

For the third year running, some of the best portfolio managers of funds held in the Meritage Portfolios® have shared their insight about key topics for the upcoming year. Access their outlook, areas of opportunity and potential concerns through this 2012 edition of the Meritage Portfolios® Round Table.

## MERITAGE PORTFOLIOS® ROUND TABLE 2012



Oscar Belaiche



Eric Bushell



Frank Gambino



Carl Kawaja



Jane Lesslie



Paul Musson

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Meritage – a blend of “merit” and “heritage” – brings together the finest portfolio managers in the industry, whose complementary visions drive the success of the Meritage Portfolios®.

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# Our Guest Portfolio Managers:

# BIOS



**Oscar Belaiche**  
Goodman & Company,  
Investment Counsel

▶ **Oscar Belaiche**, head of the Equity Income team at Dynamic, joined Goodman & Company, Investment Counsel in 1997 as Portfolio Manager. He brings to the Dynamic team 29 years of business, operational and investment experience. He manages the **Dynamic Equity Income Fund**.



**Eric Bushell**  
CI Investments Inc.

▶ **Eric Bushell**, Senior Vice-President, Portfolio Manager and Chief Investment Officer of Signature Global Advisors for CI Investments has 18 years of experience in the investment industry. He currently manages the **CI Signature Dividend Fund**.



**Frank Gambino**  
RBC Global Asset Management Inc.

▶ **Frank Gambino** is Vice-President, Senior Portfolio Manager and member of the Global Fixed Income and Currencies committee at RBC. He is responsible for managing investment-grade and high-yield corporate bond investments in fixed-income funds. With Jane Lesslie, he manages the **RBC Global High Yield Bond Fund**.



**Carl Kawaja**  
Capital Research and  
Management Company

▶ **Carl Kawaja** is Portfolio Counselor, Director and Senior Vice-President for Capital Research and Management Company. He has 24 years of experience in the industry and currently co-manages the **Capital International - Global Equity Fund**.



**Jane Lesslie**  
RBC Asset Management UK Ltd.

▶ **Jane Lesslie**, Vice-President, Senior Portfolio Manager, Global Fixed Income and Currencies – Emerging Markets, manages emerging markets portfolios since 1994. With Frank Gambino, she currently manages the **RBC Global High Yield Bond Fund**.



**Paul Musson**  
Mackenzie Financial Corporation

▶ **Paul Musson** is Head of the Ivy team at Mackenzie, as well as co-manager on the **Mackenzie Ivy Foreign Equity Fund**. He has 6 years of experience in the financial industry analyzing global equities. He won the Foreign Equity Fund Manager of the Year at the 2011 Canadian Investment Awards.

# Outlook for 2012

## Paul Musson

We look at the world as objectively as possible because we believe that we're not supposed to be bullish or bearish but rather realistic about what we're seeing out there.

What we are seeing out there is a lot of debt outstanding and fundamentals that are not sound; this causes us to worry, as it just takes a hiccup to set things off in a bad way. Our concerns are reflected through our positioning in our more defensive type names that seem more attractively valued.



*What worries us is how much influence Wall Street has in the decision-making of governments and central banks. They've got a vested interest and they're the advisors.*

Paul Musson

## Eric Bushell

As we speak, we're still working through a post 2008-crisis environment. What was a financial crisis, has morphed into an economic crisis, and is gradually becoming a social and a political crisis. Trust is eroding between investors, issuers and financial institutions. As such, we're worried about the European debt market, including the sovereign and the bank bond market which has been shut since June. Europe remains in a void, which is driving investors to continue to shed risky assets. This situation could last for sometime, which means that equities, including the Emerging Markets will be under pressure. The U.S. has been and will probably remain the stronger part of the global equity complex, while Canada will underperform, as it tends to correlate better with what happens in developing economies and commodities. Overall, the road map for 2012 will be similar to 2011.

Through it all, I truly believe that having a clean balance sheet is going to be an absolute critical factor. Regulators are asking banks to hold twice as much capital, which will cut their return on equity (ROE) in half. In response, banks will potentially increase prices for their small and medium sized business customers, where they have leverage. They have leverage against the small guy but not the big guy. As such, the cost of capital differential between highly rated companies and lower rated companies will steepen, providing companies that are competing with small and medium sized businesses with an advantage. Such companies will eventually gain market share and flourish at the expense of their competitors. We see this happening with a company like Grainger in the United States, a distributor that's got a pristine balance sheet and that has made huge investments in technology. They have a capital cost advantage against their peer group and a leverageable business model.



*Speculative forces in markets tend to focus on what they perceive the weakest country to be. And, to some extent, that focus becomes self-perpetuating.*

Carl Kawaja

## Carl Kawaja

Concerns about Europe's survival as an integrated entity have increased recently, as the Greek restructuring was too little too late. Investors who bought Credit Default Swaps (CDS) contracts to hedge against a potential default were led astray, as it turns out that they don't offer an effective hedge. The unintended consequence is a shaken confidence in other sovereign positions.

Personally, I'm in the optimistic camp for 2012: For one, stock prices are discounting a lot of negative news and the prospects of even worse conditions. That being said, I believe that should a trickle of good news come along, stocks will go up. In the end, the sun will rise again, crops will grow and companies will invent new products. Often, causes for optimism aren't noticeable at the time, but people look back and realise it years later. An example might be Argentina: Despite a 77% devaluation of its currency in the last 10 years, the Argentinean stock market is up over 100% in U.S. dollar terms.

In retrospect, one of the things that surprised investors about Argentina, post devaluation, is that, it became very competitive in the soy bean business and their ability to export grew. I don't think soy beans are going to save France, but something else will.

In general, I continue to be impressed by innovation and the number of companies that are continuously solving the world's problems. Whether it's drug companies inventing treatments for diseases that have never been solved before; technology companies making smart phones; companies with new business models, like Groupon or Amazon. That's what makes markets go up over time. It is all the effort of individual companies solving problems. An example is the healthcare system in the U.S., which I think will eventually get solved by companies that will focus on cutting medical costs, on improving health insurance and so on.

# How Will Canadian Equities Fare?

## Oscar Belaiche

Canada is what I would call “the best country in the world” right now and some have recently called it the new Switzerland. We have a stable banking system that did not require any bailouts, a strong political system with a stable government, and we have resources. We’re not really lacking anything in terms of food, energy and materials. As we look forward, we’re positive on Canada, as well as the United States, although they have some major headwinds that they’re dealing with.



*[...] Canadians are well poised to do accretive transactions [...]*

*Eric Bushell*

## Eric Bushell

Canada is one of the few remaining AAA sovereigns and its cost of capital will be attractive, which is a positive. Canada represents one of the few geographies left in the developed world where there still is trust in financial institutions, which is reflected in the higher valuations allotted to these companies relative to global peers. The cost of capital

advantage means that Canadians are well poised to do accretive transactions if they’re (a) permitted, and (b) so inclined. So there’s an advantage brought about by the stability that Canadian financials and other parts of the whole economy. But I think that Canada will underperform the U.S., and that’s because the commodity complex will likely come under pressure as credit issues expand into and drag down Emerging Markets growth. This being said, Federal and provincial governments are going to be able to access funding to launch a whole host of different kinds of spending to support employment and so we will end up with a good growth dynamic.

## U.S. Elections

### Oscar Belaiche

The U.S. Election has had an impact on our investment universe already with the Keystone pipeline. It is unfortunate that politics are getting in the way of providing energy to the United States out of the oil sands. The decision made by President Obama was basically to defer, because he didn’t want to lose the environmental votes.

Politically, the U.S. is in a stalemate, with the Republicans wanting to cut costs and Democrats wanting to increase taxes, and this is a “pretty serious” conflict. Hopefully there’ll be a new president that will be able to unite the United States rather than break it apart, because that’s what’s been happening in the last few years.



*Hopefully there’ll be a new president that will be able to unite the United States rather than break it apart [...]*

*Oscar Belaiche*

### Jane Lesslie

I think the interesting juxtaposition is that of a U.S. Presidential election year coupled with the handover to a new generation in the People’s Republic of China. You will have a new team assuming control in China just when the U.S. is in election mode with all the heightened rhetoric that accompanies that. This sounds like a potential recipe for volatility as the new team in China has to contend with potentially inflammatory comments coming from U.S. candidates. A concern we have had – which will depend in part on the strength of the U.S. economy at the time – is the potential for a surge in protectionist, anti trade rhetoric out of the U.S. This will come at a challenging time for China where it is losing export competitiveness and its own GDP growth will be slowing from a blistering post 08 pace. So far trade wars have been the dog that didn’t bark, surprising given the low growth backdrop we’ve had in the developed world.

### Carl Kawaja

I’m interested in companies that help people cut cost because I feel like that’s a focus of government and the citizens of the United States right now. I wouldn’t be surprised to see taxes go up under either sort of administration. Like others I’m a little pessimistic about the political leadership in the United States from both parties, and I hope that it can only get better. I do believe that we’re getting signs of change, which are expressions of great disgruntlement from various members of the political classes. To the extent that we don’t get a deficit reduction deal, markets will force it upon us, much like what is happening in Greece and in Italy.

# Is There a Real Estate Bubble in Canada?

## Oscar Belaiche

I don't see a Real Estate bubble. I certainly don't see it in commercial real estate as there is no speculation. The condo markets in Toronto and Vancouver are a stable place for some foreigners to put their money in a safe jurisdiction. If rates were to go higher, that could cause some issues with floating rate mortgages. Commercial real estate has high quality tenants and is extremely attractive as a source of cash flow relative to alternatives, such as bonds, money market or cash equivalents. The environment is so healthy that there's a line-up of investors willing to buy quality cash flowing institutional real estate. The only caveat is the lack of rental rate growth, because you don't have expansion. The condos that are being built are pre-sold before the banks lend them money to build. So I think that real estate is very stable in Canada, and I certainly don't see a bubble.

## Eric Bushell

There's a domestic bid and there's a foreign bid in terms of participants in the market. For the Domestic player, very low interest rates have drawn more people into the housing market, some of which are perhaps taking on a bit more leverage than they ought to. That's a distortion and a bit of risk for sure. On the international side, there is the stability and the rights of ownership that attract a lot of foreign money. In that respect, the Vancouver market is a complete stand out, as it correlates more with what happens in Hong Kong and Mainland Chinese markets. It seems to me that this market has now entered a bubble. I think that we're at the point where property markets will come under more pressure and that could impact on banks. But I don't think it will be significant, unless you have a big employment problem.

# To QE or Not to QE?

## Jane Lesslie

Forecasting is hard in current markets since we're faced with continuous political event risk. At the moment we're waiting for Mario Draghi (President of the European Central Bank) to feel that he's seen enough structural change and legislation passed in Italy to allow him to do what is needed. The European Central Bank (ECB) needs to be engaging in some form of quantitative easing (QE). But this is a challenge given the bank's official mandate. Legislation needs to be passed. Labour reform and pension reform are good examples. This would give him the political cover to adapt the ECB's mandate to the environment it now finds itself in. As with International Monetary Fund (IMF) programs he'll need to see signals that implementation is actually taking place and targets met. Promises just won't cut it anymore. One of the best recent developments has been Italy's agreement to allow the IMF to begin a surveillance program, scrutinizing the books. This resembles the start of a typical Emerging Markets - IMF plan.



*[...] you can consider that index funds investors have been indirectly bailed out by policymakers because the pressures to do so are enormous from Wall Street.*

*Paul Musson*

## Paul Musson

One of the reasons we have so many problems today is the bailout mentality and short-term fixes of the past several years. You've had corporations or countries get into trouble, and they were bailed out, because otherwise the economy would suffer in the short term and no politician wants that. In that sense, you can consider that index funds investors have been indirectly bailed out by policymakers because the pressures to do so are enormous from Wall Street. I don't know how long this mentality will last, but I believe that the next number of years will be an

environment that should favour stock pickers. We don't know what the markets will do over the next number of years and what impact the excessive levels of sovereign debt will ultimately have on shareholder returns. However, even if you were concerned that markets might not perform well, it doesn't mean you shouldn't be invested.

That is, as long as you're invested with someone who's picking stocks, as even in a down market it's possible to generate decent returns. A good example is Japan, where the index is down 70% over the last 20 years, but many individual stocks have delivered double-digit returns, over that period. So, I'm hopeful that it will be a good environment for us.

## Eric Bushell

Lower inflation expectations and broader financial conditions were signals that flagged the launch of QE2 and I think that those will be key signals this time around. The impediment is that there's some strength in the U.S. economy right now and there's a lot of political pressure on the Fed to be less interventionists. But given my view that things are going to deteriorate further, I am in the camp that we will ultimately see more quantitative easing in the U.S.

# Emerging Markets

## Jane Lesslie

Over the last couple of months, investors have been selling down their developed market bond exposure in Europe. We are clearly seeing a rotation into emerging markets and an appreciation for their lower debt to Gross domestic product (GDP) ratios, lower fiscal deficits, beneficial demographics, hefty foreign exchange reserves, and in many respects, relative transparency, in great part because these Emerging Markets (EM) countries went to hell and back in the 90's. One consequence of their IMF programs was a scrubbing of their data and improved reporting. For example, once a week, I get a snapshot of what's going on with Argentina's banking system deposits. Foreign exchange reserve data is available daily. In contrast, my colleague covering European bonds tells me he's not getting anywhere near that frequency out of Europe.

During the last couple of months, major dealers have lowered their 2012 growth expectations for the emerging world, though it is still better than what is expected in Europe or the relatively anaemic growth that is forecast for the U.S.

The rotation out of developed debt markets aside, developed market pension funds have gone through a long screening process looking into investment potential and risk in EM bond markets. They have now completed that process and have started allocating money into these regions.

Pension Funds globally are faced with difficulty acquiring enough duration in their fixed income portfolios, in part due to longevity risk. EM countries have been issuing long maturity external debt for some time now. For example last year Mexico issued a 100-year bond and Peru came out with a 40-year bond. Latin America has actually been issuing 30-year bonds since Mexico began to emerge from the Tequila Crisis in '95. This provides an avenue for pension funds to acquire the longer maturities they require. At the same time they can receive an extra risk premium which they need given low government bond yields globally. It's a win win. The pension funds get the maturities they need. The EM countries get long term funding which reduces their rollover risk. This in turn reduces country risk. How important is this? Look at what is happening with the Eurozone where countries are facing enormous rollovers. This is driving their funding costs higher. In some cases to unsustainable levels.

## Carl Kawaja

While my enthusiasm for emerging markets is still significant, it is not as high as it has been in during the last 10 years. This is partly due to the relative strength that these markets have exhibited and the additional debt that the region has incurred during this time.

# Are There Opportunities in High Yield Fixed Income?



*[...] the default prospects for the high yield and investment grade corporate are actually quite good.*

*Frank Gambino*

## Frank Gambino

We believe we're in an environment where it pays to be careful. Liquidity in the high yield market is below average. Dealers, in general, have been less supportive of this market, because most of them are bank owned and they're having a hard time making money given the volatility. They're not dedicating as much capital as they once were to the market, and just recently, Royal Bank of Scotland actually exited the market.

Though in the next three months we think it pays to be cautious, we're also cognizant that December and January tend to be the best months for the high yield market. Longer term, we are much more constructive

on the high yield asset class. This market comes back to credit risk, and the default prospects for the high yield and investment grade corporate are actually quite good. They should remain below long-term averages for the foreseeable future. Long-term average default rates are around 4.5% for high yield and in a crisis period, they can rise to 10 or 12%. The expectations for 2012 and 2013 are closer to 1.5 to 2.0%. The reason is simply that companies are in excellent shape.

When spreads are at the 800 bps, which is where we are now, our studies show that returns for the high yield market two years out are about 14% on average. This will of course depend on what happens in Europe, as spreads can widen to 1,000, or more, which would pressure the entire market lower.

## Eric Bushell

I think that we're going into a period of credit rationing. That will of course favour government bonds, but ultimately I think that the U.S. will pull through and the high yield market will benefit, as it is actually quite interesting. For the next two to three months however, I would be playing it safe. And then at that point, we will have seen a resetting of investor's expectations around growth and default risk and spreads will be wider, which will ultimately draw them back into actively managed high yield exposures.

# Gold

## Eric Bushell

The Bank of England, the Bank of Japan, the U.S. Fed and the ECB are all printing money, so confidence in paper currencies is falling and real interest rates are negative throughout the G-7. This is positive for gold. If there's a real scramble for liquidity you could see investors that own gold liquidate their positions to meet liquidity demands. On account of that, the answer could be both. It could crack down if investors use it to monetize it and convert it to cash but if that happens I'm a buyer because I believe that it's still headed higher.

## The Future of Europe



*The ECB also has a policy problem because its mandate does not include acting as a lender of last resort to sovereigns.*

Jane Lesslie

## Jane Lesslie

The problems in the Eurozone essentially arose from a lack of differentiation among a pretty disparate group of countries. Prior to the crisis government bond yields were barely distinguishing between the credit quality of a Germany and the credit quality of Greece. As people have come to understand that the quality and nature of a Germany is not that of Greece suggestions the Eurozone could break up or the possibility of countries departing are being voiced. Now combine this with a Eurozone banking sector with enormous cross country holdings in one another's government bonds. Banks have lost confidence in one another. As the risks of some governments defaulting increase, the key impact is the

knock on effect to liquidity, particularly Eurozone banks' access to funding. For example, Greece's banking sector lost 14% of its deposit base in the three months up to the end of October. This further reduces their ability to lend in an economy which is already shrinking due to profound government cutbacks.

At the same time European banks are being asked to increase the capital they allocate to loans. A contracting economy means non performing loans increase. Loan losses draw down that very pool of capital you are trying to increase. In 2008 troubled banking sectors could be bailed out by their sovereign governments. That's far harder now when sovereign governments themselves are troubled. You need a positive confidence shock and it has to come from the policy side. The Eurozone either splinters or it creates a fiscal union. No more muddling through. The crisis in Europe has exposed deeply different philosophical beliefs and fears about inflation, monetary policy, debt and sovereignty among the zone's members – at the very moment they need to come together. In late 2008 and early 2009, in Emerging Markets (EM) bonds we were emphasizing countries that had considerable foreign exchange reserves which could act as a firewall. Our basic take at the time was “he who has the cash wins.” In April of 2009 the G20 boosted the resources of the IMF and the World Bank. Then it became: “He who has access to cash wins”. In EM we keep a close eye on who has precautionary lines of credit with the IMF which can act as a buffer when the liquidity going gets tough. However countries usually have to have good policy track records or be making needed policy reforms to be granted these lines. This is the challenge for European policy makers. Frankly a number of these countries need classic IMF Structural Adjustment Programs like those many EM countries have undergone. Ultimately, as legislation got passed and they hit their targets, they received positive confidence shocks. The ECB also has a policy problem because its mandate does not include acting as a lender of last resort to sovereigns.

Another concern we hear is that the IMF does not have the capacity to perform this function for such large countries. However we think this can be addressed by the IMF undertaking bilateral loans from countries with large foreign exchange reserves as it did in 2008. Or they could issue bonds. Of course they could always increase subscriptions from large surplus countries like China. That's going to be hard slogging since it means Europe will have to give up votes on the board. All of this is doable. It's about political will and stomaching the trade-offs.

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