

Avenue Investment Management

Getting there together

March 2007

1st Quarter Review

Major stock markets around the world now tend to move together. This is a relatively new phenomenon which is referred to in financial language as positive equity market correlation. Most economies from North America, Europe, Russia and Asia are linked by trade and the world is a more politically stable place because of it. However, one of the underpinnings of modern portfolio theory is at risk.

The theory holds that when building a portfolio of stocks, diversifying your holdings into other areas of the world is supposed to lower risk because not all markets move up and down at the same time. These studies were first done in the 1970's but now the world is a very different place. We experienced a classic display of global stock market correlation on February 27th. The sell off started overnight with the Chinese market down over 5.5% and continued seamlessly around the world until the American S&P500 was down 3.5% later the same day.

Our belief is that global stock market diversification is not necessary and in many ways adds to risk. The only way to truly diversify a portfolio's investment risk is to own bonds. We would like to point out that during that same 24 hour period, our holdings in Canadian long bonds increased by 3%.

We will be giving up a certain amount of growth by not investing directly in the emerging economies of Asia. We would also argue that we avoid taking on vastly higher risk. As an example, China does not have the same degree of accounting standards, disclosure, and governance as countries in the West. China has only recently begun to discuss the usefulness of private property rights.

As Canadian investors, we can participate in today's global economic health but we can do it by investing in companies which are more transparent. In addition to bonds, we can effectively lower the risk of the overall equity portfolio by owning specific investments in parts of the financial markets which are not correlated. Financial services, energy and gold stocks all exist in Canada and on the whole do not move in the same direction at the same time.

All of these comments are very big picture. We would still like to leave you with a few more practical views on where we see current financial market valuations.

The Canadian stock market has had a strong move up for six months. However, based on current earnings, the market is not expensive, trading at a 16.5 times price earning ratio. The sub-prime lending fallout in the US has yet to impact the overall North American consumer market. Interest rates on risky assets have increased because of low quality mortgage delinquency but not enough for us to find investment-quality opportunities.

The most interesting phenomenon is the amount of cash on the sidelines of the market. OPEC countries will have \$100 billion of new cash to invest this year. The Asian trade surplus should be in the order of \$250 billion. Private equity funds have raised \$500 billion and US companies are reported to be sitting on \$2.4 trillion of cash. As long as this much money sits there unused, it is unlikely that stock markets can go down in any significant way.

A Case Study in Risk Adjusted Returns

We try our best not to include math in these quarterly reports. However, in this case study we hope we can demonstrate a very important part of what we do in terms of risk reduction in a few simple numbers.

The previous page discussed portfolio risk in its broadest form. We do calculate and keep track of Avenue’s individual equity portfolio risk but until we build a historical track record the numbers are not terribly useful. We can now lay out for you three years of risk adjusted returns.

If our clients were just interested in getting the highest return then we, as managers, would go out and take on as much risk as possible. However, if risk is important, then the more relevant calculation to the investor is the risk adjusted return.

By definition, the optimal risky portfolio seeks to maximize return to volatility. As we have previously written, in financial terms volatility is the true meaning of risk. The calculation for risk adjusted return is called the Sharpe Ratio.

What we would highlight here is that Avenue’s portfolio volatility or risk, versus the volatility of the TSX Index, is significantly lower. Consequently, the risk adjusted return as measured by the Sharpe Ratio is higher than that of the TSX in all of the past three years. In simple terms: a higher Sharpe Ratio is better.

$$\frac{R_p - R_f}{Op} = \text{Sharpe Ratios}$$

- Rp = The Return of the portfolio
- Rf = The Return of a one year Government of Canada Bond
- Op = The Volatility (Risk) of the portfolio**

	Avenue’s Equity Portfolio		TSX Index
2004	7.8% - 3% ----- = 0.7 7.3%	65% less risk	14.5% - 3% ----- = 0.5 21.2%
2005	19% - 3% ----- = 1.6 10.2%	41% less risk	24.3% - 3% ----- = 1.2 17.4%
2006	26% - 4% ----- = 1.8 12%	36% less risk	17.3% - 4% ----- = 0.7 18.8%

In 2004, Avenue’s portfolio had 65% less risk than the overall Canadian market. In 2005 the risk level was 41% less and in 2006 the level was 36% less. We acknowledge that the level of risk has increased in

the portfolio over the past three years. Most of this increase is because we currently cannot find good quality high yield bonds and subsequently the overall equity exposure has increased as the bond positions have been reduced. We are always looking for these types of bonds but for now we have to be patient and wait for the opportunities to present themselves.