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Accretive Elite™ Advisor

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Accretive Elite™ Advisor

I am pleased to announce that I am one of (fewer than 50) Advisors in Canada to have qualified for the Accretive Elite™ advisor status.

Qualifications for Elite Advisor status involve a rigorous multi-dimensional process including a survey of clients. See: http://www.accretiveadvisor.com/advisor/elite/AssanteWealthManagement_choran

Thank you very much for your continued loyalty and confidence.

Review

You will have received your December 2011 account statements recently. Very likely your portfolio will be down over the year, as the decline of 12% in the TSX and 8.3% in Europe were not offset by gains in the bonds you may have held, and although US equities recovered strongly in the last quarter, over the year they returned exactly zero[1].

Keep Your Statements

Please keep your Assante and your money manager statements (much as you may be tempted to throw them out). They may contain important tax information. Please file the statements with your other tax papers so your accountant can refer to them at tax time.

Dangerous Times

These are dangerous times to be an investor. While it is perfectly understandable to be nervous or frustrated with investment markets today, the danger may not be where you think it is. The financial world is a dangerous place and not everyone is your friend.

The danger today is anxiety and frustration, and the temptation to do something different. Most of my clients have a 5 year return somewhere close to zero[2]. The news stream holds little to be confident about and much to fear. Anxious investors are open to being seduced by 'a second opinion': a sales pitch to change your strategy[3].

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[1] MSCI Europe, C$, S&P500 Index, 2011
[2] Represented by a $2 million balanced account, measured by an independent measurement service.
[3] A bank even has a marketing campaign called 'Second Opinion'. The way it works is the broker finds something negative about the person's portfolio that can be used to disturb them enough to move their account. The highly doubtful implication is that the broker would never have done what you did. The test, by the way, is to ask the broker for a copy of a million-dollar client statement from 10 years ago and see what he was actually doing.

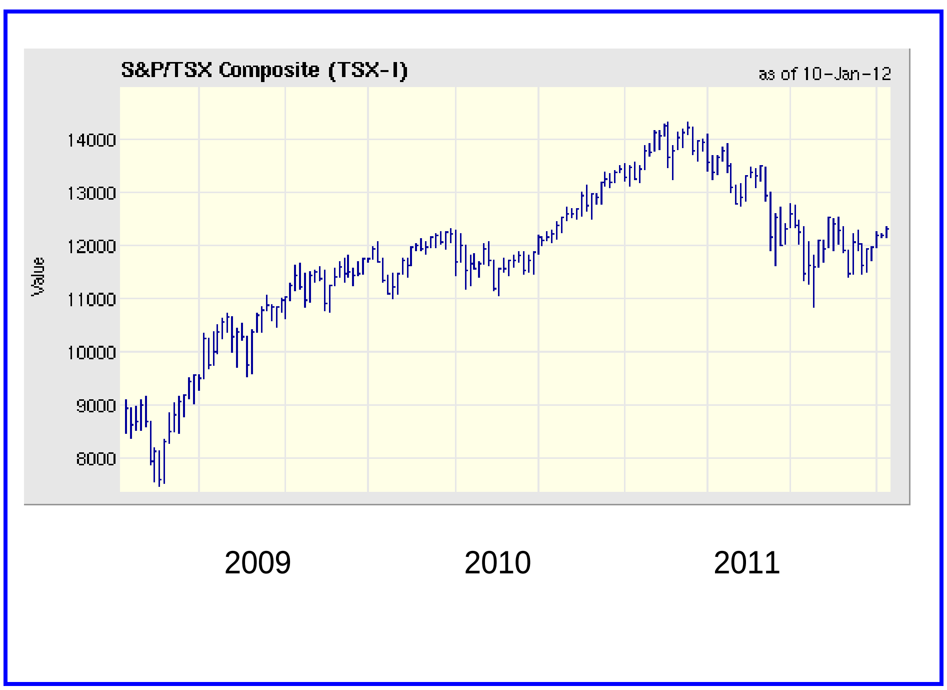
A change in strategy now will almost certainly take you into something whose last 5 or 10 years looks better than yours. [A 5 year return of zero is actually good, since the world markets are -4.5%/yr.] And something – the only thing - that has done well in the last 5 years – bonds – is highly likely to **lose** purchasing power over the next 10 years. (sound familiar? See *Déjà vu All Over Again*, www.chrishoran.ca).

A change in strategy now, besides being almost certainly based on a less-than-honest sales pitch, will probably provide a few months of relief, followed by a lifetime of regret.

2011 Rear View Mirror

The surprise asset class of 2011 was the bond market: the decline in government bond yields, for yet another year, resulted in a return of 10% in the US Treasury (bond) market[4] (bonds go up when rates decline, and down when rates rise[5]. The surprise behind the bond market was the Euro crisis and its threat to the global economy, which forced interest rates lower – German bonds actually sold at a negative interest rate, such was the level of panic.

The chart below shows the story of the Canadian market over the past 3 years: the recovery from the 2009 lows resumed strongly through mid-2011 before the Euro crisis hit. In the context of 3 years, though, the summer of 2011 begins to take its place as a temporary correction.



4 Bank of America Broad Bond Market Index. C$, 2011 Source: Morningstar
5 For a refresher on how bonds work, see 'Primer on Bonds' www.chrishoran.ca

The Very Big Picture

The aftershocks of the financial crisis that began in the United States in 2007 continue today. The banking crisis was a deflationary economic shock that has jolted consumers to increase saving – also contractionary - and forced large government deficits to recapitalize the banking system and counter the economic contraction. Now everyone is realizing that high debt in a low-growth world is a deadly combination (except Canadians, who are using 30-year mortgages to chase housing at all-time highs …).

Nevertheless, the US economy continues the slow but steady recovery that began in mid-2009, and should post growth of about 2% for 2011. This is good. The US housing market decline appears to have reached a bottom, and unemployment has dropped from over 9% to 8.3%[6]. Even the US trade deficit, which you may recall as financial journalism's previous favorite monster, has declined sharply. All good.

[Reports that growth of 2% is weaker than past recoveries are factually correct but miss the point: past recoveries were rebounds from interest rate-induced recessions, and were therefore more of an economic 'catch-up'. Conversely, this time is a 'balance sheet recession', where consumers pay down debt regardless of low interest rates[7]. So a weak recovery is fine.]

Europe: At this point (February 2012) Europe is drifting towards calmer seas: Italian and Spanish bond yields are declining (good), the political rhetoric is now businesslike, and markets are rising. Markets are relieved that Italy and Spain are taking the decisions towards financial sustainability, and that the ECB has injected capital into the banking system (all good).

[We might all reflect on the fact that the new Italian Prime Minister, Mario Monti, an unelected technocrat, is succeeding in making the difficult decisions where the predecessor elected government was not…]

Greece is heading for default. The debate is about how much the bondholders (who are the lenders) will lose versus how much the European taxpayer will kick in. Taxpayers, rightfully so, are in no mood to kick in a nickel. The bondholders will lose a lot, as they should. And those banks that insured the bonds (through credit default swaps) will also lose a lot, as they should.

Greece is somewhat of a special case and is not a threat to the Euro at this point. Greece camouflaged its annual deficits for years, thereby keeping its interest rates artificially low while allowing total debt to build up, now past the point of no return. Greece ignored the fact that when debt is over 150% of GDP, even a mild increase in interest rates quickly swamps your ability to pay.

Greece is now in a financial death spiral as austerity compounds a sharp economic contraction, making it impossible to simultaneously raise tax revenues and implement the economic reforms that would sustain the economy.

The script for a sovereign default is well-known (courtesy of Chile, Argentina, Mexico, Brazil, etc). The US has the template for managing a major financial shock, and Greece is a zit on an elephant's back, so there is no reason why the Greek default shouldn't be contained.

Thus will the rules of debt be re-established.

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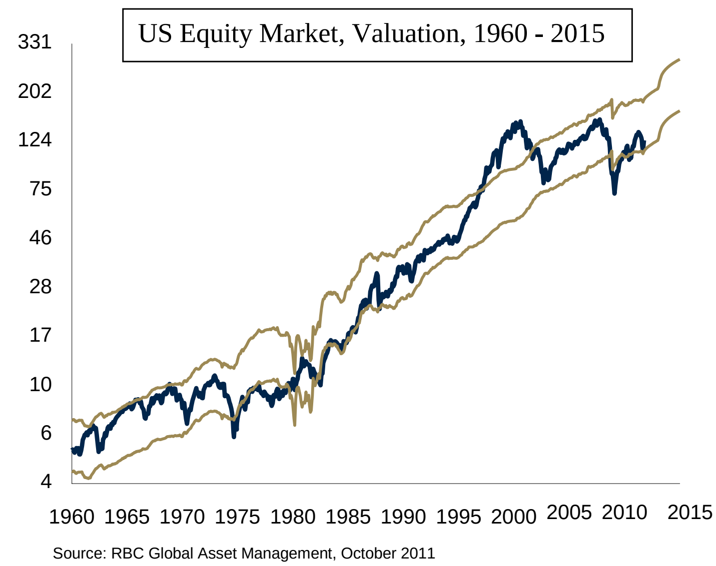
[6] Financial Times Feb 4, 2012. Trade data from The Economist.

[7] See Richard C Koo, 'Holy Grail of Macroeconomics', 2009; the only balance sheet recessions were the 1930s and Japan in the 1990s.

Investment Outlook



The chart above tells a story of a million words. It shows the US equity market from 1960 to 2011. The light colored bands are the range of high and low valuations, based on earnings and interest rates.

The chart shows 2 episodes in the last 50 years where the market went nowhere for more than 10 years: first from 1969 to 1982, and more recently from 1999 to today. During these periods, the market went from overvalued (near the upper line) to undervalued (near the lower line). The markets are as undervalued today as in 1982.

The markets were undervalued in 1982 (the 2nd year of my career) because things were horrible: the US market had just fallen 35%, the TSE was down 50%, inflation was over 10%, interest rates were 19%, and a Hollywood B movie actor was in the White House*. Investors wanted nothing to do with equities because real estate and gold had gone up much more (sound familiar?).

The markets are undervalued today for exactly the same reason: things have been horrible: The tech stock crash wiped out $10 trillion in 2003, government-mandated sub-prime lending crippled the US financial system in 2008, and then the 2011 Euro crisis threatened a nasty sequel.

The Credit Suisse Global Risk Appetite index, a measure of investor confidence, hit panic territory in each of the crises above. The last was the worst, a 30 year low, reached on October 4, 2011. This is panic territory for only the 4th time since 1980.

* Ronald Regan had the guts to crush the Soviet Union, and the tyranny of the public-sector unions by firing the Air Traffic Controllers, and allowed Volker to stop inflation.

RSP Reminder

The deadline for 2011 RSP contributions is Wednesday, February 29th, 2012. The limit is $22,450 for the 2011 tax year and for 2012 it rises to $22,970. (Please call Barb McKenzie to make arrangements!)

Your personal limit is on your Notice of Assessment from your 2010 Tax Return; your contributions to-date are on your Assante RSP statement.

Tax Free Savings Accounts (TFSAs)

Want to open a TFSA or transfer an existing TFSA to Assante?

Please contact Barb McKenzie at (416) 646-3836 or by email at bmckenzie@assante.com to find out how.

The Global Risk Appetite lows are associated with major market bottoms: in the 12 months following each the previous lows, the average total returns for the TSX and S&P 500 were 57% and 50% respectively. The three years following major lows in the GRA, the market returns were 96% and 80%[8].

Not only are GRA lows associated with major market bottoms, 10 year periods of low returns are precursors to very large gains.

The old expression, "The bigger the base, the bigger the bang' refers to the idea that the longer the price of something has gone sideways (i.e. built a base) the more it rises when it finally moves. (There is strong psychology behind the idea, but it will have to wait for another newsletter.)

The other time that the market went nowhere for 10 years was the 1930s. So today is the third time in 100 years. Both those previous times were followed by markets rising more than tenfold. The chart on page 4, which is a logarithmic scale, shows that $10 invested in the early 80s is worth about $100 today.[9]

People laughed in 1982 when some guy named Warren Buffett said the US market was the cheapest in 30 years and investors should get ready to make a lot of money. Sound familiar?

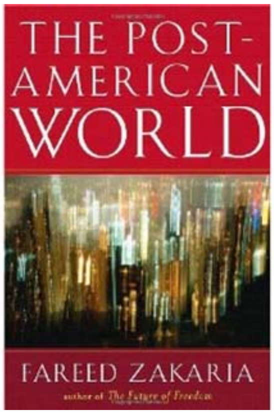
Here's the math:

Today the price/earnings ratio on US stocks is around 12[10]. If the P/E goes back to its 30-year average of 15 in 3 years, and company earnings grow at 8%, that would put the S&P500 at 1900 - a gain of more than 50% in 3 years from today's levels.

Just a guess.

[8] Tetrem Quarterly, January 2012, p4.
[9] Long term returns from Ibbotson, 1926-2010, and Towers Perrin *Economic Tables*
[10] S&P500 2011earnings estimate $100 per Bloomberg, Nick Murray; Index at December 2011= 1257 per Bloomberg

Book Review



The Post-American World, Fareed Zakaria, 2011 ed

The book is an excellent perspective on the United States in the modern world. Zakaria strikes a strong balance of readability and insight: clear writing covers a lot of ground quickly, yet he makes interesting points.

For instance, Zakaria observes that India's experiments with socialism in the 70s and 80s eroded the private sector and legitimized government intervention, which has now combined with the fractious, highly localized political system and resulted in a high degree of government self-interest and corruption. It is a great example of the fragility of the modern political economy, and the role that government policy plays.

Zakaria is refreshingly nonpartisan and reasonably optimistic. He is not calling for the decline and fall of the US, but rather for the continued growth of the 'others'. He says the challenges facing western democracy are on the citizens to solve. Many US problems are policy issues, which are more easily solved – by policy changes – than say Europe's demographics or Japan's aversion to immigration, and yet, he says, because the 'policy changes would involve short term pain, the political system cannot make them'. To me, the statement is a perfect encapsulation of the danger we face – it is us.

He shows how a multi-polar world could force the United States to act in a much more adult, thoughtful way. The world could be a very progressive and prosperous place, as the emerging world adopts the big picture principles that Britain and the US have followed for so long: mass education, economic and political freedom, and global trade.

A *New York Times* 'Notable Book of the Year', a *Seattle Times* 'Best Book of 2008'. An excellent perspective on the 21st century.