



# In October, caution is the operative word

**ROB CARRICK** talks to three strategists and gets three subtly different takes on how to protect yourself from market hobgoblins

**H**appy October, investors. The nastiest, most capricious month in the financial calendar is in vintage form this year.

September is actually the worst month for the stock market on average, but October has delivered shocks like the crashes of 1929 and 1987. Yes, the weight of history is considerable as we assess the disastrous week that was on the formerly unstoppable Toronto Stock Exchange.

The S&P/TSX composite index is up about 81 per cent in total over the past three years and, even after its 519-point plunge from Tuesday to Thursday, it's up about 15 per cent in 2005. The question for investors is how to position a portfolio to capitalize on any gains still to come while protecting against the risk that were evident this week.

For some ideas on what to do, let's check in with three market strategists whose job it is to size up the stock and bond markets and tell clients how much exposure they should have to each, and also to super-safe cash. Wilf Hahn, a money manager, is president of asset manager Hahn Investment Stewards; George Vasic is chief economist and strategist for investment dealer UBS Securities; and, David Wolf is head of Canadian economics and chief strategist at Merrill Lynch.

Forget about finding any unanimity of opinion. Mr. Vasic is relatively optimistic about what the next 12 months hold for stocks, Mr. Wolf suggests a defensive approach and Mr. Hahn is a little more cautious than that.

Mr. Vasic recommends an asset allocation of 50 per cent stocks, 35 per cent bonds and 15 per cent cash, but this week's decline on the S&P/TSX may call for some change in that. "Given where we're at, further movement downward would suggest it's time to take some of that cash and move it over to stocks."

The thinking behind this comparatively aggressive stance is that the S&P/TSX composite will hit 11,500 points in 12 months, which would mean an upside of about 8 per cent from the current level. The 11,500 forecast was issued on Monday, before the market went south, but Mr. Vasic's not budging. "It's a reminder to everyone that markets don't go up in a straight line."

To understand what's happened on the TSX this week, Mr. Vasic suggests you look at the 14-per-cent gain by the index in the third quarter of the year. After a performance like that, it's natural for stock prices to pull back. Energy stocks soared 25 per cent in the third quarter, and it was this sector that bore the brunt of this week's decline.

As for bonds, Mr. Vasic's not especially enthusiastic right now because economic growth remains strong in Canada and because there's a risk that rising energy prices will flow through to other goods and send inflation higher. Still, it's worth noting that the bond market has shown some resilience in the face of rising Canadian and U.S. short-term interest rates.

At Merrill Lynch, they suggest that 40 per cent of portfolios go to stocks, 45 per cent to fixed income and 15 per cent to cash. "That's really quite conservative," Mr. Wolf said.

He said this asset allocation model was developed for the U.S. market, but he's comfortable with it for Canada even though he's less concerned about the strength of the economy here than he is about the economy south of the border.

The wild-card for Canadian investors is oil prices, Mr. Wolf said. "Overall returns in the Canadian equity market are going to be dominantly driven by whether we see oil at \$40 or \$80 [U.S.] in six months," he said. Merrill's energy strategist has said that the price of crude oil will average \$65 a barrel through the end of next year, while Mr. Wolf, the chief strategist, has been using a \$60 forecast.

The rise in oil prices to \$70 from \$50 a year ago is a major reason why

the S&P/TSX has decisively outperformed the major U.S. stock indexes in 2005 and over the past three years. But you have to wonder how long this will continue. Oil traded at about \$61.50 late this week, which is pretty much where Merrill Lynch sees it in the next 12 to 15 months.

This is the thinking behind Mr. Wolf's forecast that the S&P/TSX will rise just 6 or 7 per cent next year, and it explains his recommendation that investors take a conservative approach by looking at classic defensive market sectors, such as utilities, consumer staples, health care and telecom.

While Mr. Wolf is neutral on financial stocks, UBS's Mr. Vasic has identified them as a good defensive play right now because they offer a blend of decent valuations and low correlation to oil prices. Health care and telecom also scored well on Mr. Vasic's list of top defensive plays, while information technology was worst. Interestingly, utilities were the second-worst choice.

Mr. Hahn, of Hahn Investment Stewards, has a cash weighting of 14.5 per cent, which is a bit less than the other two but actually more dramatic because his benchmark cash allocation is just 4.5 per cent.

His cash weighting might even be higher if not for the fact that he's got 12.5 per cent of client portfolios on average in alternative assets, a category in which he includes gold and stocks that give him exposure to China and emerging markets. Gold is part of the mix because of Mr. Hahn's concern about the U.S. dollar and inflation. Gold has an inverse relationship with the U.S. dollar, and it's a favourite hedge against rising prices.

Over all, alternative assets are part of Mr. Hahn's 43.1-per-cent weighting in stocks. He pegs bonds at 42.4 per cent.

Mr. Hahn has been increasing his cash holdings gradually, in part by reducing exposure to the energy sector.

"We believe as most do that oil will probably go a lot higher longer term, but for now we're due for a cyclical downturn," he said. "So we're taking our profits there."

Oil could fall \$10 to \$15 a barrel, Mr. Hahn believes. If that were to happen, then the TSX could suffer as global investors pull their money and look for the next big play. This week, selling by U.S. investors was highlighted as a contributing factor in the price declines by some of Canada's largest oil and gas companies.

"There's a good chance we've seen the shorter-term peak [on the TSX]," Mr. Hahn said. "I don't mean to be negative on Canada, it's just that we've got all this foreign money sloshing in and out."

And now a word about the unsung asset class -- cash. With the Bank of Canada ratcheting up short-term interest rates, returns from Treasury bills and money market funds are growing.

The return on a three-month T-bill is now about 2.93 per cent, and one-year T-bill now earns about 3.3 per cent.

"Cash is actually becoming a very viable alternative investment," said Sheldon Dong, vice-president of fixed-income strategy at TD Waterhouse. "For parking money, it looks better now than it has for the last couple of years now."

As the most unpredictable month of the year for investors unfolds, this is something to remember.

## Three takes on the markets

A volatile week for stock markets raises questions about how investors should position their portfolios for the rest of the year and beyond. A trio of strategists were asked to offer some suggestions and here's what they came up with:

### **Wilf Hahn**

President, Hahn Investment Stewards

#### **Asset allocation:**

Stocks - 43.1 per cent (includes 12.5-per-cent weighting in alternative investments)  
Bonds - 42.4 per cent  
Cash - 14.5 per cent

**Defensive Pick:** Gold

### **George Vasic**

Chief economist and strategist at UBS Securities

#### **Asset allocation:**

Stocks - 50 per cent  
Bonds - 35 per cent  
Cash - 15 per cent

**Defensive Pick:** Financials

### **David Wolf**

Head of Canadian economics and chief strategist at Merrill Lynch Canada

#### **Asset allocation:**

Stocks - 40 per cent  
Bonds - 45 per cent  
Cash - 15 per cent

**Defensive Pick:** Utilities, health care, consumer staples, telecom

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