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## Reprints, Referrals

I have had a number of people suggest to me (strongly recommend) that I more formally publish the series of newsletter essays that I've written over the last 5 years or so. Together the essays make an excellent record of my analysis and advice to minimize tech stocks in favor of value stocks. Many clients have expressed their deep gratitude for having missed the tech bubble and growth stock losses as a result.

Copies of the articles are now available. I will be more than pleased to send you a copy and of course, if you have friends or family who might be interested in good advice, please put them in touch with my office, or let me know. I would appreciate the opportunity to send them the articles and/or talk personally.

Thank you.

# Bear Markets, Continued

The storm that has hit equity markets worldwide since April of this year has caused, in the words of the New York Times, 'Pain for the Record Books'. Since April the decline has broadened out to include even the value stocks and value managers that make up the bulk of my clients' portfolios. For many of you, this will be the first 3-month decline since 1998. How bad is it?

To the end of September, 2002, major stock market indexes posted their biggest 3-month declines since the 4th quarter of 1987. On October 19, 1987, known as 'The Crash of '87', stock markets fell about 25% *in one day*. It was pretty scary, for those of us who were there. According to The New York Times, US equity mutual funds, (many of which didn't do too badly in '87) have just finished their worst 3 months since 1981. That's more than *20 years* ago.

And that's just the latest three months. The broad markets, represented by indexes such as the S&P 500, the 500 largest US companies, have fallen almost 50% from their peaks of March 2000. Of the 21 major markets around the world tracked by The Economist, a business newspaper, the average decline from the record high is 51%. This year alone, the average decline is 27% (to October 5, 2002). Not *one* major market is positive. Stunning. The US market indexes are now back to where they were in 1997, five years ago. (Except for the NASDAQ, which is worse. And Japan, mired in group think and political dysfunction, is at a 17 year low).

These declines are bigger than 1981, when the TSE 300 as it was then known, fell 39% between June 1980 and June 1981. I remember well, because it was my first year in the business.

It's bigger than 1973-1974. The '73-'74 bear market has been the benchmark decline of the post-Depression era; it took the S&P index 21 months to slide 43% between December 1972 and September 1974. But the current decline, according to Ibbotson Associates, a market research firm, is now worse in both duration and magnitude than 1973-74, taking the 25 months from August 2000 to September 2002 for the S&P to fall 46%. Yikes!

In fact, to find a bigger drop, peak to trough, you have to go back to the 1930s. That's right, investors today have the dark privilege of living through the worst bear market since the 30s. This really is one for the record books.

Before you run for the sherry cabinet, let me point out something. None of my clients have experienced returns anything like the indexes referred to above. Almost all my clients have value managers as the dominant equity manager style. Anyone who has read my newsletter (back copies available – please ask) or spoken to me knows that the reason we have done so well compared to the averages is because of the strategy – diversified across markets, bonds in many accounts, value style managers, little or no technology/growth style stocks. I am very proud of this.

Meanwhile, what is the public doing? Public perception has turned away from the greed of only 2 ½ short years ago when everything seemed to go up in price forever and it all seemed so easy. Now the public is gripped by fear that the decline will never end. Fear drives the inexperienced public to sell good quality long-term investment assets at fire-sale prices. Want proof?

June and July of 2002, when the broad market was marking a 32% drop for the year, were the first 2 months of net redemptions from equity mutual funds in the US since September 2001, according to The Wall Street Journal. The third quarter of 2002 is the first quarter of net liquidation of equity mutual funds in the

## RESP Alert

Most clients are aware of the Registered Education Savings Plan (RESP), but there are some important things you should know.

The RESP program generally allows a maximum annual contribution of $4,000 per child. The Federal Government will pay a grant of 20% of the contribution up to a maximum of $400. This means that the first $2,000 each year will attract a grant of $400. (Additional contributions between $2,000 and $4,000 are allowed, but do not attract grant money.)

The thing most people are unaware of is that starting in 1998, each child who was a resident of Canada began to accumulate grant contribution room regardless of whether or not they had an RESP. This means that even if you don't have a plan yet, you can still catch up, but it will take several years. The reason for this is that because of the way the rules works, if you have missed past years, you can only contribute for one missed year at a time. In other words, if I just opened an RESP, I can contribute $2,000 for 2002 and $2,000 for 2001 now. Next year, I can contribute $2,000 for 2003 and $2,000 for 2000 and so on back to 1998. By the year 2005, I will have caught up.

The grant is a good deal (a 20% return is always good). If you miss this December, it will take another year to catch up. So check that your children or grandchildren's RESPs are up-to-date.

RESPs are complicated and the contribution rules are complex, so if you have any questions, please contact my assistant, Barb McKenzie or visit the HRDC web site at http://www.hrdc-drhc.gc.ca/hrib/learnlit/cesg/006_e.shtml

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Bear Markets, Continued

US since the terrorist attacks of September 2001; that historic market decline of Q3 2001 was the first quarter of net liquidations in the 10 years since Q3 1990, when Iraq invaded Kuwait and sent the markets to bear market lows.

The picture is similar in Canada, according to Morningstar, a mutual fund analytic firm. Canadian investors withdrew a record $743 million from Canadian and International equity funds in September 2002, the largest of 4 straight months of net withdrawals.

Much of the money that left equity funds went to bond funds. Of course, bond funds have recently been the best-performing asset group, turning in their best quarterly performance in the last 2 years, according to Morningstar. This flow of cash into the bond markets has driven interest rates down to 40-year lows. (As bond prices are pushed up, interest rates are driven down - please speak to me if you don't understand )

Unfortunately, investors piling into bonds now may be too late. In the opinion of Bill Gross, manager of the Pimco Total Return Bond Fund, the largest bond fund in the US, '*We are much closer to the end of the bond market rally than the beginning. There is much more risk in the bond market now than there has been for a long time. Bonds can go down just like stocks do.*' (He's referring to the probability that as the economic recovery picks up steam, interest rates tend to rise, pushing down bond prices).

In other words, neophyte investors continue to sell stocks in record volumes after a once-in-a lifetime decline in prices. They are buying bonds at 40-year high prices. The old 'sell low, buy high'. Except that the expression is 'buy low, sell high'.

What do the next 5 years look like? Of course, we can only learn from history, but history tells us that the markets tend to do well after periods of low returns. The evidence?

Let's look at 5-year average returns. We can go all the way back to 1929, which is when good data on markets is available. One way analysts look at long-term periods is by using overlapping or rolling 5-year periods. For example, the first 5-year period is 1929 to 1933; the next is 1930 to 1934, and so on all the way to 9/1997 to 9/2002. There are 69 of these rolling 5-year periods.

The current 5-year period is one of only 8 since 1929 where the US market has had a negative return, according to Ibbotson. If you exclude the 1930s, it is one of only 4.

Observation #1: a 5-year period of negative returns is very rare.

Observation #2: The average annual return for the 5 years following *every* negative five year period was at least 11% per year. Excluding the depression periods, the average 5-year return was 16% per year. In other words, a 5-year period of negative returns has *always* been followed by a 5-year return of *at least* 11% per year. Since the Depression, it has been followed by a 5 year return of *at least* 14%/yr.

I do not know whether the storm will clear tomorrow or not. I do not pretend to know whether the next 1,000 point move in the market will be up or down (only a fool does). What I do know is that storms at sea are inevitable. A good captain does not pretend to avoid all storms. A good captain 'battens down the hatches' to prepare the ship and will reassure the nervous owner that the ship will reach the destination. I also know that good investment, purchased at reasonable prices, and patiently held, will reward investors.

As they say in the investment business, '*Nobody rings a bell*' to signal the bottom of a market. It is only in hindsight that we see where the bottom was. But because the market looks towards the future, the markets will turn up well before you read about it in the paper.

Chances are, now that we've seen the worst drop in 65 years, we'll look back to today and see that the bottom was very close around here somewhere.

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