

North American markets posted strong returns during 2010. The annual total return for the TSX was 17.6%, 14.96% for the S&P 500® and 17.47% for the NASDAQ. The entire total return for equity markets was achieved during the August to December period. Markets returned over twenty per cent during the last five months of 2010; one of the best return periods during the past forty years and a sharp reversal of the year's earlier losses.

This strong turnaround from the losses incurred during the first seven months of the year was built on the hope that the U.S. economy would by-pass a double dip recession and that both business and consumer confidence were improving. Prospects for GDP growth and unemployment were reported to be improving as well. In addition, the recent U.S. elections and a move by the Democrats to the center of the U.S. political spectrum have resulted in a Congress that appears friendlier to business. This new political environment in Washington gave investors hope that a more business friendly administration would be positive for the economy and markets.

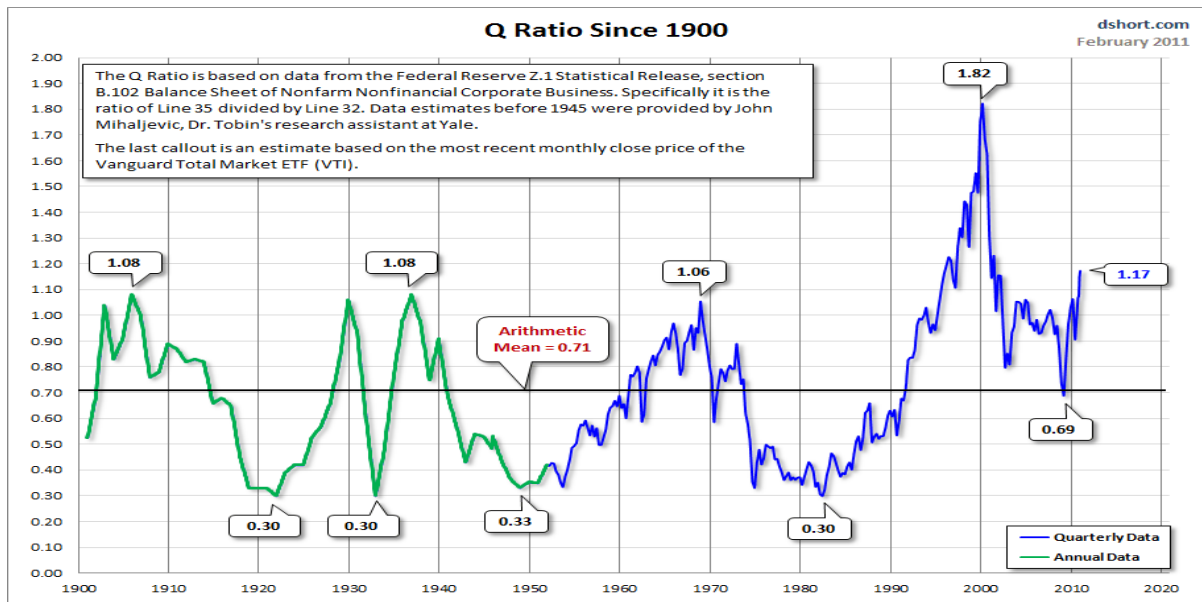
In stark contrast to the first half of the year, market participants initially grew more tolerant of potentially troublesome economic developments and then almost euphoric as price momentum increased. The continuing debt crises in Europe, potential rate hikes in China and negative developments on the U.S. housing front were all overlooked. Investors reacted very positively to the Federal Reserve's quantitative easing program in the anticipation that increased liquidity would spur equity markets higher.

The Wall Street Journal captures investor sentiment in the following quote:

“Wall Street is booming lately. The Dow Jones Industrial Average has risen 22% since last summer, and the Nasdaq Composite 30%. Market spirits are up. The optimists are out in force. And after an impressive 2010, stock market strategists are forecasting good gains for 2011.”

As you might expect we are of a different mindset. We believe that now is the time to be very cautious. The past year’s strong returns have increased valuations to levels that we feel are extremely risky. As the charts below indicate equity valuations are at the high end of the valuation range and in risky territory. From today’s price levels the potential returns do not justify the risk of potential losses.

Chart 1
Tobin Q Ratio



Source: dshort.com

Chart 2



Source: The Chartstore.com

Tobin's Q Ratio, a measure of stock market capitalization to aggregate economic asset values, is flashing red and the dividend yield on the S&P 500 is below two per cent. This low dividend yield has historically been an indication of dangerous valuation.

Canadian equity markets are also in the danger zone; also driven by the factors described above. Aggregate valuation statistics on the TSX are near all-time highs. International investors see Canada as a safe play on emerging markets and have been buying Canadian equities; particularly resource companies as a means of obtaining investment exposure to emerging markets. Historically, such circumstances have pointed to a market top. Once investor sentiment towards Canada changes these international investors quickly pull their investments out of Canada. Consequently, Canadian equities and the Canadian dollar suffer large drops.

At the root of this enthusiasm in financial markets is the old adage; don't fight the Fed. This approach essentially says that as long as the Federal Reserve is pursuing loose monetary policies money will flow into financial markets driving prices upward. This belief coupled with the view that government authorities will bail out financial markets in the event of trouble has once again resulted in excess valuations across several asset classes. Not only are most broad based equity indices overvalued but fixed income markets, commodity prices, emerging market equity and bond markets are all severely overvalued.

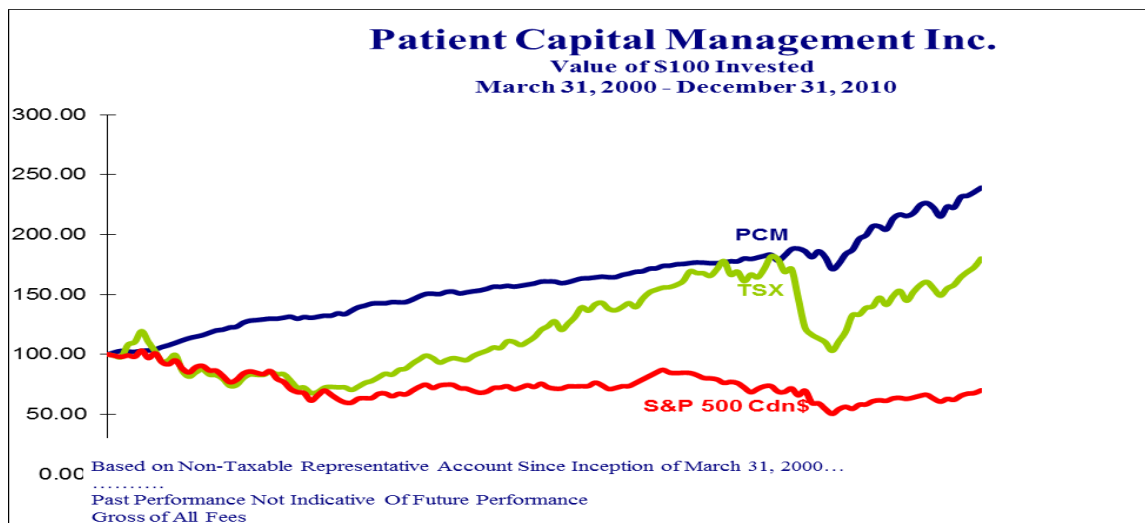
We believe that relying on Central Bankers to pump up and/or bail out financial markets is SPECULATION! Current policies implemented by the Federal Reserve create speculative rallies resulting in boom and bust cycles. There is ample historical evidence that these situations end badly. The substantial loses in Japanese equities in 1989, the technology bubble in 2000 and the financial meltdown in 2008 all had their roots in low interest rates and the strong belief that monetary authorities would prevent problems in financial markets.

Strongly rising markets are a double edged sword. We have enjoyed the recent strength in the markets as we have taken substantial profits in many of our holdings over the past several months and most of our remaining holdings have shown strong appreciation. On the other hand, current circumstances make it difficult to find investments that meet our very high standards of value and quality.

We are fortunate and thankful that you have given us the mandate to wait until we find the opportunities that meet our criteria to reinvest the proceeds. Unlike other managers who must be fully invested we do not have to compromise on our investment criteria just to meet an arbitrary mandate.

Buy securities at very attractive valuations, sell at intrinsic value and wait for the next “perfect pitch”. This is how we have managed your capital at PCM. This philosophy has proven to preserve and grow capital over the long term with much lower risk. While in any one year performance relative to a benchmark is random, over several years our strategy has proven to provide excess returns as the graph below illustrates.

Chart 3



Over the past several months Domenic and I have been meeting with many of you to conduct our annual review. We are always humbled when you thank us for managing your capital. It is we who are truly grateful for the privilege of working with all of you. Your trust in our approach and patience in seeing our strategy through is a rare blessing in our industry.

We wish all of you and your families the very best for 2011.

Vito Maida

February 7th, 2011
