DM Monthly Report

October 2014

PORTFOLIO ACTIVITY

In September, we rebalanced equity portfolios to bring actual position weights back to target allocations.

FEATURE STOCK

Johnson & Johnson (JNJ)

Earlier this month, JNJ reported third quarter earnings that exceeded analyst expectations, prompting the company to raise its full-year outlook for the third time in 2014. Especially strong in the company's portfolio was its prescription drug unit, with Olysio (hepatitis C), Remicade (arthritis), and Zytiga (prostate cancer) all contributing to rising aggregate income. And, according to at least one industry analyst, there should be more profit growth to come for JNJ, driven by "newly launched biopharmaceutical products and a decreasing impact from patent losses." In April, the company raised its dividend for the 51st consecutive year and, with a stable cash flow stream and strong balance sheet, it is one of only a few companies to have earned a triple-A credit rating. With JNJ shares having run up significantly in the first half of 2014, we trimmed the position in DM Foreign Equity when it traded at roughly $107 in late September. With the stock having since sagged to the $98 range, we may look to add capital to it in the months ahead.

EUROPE … IT'S DEFINITELY EUROPE

Although, the guy on CNBC yesterday was adamant that falling stocks were the Fed's fault. Of course, the Middle East is a hornet's nest, Hong Kong sits on a razor's edge, and what about Ebola? Things are so bad, we don't even hear about Ukraine anymore ...

While any or all of these difficulties may have helped to trigger the recent equity selloff, the root cause of the decline is likely far less captivating than commentators would have us believe. The fact is that markets don't follow a smooth path and, while much of the industry spends significant time attempting to definitively label gyrations after the fact, most drops are just part of the cycle and not so closely tied to the nightly newscast.

In deploying savings, individuals are presented with two principal options: *lending or owning*. When we purchase bonds or buy GICs, we have elected to become lenders in return for a fixed return, generally expressed as an interest yield. This option brings with it a high degree of predictability, at the cost of limited upside potential and generally adverse tax treatment. When capital is devoted to stocks or investment real estate, on the other hand, an ownership stake is taken in the underlying entity. This approach offers the potential for both capital and income growth, but also comes with less certainty and a greater possibility of capital loss. Naturally, a higher return is expected for assuming this risk and, sure enough, over the long run stocks have produced about a 3% annual performance advantage over bonds.

The "risk premium" we get on equities must be *earned*, however, otherwise people would always take the free lunch for owning stocks and their advantage over bonds would be quickly bid away. In 2013, anyone with equity holdings got off easy and really wasn't taxed at all for their decision to participate in markets; this year, however, it looks like we'll be making a short term payment for the long term gains we expect to capture through our stock portfolios. How much of a setback will the current bout of weakness amount to? Impossible to say for sure—stocks might have more room to slide, or the downturn may be complete as we write this piece. Either way, though, the preponderance of probability would suggest that current volatility will account for just another diversion on the market's zig-zagging path.

As stewards of client capital, it is our job to determine what assets are worth to the best of our ability and acquire them at prices below this value. If our methods are sound (and we emphatically believe they are), we can use periodic volatility and market anxiety to reallocate capital toward existing holdings which have been unduly punished, or to new ideas which have become compelling at lower prices. Accordingly, DM will endeavour to use today's instability as an opportunity to incrementally improve portfolios, rather than as a catalyst for dramatic change.