

Mutual Fund News

Dress up your holdings with some Stars & Stripes

The Fed's rate pause should help the performance of U.S. stocks, ROB CARRICK writes

ROB CARRICK

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It's time for Canadian investors to buy American.

When the U.S. Federal Reserve Board halted a two-year run of interest rate increases on Tuesday, it provided some fuel for U.S. stocks that should help them outperform the Canadian market over the next 18 months.

The people at Scotia Capital recently took a look at what happened to the Canadian and U.S. stock markets in the period following 10 separate rate pauses by the Fed going back to October, 1959. The S&P/TSX composite index averaged a 4-per-cent gain over the next 18 months, while the S&P 500 averaged 10 per cent in U.S. dollars and 12 per cent in Canadian dollars.

Mutual fund sales figures show that while investors have shown increased interest in global investing this year, they've been wary of putting money directly into the U.S. market. Right now, though, the U.S. stock market looks attractive.

"We are pounding the table to get our retail clients' attention," said Vincent Delisle, strategist at Scotia Capital. "Unfortunately, people will probably get more interested in U.S. stocks after the S&P 500 is 10 to 15 per cent higher."

Canadian investors have had some good reasons to keep their money at home rather than investing in U.S. stocks. The commodity boom driven by soaring oil and metal prices has pushed the S&P/TSX composite index to a cumulative gain of 65 per cent over the past three years, while the S&P 500 has risen 30 per cent. In the past 12 months, the S&P/TSX is up 13 per cent and the S&P 500 is up just 4 per cent. Year to date, we're up 6.5 per cent, and they're up 1.4 per cent.

War in the Middle East has driven up oil prices lately, and the machinations involving Inco Ltd. show that there's still a lot of enthusiasm for metal stocks. That's all good for the Canadian market.

But a halt in interest rate increases by the Fed suggests slower growth in the United States, the world's largest economy and a huge market for commodities. That's not good for the Canadian market.

The sector weightings of the Canadian and U.S. markets help explain why American stocks may outperform in the next 18 months. About 27.5 per cent of the S&P/TSX composite index is in the energy sector, which according to Scotia Capital is the worst-performing TSX sector in the year and a half after a Fed pause. The S&P 500 has a weighting of approximately 9 per cent or so in energy and materials.

One of the best performing sectors after a Fed pause is financials, the largest sector in both the Canadian and U.S. benchmark indexes. But there's more than twice as much exposure to the other top post-pause sectors -- consumer staples, utilities and telecom -- in the S&P 500 as there is in the S&P/TSX composite. The S&P 500 also includes more large-sized, dominant companies, which tend to do well in the slower-growth environment that follows a Fed pause.

Historical data tells us nothing of any certainty about what's to come, but Mr. Delisle said the U.S. market has already started to follow its usual pattern when rates have peaked. "For the past six weeks, the S&P 500 has been trading in a textbook Fed-pause fashion. The outperformers have been health care, utilities, consumer staples, financials and telecom."

The great thing about the U.S. market is that, unlike in Canada, you can invest in the broad indexes or in virtually any sector through exchange-traded funds and, to a lesser extent, mutual funds. There are a few sector ETFs for Canadian stocks, but none for consumer staples, telecom or utilities.

If you prefer mutual funds, then take a look at the list of U.S. equity funds that accompanies this article. The funds were selected by the independent analyst Dave Paterson of Paterson & Associates on the basis of their job their managers have done, and their balancing of risk and returns.

Index funds are another option -- they give you exposure to the S&P 500, the Dow Jones industrial average and other indexes in a package that comes with much lower fees than traditional mutual funds. Two good low-cost choices in U.S. index funds are the e series from TD Asset Management -- they're sold only on the Internet directly from TD or through the on-line broker TD Waterhouse -- and the Precision series from the no-load fund company Altamira Investment Services.

If you have a brokerage account, then you're better off with ETFs. There are cost reasons for this, and flexibility issues as well.

While index funds are generally sold without fees of any kind, you'll have to pay a commission to buy an ETF that would range from a minimum \$20 to \$29 at on-line broker. You'll be more than compensated for this cost through the low management expense ratio, however. The average U.S. equity funds MER is 2.70 per cent, while ETFs covering the broad U.S. market clock in at anywhere from 0.07 per cent to 0.24 per cent.

With ETFs, you can also buy into the sectors that have historically outperformed after a rate peak. Some examples:

Select Sector-SPDR Consumer Staples (XLP-American Stock Exchange): Gives you exposure to companies such as Procter & Gamble Co., Altria Group Inc., Wal-Mart Stores Inc., PepsiCo Inc., Coca-Cola Co. and Anheuser-Busch Cos. Inc., and offers a low MER of just 0.25 per cent.

Vanguard Utilities ETF (VPU-Amex): Not very actively traded, but you do get a MER of 0.25 per cent and dividend yield of 3.4 per cent.

iShares Dow Jones U.S. Telecommunications Sector Index Fund (IYZ-Amex): The MER is a bit stiff at 0.6 per cent, but this is still an easy way to own the shares of major phone utilities like AT&T Inc., Verizon Communications Inc., Sprint Nextel Corp. and Canada's own BCE Inc.

Before you buy these or any other U.S. market ETFs, be sure to look at all your choices. There are multiple ETFs for each index and sector and they differ widely in terms of their fees and trading volumes, which is more of an issue for active traders than for buy-and-hold types. The American Stock Exchange website at amex.com is a good place to get an overview of the ETF marketplace in the United States.

One of the main reasons why Canadians have been gun-shy about investing in the U.S. market is because the rising loonie has depressed returns from American stocks. If you're concerned about losing out on some of the gains from the U.S. markets if our dollar keeps rising, then consider an ETF or mutual fund that uses hedging to screen out an impact from currency fluctuations.

The iShares CDN S&P 500 Index Fund is listed on the Toronto Stock Exchange under the symbol XSP, and it has an MER of 0.24 per cent. If you like the idea of hedging, there are also some U.S. equity funds that use it (examples include RBC O'Shaughnessy U.S. Value, Mutual Beacon and AIC American Focused) and some index funds that do so.

The view on hedging taken by Mr. Delisle of Scotia Capital is that investors may not want to bother. He sees the loonie being flat to slightly up against the U.S. dollar in the months ahead, and he argues that with our dollar having risen to the 90-cent (U.S.) range, there isn't a lot of upside left.

"I would not expect the Canadian dollar in the next 12 to 18 months to dramatically eat away from any upward potential performance from U.S. equities."

Mutual funds

We asked independent mutual fund analyst Dave Paterson of Paterson

& Associates for this top three U.S. equity funds. Here they are:

Chou Associates

MER 1.74 per cent

Minimum Investment \$10,000

Note: "This fund is very well managed...the manager looks for funds that have at least a 40 per cent to 50 per cent discount from what the manager feels the "true value" for the stock is...performance has been strong, both on an absolute and risk adjusted basis, outperforming the S&P500 (in C\$) in 40 of the past 60 months."

RBC O'Shaughnessy U.S. Value

MER 1.57 per cent

Minimum Investment \$1,000

Note: "Performance has been strong, both on an absolute and risk adjusted basis...all currency exposure is hedged back to the Canadian dollar, a positive in a rising Canadian dollar environment...costs are reasonable."

CI Value Trust

MER 2.63 per cent

Minimum Investment \$500

Note: "This fund has been having a bit of a struggle so far this year and is lagging the broader index by a bit...the manager has an impressive track record and a strong security selection process....I do have some concerns about this fund, specifically the level of volatility."

Index & exchange-traded funds

Here's a selection of low-cost index funds and exchange-traded funds that allow you to buy exposure to

the U.S. stock market in a single investment.

TD Dow Jones Average Index - e

MER 0.31 per cent

Minimum Investment \$100

Note: Must be purchased on-line through TD, or the on-line broker TD Waterhouse

TD U.S. Index - e

MER 0.33

Minimum Investment \$100

Note: Tracks the S&P 500 index

RSP Index - e

MER 0.48 per cent

Minimum Investment: \$100

Note: This fund is insulated against currency fluctuations.

Altamira Precision Dow 30 Index

MER 0.54

Minimum Investment \$1,000

Note: Tracks the Dow Jones industrial average.

Altamira Precision U.S. RSP Index

MER 0.54

Minimum Investment \$1,000

Note: Tracks the S&P 500 index and offers protection against currency swings.

iShares CDN S&P 500 Index

MER 0.24 per cent

Minimum Investment None

Note: Protected against currency moves.

iShares S&P 500 Index

MER 0.09 per cent

Minimum Investment None

Note: Cheap exposure to the S&P 500, but no currency protection.

Diamonds

MER 0.18 per cent

Minimum Investment None

Note: Tracks the Dow Jones industrial average.

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