30, the $50.6-million fund had returned an annualized 6.1 per cent net of fees since it launched in December 2010.

2 Recent investment picks

REIT debt

After finding good opportunities in municipal bonds over the past year or so, including the debt of cities such as Montreal, Toronto and Vancouver, Gilliland's team wants to exit some of those investments because they no longer offer much of a yield premium over their underlying provincial bonds. It's now seeking higher-quality corporate debt with a decent risk-return trade-off, he says. Given a four- to five-year time frame, one area that he and his colleagues are reasonably comfortable with is bonds issued by REITs.

The REITs in question have diversified portfolios of commercial properties and the yield on their debt is significantly higher than that of bank deposit notes and other corporate debentures with similar terms, Gilliland adds. Yields are between 3.5 and four per cent, which might not sound great from a headline perspective, he admits. "But when you look at pairing that with dividend equities, and as these bonds come closer to maturity, we find that their spread compresses and they can therefore be sold at a premium," Gilliland says. "That combination provides a pretty attractive risk-return."

Callable preferred shares

"Because of our cautiousness as it relates to interest-rate risk, one thing that we've been doing is substantially curtailing our exposure to perpetual preferred shares," Gilliland says, referring to preferred stocks that don't usually have a specified maturity date. The team has turned to callable preferreds, which the issuer can redeem after a set period–say, two or three years.

In 2013, rising interest rates affected these securities much less than the broader preferred-share market, Gilliland says. "The types of preferred shares that we owned and form the bulk of our preferred-share portfolio held in exceptionally well because of their shorter duration and because of their expected call dates." Although retail investors can buy preferred shares through a broker or an exchange-traded fund, Gilliland argues that more active management is a better option, given the groundwork involved in understanding these securities.

ASSET CLASS

STRATEGY

PERFORMANCE

David Barr

Chief Investment Officer,
PenderFund Capital Management Ltd.

- Small-cap equity
- Look for Canadian small-cap value, think long-term
- One-year return, Pender Canadian Equity Fund: 17.47%

Value investor David Barr focuses on bottom-up stock analysis with his $43-million Pender Small Cap Opportunities Fund; his research involves meeting with company management and understanding the economics behind the business. "I'm trying to find companies that are doing really well and are undervalued so I can buy them at a good price," Barr says. That approach is paying off: at the end of October 2013, the Pender Small Cap fund had gained 19.55 per cent annualized since its June 2009 inception.

Barr splits his focus between the U.S. and Canada and has a relatively long investment horizon. "What the economy's doing on a month-to-month, year-to-year basis isn't that important to me," says the CIO of $326-million PenderFund. "It's where the business itself is going to be in five years."

For 2014, Barr is looking at high-performing Canadian junior industrial, technology and health-care companies that earn most of their revenue stateside. Those companies are doing well because U.S. consumers are spending more after paying down debt since 2009, he says. Meanwhile, U.S. companies are making acquisitions or buying technology to become more efficient, Barr adds. "Most of the companies I'm invested in are located in Canada, but they'll be selling almost 100 per cent of their products and services to customers in the United States."

> "I'm trying to find companies that are doing really well and are undervalued so I can buy them at a good price"

With U.S. markets at an all-time high in late 2013, Barr is a little worried about valuations and the market in general. "At the portfolio level, I control risk two ways: first of all by making sure I buy companies at a substantial discount to what they're worth, and second, through portfolio weighting," he says. "A high-conviction idea for me will be a five to six per cent weighting in the fund. If it starts to exceed what I think the company is worth, then I'll trim that position down."

2 Recent investment picks

TIO Networks Corp.
(TSX-V:TNC)

"I recently dramatically increased my weighting in TIO Networks," Barr says of the Vancouver-based company, which processes North American bill payments through channels that include kiosks and mobile phones. About 10 per cent of U.S. residents don't have bank accounts, so TIO has put its payment kiosks in gas stations and convenience stores, Barr explains. For the fiscal year ended July 31, 2012, the company grew its revenue 16 per cent, to $42.2 million. "I see substantial topline growth and increasing profitability for TIO over the next 12 to 24 months, so it's one of my high-conviction ideas now," Barr says.

QHR Technologies Inc.
(TSX-V:QHR)

Barr thinks Kelowna-based electronic medical records provider QHR, which posted revenue of $29.5 million in 2012—a 23.5 per cent increase—will ride the trend of moving toward electronic medical records. With about 56 per cent of Canadian physicians using EMR products in 2012, according to New York-based foundation the Commonwealth Fund, he predicts that Canada will eventually match some fellow Commonwealth nations by exceeding 95 per cent adoption. "A company like QHR, which is one of the market leaders, they just continue to grab their market share," Barr says. "It's a company that's going to be two-and-a-half times larger in three to five years than it is today."

Hanif Mamdani

Head of Alternative Investment,
RBC Global Asset Management Inc.

- A hedge fund combining multiple asset classes
- Finding undervalued assets in the absence of cheap money
- One-year return, PH&N Absolute Return Fund: 13.86%

Hanif Mamdani's long-term track record speaks for itself. He is lead manager of the PH&N Absolute Return Fund, an $860-million multi-strategy hedge fund that posted a 20.59 per cent five-year annualized return after fees as of October 31, 2013.

His current outlook stems from the observation that during the past year, investors rapidly adjusted to the idea that the U.S. Federal Reserve Board plans to "taper" or reduce its bond-buying monetary stimulus. "In 2014, I would argue we'll see the onset of tapering in earnest," he says. "Now that the taper news is well understood by the markets, it will be less about adjusting to specific taper amounts and more about investors trying to find undervalued assets in the absence of cheap money. This may require finding companies that can generate superior earnings growth yet are priced reasonably."

> "Besides REITs and high-dividend equities, investors could consider shifting some traditional fixed income"

Mamdani, who also manages the $3.25-billion PH&N High Yield Bond Fund at RBC Global Asset Management, has his own take on the so-called Great Rotation from bonds to stocks, which some pundits predict will gather steam as investors follow the Fed and pull out of bonds. This massive shift is already well under way, but it may not be as simple as exchanging one for the other, he says. Instead, it may be a rotation from traditional fixed income to a new-age bond-like portfolio that might include certain kinds of equities along with non-traditional asset classes. Real estate investment trusts (REITs) and high-dividend-paying stocks could become key sources of bond-like exposure with a modest element of growth but more risk, Mamdani believes.

"Be smart about defining your fixed-income bucket," he says. Besides REITs and high-dividend equities, investors could consider shifting some traditional fixed income like long-dated government bonds toward high-yield and convertible bonds, leveraged loans and other asset classes that can provide better risk-adjusted returns.

As M&A activity heats up, 2014 will present more opportunities for alternative investment strategies such as risk arbitrage, Mamdani predicts. That's where investors try to capture a premium between the final bid price of a stock in an announced merger and the stock's current trading price.

"Rather than simply relying on traditional asset classes that now appear fully priced, taking advantage of some of these unconventional hedge fund strategies could generate mid- to high-single-digit returns with a lot less volatility and reduced correlation to the stock market," Mamdani says.

Recent investment pick

Canadian REITs

When the government bond, high-yield bond and REIT markets sold off sharply last summer in reaction to the prospect of Fed tapering, Mamdani and his team saw a mispricing. As of October, both bond markets had recovered much of their losses, but some top Canadian REITs were hitting new lows, with unit prices declining as much as 25 per cent.

The Absolute Return Fund rotated some money out of government and high-yield bonds and into high-quality domestic REITs that were trading at about 12 times earnings, compared to 16 times just four months earlier. "On average this package probably yields around seven per cent today," Mamdani says. "That's a cash yield that's fully covered by the cash flows of these REITs."

If the economy is strong, REITs will enjoy some growth as the properties they own increase rents, Mamdani believes. The investment trusts are also continually making acquisitions, refinancing old debt that still pays a high coupon with new debt, he adds. And many of them are being smarter about how they use real estate by doing things like securing the rights to build condo towers atop strip malls.

"You put all of that into the mix and you get something like maybe four or five per cent earnings growth," Mamdani says. "We think we can make 10 per cent per annum on these REITs including the growth, versus probably breaking even in government bonds and maybe making a low- to mid-single-digit return in high-yield bonds today."

FINANCE-SPEAK DECODED

Annualized Return
A rate of return for a given period that is less than a full year, but that is computed as if the rate were for a full year.

Arbitrage
The simultaneous purchase and sale of an asset in order to profit from a difference in the price, typically on different markets or in different forms.

Compound Annual Return
The annualized rate at which capital has compounded over a period of time.

Derivative
A contract between two parties whose value is derived from the performance of an underlying asset. One example is a futures contract, where one party agrees to buy a commodity or financial instrument at a pre-determined price in the future. Another is a warrant, where the issuer gives the holder the right to buy securities at a fixed price within a given time frame.

Fixed Income Investments
Investments that pay returns at predictable levels at regular intervals. Common fixed-income investments include bonds or guaranteed income certificates (GICs).

Hedge Fund
Investment fund employing advanced strategies such offsetting long and short positions, dealing in derivatives, pursuing arbitrage opportunities and seeking event-driven special situations.

Income Investments
Investments that pay regular interest or dividends. These are typically suited to retirees who count on predictable returns, as opposed to fluctuating stock prices.

Large-Cap, Small-Cap
"Cap" refers to market capitalization, or total value of a company, determined by multiplying number of outstanding shares by share price. Small cap typically refers to smaller or startup companies while large-cap typically refers to large multinational companies.

REIT
A Real Estate Investment Trust is a company that invests exclusively in real estate and mortgages and passes cash flow on to investors. These offer high yields, as well as a highly liquid way of investing in real estate. ■