INDIVIDUAL ASSET MANAGEMENT, INC.

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The Year Ahead

2013

Individual Asset Management is a Registered Investment Advisor

Inside this issue:

Points of interest:

- **Bond alternatives in an era of low interest rates.**
- **Dangers of commodity ETNs.**
- **Pros and cons of various emerging markets.**

This time last year I was writing about how the European Sovereign debt crisis was coming to a head and that we were seeing continuing improvement in the US economic picture. I suggested we should avoid European markets until a resolution could be found in Europe, either in the form of an exit of one or more countries or by an unlimited pledge of financial support for needy countries.

This turned out to be good advice, as US markets outperformed European markets in the first half of the year but, once the Europeans in essence pledged unlimited support for European banks and it became clear that Greece was not going to be allowed to default, European markets outperformed in the second half of the year.

Despite the recent outperformance of European markets, it seems clear that the EU economy is not doing well. Even in Germany, which has been the main pillar of support for Europe, GDP growth is forecast at less than 1% this year. Housing prices continue to fall in places like Spain, and unemployment remains very high, especially youth unemployment.

In contrast, the Unites States seems to be slowly but steadily recovering. House prices are rising, as are home purchases. Retail sales have been good, and unemployment, while still elevated, is gradually coming down. From this perspective it seems that, while European markets may have experienced a good relief rally, long-term investors may be better served by betting on US markets.

About this time last year I also wrote about how emerging markets were, once again, becoming interesting as inflation seemed to have been controlled in many places, most importantly China, and as growth rates had stabilized at more sustainable levels.

Indeed most emerging markets did reasonably well last year with the exception of the local China market. In my opinion, this makes the Chinese market quite attractive at this point.

An interesting topic these days is that of "inshoring" - which is the opposite of the offshoring trend we have seen over the last two or three decades where manufacturing and other low-level jobs have moved from high-cost regions like the United States to low-cost regions like China. Some of these jobs are now moving back as Chinese labor costs have risen at a 20% annual clip for a number of years so, once transportation costs, intellectual property protection and customer access are considered, the US becomes attractive as a manufacturing center again - more on this later.

On another note - for the third (or is it fourth) year I am warning about the dangers of buying bonds at today's very low interest rates. The day when there will be an exodus from fixed income investments is getting closer. If investors become more confident in equity markets as many economies pick up, then this could be the catalyst for a bond sell-off.

Commodity markets were up and down in 2012 as concerns around a general economic slowdown persisted. However, now that it seems growth has stabilized in China and is continuing in the US, I would expect commodity markets to do reasonably well - with the added benefit of a hedge against the Iranian nuclear standoff, which will likely come to a head this year.

Generally I am fairly bullish for equity markets this year, and for the first year in a long time I would recommend growth-oriented holdings rather than value stocks; at least in the USA, certain emerging markets, and commodity-based developed markets.

Developed Markets

Most developed equity markets ended up doing quite well in 2012 as a result of the measures taken to stabilize the European economy mid-year. In fact the EU equity market as a whole dropped 20% from March to June on economic concerns, but then rallied from there, with countries such as Greece leading the way. Greek GDP was about –7% in 2012, whereas Chinese GDP was about +7%, and yet the Greek stock market was up about 40% for the year and the local Chinese market was up only about 3%. Clearly there is a lot more to choosing the right investment region than just looking at economic statistics. When there is a turnaround in sentiment or expectations, this is often the driver for stock market performance rather than economic data.

Stock markets are considered to be leading economic indicators. Given this fact, we should be looking at whether things are getting better or worse in our investment markets, not what they now look like. In most developed markets, most notably the United States, things seem to be getting better. Even Europe has perhaps bottomed, although I expect years of slow growth there.

I think there is a risk that the rally we saw in European markets in the second half of 2012 may turn out to be simply a relief rally, and not based on expectations of future good economic prospects. It is difficult to imagine Europe growing in a meaningful way with all of their issues surrounding high unemployment, a bloated welfare state, high taxation, and still a relatively strong currency.

In my opinion, the US markets are a less risky bet these days. In the US we see statistics month after month that imply a slow but steady economic revival: House prices up 6% from a year ago, new home inventories at very low levels, unemployment at 7.8%, still high but down from 10% during the financial crisis, wages increasing or holding steady, and companies investing in new factories. All this combined with a still relatively cheap currency, and low borrowing rates, makes for a compelling investment picture.

Trends seem fairly clear in the US and Europe, but not so in other developed markets such as Japan, Australia, and Canada. The Aussie stock market did quite well in 2012, mostly keeping up with Euro and US markets, but Japan and Canada underperformed in USD terms (although in Japan this was as a result of a falling Yen, the local market was up 23%).

This is interesting because both the Aussie and the Canadian markets are considered to be commodity-based, so in a year like 2012, where commodities didn't do very well (the Dow Jones-AIG Commodity index was down 5%) and currencies were stable, why the discrepancy in stock market performance?

The answer lies in the composition of the stock market indices. The Australian index is almost 50% financials and about 1/4 materials (mining companies mostly), whereas the Canadian index is only about 1/3 financials, 1/4 energy, and 1/5 materials. Well, banks had a pretty good year in 2012; much better than energy or mining companies.

The Japanese market most likely did well because of a rebound from the dismal year they had in 2011 when all the tsunami-related issues hit hard. Non-Japanese investors need also to consider currency effects since the Japanese government is dong everything it can to weaken the Yen to make Japanese products more competitive globally. This has a positive influence on corporate returns and their stock values, but is offset but a weaker currency. For this reason I would suggest avoiding the Japanese market if you use a different base currency for investments.

This underlines the point made on page one of this newsletter: Clearly it isn't enough to just consider a country's economic prospects in making investment decisions - not only because economic data is not necessarily correlated to stock market performance, but also because currency effects and the sector breakdown of the index are important.

Have a look at the chart below. It shows the substantial outperformance in Canadian and Aussie markets vs. the US over the last ten years or so, despite the tame returns of the commodities index. Over this time period the US Dollar weakened by 47% vs. the Aussie Dollar and by 34% vs. the Canadian Dollar.

This weakening USD trend clearly isn't sustainable since it would lead to Aussie and Canadian exports being priced out of world markets.

* Australia (EWA), Canada (EWC), US (SPY), and Commodities (DJP) markets 2001-2012 in USD.

Currencies

Last year I wrote about how it might be wise to hold currencies of commodity-based countries rather than the Euro in 2012 due to the European economic problems, and I also suggested the US Dollar might do OK on the back of improving economic fundamentals.

In fact the USD strengthened about 5% vs. the Euro in the first half of 2012 but lost all this gain in the second half of the year when Euro zone prospects improved. Commodity-based currencies were similarly up and down, mostly ending flat vs. the US Dollar on the year.

The most interesting thing in currency markets these days might be the Japanese Yen, which sold off dramatically early in 2012 and then again in the last quarter; a trend that continues in 2013.

More interesting than last year's up-and-down currencies might be the longer-term trend. The chart below shows the US Dollar vs. several other currencies over the last decade. Clearly there has been a dramatic weakening in the US Dollar; 50% against the Aussie Dollar at the extreme end.

This trend has been the result of a number of factors: A general movement towards currency diversification away from the US Dollar amongst most central banks, most notably China's. The relative outperformance of many economies compared to that of the US. Concerns over US sovereign debt since the USA is much more heavily indebted than most of these countries (except Japan, which is by far the most heavily indebted of the developed nations - but Japanese debt is largely held internally, whereas US debt is over 50% external).

Clearly this trend of a weakening US Dollar is not sustainable forever since at some point US goods would become so cheap in international markets that demand for US goods would increase driving up the currency as well. I think we have recently seen signs of exactly this happening. One indication is the movement to inshoring that I discussed on page one. It is becoming economic for companies to, once again, build factories in the USA - despite the still large discrepancies in some labor costs. Other indications are an Australian wine market that is suffering due to the global cost of its product, and numerous other industry-specific examples.

The other pillar that often supports currencies (although not in Japan's case) are relatively high interest rates. Higher interest rates drive investors to take money out of a low yielding currency and put it in a high-yielding currency. So higher interest rates generally mean a strengthening currency and interest rates have been significantly higher outside the USA in recent years.

Now, however, there is less of a gap in interest rates as Europe, Australia, Canada, and many other nations all seek to stimulate their economies and make their currencies more competitive.

For all these reasons, I think perhaps the trend of a weaker US Dollar may have bottomed. I wouldn't expect the USD to strengthen significantly since many nations are still diversifying out of the US currency, but I am thinking that there may not be much money to be made betting against the US Dollar over the next few years if congress finds a way to address the long-term debt issues of the United States and if growth continues.

"Currencies tend to be mean-reverting over the long term as a result of purchasing power parity - but the long term could be ten years or more."

Commodities

It was a pretty boring year for commodities in general with the Dow Jones-AIG commodities index (DJP) meandering about and finally finishing down about 5%. What is interesting is that share prices of commodity-related firms mostly did worse than the commodity indices would suggest.

For example mining companies with a large exposure to South Africa have been hit by new regulations that threaten nationalization and pervasive strikes in that country. This of course is bad for share prices of these companies but tends to raise prices of the commodities mined there on expectations of scarcity.

Gold producers have seen their share prices fall even as the price of gold has held steady. This is most likely attributable to the increasing difficulty in mining gold. Mines have to reach deeper and have lower yields than in years gone by.

Agricultural firms have recently come out of their funk - a trend that is worth watching. Over the last year or so, as investors have fretted that the Chinese economy has been slowing down too much, commodity prices have been affected, as have the share prices of commodity-related firms. But in an era of increasing wealth in emerging markets in general and China specifically, I would think that commodity-related companies should do well; especially agricultural concerns. In my opinion, this is a long-term trend and there is currently good value in many commodity-related companies.

Beware the commodity ETN.

There are a number of ways to invest in commodities: You can buy the commodity itself, you can purchase commodity futures, you can buy shares in commodity-related companies, or you can buy ETFs and ETNs.

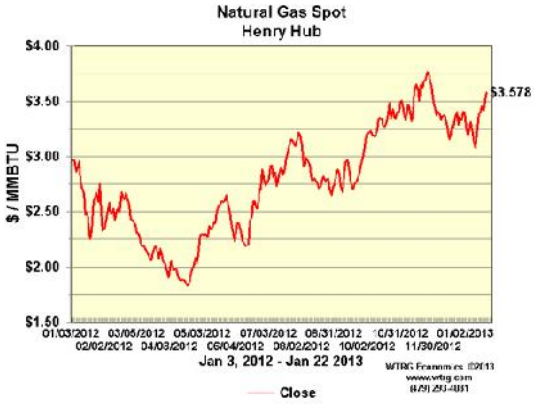
ETFs are Exchange-Traded Funds, which are investment vehicles that sell shares and each share represents a certain amount of a physical commodity - the fund has to hold the commodity itself. For example, the Gold Fund (GLD) holds physical gold in a vault and each share represents, in essence, ownership of physical gold.

ETNs are Exchange-Traded Notes. Each share represents a certain value based on a commodity but the notes do not represent ownership in the commodity itself. Most often ETNs represent positions in commodity futures contracts and this is an important distinction from ETFs because the price of futures contracts is based on expectations for future prices and not just on the current price of the commodity.

The chart below shows a fund of oil and gas companies (XOI), and two ETNs, a natural gas ETN (GAZ), and an oil ETN (OIL). Notice the discrepancy in returns for 2012. The ETNs are down 20% to 30% while the XOI was about flat. In fact the XOI better tracks prices of gas and oil, as can be seen from the natural gas price chart below (oil was also up and down but ended largely flat for 2012).

Clearly an investment in ETNs would not be representative of either the performance of the producers or of the commodities themselves. The reason why this is so has to do with the shape of the commodity futures curve, the more expectations for future commodity prices differ from current prices, the more difficult it becomes for an ETN to represent current prices. It has to do with something called "contago" and the "roll yield" - terms which are beyond the scope of this newsletter but you can Google them for more info.

The bottom line is beware of commodity ETNs - you may not get what you expected.



Broad commodity index (DJP), Gold miners (RING), Energy producers (FILL), Metals & Mining producers (PICK), Agriculture producers (VEGI)

Emerging Markets

Emerging markets had a decent year in 2012 with the broad index keeping pace with most developed markets.

There were some trends to note: First of all, the considerable outperformance of the Thai and Mexican markets in my opinion speaks to the theme I mentioned on page one - Chinese labor costs increasing and outsourcing moving to countries with cheaper labor costs such as Thailand, or to countries located closer to large import markets such as Mexico to the USA. Also the ongoing recovery in the US should generally be good for the Mexican market.

The resilience of the Thai and Mexican markets is especially notable since the currencies have been relatively stable against the dollar, and also because it is the second year in a row that these countries have outperformed the emerging market index.

The Brazilian market underperformed for the second year in a row, in part because of a weakening currency vs. USD - the Real has fallen 25% vs. the USD in two years.

The Indian market bounced back after a disastrous 2011 despite a continuing decline in the Rupee.

In my opinion, both the Indian and Brazilian markets are worth looking at since it seems that perhaps the decline in their currencies has bottomed.

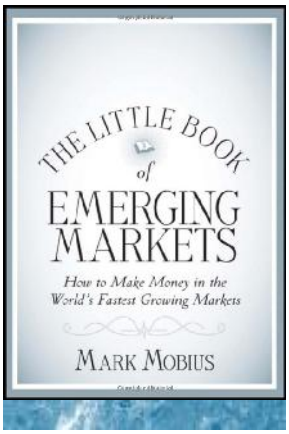
Another emerging market that isn't graphed below but that has done very well over the last two years is the Philippines - up 40% in 2012 in USD terms.

Some emerging markets may also offer diversification benefits. Most emerging market indices tend to be weighted towards financials but a select few are not. For example, the Mexican and Chilean markets are actually quite diverse, with financials representing only 12% in Mexico and 18% in Chile, where utilities are the number one sector. However, in Mexico one company, America Movil, makes up over 20% of the index.

Mexico is an extreme example but it pays to be aware of what you are buying when investing in emerging market index funds or ETFs. Peru is another such example - 50% of the index is materials, mostly mining companies, but a financial company, Credicorp, makes up 22% of the index.

I think many emerging markets represent better value at this time than developed markets, with lower price-earnings multiples and higher growth rates. Also many emerging market countries have been very careful regarding their debt obligations and the flow of fast money into their economies ever since the emerging market crisis of 1998.

Another consideration is that non-US companies tend to pay higher dividends and, since these dividends are paid in non-US Dollars (converted to USD if you buy a US ETF that invests in non-US countries), they represent a source of diversification.



An interesting book from a 30-year veteran of emerging market research.

Emerging market fund performance in US Dollars for 2012: Broad emerging market index (EEM), Brazil (EWZ), India (INDY), China (FXI), Thailand (THD), Mexico (EWW)

Income

The European debt situation and the generally large sovereign debt in many other developed countries, most notably the US and Japan, highlight the risks of investing in sovereign bonds. Even if countries such as the US, Japan, Germany, and so on, are not likely to default on their debt obligations, the very low yields available today on investment grade bonds hardly makes investment worthwhile. Given the fact that the first few years of Baby-boomers are now retiring, and people in retirement tend to favor income-producing investments, it seems there should be considerable demand for alternatives to bonds.

These alternatives should pay a good income stream, should be relatively conservative, and should offer diversification benefits to stocks.

This is a tall order and the fact is, as we saw in the panic of late 2008, nothing offers the diversification benefits of US Treasury Bonds; pretty much all other assets fell during this time period. Nevertheless, panics aside, there are a number of investments that offer at least some diversification and have many of the other properties in which we might be interested.

I mention some specific examples below; these are not necessarily recommendations, just examples. It should be stressed that all of the income alternatives mentioned below are likely more volatile than fixed income investments.

"Bond alternatives should pay a good income stream, be relatively conservative, and should offer diversification benefits"

Preferred Stock: This is generally mid-way between common equity and bonds in terms of risk although in a panic it tends to behave more like stocks. Preferred shares pay a higher dividend than common shares and receive dividend payments before any such payments are made to common stock investors. As an example, Goldman Sachs 'B' preferreds had a 6.2% yield when issued and currently have a 6.5% yield, whereas GS stock yields about 1%. In return for less volatility and higher dividends, the preferreds' investor gives up much of the capital gains upside as compared to common stock.

Real Estate Investment Trusts: These come in two flavors; mortgage trusts and equity trusts. Mortgage trusts get their cash flow from mortgages and therefore their fortunes are tied to the spread between their borrowing rates and their lending rates. As inflation increases, generally the government raises the Fed Funds rate and short-term interest rates rise. At some point short-term rates rise faster than long-term rates and this is when mortgage REITs underperform. Equity REITs get their cash flow from property rents and sales, which tend to increase with inflation, so these are less sensitive to rising interest rates. An example of a mortgage REIT is Annaly Capital, which currently pays a 14% dividend but its stock price fell 50% in late 2005 as interest rates compressed (and again in 2008 during the bank crisis). General Growth Properties is an example of an equity REIT that specializes in shopping malls. It was relatively unaffected by interest rate compression in late 2005 but got killed in 2007 and 2008 as real estate prices fell and consumers cut back on spending during the recession - its share price went from $50 to $1 (yes $1) during this time period.

Royalty Trusts and Master Limited Partnerships: These are similar to REITs but the income stream comes from other types of assets, mostly from oil and natural gas producing properties. Canadian Royalty Trusts generally try to replenish their reserves, whereas US Royalty Trusts generally do not. This leads to differences in taxation of dividends and obviously the US Trusts have a finite life. MLPs may replenish their reserves and are structured as limited partnerships, which means different tax treatment again. An example of Canadian and US Royalty Trusts are Enerplus in Canada and Great Northern Iron Ore Properties in the US; an example of a MLP is Kinder Morgan Energy Partners. It should be noted that recent tax changes in Canada have brought about the conversion of most Canadian Royalty Trusts to a high-dividend paying corporate structure.

Business Development Companies: This is basically a private equity investment for the common man. Normally private equity investments have high minimums but certain companies have created funds that invest in private rather than public companies - these are BDCs. Some, but not all BDCs have good yields; for example the Blackrock Kelso Capital Corp. sports a yield of 11%. We can expect that BDC share prices will be highly correlated and probably somewhat more volatile than the S&P500, but the high dividends give us a cash-like, uncorrelated, income stream (as long as they are paid).

Infrastructure Funds: These funds invest in certain infrastructure plays. For example, they might be toll-road operators, getting a cash flow from the tolls, or railroad or port operators. Generally they pay good dividends and are somewhat less volatile than stocks. Their stock prices are usually highly correlated to stock markets. The Macquerie Global Infrastructure Fund is an example.

Dividend paying common stock: Let's not forget these - you can get a 5% plus yield in some blue chip companies these days, and others, like GE for example, are increasing their dividend payouts as their business improves. Generally such companies tend to be less volatile than the stock market as a whole; although of course highly correlated to the stock market.

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Our focus is purely on portfolio management and financial advice, we do not have conflicts with investment banking concerns and our research is entirely impartial. Our clients enjoy access to the professionals who actually make investment decisions, not just to sales representatives.

As times have illustrated, a static portfolio strategy cannot be effective in every economic climate. At Individual Asset Management we develop a global investment strategy that is appropriate for market conditions as well as for your specific goals and risk tolerance.

This newsletter is for informational purposes only, it is not intended to offer advice or guidance on legal, tax, or investment matters. Such advice can be given only with full understanding of a person's specific situation.

Until next time,

Tom Zachystal, CFA, CFP®
President

In Summary

Global economies and investment markets go through cycles and investor behavior follows a predictable pattern.

There are growth cycles, such as that experienced in many developed markets from 2002 to 2007 where investor sentiment goes from Hope at the beginning of the growth phase to Confidence that the growth phase is entrenched, to Greed near its end. The growth times tend to be long, 5 years or more and ultimately culminate in a bubble of greed such as we saw in the real estate and lending markets in 2007.

Once the bubble has burst there is an initial period of disbelief amongst investors, another Hope period as the market starts to decline. As the decline accelerates, investor sentiment turns to Fear, adding fuel to the decline. Panic marks the bottom of the market cycle, something like what we saw in the first quarter of 2009. This, of course, is the best time to get in but not so easy to do because at the time there are all kinds of reasons why the market could go lower.

Panic is usually short-lived and from there the market recovers as sellers have been satisfied and only long-term buyers and holders remain. With few sellers, the market turns upward, most likely ahead of an economic upturn, and we go from Panic to Fear that the upturn is just a mirage. Sometimes there are several fits and starts in this phase, adding to the Fear.

As the recovery continues Fear turns, once again, to Hope as the growth cycle becomes more entrenched.

It seems to me that perhaps we are at the beginning of the growth phase and that recently investor sentiment is just now making the transition from Hope to Confidence on the back of an improving picture in Europe and the US and stabilizing emerging market economies.

The IAM newsletter discusses investment and financial planning issues.

If you have questions regarding the information in this newsletter or on other investment or financial issues, or if you would like to suggest topics for upcoming newsletters, please contact us by email or telephone at the numbers listed on this page.