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## Investors Behaving Badly (Again)

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### Inside This Issue

1 Investors Behaving Badly (Again)

3 RSP Deadline

4 Book Review

*The four most dangerous words in investing are, "This time it is different".*

*Sir John Templeton*

Peter Lynch, while manager of Fidelity's Magellan Fund, famously remarked once that even though his fund was one of the top-performing global equity funds on the planet over 10 years, his analysis showed that most of the investors' dollars in the fund didn't make any money.

This essay will explain the phenomenon, and will demonstrate how long-term investment success is much more about behaviour than it is about investment performance.

In 2005 the TSX, the main stock market index in Canada, had a total return of about 24%. That's not a bad year. It is certainly a much better return than from bonds, which were about 6%.

In fact the TSX is the only major market of the world to be even close to its peak of 2000, according to *The Economist*. European markets are on average still almost 30% below their peaks, the US is 18% below, and the high tech NASDAQ is 55% lower than it was 5 years ago.

So the markets of the world are still recovering from the mauling of the great bear market that ran from March 2000 to March 2003 (see "Bear Markets, Continued", October 2002 at www.chrishoran.ca ).

That bursting of the tech and growth stock bubble took the major US stock market (S&P 500) down 46%, and the major markets of the world down an average of 51%. It equaled the great decline of '73 - '74, which is one of only 4 times the major markets have declined by more than 30% in the 60 years since WWII.

I suggested at the time and I continue to expect today that the markets are on their way to continuing their long-term average growth rate of 10% per year (give or take, depending on what market) that they have cranked out since 1926.

*Please see Investors Behaving Badly (Again) on page 2*

*Investors Behaving Badly (Again) from page 1*

*"Tis the set of the sails not the gales that determines where you go."*

These last 5 years serve as a laboratory for what may be the most important lesson any of us can learn about successful investing. We learn the lesson from analyzing the flow of investors' money into and out of the major investment fund categories.

Data from The Investment Funds Institute of Canada (IFIC) show that as the major equity markets approached the greatest speculative bubble since 1929, Canadian investors were piling into the 3 categories of equity funds available in Canada. The peak passed in March 2000, (although Nortel didn't peak until the summer), and investors continued to pile in: net sales of equity mutual funds in Canada were $42 billion for the 3 years ended December 2001.

In a nutshell:

Market Peak: March 2000
Net amount of money flowing into Canadian, US, and International equity mutual funds 1999 – 2001: $42 billion
Market decline, March 2000 – March 2003: approx 48%
Bottom of market decline: March 2003
Net amount of money flowing out of Canadian, US, and International equity funds, 2003 – 2005: $15 billion
Market gain, March 2003 – December 2005: 93%

The data show that, almost to the month, investors' love affair with equity funds peaked at the top in 2000, and continued all the way to the bottom in 2002. Net liquidation of equity mutual funds began in 2003 and continued steadily for the 3 straight years to December 2005. Investors have pulled $15 billion out of equities, as the markets have gained in each of those years.

In other words, the public buys equities most heavily at the top – starts selling at the bottom, and continues selling as the markets gain, all the way back up. Investors' money is flowing in at high prices, and flowing out at low prices. Why would people do this?

Investors, being human, are most strongly influenced by events of the recent past – in this case, falling equity prices. This backward-looking tendency is known by investment pros as 'driving by the rear-view mirror'. It's just as disastrous in investing as it is driving a car.

This phenomenon of inexperienced investors heading for the exits *after* the markets have gone down, so that they can buy yesterday's good idea, is a screaming example of investment *hari kari* that Nick Murray calls 'The Great Mistake': it's the exact opposite of what a wise investor should do. It's *hari kari* because locking in a 50% loss to invest in a bond at 4% will take 20 years to recover.

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*Please see Investors Behaving Badly (Again) on page 3*

*Investors Behaving Badly (Again) from page 2*

Investors, eyes glued to the rearview mirror, have spent 2004 and 2005 piling into bonds and income-producing funds. Bonds are *yesterday's* safe investments. Not only are investors selling equities at a loss, the main factor driving good bond returns – falling interest rates – by definition has almost zero chance of continuing in the future. (Bonds do well when interest rates decline, they do poorly when rates rise, and rates have been falling for most of the last 20 years!)

Five years ago, US stocks were expensive: selling at price/earnings (P/E) ratios of 30x (vs. the long-term average of 15x), dividend yields under 1% and when tech stocks as a group made no profit, the public couldn't buy enough of them. In fact, the higher the P/E, the better they liked them. Bonds paid interest rates of 6% by comparison, yet bonds were deemed silly. (Bond and dividend funds in Canada were in net redemptions at the peak in 2000). Virtually all my client portfolios had some bonds in them. Five years ago, value-style managers who were buying low-priced and dividend-paying stocks were widely scorned. (Virtually all my portfolios had mostly value-style managers in them)

Today, US stocks are cheap: US equity portfolios, such as those managed by Jim Young at Trimark, and the US Value Pool managed by Tom Sassie of Deutschbank in New York, have average P/Es of 12x-14x, dividend yields of 1.5%, earnings growth of 34% in 2005 (wow!), and with competition from interest rates at only 4% by comparison, investors don't want US stocks: at a meeting of investment advisors last week, one advisor complained that her 'clients just want to get out of US stocks'. (Virtually all my client portfolios have US stocks in them today.)

I do not know whether the next 1000-point move in the markets will be up or down. What I do know is that in 1982, my first year in the business and the last time the stock market fell by 40%, the index sat at about 1300. Then, as pundits forecast doom and gloom, it tripled over the next 4 years. Today the index (TSX ) stands at a little over 11,000 – nine times higher. And that doesn't include dividends.

Surely the lesson to be learned from the last 5 years is that when the crowds, egged on by the news media, are piling in to the investment darling *du jour*, surely that is the time to be headed in the opposite direction. When the shoeshine boy is giving stock tips - that is the time to be worried. So if the crowds are still selling their equity funds, it is a good sign for equities.

Finally, a sincere and deeply felt thank-you to my clients; you understand all of this, and that makes my job of going gently against the crowd so much easier. It is a pleasure to work with you. Thank you.

PS - If this newsletter seems familiar, it is. You can check the July 2000 newsletter titled 'Investor Psychology' (see http://www.chrishoran.ca/). That was when the shoeshine boy was giving stock tips.

## RSP Reminder

The deadline for 2005 RSP Contributions is Wednesday, March 1st, 2006. The limit is $16,500 for the 2005 tax year and for 2006 it rises to $18,000. (Please call Barb McKenzie to make arrangements!)

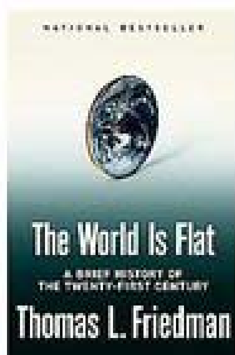
Your personal limit is on your Notice of Assessment from your 2004 Tax Return; your contributions to-date are on your Assante RSP statement.

If you know someone who would be interested in this newsletter, and if they are the sort of person that might need a good Financial Advisor, I'd be happy to add them to my mailing list. Just let me know.

# Book Review

The book reviews have been a popular part of the Newsletter. Many of you appreciate the value from reading good books and are interested in more ideas. The book review will be a regular part of the Newsletter.

The World is Flat
By Thomas Freidman
Farr, Strauss,
New York, 2005




Friedman is one of the rare journalists (he is Foreign Affairs columnist for the *New York Times*) who has developed some understanding of what he is writing about. His first book, 'From Beirut to Jerusalem' was a surprisingly even-handed assessment of the Arab-Israeli conflict, and he has won 3 Pulitzers.

Aside from the title – a flat world is a bit too pre-Columbus for me - the book is a good take on the Global Village concept.

Friedman reviews, in a readable way, global economic integration and the shrinking or 'flattening' of the world. His descriptions of outsourcing, offshoring, communications convergence and other 'flattening' forces are accurate and free of dogma or ideology, which is refreshing. These descriptions include many examples and stories, which are helpful in identifying with the people involved.

For example, Friedman tells the story of how a software company was started in Bangalore to service US customers; by including the actual people in the story, we identify with the Indian students and businesspeople starting the business. It is easy to see them as just like us: they are putting kids through school, they want to improve their lives, and they want to be productive and successful. When we see that they are just another family, it is easier to see them as a positive addition to the global picture, not something to be feared.

A thread that weaves, possibly unintentionally, through the book, is how closely we are economically related to each other around the world, and in a positive way. You can see that these globalization 'forces' that we fret about today are nothing more than the continued advancement of the modern world - the forces that have led to the most rapid improvement in standards of living, and reduction of poverty, for the greatest number of people on the planet in the history of mankind.

Friedman does not sugar-coat it. He discusses some of the criteria for third world development which apologists like to forget: that the seeds of economic development are doomed without rule of law, property rights, and basic honesty as a cultural value, and that these ideas simply do not exist in many countries today. These countries are doomed to their status quo, or worse, and no amount of economic assistance can help until they have developed a civil society.

He also points out that our challenge is to continue to improve our own education, science research, organizational systems and so on. Just as developing countries have a responsibility to build their own civil societies so they can participate in the modern world, we also have a responsibility to be the best we can.

One optimistic anecdote is the Dell Theory of Conflict Prevention, which states that no two countries that are part of a Dell Computer supply chain have ever fought a war with each other.

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