

Sunday, September 21, 2008

Dear Client:

As I write this, the markets have taken a breather on the weekend after one of the wildest weeks on record after being down 7% at the end of Wednesday, the Canadian market ended up 1% for the week.

There has been a lot of anxiety among investors and investment industry professionals. Clearly, these are challenging times. No one can predict exactly what lies ahead in the next few days, weeks or months.

Given the uncertain times in which we find ourselves, I thought it would be helpful to review some of the fundamental truths about investing which have guided my approach to designing your portfolio and are at the heart of the advice that I have given you. As well, I wanted to share my outlook for the period ahead.

Please note that while I normally try to keep my correspondence fairly short, the circumstances today have made this note longer than normal – please bear with me as you read this.

There are six principles that guide the advice you've received:

1. *Well chosen funds outperform every other asset class over the long run*

The U.S. stock market is the one that provides the best data over a lengthy period of time, with information going back to 1925. If we go back to that time (which includes the great stock market crash and depression of the 1930s) stocks of large American companies have outperformed the bonds of those same companies by a margin of roughly 1.75 to 1. That means the money made from stocks was almost twice that on bonds over 5 years and with compounding nearly three times that of bonds over a 20-year time-frame. If you'd like more information on this, please let me know and we can discuss in greater detail.

Note: The difference in returns becomes dramatically more compelling if expressed after inflation and taxes – unfortunately, this risks adding complexity and perhaps is best covered in a follow up conversation.

2. *The price you pay for that superior performance is volatility*

Along with superior performance comes volatility. As a general rule, stock markets make money roughly three out of four years. That means, of course, they lose money that fourth year – the reason stocks are a good long term investment is they do well enough in the 75% of the time they make money to offset the 25% of the time they lose it. Academics call the margin of outperformance for stocks over cash the *equity risk premium*. In fact, academics say that if stocks were not risky, they would not provide a superior return – stocks have to provide higher returns over time to compensate investors for their volatility. If they weren't volatile, their return would be the same as GICs. If you'd like to discuss the principle of the risk premium in stocks and what it means when we talk next, I'd be happy to do so.

3. *Volatility cannot be avoided in the short term*

All of us would love to own stocks when they rise and to be on the sidelines when they fall. Unfortunately, that's simply not possible. If you were to ask a group of investment professionals to name someone who did a consistently great job of picking stocks over a long period of time, a number of obvious candidates would emerge – John Templeton globally, Warren Buffett in the United States, Bob Krembil who ran Trimark Funds until 2000 here in Canada.

Ask those same professionals to name someone who has consistently predicted when to get into and out of the stock market and they'd draw a blank. Lots of people have made one, two or even three good calls on when to get out of the market. However, no one has demonstrated the ability to get this consistently right – and people who have tried to time getting into and out of markets have typically been wrong at least as often as they're right.

Investing always entails a combination of pain and gain – the only question is when they occur. When we have weeks like the past one, the pain of investing is immediate, the gain is in future.

If you avoid stocks, the gain in peace of mind is immediate; the pain in lost opportunity and retirement lifestyle is down the road.

In times like these, sitting on the sidelines can be tempting and that's certainly an option if you truly can't live with the volatility we've experienced of late. Let us remember, however, that history shows that when stocks recover from a significant drop, they tend to do it very quickly – being out of the market can mean missing a rise of 25% or more.

4. *Volatility decreases the longer you invest*

The good news about volatility and risk is that the longer your time horizon, the less of an issue it is. Looked at over periods of five or ten years, the variations in returns are reduced to a fairly modest level.

For investors who need to cash in their savings in the very near term, these markets do indeed pose a very real problem. Before recommending that my clients purchase stocks for their portfolio, my team and I try to ensure that the money will not be needed in the short term – so that my clients are not in the position of being forced to sell.

For the very same reason, I normally advise against borrowing to buy stocks – investing is volatile enough without amplifying this by buying on margin.

Based on historical experience, for investors with a time horizon of ten years or more, volatility decreases to the point that it's almost a non-issue. The next time we meet, I'd be pleased to share some charts that illustrate this point.

5. *Investing based on fads and emotional reactions to events can be devastating*

In my twenty plus years in the investment industry, I've seen fads come and go and have observed how they can devastate portfolios. That is why I bring a conservative stance to the portfolios that I construct for clients, avoiding "flavour of the day" investments that are hot one day and tend to plunge the next. For example, I'm proud to say that my clients were generally insulated from the effects of the tech crash in the early part of this decade. Yes, they missed some of the run up in technology stocks in 1999 and 2000 – but also missed the bloodbath that followed.

Similarly, emotional reactions can be fatal to a well-balanced portfolio. There's a well known expression that most investors fluctuate between and that is fear and greed. Excessive optimism has dominated in the past until recently; today it is fear and pessimism that rule the day.

Making decisions based on fear and greed can destroy value in a portfolio. I see my role in part as being an emotional anchor for clients – preventing the emotional highs from being too high, and the lows from being too low. Until recently, my struggle with some clients was avoiding an overly optimistic viewpoint, throwing caution to the winds. Today, for some of those same clients, it's preventing an excessively pessimistic and negative outlook.

6. *Based on history, the right managers will prove their worth over time*

I spend a great deal of time conducting due diligence on the money managers that I recommend. Before I include money managers in client portfolios, I look for strong investment convictions and discipline, teams of investment professionals, consistent outperformance over an extended period of time and a track record of mitigating losses in downturns. And once I select a money manager, I spend a lot of time monitoring the stocks they're buying.

I believe that we have a strong team of managers in place that will serve us well over time. As I write this, those managers are looking for bargains among the stocks that have been beaten down by recent events.

Some clients have expressed the concern that we are standing pat in the face of turbulent markets. It's important to understand that while we may not be making changes in the managers we work with, beneath the surface your portfolio is being modified as these managers realign the stocks they hold to capitalize on opportunities.

The outlook for the period ahead

It is almost certain that stock markets will continue to see unusually high levels of volatility in the period ahead – and without question it will take some time for U.S. and Canadian markets and economies to work through the excesses of the recent past, whether from the U.S. housing bubble or the run up in commodity prices.

As we look past the current environment and ahead to the mid term, despite the ups and downs (especially the downs) of the past while, there are a number of things from which we can take encouragement:

1. Central banks around the world have made it clear that they will intervene if that's what it takes to keep markets functioning – as happened last week.
2. The ban announced in the US on short selling of financial institutions (a tactic used by some predatory investors to put pressure on the stock prices of those companies) is likely to reduce the extreme volatility in that sector.
3. To this point, this has been a financial crisis rather than an economic one. While economies in Canada, the U.S. and elsewhere have slowed, to date there is no sign of a steep recession on the horizon. The fact that the U.S. and Canadian central banks did not cut interest rates at their recent meetings suggests that they are not predicting a significant downturn – again, I'd be happy to discuss this with you when we talk next.
4. A number of very positive forces are in place for the mid-term. Among these are generally low inflation, the continued positive impact of technology and innovation on productivity, the overwhelmingly beneficial effects of increasing global trade, good economic and political news from most of Eastern Europe and South America and the unstoppable momentum towards opening up of markets in China, India and other parts of the developing world. Importantly, while declining oil prices have hurt stocks in the oil patch, they are helping boost consumer confidence and wallets.
5. Good managers are finding exceptional values today. As a result of the run up in financial stocks, some managers with a superior track record for picking stocks, largely avoided the U.S. financial sector because of overheated valuations; in some instances, these managers are taking advantage of depressed prices and starting to buy these stocks.

In summary

The American sportswriter Damon Runyon once wrote: "The race may not go to the swift - nor the battle to the strong, but that's the way to bet."

When it comes to our investment strategy over the next while, it is of course possible that all the past lessons may not be of value going forward and some managers who have proven their worth in the past may fail us in the future. That said, when it comes to investing, building on the lessons of history and putting managers with strong track records to work for us is the best way to tilt the odds in our favour.

Should you have any immediate questions, I would be pleased to speak with you, either in person or arrange to have an appointment over the phone. Thank you for the continued opportunity to work with you – I truly value our relationship and look forward to serving as your financial advisor for many years to come.

Sincerely,

Donald G. Flack CFP, CLU, CH FC

Halton Financial Group