Navigating the Recovery

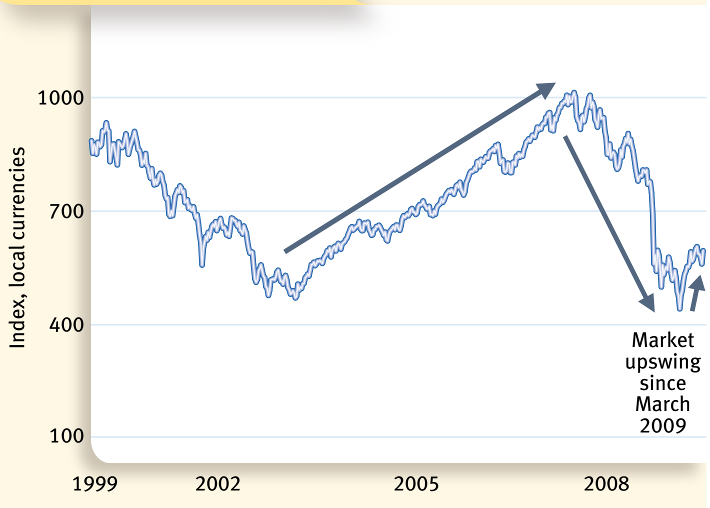
Focusing on fundamentals to help rebuild your portfolio

Many experts agree that the worst of the recession is behind us. The road to recovery may be bumpy, though, as high levels of household, corporate and government debt could pose a challenge to growth. In navigating the recovery, investors should draw on lessons from history and carefully consider current indicators as they chart their course to rebuild their portfolios.

Where are we in the stock market cycle?

After hitting a low in March 2009, stock markets and investors around the world enjoyed a strong rally that few predicted. Investors who were on the sidelines waiting for an end to the volatility missed those unexpected gains. Some continue to wait for the next pullback to perfectly time their market re-entry. The goal in this rebuilding phase, however, should not be to identify the market bottom of the current cycle. Rather, it should be to position your portfolio for the next 10, 15 or 20 years. The graph on the right shows that, despite the recent rally, equities remain close to their 10-year lows. In other words, entering the market now, when it is near its long-term bottom, enables you to take part in potentially significant gains as we pull out of the recession.

The recent stock rally in a 10-year context



Source: MSCI

If you think you've missed the bulk of potential gains that the stock market can provide over a longer-term cycle, think again. The typical bull market lifespan since 1942 has lasted 49 months.

Good news for equities: With recovery comes opportunity

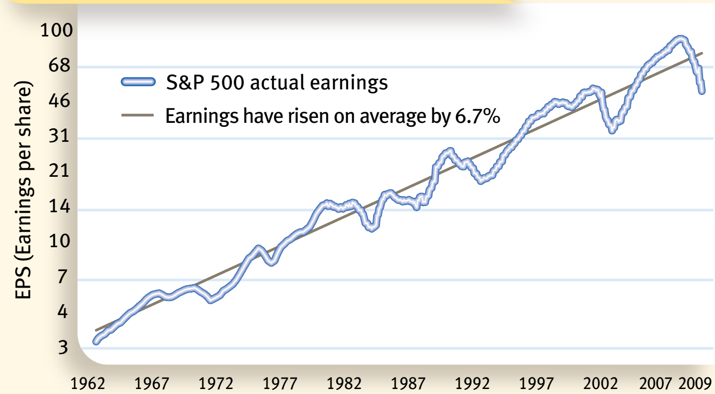
Here's another way to gauge the opportunities in equity markets. Corporate earnings are a key determinant of the performance of stocks. Analysis by the RBC Investment Strategy Committee suggests that the earnings growth rate of companies in the S&P 500 Index averages about 6.7% over a full economic cycle. You can see from the chart at the top of Page 2 how corporate earnings have grown over the past 50 years. In some periods, earnings growth beat the average while in other periods it fell below. Nonetheless, throughout the period, there is a very strong tendency for earnings to gravitate back to the average long-term growth rate.

The good news for equity investors

Since we have just experienced a period of below-average earnings, in order to recover to the long-term average of 6.7% we expect earnings to enjoy a period of above-average growth. By extension, we should be looking for double-digit returns in equities for a number of years as the economy heals — welcome news for equity investors.

Even if it takes a long period of time to recover to the historical earnings growth rate, the return potential for equities should remain superior to fixed income for some time. Historically, we saw this happen after bear markets in the 1930s, 1970s and 1980s, when stocks rebounded in a similar manner from low valuation levels.

Long-term corporate earnings growth is positive



Source: RBC AM, RBC CM

Uncovering opportunities: Strategies for carefully rebuilding your portfolio

For investors who are hesitant about re-entering the market after seeing assets decline so dramatically last year, exposure to a mix of equities, fixed income and cash remains the best long-term strategy. Within the context of a well-diversified portfolio, the appropriate asset mix can help rebuild your wealth and ensure that you are well-positioned for the opportunities this recovery may bring.

› Dividend-paying equities

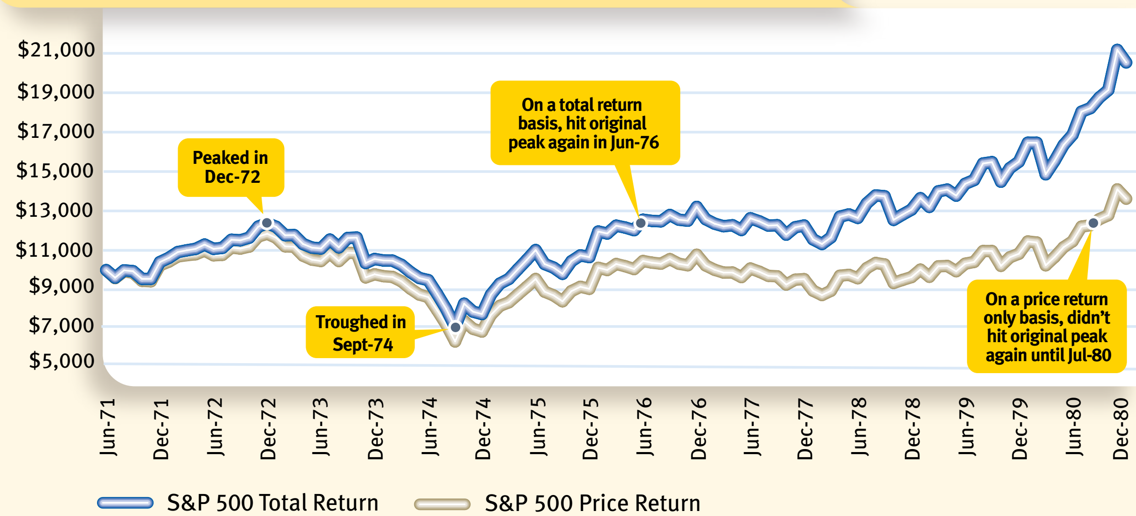
Companies with stable dividend payments offer investors income streams with sometimes higher growth potential and greater tax savings than bonds and income trusts. We can see this in the chart below, which uses an example from the bear market and recession of the 1970s. Looking at the S&P 500 Index on a total return basis, which includes dividends, the index was back to pre-bear market levels more than four years before the price return which excludes dividends reached the same level.

› Another approach to fixed income

Opportunities in fixed income exist beyond treasuries and government bonds. High-yield bonds offer attractive yields

Historic example: A look at the 1970s bear market

Investing in dividend-paying equities can help grow your portfolio



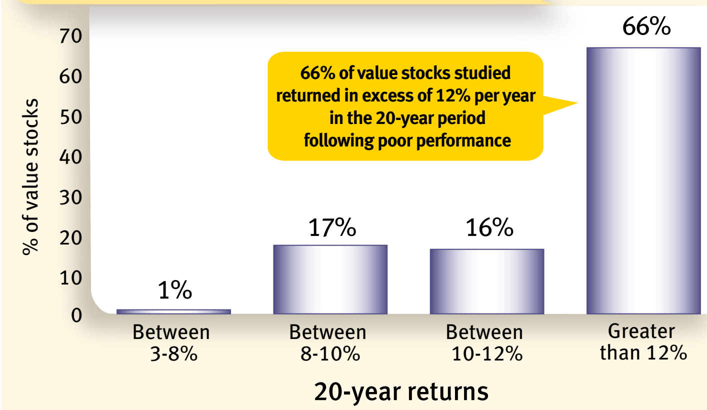
Source: RBC AM

above what can be earned on government bonds; they also provide the opportunity for capital gains as the credit markets improve. As a portion of your fixed income portfolio, high-yield bonds are a good way to "get paid while you wait".

› Value stocks

Stocks of companies that trade well below the price at which the fundamentals of the company suggest they are worth are called "value stocks." Last year's dramatic, and sometimes indiscriminate, stock market sell-off created what many call a "generational opportunity" to buy the stocks of high-quality, market-leading companies at rock-bottom prices. The graph shows that in one particular study of large-cap value stocks after periods of lacklustre returns, 66% had 20-year returns in excess of 12%.

Value stocks may be presenting the opportunity of a lifetime



Source: O'Shaughnessy Asset Management

Uncovering opportunities: Strategies for protecting your portfolio from inflation

Currently, inflation is around zero so it is not a near-term concern. As the economy heals and spending resumes, there is the potential for an increase in inflation. We do not know exactly what the inflation rate will be in 2010 or beyond, but in a healthy economic environment, the Bank of Canada targets an inflation rate of 2% to 3%. Consequently, addressing the eroding effects of inflation on the value of your portfolio should *always* be a consideration over the long term. The following are two ideas to consider as core holdings to protect the value of your portfolio.

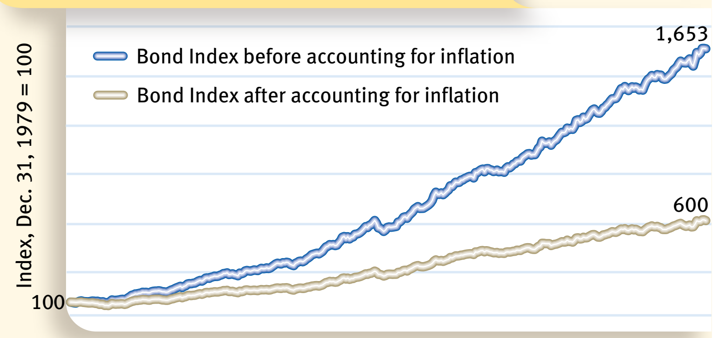
› Real Return Bonds (RRBs)

The coupon payments and underlying principal of RRBs are automatically adjusted to compensate for increases or decreases in inflation as measured by the Canadian Consumer Price Index (CPI). This helps protect the purchasing power of the bonds from the eroding effects of inflation. For this reason, investors should always consider a strategic allocation to real return bonds in their portfolios to help preserve their wealth over the long term — beyond a possible short-term inflation surge.

› Commodities

As the accompanying chart shows, investments in commodity-based companies can help protect against the eroding effects of inflation. While the prices of commodities can be volatile, many feel that because they are tangible assets with limited supply (such as crude oil, timber and gold), their prices have the potential to increase significantly as economies worldwide recover. Since commodities are considered riskier than the equity and fixed-income opportunities discussed earlier, for most investors an allocation to commodities should be significantly smaller than to the other two asset classes.

Inflation takes a bite out of bonds

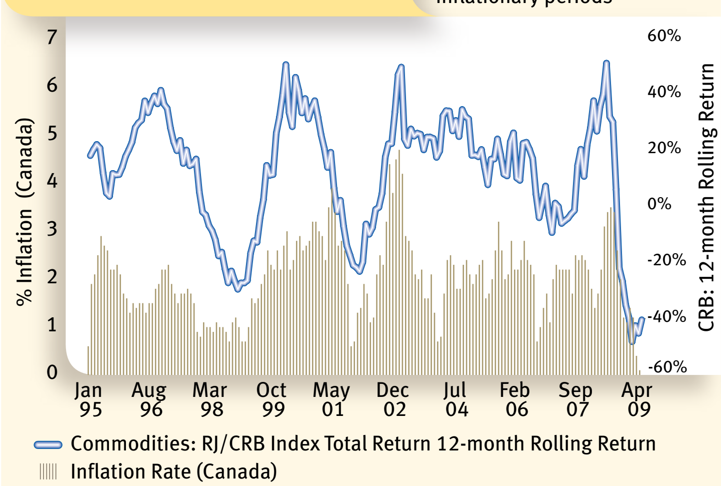


DEX Universe Bond Index and Consumer Price Index, December 1979 to May 2009

Source: PH&N, FactSet Research Systems

Commodities and inflation

Commodity values have historically increased during inflationary periods



Source: RBC AM

While the economy still faces challenges in the near-term, the opportunities for long-term investors are tremendous. Talk to your advisor to identify the solutions that offer the right mix of investments to suit your individual profile, so that you are well-positioned for the recovery and beyond.

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