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Lessons From Capital Market History

August 2013

Hillsdale Investment Management

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Topics for Discussion

- A Look Back At Market Returns
- Current Market Environment and Its Investment Implications
- The Arithmetic of Expected Bond and Stock Returns
- Investment Options in the Current Environment

The Death of Equities Is Still A Popular Idea

"US Stocks Plunge Amid Widespread Fears of Second Recession"[2]

Global Fears Keep Stock Ma

"Stocks Sell-Off Sparked By Global Recession Worr

"Global Stocks Slump on Fed Fears and Uncertainty"[6]

""after facebook, more fear of stock market"[8]

"Fixed Income Continues to Dominate"

"Investors dump US stocks for 13^{th} straight week"[5]

"funds continue to flow out of U.S stocks"[4]

"Global Sell-Off Could Echo Summer of 2011" [3]

"…Small Investors Flee Stock Market"[7]

1 – Rizzo, Patrick.., "Stocks Sell-Off Sparked By Global Recession Worries". (Sept 2011). The Bottom Line: MSN. Available Online.
2 – Rushe, Dominic. "US Stocks Plunge Amid Widespread Fears of Second Recession" (Sept 2011). The Guardian. Available Online.
3 – Campbell, Ian. "Global Sell Off Could Echo Summer of 2011". (May 2012). Thomson Reuters. Available Online.
4 – Weinreich, Gil. "TrimTabs: Funds Continue to Flow Out of U.S Stocks" (Mar 2012). AdvisorOne. Available Online.
5 – Yousuf, Hibah. "Investors Dump US Stocks for 13^{th} Straight Week". (May 2012) CNN Money. Available Online.
6 – CNBC. "Global Stocks Slump on Fears and Uncertainty", (Jun 2013). Available Online.
7 – Bowley, Graham. "In Striking Shift, Small Investors Flee Stock Market"., (Aug 2010). New York Times. Available Online.
8 – Popper, Nathaniel. "After, Facebook, More Fear of Stock Market". (May 2012). New York Times. Available Online.

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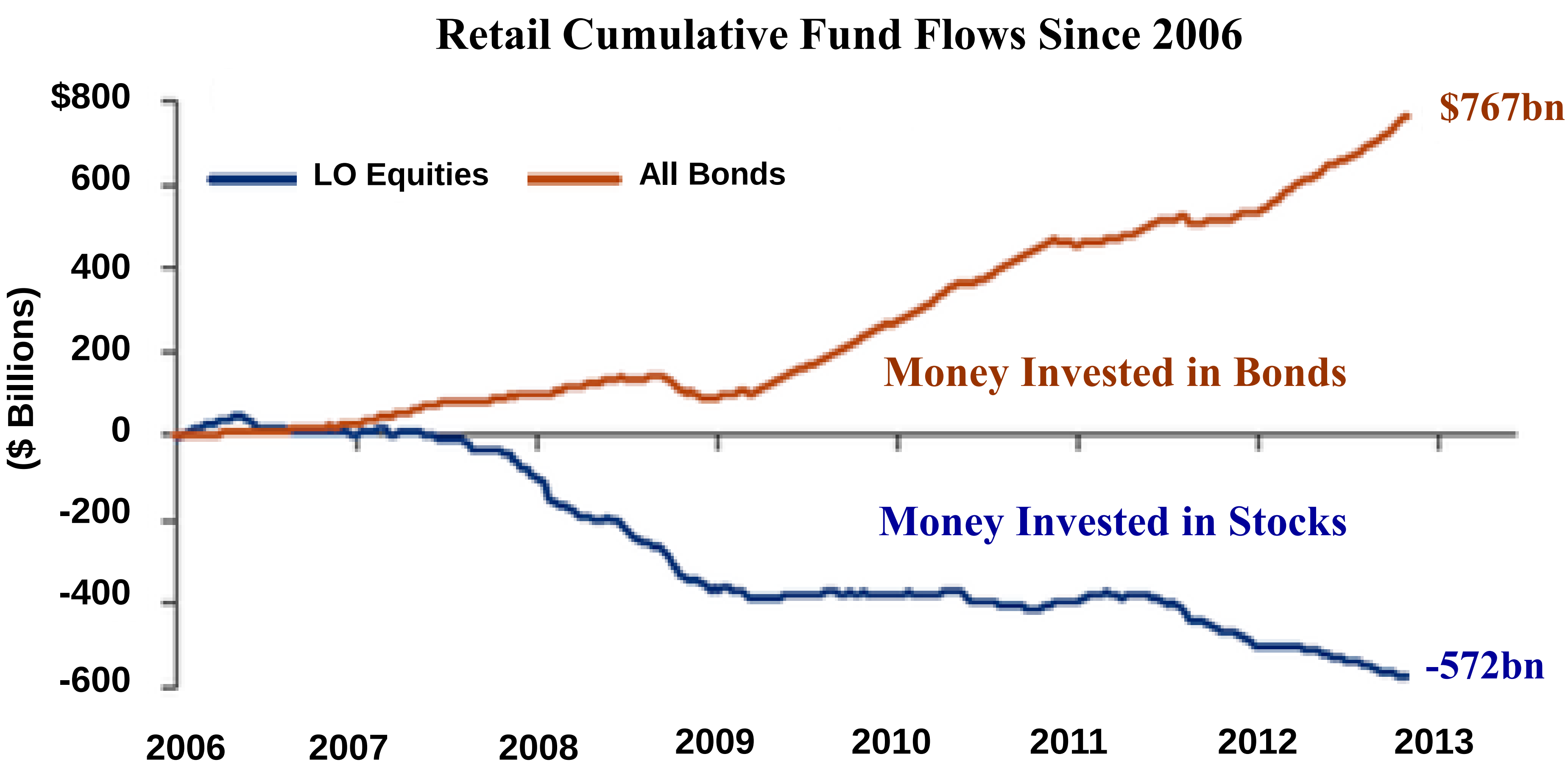
Investors Have Been Selling Stocks and Buying Bonds For Some Time Now



 Source: BOA Merrill Lynch Global Equity Strategy, EPFR Global

Investors Have Missed The Recent Bull Market In Stocks

Annualized Return and Risk Data: March 2009 – June 2013

	Return	Risk
Russell 2000 Equity TRI *(USD)*	25.4%	20.1%
S&P 500 Equity TRI *(USD)*	22.4%	14.8%
MSCI World Equity TRI *(USD)*	19.4%	16.6%
MSCI Emerging Markets TRI *(USD)*	19.0%	23.4%
S&P/TSX Composite TRI *(CAD)*	12.9%	12.9%
Dex Universe TRI *(CAD)*	5.5%	3.3%
Citigroup Broad Investment Grade TRI *(USD)*	5.1%	2.9%
HFRX Equity Hedge TRI[1] *(USD)*	2.4%	7.3%
Cdn CPI *(CAD)*	1.5%	0.3%
Cdn T-Bill TRI *(CAD)*	0.7%	0.1%

1- The HFRX Equity Hedge Index is designed to be representative of the overall composition of the equity hedge segment of the hedge fund universe. In an equity hedge strategy both long and short positions primarily in equities are maintained.

Risk is annualized based on monthly return data.

Source: Hillsdale Investment Management.

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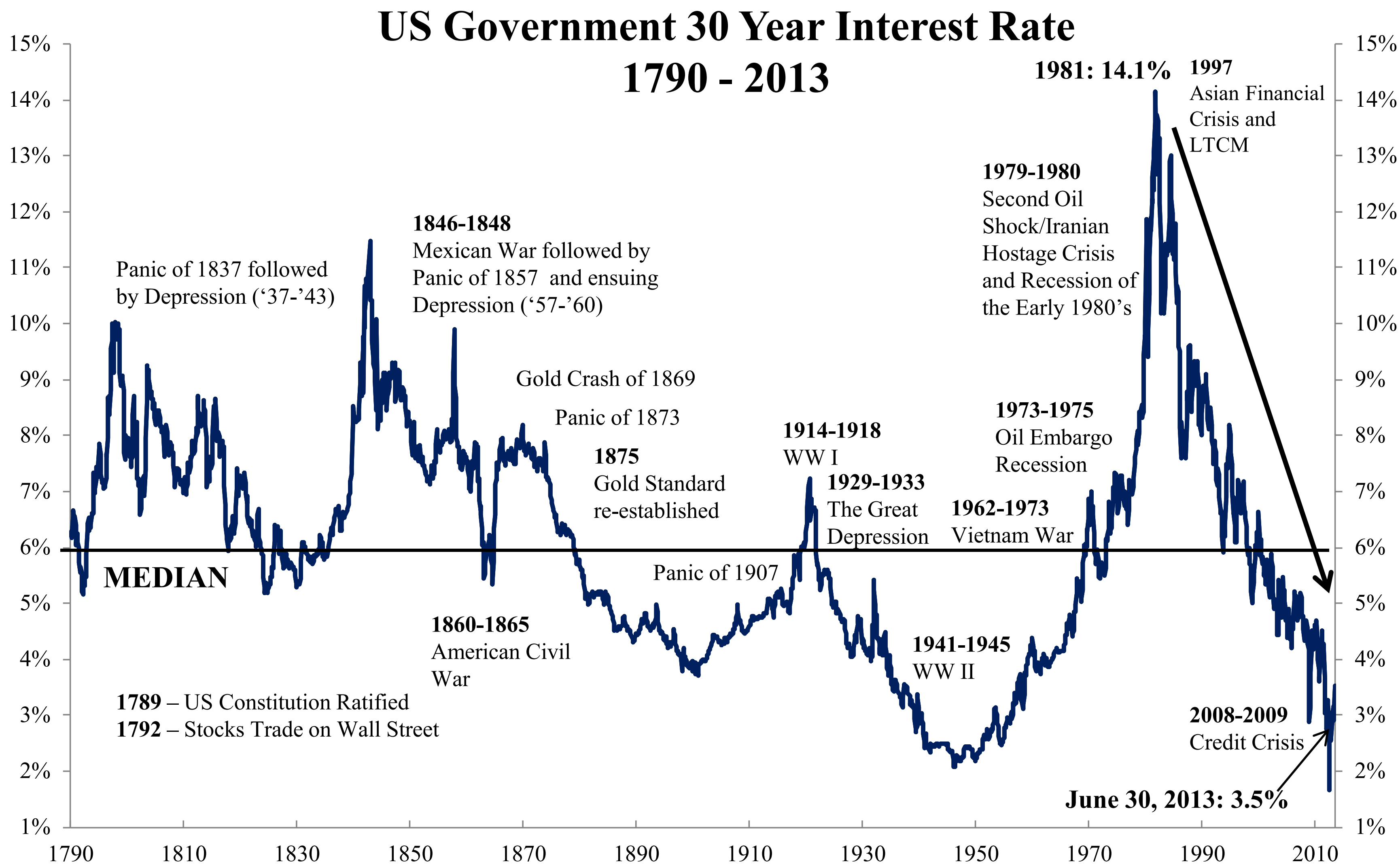
Our Perspective Has Been Skewed By The Greatest Bond Bull Market Ever



Source: See Hillsdale Investment Management . As of June 30, 2013.

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Current and Foreseeable Capital Market Environment

1. Investor Risk Aversion Remains High

Investors Continue To Avoid "Risky" Assets Selling Stocks and Buying Bonds Contributing to Low and Negative Bond Yields

2. Diversification is Perceived To Be More Difficult

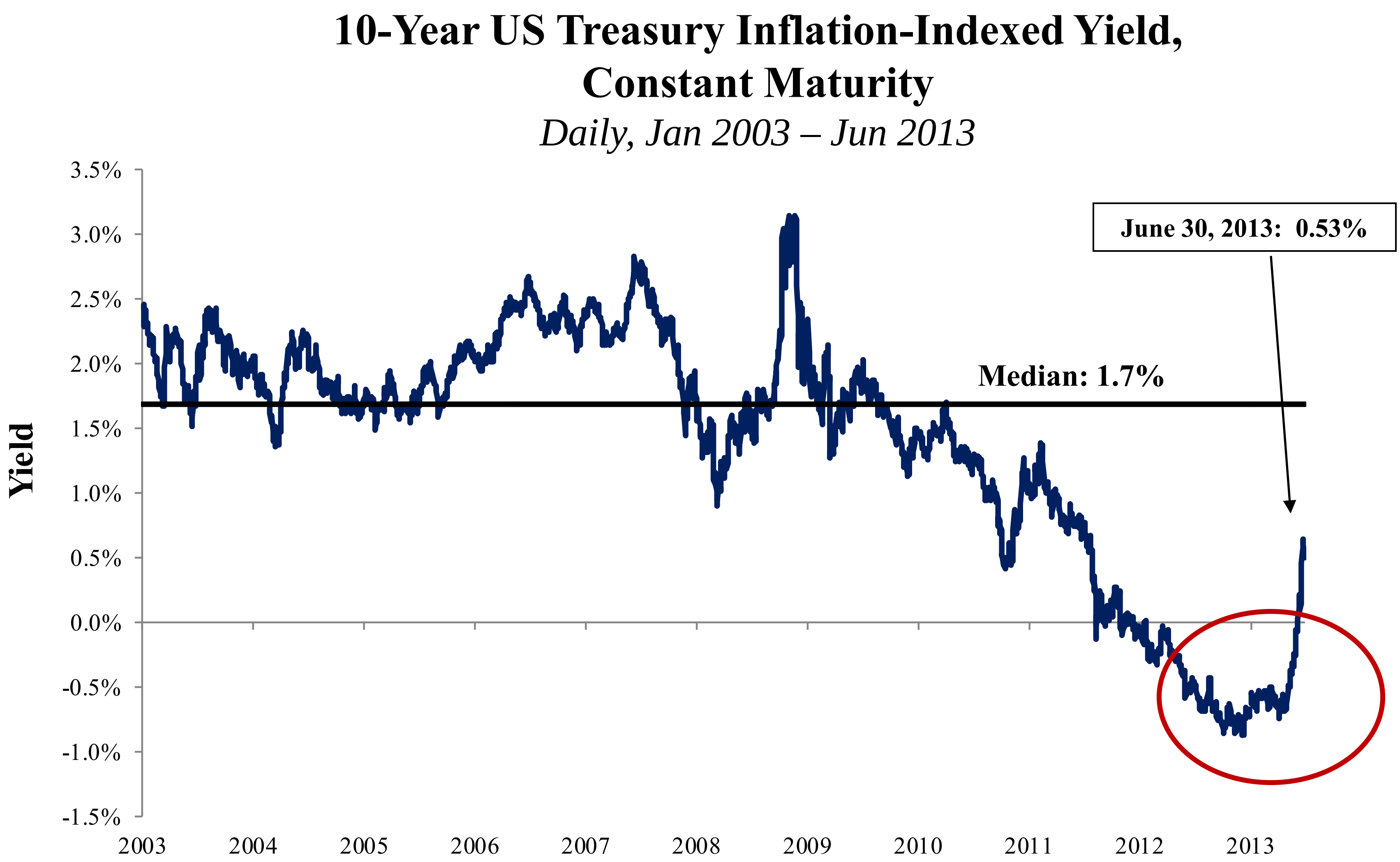
Investors Have Pursued Less Liquid Alternatives (Private Equity, Infrastructure, Real Estate etc…) In An Attempt to Diversify Risk

3. Cash and Bond Yields Are At Extraordinary Low Levels

Central Banks Policies Have Led to Extraordinary Low Yields for Cash & Bonds Distorting Typical Stock, Bond & Cash Relationships and Contributing to Low and Negative Real Bond Yields

4. Dividend Yields Are Higher Than Cash and Bond Yields

Negative & Low Real Treasury Yields Can Be Partially Attributable To Investor Risk Aversion



 Source: St Louis Federal Reserve.

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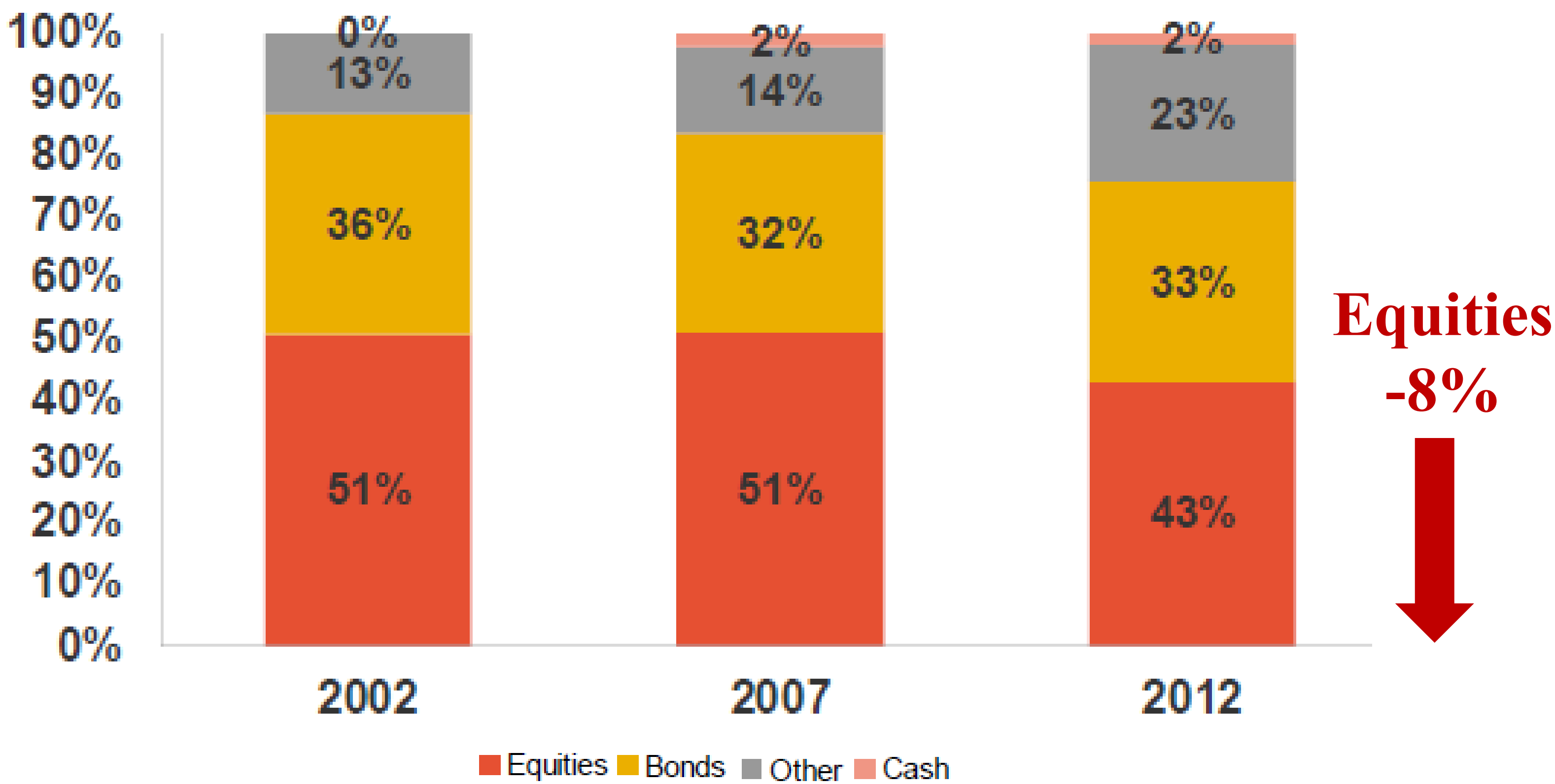
Diversification is Perceived To Be More Difficult

Investors Have Pursued Alternative Strategies (Private Equity, Infrastructure, Real Estate Etc.) and Decreased Their Equity Allocation Over Time

Average Canadian Pension Plan Asset Allocation Over Time



Source: Towers Watson Global Pensions Asset Study 2013.
"Other" asset class includes property and other alternatives.

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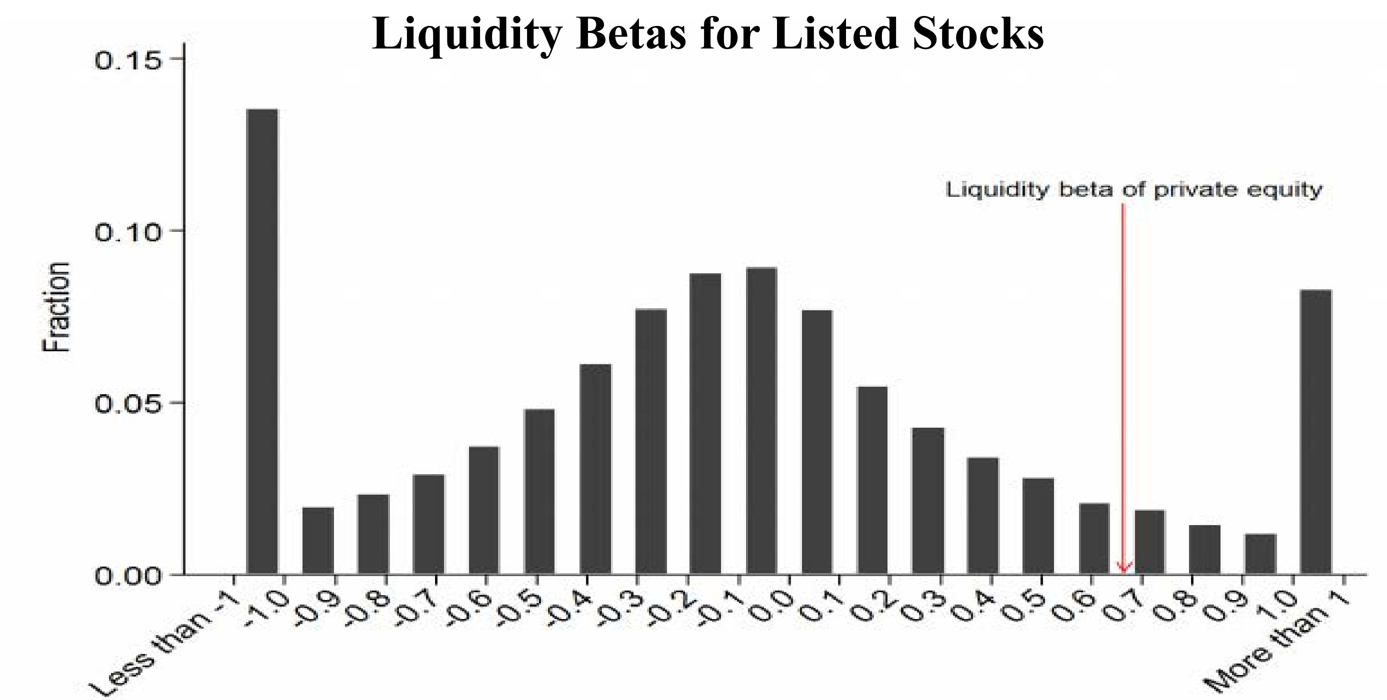
The Liquidity Risk Premium For Private Equity is High Relative to Publicly Listed Companies

- **Replacing Equities With Alternatives Is Substituting Liquid Investments for Illiquid Investments**
- **For Private Equity, "The Liquidity Risk Premium… Appears To Be An Essential Component To Fully Account For Average Private Equity Returns"[1]**



***Fraction is the percentage of total number of betas.**

1-"The Unconditional Liquidity Risk Premium Is About 3% Annually…The Inclusion Of This Liquidity Risk Premium Reduces Alpha to Zero".
Source: Franzoni, Francesco, Nowak, Eric, and Ludovic Phalippou. "Private Equity Performance and Liquidity Risk". (2012). *The Journal of Finance*. Page 2356.

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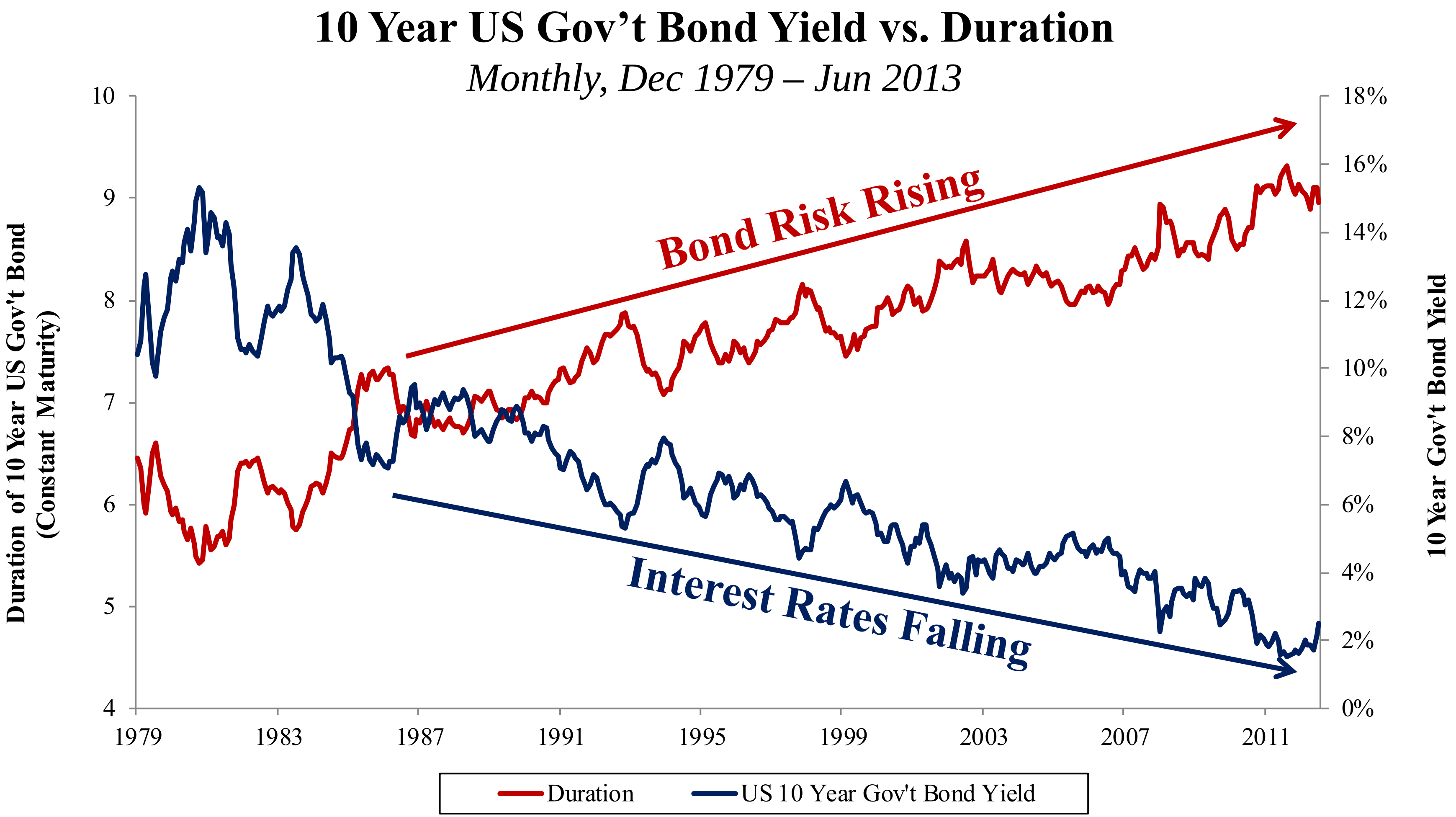
Treasury Bond Interest Rate Sensitivity Has Nearly Doubled As Interest Rates Have Dropped



Duration is a measure of interest rate risk as it approximates a fund's price change in response to interest rate changes. For example, a fund or individual bond with a 10-year duration can be expected to change in price by approximately 10 percent when interest rates change by 1 percent. Source: Thomas Collimore. "Five Things Every Investor Should Know about Bond Funds". (2010). CFA Institute.

 Source: Hillsdale Investment Management

Expected Returns, Risk and Correlations

- **There is a Crucial Distinction Between Realized Returns and Expected Returns.**

- **Since Returns Vary Over Time, Past Average Returns May Be Poor Predictors of Future Returns – And They Can Even Be Poor Proxies of Past Expected Returns.[1]**

"I Skate To Where the Puck is Going To Be, Not Where It Has Been."
- Wayne Gretzky

1- See Antti Ilmanen (2012). "Expected Returns On Major Asset Classes," *Research Foundation of CFA Institute, John Wiley & Sons, Inc.*, Vol. 2012, No. 1 (June): 1-166.

In Just Two Months, The US Treasury Bond Market Has Corrected Some of Its Overvaluation

	Nominal Yield*	=	Real Yield*	+	Expected or Breakeven Inflation
April	1.70%	=	-0.64%	+	2.34%
June	2.52%	=	0.53%	+	1.99%

*Real Yield is based on 10-Year US Treasury Inflation-Indexed Security Yield, Constant Maturity as of April 30, 2013 and June 30, 2013.
Nominal Yield is current yield on 10 Year US Gov't Bonds as of April 30, 2013 and June 30, 2013.

Investment Options In A Low Return Environment

1. Reduce Return Expectations

2. Consider "Higher Yielding" Strategies

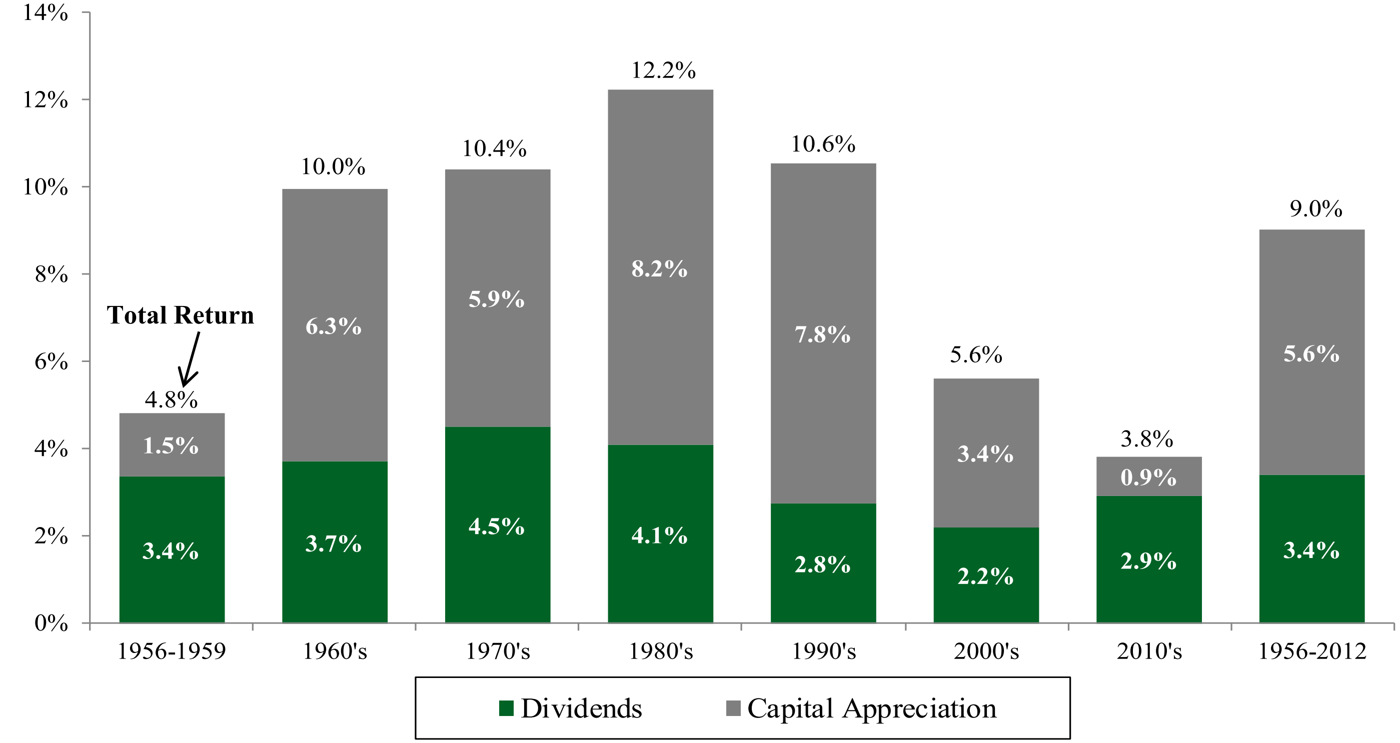
3. Utilize Active Investment Management

4. Evaluate "Smart" Beta Strategies

Dividends Are A Critical Portion of Total Equity Returns

TSX Composite Total Return: Dividends vs. Capital Appreciation

Annualized Returns, 1956 – 2013



% of Total Return	1956-1959	1960's	1970's	1980's	1990's	2000's	2010's	1956-2013
Dividends	69.7%	37.1%	43.2%	33.4%	26.1%	39.5%	76.0%	37.7%
Capital Appreciation	30.3%	62.9%	56.8%	66.6%	73.9%	60.5%	24.0%	62.3%

*2010's is represented by the period: Jan 2010 – Jun 2013.
Dividend Return = Total Return – Price Return
Source: Hillsdale Investment Management.

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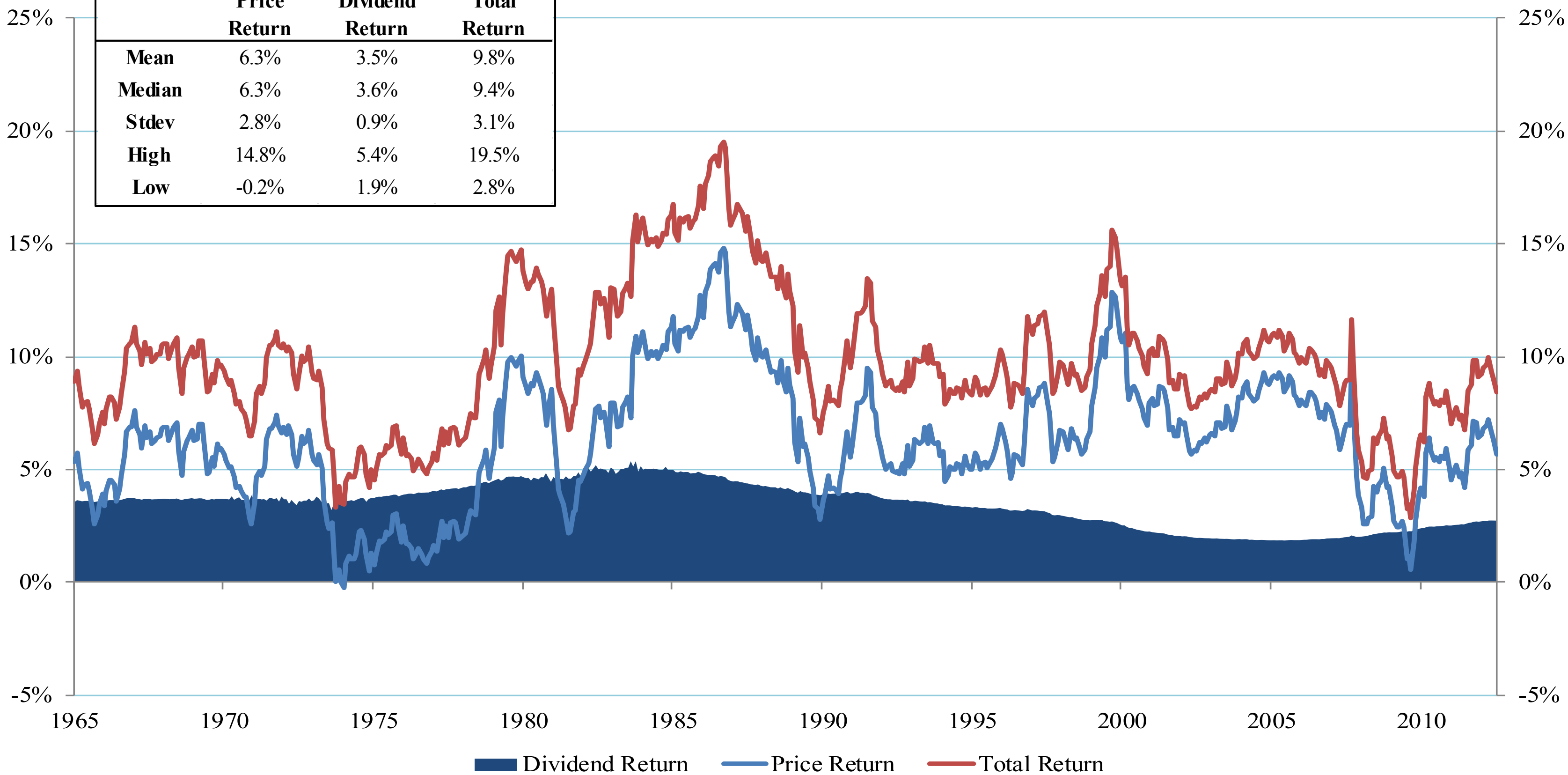
Dividends Are The Only Constant in Variable Equity Returns

TSX Composite Rolling 10 Year Annualized Price Returns vs. Dividend Returns

Monthly, Jan 1956 – Jun 2013

Statistics

	Price Return	Dividend Return	Total Return
Mean	6.3%	3.5%	9.8%
Median	6.3%	3.6%	9.4%
Stdev	2.8%	0.9%	3.1%
High	14.8%	5.4%	19.5%
Low	-0.2%	1.9%	2.8%



Dividend Return = Total Return – Price Return

Source: Hillsdale Investment Management.

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Use Active Investment Management If You Have An Edge

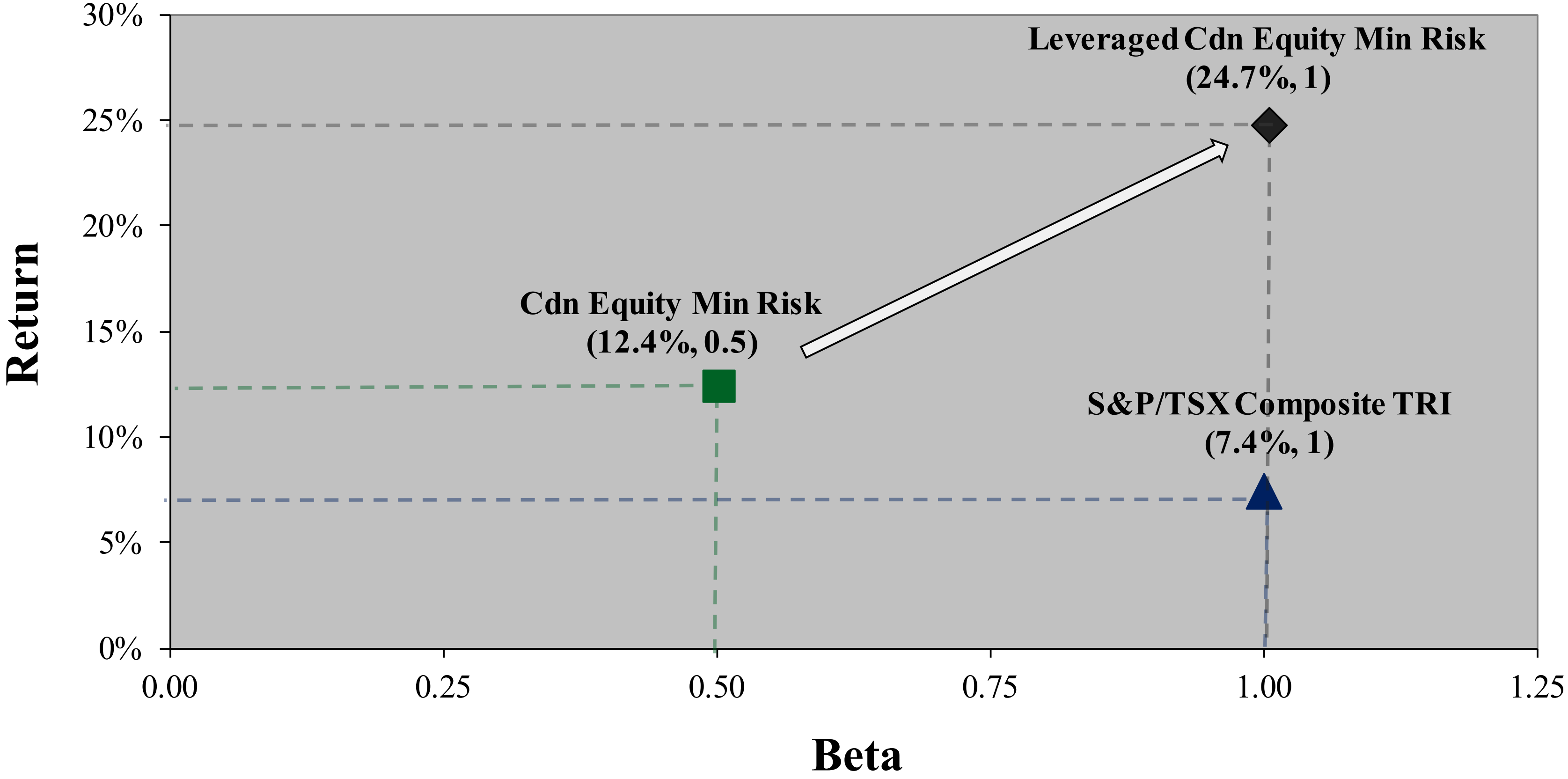
Asset Class	Breadth	Skill	Odds of Success
Cdn. Fixed Income	Low	Low	Low
Cdn. Equity	Low	Avg.	Avg.
Cdn. Small Cap	Avg.	High	High
U.S. Equity	High	Avg.	Avg.
U.S. Small Cap	High	High	High
Global Equity	High	High	High
Emerging Markets	High	High	High

Source: See introduction to "Perspectives on Institutional Investment Management" By Harry S. Marmer, Rogers Publishing, (2002).

Evaluate "Smart" Beta Strategies

Simulated Annualized Return vs. Beta

Monthly, Jan 1990 – Jun 2013



 Source: Hillsdale Investment Management

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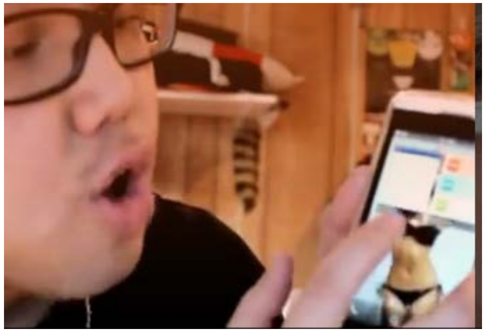
Concluding Thoughts

- Capital Market History Has Much To Teach Us
- However, The Future Only Rhymes With The Past
- Expected Returns & Risks Should Always Be Forward Looking
- About Half The Correction in the Bond Market Has Occurred
- In A Low Return Environment, Strategies to Increase Total Equity Returns Include:
  - Employ Higher Yielding Strategies
  - Utilize Active Investment Management Where It Makes Sense
  - Small Cap Offers Significant Alpha
  - Evaluate "Smart" Beta Strategies



- "In The "Crackberry" Generation, Differentiating Between Signal and Noise Will Continue To Be An Increasing Challenge For All Investors"

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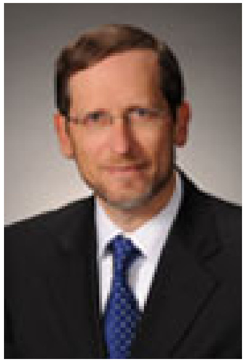

Harry Marmer, BBA, MBA, CFA, Executive Vice President, Institutional Investment Services, Partner. Mr. Marmer joined Hillsdale Investment Management in 2008 and is Executive Vice President, Institutional Investment Services. Prior to joining Hillsdale, Mr. Marmer led the Canadian institutional investment business of Franklin Templeton Investments and before that the institutional business of the Russell Investment Group. He was also a principal and co-head of Mercer's Canadian Investment Consulting Practice. Mr. Marmer is a frequent conference speaker and has authored more than 47 articles. His book, *Perspectives in Investment Management*, was published in September 2002. He has served on a number of professional and industry boards and was past president of the Toronto CFA Society. Mr. Marmer received the Volunteer of Distinction Award from the Toronto CFA Society and was awarded the Society's Research Award. He has an MBA and a BBA, finance and investments, York University.

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Disclosures

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