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A Note on Risk ... and Regulation

June 2007

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Risk and Return

The questions of risk, (and the mirror issue of expected returns), are probably the most important questions for an investor to understand. The risk/reward tradeoff is based on the concept that higher-risk investments are expected to generate higher returns over time. Technically speaking, investors are said to require higher compensation for the increased uncertainty or risk that an investment holds.

In designing a portfolio, the risk/return equation starts with the balance between the two major asset classes, stocks and bonds, which are polar opposites in many ways. Stocks represent a share in the ownership of a company, whereas bonds are debt: bondholders are lending their money to a government or corporate issuer.

Stocks are more volatile in the short term, for instance: a major decline in stocks is a drop of 30% to 50%, whereas a bad year in bonds is usually a drop of only 5% or 10%, such as in 1994.

The uncertainty doesn't end there. A stock market decline can take anywhere from a week (October 1987) to 3 years (March 2000 – 2003), and the recovery can vary over similar timeframes as well.

So over short periods like 1-5 years, stocks seem indeed 'risky', while bonds appear low risk.

Unfortunately, the long-term picture is not so clear. In fact longer term, the risk picture reverses itself completely, so that bonds become a danger, and stocks become a much safer bet.

Returns from bonds are historically lower than stocks. In a taxable account, the return from bonds after inflation is generally close to zero. This means that the purchasing power of your money will not keep pace with inflation, and you will be losing purchasing power each year. If you try to withdraw money at say 6% or 7% per year from a taxable bond portfolio, in 15 years you are probably out of money. This is not good.

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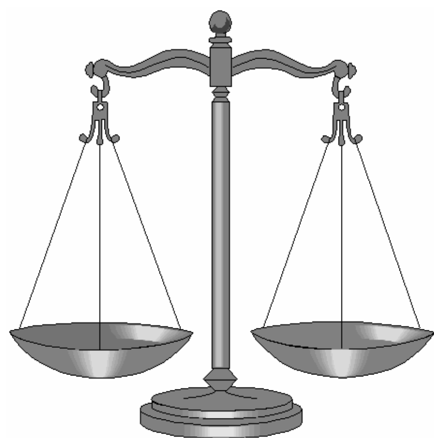

On the other hand, the longer term return from equities is, although variable and unpredictable, historically much higher than inflation. You may not know how much your portfolio will be worth year to year, but over the longer term, you can be more confident that your purchasing power will be protected.

When you view the money management challenge over a longer term, you see that the problem is to retain the purchasing power *after inflation* while withdrawing from the portfolio each year.

From this longer term perspective, the risk/reward equation gets turned around completely – the low risk assets (bonds) actually have a high probability that you will suffer a long-term loss of purchasing power, while the so-called high risk assets (equities) are actually safer, because they have the highest probability of generating an average return significantly greater than inflation, over 10 or more years.

A diversified equity-based portfolio provides the best opportunity to generate a positive return after tax and after inflation over a long period of time. And chances are that a 70-year old today is going to live for 15 years or more.

So even a 70 year old needs to have a significant portion of so-called 'high risk' assets in her portfolio to reduce the chance of running out of money.

Industry Regulation

As a licensed Financial Advisor, I am required by various regulatory authorities to keep certain information on each client. This information is required to be on a certain form (called the New Client Account Application or NAAF), so that it can be audited from time to time.

One of the purposes of the NAAF is to classify each of your portfolio holdings into one of three risk categories, 'High', 'Medium', or 'Low'. The objective is to have clients and advisors agree on the risk parameters of the portfolio.

So far, so good.

The risk category that a particular fund or other investment holding fits into is usually defined to some degree either by Assante's Compliance Department or in the 'Simplified Prospectus' for each fund. So you and I can agree that your portfolio is, for example, going to comprise 50% 'high risk' investments.

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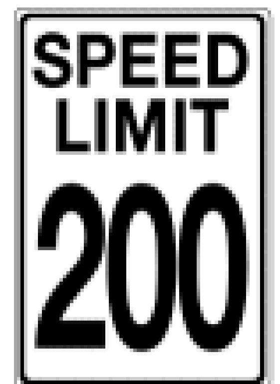
Unfortunately, neither the investment industry regulators, nor the fund companies, nor Assante Capital Management Ltd provides definitions of what 'high' or 'medium' or 'low' actually means. So although we agree that your portfolio is 50% 'high risk', we have no industry standard on what high risk actually is.

We are therefore in the situation where the definition of risk depends on who is doing the defining. Since risk is not actually quantified, the difference between 'high' and 'medium' risk is left to the advisor to explain. It is therefore entirely possible that the client's perception is different from the advisor's perception.

This situation is analogous to the highway speed signs being posted as 'high' or 'medium', or 'low'. Imagine if the speed limit on the 400 was posted as 'high'. You and I can easily agree that we want to go fast, for example, but you could still be scared silly when you see what I think fast is.



This is why I spend so much time discussing with you the potential for your portfolio to decline in market value. To do this we use actual historical market data to estimate how much of a decline in market value you could expect from your portfolio under adverse market conditions.

This downside risk testing allows you, the client, to estimate an actual dollar decline, and to judge whether the risk is acceptable in light of the return that you require to meet your goals.

Of course the intent is to demonstrate approximate downside risk, so that you have a more specific idea of what 'high', 'medium', or 'low' actually means.

If you would like a refresher on your personal downside risk, please call me and we'll discuss.

Risk in the World Today

Today the world is experiencing one of the greatest economic growth periods in history. Global GDP growth has averaged over 5% per year for the last 5 years, according to the Bank Credit Analyst, a highbrow independent analytics firm.

Unemployment in Canada is at a 30-year low. Inflation, the scourge of economic growth in the 70s, in the G7 countries is around 2%, having fluctuated between 1% and 3% for more than 10 years now.

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As a result of low inflation, interest rates remain low at around 4½%. (Ten years ago, the idea of 4% interest rates seemed impossible.) Low inflation and low interest rates allow people and companies to make long-term investment decisions, say for equipment, machinery, or a house, with confidence in the future.

What is driving economic growth? Three primary factors, according to the BCA: Global trade, new technologies, and economic reforms.

Global trade, driven by free trade agreements and the emergence of the post-communist and other underdeveloped nations, is probably the single most important economic development in the world today.

Global trade allows the citizens of emerging nations to sell their goods and get a foot onto the economic ladder. Trade allows developed nations access to low-cost labour for the simple things that their citizens require, like clothing and manufactured goods. Yet with unemployment at 30-year lows, labour from say India or China has not expanded at the cost of Canadian jobs.

Free trade encourages individual enterprise and economic freedoms in emerging nations. Economic freedom goes hand-in-hand with political freedom, and surely economic and political freedom is the fundamental progress of humanity.

Technology has tremendously facilitated trade and other economic efficiencies. For example, companies like UPS make extensive use of technology to revolutionize global logistics in ways that were unimaginable just a few years ago.

The improvements in G7 productivity have led to unprecedented growth in corporate profits. Companies have used these profits to pay down debt, buy back shares (a way to return capital to shareholders) and make investments in technology and equipment to improve productivity and reduce pollution even further.

What threats are there to the boom?

If the boom is driven by global trade and other economic activity, then obviously anything that threatens trade is a potential problem. Probably the biggest risk here is political, for instance, the election of an anti-free-trade President in the US next November, or a minority Parliament on Ottawa starting a trade war with an important partner.

Free trade is a tricky thing for politicians. Its benefits, while able to transform the world (no less the Canadian economy too) for better, are diffuse and take time to emerge. Trade can therefore fall victim to short-sighted and self-serving political slogans. Protected industries, such as dairy farmers in Canada, are very profitable and it is therefore in their interest to fight hard to maintain their protection.

The interesting thing about this particular economic cycle is that these factors (trade, technology, and reforms) are more structural and less cyclical in nature, so they could go on for a long time.

The beginnings of the global trade and deregulation boom were in Deng's liberalization of China, Gorbachev's glasnost, Thatcher's breaking of the UK unions, Reagan's breaking of the air traffic controller's strike, and Mulroney's pushing free trade with the US. (see 'Summer Reading')

Just as these liberalizations took years to take effect, it may take years for negative political developments to erode them and push us back into a socialist/communist/tariff-protected world. If we as a society are able to embrace economic liberty as a value, these structural forces may be in place for a long time yet.

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Investment Market Risk Today

Looking at the investment markets, the media are full of their usual gloom. Adding to the litany of financial woes, we even have the hysteria of human CO2 emissions driving catastrophic global warming. (A perfect media issue: long on conjecture, short on data, incorporates rich/poor tensions and impossible solutions.)

Looking at investment markets, the primary indicators of risk are the valuation measures such as the Price/Earnings ratio (P/E). Valuation measures in global markets are reasonable, within historical norms, so in this regard the risk of a calamitous drop in markets is limited. Not zero, but not dangerous.

As this is written (June 07) there is some hoopla in the media about markets at record levels. Always trying to alarm and disturb, the media implies that record heights must reflect severe risk. However, as I mentioned in my January 2007 newsletter, the US market today is only recovering the levels it reached in 2000 - 7 years ago. Since markets tend to rise over time, it is only logical that they spend a lot of time in 'record territory'.

Not only are market valuations reasonable, but the media has gone silent on its last pet bugaboo, the US trade deficit. No wonder, because the deficit is beginning to decline. Last month, the decline in the monthly US trade deficit was revised downward for the second month in a row. The decline, as predicted here, ('Dollars, Deficits, and Markets', www.chrishoran.ca) is the natural consequence of the US currency declining as it has.

Markets are always susceptible to a short-term shock, and today is no exception. The equity markets have had quite a run and are overdue for a correction of 10% or more. Many commodity prices are far above the long-term cost of production and are therefore susceptible to price declines.

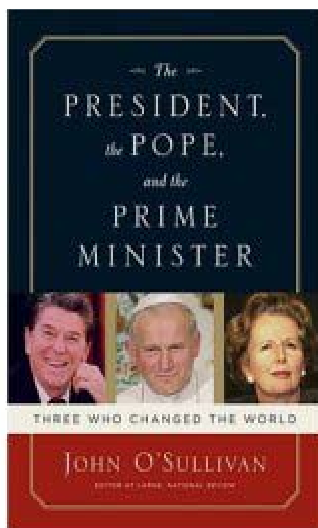
Probably the most dangerous animal in the global zoo today is Putin's Russia - a totalitarian state devoid of personal freedoms, run by barons and a king with no thoughts of a Magna Carta, and a still-potent military to spend its considerable oil dollars on. Worse, Russia probably feels a little left behind by the freedoms and quality of life progress being made elsewhere around the world.

So I would not be at all surprised by a shock of some sort - a market correction - possibly driven by Russion belligerence over something, the Chinese government yanking the leash of personal freedoms, or the Mideast finally catching fire.

The investment climate today is reminiscent of the 1980s: a strong economic rebound off a very significant decline, skepticism of the recovery, and a fundamental change in economic structure that is only beginning to dawn on people. In the 80s it was interest rates and inflation declining. This time around it could be the emergence of 2 billion people onto the world stage.

Bottom line: the world economy is as good as it has ever been. Always fly with your seatbelt fastened, and be ready for sudden turbulence.

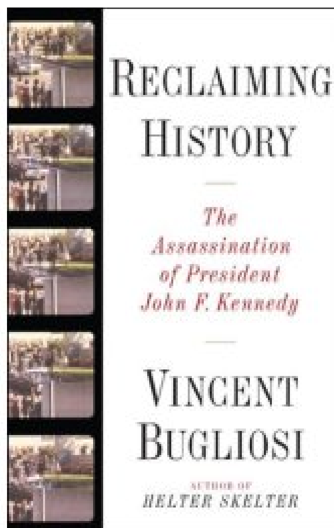
Summer Reading



In *The President, The Pope, and The Prime Minister*, John O'Sullivan shows how three world leaders worked from personal strength, courage and conviction to revitalize the West and force the bankruptcy of the Soviet Union.

He uses some great little stories, for instance, when the Polish Communists decreed the church would not be permitted to hold Mass, the church proposed Masses door to door; the Communists threatened to block door to door Mass, John Paul, a Pole, said he'd pop up from the Vatican and do a few Masses himself.

Contrary to popular opinion, it was Reagan's personal command of the issues, and his personal comments to Gorbachev in Iceland, that convinced the Russians that Reagan was not about to back down on missile defense.



Reclaiming History – The Assassination of John F Kennedy, by Vincent Bugliosi.

Just so you don't think your advisor never changes his mind, I *was* a firm believer in the conspiracy idea behind the assassination of JFK ... probably influenced by Oliver Stone, and after reading J Edgar Hoover's biography a few years ago, I was pretty sure that there had to be something going on behind Lee Harvey Oswald and Jack Ruby.

Vincent 'The Bug' Bugliosi, a master lawyer (prosecuted OJ Simpson and Charles Manson of Tate/LaBianca fame) recounts the agreed facts in a spellbinding brief of the assasination, and then addresses each of the conspiracy theories, arguing very persuasively against each. His particularly scathing criticism of Oliver Stone is worth reading for anyone who is interested in the importance of truth.

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