

## Thought for the Week: Monday, November 15<sup>th</sup>, 2010

### DIAS Portfolio Changes

#### Asset Value Appreciation

For DIAS investors and portfolios that seek asset appreciation ahead of income (the Growth Portfolios) the rapidly rising portfolio values we have experienced in the last year or two are a universal positive.

For investors in income-based portfolios, rising asset values are to be welcomed; however, the **current portfolio yields have fallen pro-rata to price rises**. For example, if a portfolio which yields \$6 is valued at \$100, when its value rises to \$113 the yield for investors at the higher price will fall to 5.3%.

Although this change in yield is immaterial to investors who bought at lower asset values; \$100 in the example above as their income is still \$6 per year, **we have made changes to the portfolio to raise the current yield back closer to 6% for new investors**. The portfolio changes we have made are subtle as **we do not want to increase the overall portfolio risk by ‘chasing’ yield**. In a year where our percentage total return is generally in double figures, it's prudent to allow yields to fall to some degree.

#### Inflation and Income Portfolios

Once the threat of a “Double-dip” recession receded and the specter of Deflation vanished, our minds turned to the **risks and rewards associated with the potential for rising inflation**.

**Inflation and Interest Rates generally move together** in order to maintain economic balance, therefore, rising inflation could be the precursor to higher interest rates. Given the frail state of the economic recovery, housing, employment and political stability; there may be a significant **delay between rising inflation and interest rate increases**. Moreover, inflation is currently below the government's target range which means a reasonable increase will only bring it back within acceptable limits – hardly a cause for concern but we are cognizant of the Government's stated goal of higher inflation.

Inflation traditionally occurs **“when too much money chases too few goods”**. **For the immediate future, we don't see masses of money chasing anything**, apart from pushing bond prices upwards.

We therefore feel that income-based portfolios; those with a majority of bond-like and interest rates sensitive investments, have some way to run before interest rates significantly threaten their values. However, a number of **protective investments held within our portfolios, TIPS and TBTs for example, have benefitted from increased inflation expectations**.

Bear in mind, this type of security moves on expectations, not reality. It can be easier to predict the expectations of investors than the ‘reality’ of economic numbers.

#### Wall Street Journal Headline:

##### **Tax-exempt Muni Bonds ‘Meltdown’**

*A rush to sell federally subsidized Build America Bonds before the program expires at the end of the year has flooded the market with supply and overwhelmed demand, which has been damped by growing concern about the ability of state and local governments to pay as tax revenues fall and costs rise.*

**We expect further credit or demand issues to impact Municipal Bonds before opportunities appear.**



## Inflation and Growth Portfolios

For Growth-based portfolios such as Focused Growth and Global Active Alpha, we see both the **expectation and reality of rising inflation creating opportunities in equities, commodities and commodity based equities and regions**. We have therefore increased our exposure to these areas.

We held Atlas Energy when Chevron announced its purchase and **the price of Atlas jumped over 30%**. We immediately locked in this gain. **Our Sell Discipline** mandates selling a stock when it goes up this amount, unless we have a good reason for holding.

This is affirmation of our energy/commodities investment theme and a taste of what increased merger and acquisition activity might do to equity markets.

## Telecoms vs Utilities

Utilities have been a great supporter of DIAS portfolios throughout difficult times gone by. When investors question the ability of many companies to continue selling their goods, we didn't see our Florida neighbors disconnecting their air conditioning units. When times are tough, **we like boring companies that produce steady cash flows**. However, Government efforts to step up the influence of the Environmental Protection Agency (EPA) may have similar negative effects to those envisaged from Cap and Trade. Consequently, the time has come to stop fighting that particular battle and move on to preparing for the next war.

**We are steadily replacing our Utilities investment theme with International Telecoms**. While the majority of the U.S. telecoms infrastructure is primarily built-out, vast tracts of telecoms 'real estate' lay ready for development in many emerging markets including the Antipodes. Examples include Telestra and New Zealand Telecom, Australia and New Zealand's monopoly phone, cellular and Internet providers.

While domestic service providers fight over existing users and replacement sales, the cell phone has become a primary aspirational purchase for the millions regularly jumping on the capitalism train. The international telecoms names we are moving to are often **monopolies with strong financials and attractive yields underwritten by their governments**. **We like this growth opportunity and the yield it often produces**.

## International Yield & Interest Rates

Rising asset values and historically low domestic interest rates have made it increasingly difficult for our income portfolios to maintain yields at the levels of 12 months ago. With U.S. credit risk measurements remaining fragile, chasing higher yields isn't an option for our conservatively biased management.

Emerging market and commodity-based countries, on the other hand, are already putting interest rates up to control expansion at sustainable levels. Although this may have a negative effect on the price of bonds, **there are interest producing investments that may benefit from higher interest rates**. We will continue to **search the world for attractive, low risk yield**. The broad strength of emerging markets balance sheets makes this a low risk, enhanced yield environment in our opinion.