

FINANCIAL POST

A note of caution



Peter J. Thompson, National Post Files

David MacNicol remains concerned about the U.S. equity market but more bullish on China.

Jonathan Ratner, Financial Post · Thursday, Sept. 16, 2010

Investors continue to pour money into the bond market as a result of disappointing returns in equities and concerns about the direction of the economy.

At this point, the biggest question is whether we are in for an extended period of slow growth or heading toward a double-dip recession.

David MacNicol, president and portfolio manager at MacNicol & Associates Asset Management, admits he doesn't have the answer, but believes it will likely be slow growth.

"Much of the economic news coming out lately is not very positive, but the market still continues to hang in there somewhat," he says. "Unfortunately, there is a herd mentality trade. The 'smart money' is trying to get ahead of what could be a double-dip recession by heading into the ultimate safe haven, government bonds in the United States and Canada."

But MacNicol thinks those investors will be in for some bad news when governments around the world start to raise interest rates.

"Sometimes in the investment world, the best thing to do is nothing. Investors tend to act with a herd mentality," the manager says. "You've seen that happen with the euro and its spectacular run. Now it is trading lower and the money is flowing into U.S. treasuries."

Despite his call to get out of the U. S equity market entirely in 2002 (except for a few multinationals with most of their earnings coming from outside the United States), MacNicol is starting to see signs of life in the U.S. economy. For example, while employment numbers across the nation as still dismal, state-by-state results are looking better.

However, he isn't jumping back in just yet as he is still concerned about softness linked to the expiration of tax credits and less money being handed out by the government for home purchases.

"It is questionable whether there is enough stability in that system to carry them forward without more government incentives," MacNicol says. "We're still concerned with what we see."

He is much more optimistic on the Chinese equity market, playing it through the iShares FTSE/Xinhua China 25 ETF (FXI/NYSE) and Canadian names trading on the TSX with operations in China.

Precious metals remain the asset to which MacNicol has the most exposure.

"Until things start to improve in terms of the U.S. debt problems and everything else, that will continue to be our largest area," he says.

Most of the names in MacNicol's portfolios pay healthy dividends. Given the confused state of the market these days, he prefers utilities and telecoms. The manager also likes a handful of income trusts that have yet to convert to corporations, noting several have tax pools that will allow them to maintain their yields when distributions become dividends.

MacNicol and fellow portfolio manager Scott Baker believe the return profile for the public market will be a lot lower than it has been. As a result, they have put together an alternative asset trust.

Clients can access three different pooled funds: One focused on private real estate in North America, another in private equity and the third targeting high-yield corporate debt and proprietary trading funds.

While they are allocating less money to hedge funds these days and see rates of return in high-yield corporate debt of 7% to 9%, both private equity and the property market are seen to have the potential to produce returns in the 20% range.

"You read about the U.S. real estate market and how terrible it is, but that's where the huge opportunities are coming," Baker says.

"Because we are buying from really distressed sellers, we're often able to purchase homes, condos and apartments for less than half of replacement cost, and at significant discounts to what the same unit would be selling for literally around the corner."

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BUYS

BOMBARDIER INC. (BBD.B/TSX)

With the manufacturer of transportation equipment currently trading around \$5 per share, MacNicol's price target of \$8 represents plenty of upside. The stock also offers a dividend yield of more than 2%.

"It is a good growth story that pays a reasonable yield while you wait," he says.

The manager highlights Bombardier's C Series family of planes, which he says is competing very well in the 100-150 seat market - "a huge growth area."

With more than 150 major airports either operating or under construction in China, he believes the CSeries jets are a very attractive for that market.

In addition to a largest-ever order backlog of more than \$44-billion, Bombardier has more than \$3.5-billion in cash, and recently received another contract with the French railways (SNCF) for an \$11-billion contract for 860 double-deck trains.

CGI GROUP INC. (GIB.A/TSX)

MacNicol has owned this computer service provider for quite a while and notes how well it held up during the credit crisis.

"Stocks that perform well relative to the market in that environment are likely worth holding or adding to going forward," the manager says.

The manager highlights CGI's US\$900-million purchase of Stanley Inc. to increase its exposure to the U. S federal government. "They paid a significant premium for it, but we think this is going to be a growth engine for that business."

After the transaction, he noted that the CGI Federal division will have approximately 7,000 staff, US\$1.2-billion in annual revenue, as well as a diversified blend of 55% defence and intelligence, and 45% civilian agency business.

With estimated earnings growth of 14% going forward, MacNicol has an \$18 target for the stock.

AGRIUM INC. (AGU/TSX)

MacNicol believes the potential takeover of Potash Corp. will have a positive spillover effect for Agrium and other agriculture stocks. "If the BHP bid goes through, the trickle-down effect of that already seen should continue," he says.

While Agrium is paying a premium for AWB Ltd., Australia's largest agricultural retailer, the manager is confident it will be a positive move.

"They see it as a stepping stone into the Chinese market," MacNicol says. "And it's not just potash, Agrium is into other fertilizers and products related to the agricultural chain."

Since it has a much more diversified business than Potash Corp., the manager says this lowers some of the commodity risk.

He also highlights the increased demand for nitrogen and similar commodities with diets changing in emerging markets as incomes rise.

SELL

MANULIFE FINANCIAL CORP. (MFC/TSX)

The manager continues to trim his exposure to Manulife, as part of a broader move to lighten up on lifecos recently.

"Manulife sold products based on guaranteed returns that were not properly accounted for," MacNicol says.

He points out that shares of financial stocks are reflecting the probability of rising interest rates, and Manulife is being hurt even more as a result. The company is also being forced to put aside capital for segregated funds and similar products, and analysts continue to reduce their outlooks.

"Even the insurance industry itself hasn't stated what the actual capital requirements should be," MacNicol says. "It's like anything, when there is confusion and misunderstanding, prices tend to go south."

As a result, he thinks Manulife could potentially trade down as far as \$8 per share.

PROFILE

Manager David MacNicol, MacNicol & Associates Asset Management

Portfolio Global balanced

Assets under management \$350-million (300 families)

Description Combination of equity, fixed income and alternative asset strategies

Style & Process Opportunistic blend of value and growth

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