Assante WEALTH MANAGEMENT

Chris Horan, Financial Advisor

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Now You Have Seen the Movie

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The movie is 'The Exorcist' of the investment genre. It was the scariest thing that anyone alive today has seen. It involves the destruction of billions of investors' dollars, and demonstrates why most individual investors underperform even the investments they hold.

We pick up the thread in the summer of 2007 with the broad equity market, represented by the S&P 500, breaking through 1550 to achieve new all-time highs, thereby completing its recovery from the speculative tech/growth stock bubble of 2000-2003, itself a massive 45% decline that marked the end of one of the greatest bull markets of all time.

The world looked a fairly benign place in 2007: the asset-backed commercial paper crisis (ABCP) was on the radar as Coventree Capital collapsed, but it looked like a run-of-the-mill investment-gone-sour problem.

Between the market peak of 1565 in October and the beginning of September 2008 the S&P trended downwards, but the decline was no more alarming than a normal correction. Bear Stearns, a US investment bank, blew up in early 2008 and was quickly taken over by regulators and other banks, as was standard practice.

The storm clouds gathered quickly and burst in September of 2008 as the sudden collapse of AIG, the insurance company, and Lehman Brothers detonated the US financial system. It is no exaggeration to say that the Western economies were at the brink of disaster as money stopped changing hands. (See 'A Brief History of the Financial Crisis' www.chrishoran.ca , Resources, Newsletters)

130 Adelaide Street West
Suite #3401
Toronto, ON M5H 3P5

Phone: **(416) 216-6532**
Fax: **(416) 216-6512**
Email: **choran@assante.com**
Website: **www.chrishoran.ca**

Source: BigCharts.com

From the peak in 2007 to the depths of 666[1] in March 2009 the S&P 500 fell a sickening 57%. This was further than the 39%[2] bear market that began my career in 1981-82, further than the previous 50% bear of 1973-74, and second only to the great crash of 1929 – 1932. Royal Bank, a Canadian icon, fell from $61 to $25.

The news media was unequivocal that any recovery would be protracted at best - 'U' shaped, or 'L' shaped, but definitely not a 'V'. Even financial research such as The Bank Credit Analyst was guarded, although confident that ultimately the central bank did have the tools to deal with the situation.

The plot, as usual, confounded the pessimists. Even as individual investors sold investments by the billions, the markets – looking forward, as they do - saw that the bold moves by the US Federal Reserve and the new US government would prevent disaster, and the economy would recover. Starting March 10th, the market reversed course and moved strongly upwards.

This sharp - explosive - reversal upward was a signal, very similar to August 1982, that the worst of the market declines was over and a new bull market had begun. In bold defiance of the negative zeitgeist, the market roared back, recovering 50% of its losses by mid-2010, a little more than a year after the bottom. Investors that remained on the sidelines were left behind.

[1] The intra-day low of 666 on the S&P 500 was spooky to say the least; the closing low was 677 the same day, March 9, 2007.
[2] Canada, TSE 300, peak to trough decline, from SEI Pension Services data; RBC per author's memory.

Investors remained unconvinced, pulling billions from equity funds in Canada and the US[3], *even as the markets doubled off the lows*. Redemptions of equity funds continued, in Canada and the US, from 2008 until 2013 as investors, motivated by emotional retrospection, aided by foolish financial salespeople, and egged on by the incessant negativity of news media, succumbed to their fear and sold out perfectly good equity portfolios.

Such was the fear – the panic - that people grasped for safety at any price: the price of bonds was bid so high that, even with interest, buyers wouldn't recoup their investment at maturity. Hard to believe today, but short term US Treasuries and Swiss government bonds went to negative yields, which means that the price was higher than the maturity value plus interest - a guaranteed loss, but preferable (by some) to the uncertainty of equity prices[4].

The Tragedy

The tragedy, however, was not that the markets had declined by more than half. The tragedy was that so many people thought it was a good idea to sell out decent portfolios and sit in cash 'until the worst blew over'. I personally am aware of several cases where people with portfolios of a million dollars or more sold out into the panic – and then sat in cash while the markets recovered. (No clients of mine.)

Europe threw sand into the works in 2011 with the revelation that Greece had been misstating its debt and was bankrupt. The S&P 500 peeled off 20% through the summer of 2011 as it digested the probability of the Euro disintegrating.

However, with Euro peripheral populations polling their support to stay in, and the European central bank stepping up to backstop the bond markets, the Euro question went onto the back burner. The S&P 500 fully regained its 2007 (and 2000) highs by April 2013 and as of today (June 2014) is 20% over the previous all-time highs. Only now, with the S&P up 185% from the 2009 low, is the sense of relief beginning to be felt among the general investing public.

The skepticism about the recovery will be overcome, as always, by renewed company earnings, dividend increases, new products and new ways of providing for customers. Eventually, the memory of the 57% decline of 2009 will fade from the popular memory, optimism will return. And a new version of the movie will begin again.

The Plot

I have seen the investment movie now half a dozen times, and the plot is always the same. The characters, the script, and especially the set all change each time, but the plot never changes. First shown to me in 1981 by Leon Tuey, a well-known market analyst, the plot runs like this:

(a) **Relief**: investment markets recover losses, supported by real economic growth and company profits (as in 2007). As years pass, markets move higher in their jagged, uneven path, to new all-time highs and far, far beyond. Corrections of 10 -20% occur often - most years - triggered by some *panic du jour*, but the long term trend is up.

(b) **Exuberance (Greed):** After the fear of the last bear market has faded from popular memory, overconfidence returns, and valuations (not the same as prices) are bid to unsupportable levels. Talk of a 'new paradigm' creeps into the lexicon. Older investors are scorned for being too conservative, while 40 year olds are driving Rolls Royces.

[3] Cambridge Investment Advisors Presentation – March 2014
[4] Tetrem Quarterly Review, July 2009

(c) **Uncertainty**: Eventually, underlying economic weakness triggers softness in prices. People talk of lower prices as a 'buying opportunity', or an 'entry point'.

(d) **Fear:** Market declines of 20 – 40% or more trigger massive capitulation and destruction of investor capital (sometimes quickly, as in 2002, sometimes slowly as in 1969 – 1982). At the bottom, older investors (with grey hair and long investment records), counsel patience and the opportunity to purchase bargains at lifetime low prices. They are ignored (but not by my clients).

(e) **Recovery**: long before any economic data shows evidence of recovery (because economic data is historic, not prospective), the markets – looking forward, as they do – sense a recovery and prices begin to go back up. The public remains fearful as news media continue to call for renewed disaster, while markets continue to rise ('defying gravity').

Eventually a sense of relief is felt, and the movie begins again …

Key Points

Two key points:

First: the declines, while scary, are temporary; the advances permanent.

It is surprising to many people that equity markets decline on average 14% in any given year[5]. Declines of greater than 20%, called bear markets, have occurred 13 times since WWII. At the end of WWII the US market index was about 14[6]; today it is around 1900. So these temporary declines have interrupted a long term increase from 14 to 1900. That's a return of 130-***fold***. I'll say it again: declines temporary; advances permanent.

Second: Now that you have lived through the movie, you can begin to be inoculated against its effect: the fear.

The Exorcist may terrify you the first time you see it. The second time, it isn't likely to be so scary. And if you see it a dozen times, you are getting to know what to expect. You may even begin to see it differently. You will come to know that in the investing movie, the white hats – the long term investor - always win.

These two points together – that bear markets are temporary interruptions in a permanent uptrend, and that you have to live through one to understand - form the foundation of my investment perspective. They are the key to successful investing.

The reason so many investors fail miserably is that we humans are – for behavioral things like investing or scuba diving - experiential learners: we need to experience something close up, in our face, before we understand the lessons. Textbook learning is theoretical, and will only get you so far.

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[5] Nick Murray, letter, February 2014; the average intra-year decline in the US market since WWII is 14%
[6] 1945 and 1982 market levels are S&P 500, per BCA Research

Successful investing cannot be taught theoretically. If investors were theoretical learners they would just read one of the great books, like Jeremy Seigel's *Stocks for the Long Run* - or my newsletters - and nobody would lose money. But a book can never describe the stab of fear removing your mask in cold water scuba training. You have to be there to get it.

Your Advisor at the Theatre

I first saw the movie in 1980, as the last oil and mining boom turned the Alberta and BC economies to bust. I hid under a chair and was only crawling out when the sequel ran in 1987 (US market lost 23% *in one day*). I recall John Templeton (whose picture is on my office wall) appeared on *Wall Street Week*, calmly looking into the camera and declaring that he was fully confident the markets would recover, and he was finding bargains everywhere. I wondered how he could be so serene.

Back then, thirty two years ago, the S&P 500 was around 160. Today it is around 1900. That is a 12-***fold*** increase just in my career. And that doesn't even include dividends. The bear market of 2009 took prices back to 1996 levels, but even that awful low was more than *7 times higher* than 1980. One more time: declines temporary; advances permanent.

After those first experiences in 1982 and 1987, the movie ran again for me in 1992 when rates began to go back up. Again in 1998 when the Far East currencies melted down and a New York hedge Fund (Long Term Capital) blew up, threatening to take the biggest US banks down with it.[7] By then I was finding myself sounding a little like older investors such as Templeton, counselling patience and opportunity.

In 1999 the movie ran again, this time a re-run of the resources boom of the 1970s as the technology and growth stocks flew too close to the sun before their epic collapse.

If one of the lessons of the movie is to overcome the fear of the declines, the corollary is to resist the euphoria of a bubble.

The 1979 – 1982 episode was an exact prelude to the tech crash 20 years later. In 1979 the 'Blue-eyed sheiks'[8] like Smilin' Jack Gallagher of Dome Petroleum seemed to be minting fortunes, and people were lined up around the block to buy gold bars, before it all came crashing down with 21% interest rates.

From my vantage point …

From my vantage point on the floor of the Vancouver Stock Exchange in 1982 I saw the surge of the traders, the prices going to the moon, the brokers (my boss) driving Rolls Royces, and the naïve investors thinking they'd be smart by winning a stock price lottery. And then the destruction of all of it …

The point is that my ringside seat experience back then gave me the courage to withstand the tech stock bubble 20 years later with the strength that made my career (and preserved many of your fortunes).

Not only that, if I hadn't seen the crushing agony of that bear market I may not have had the courage to stand against the tide of fear in 2009.

Most of you have seen the movie with me more than once. Some of you have seen every one since 1992 with me. So get some popcorn, and enjoy the show. The movie is beginning again.

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[7] In a perfect prequel to 2009, the Fed Chairman held a weekend meeting with the CEOs of the largest US banks to map out the demise of Long Term Capital. See 'When Genius Failed' by Roger Lowenstein.
[8] As Peter Newman's book referred to the Canadian oilmen at the time

A Note on Optimism

Below is an antidote for the endless and nauseating stream of negativity about the world. A few of my favorites (most data is US)[9]:

1) Life expectancy was 39 years in 1800, 49 years in 1900, 68 years in 1950, and 79 years today. The average newborn can expect to live an entire generation longer than her great-grandparents could.
2) The average North American now retires at age 62. One hundred years ago the average American died at 51. Enjoy your golden years – your ancestors didn't get any of them.
3) Incomes have grown so much faster than food prices that the average household spends less than half as much of its income on food as it did in the 1950s. Relative to wages, the price of food has declined 90% since the 18th century, according to the Bureau of Labour Statistics.
4) In 1900, 44% of all jobs were in farming. Today it's around 2%. That means we have become so efficient at feeding ourselves that almost half the population has been able to leave farming and work on other things.
5) This revolution in agricultural productivity is a perfect example of science harnessed by free enterprise, and has produced one of the greatest improvements in human welfare in history.
6) Despite a huge surge in airline travel (and increase in the size of aircraft) there were half as many fatal airplane crashes in 2012 as there were in 1960, according to the Aviation Safety Network.
7) Two percent of American homes had electricity in 1900. JP Morgan (the man) was one of the first to install electricity in his home, and it required a private power plant on his property. Even by 1950, close to 30% of homes didn't have electricity. It wasn't until the 1970s that virtually all homes were powered. Adjusted for wage growth, electricity cost 10 times more in 1900 as it does today, according to Professor Julian Simon.
8) US median household income adjusted for inflation was about $25,000 per year in the 1950s. It is nearly double that today. We have a false nostalgia about life in the 1950s because our definition of middle class has been inflated – see the 35% rise in the size of the median American home in the past 25 years. If you look into how the average 'prosperous' American family lived in the 1950s, you'll find a standard of living that we call 'poverty' today.
9) The cost of an average round-trip airplane ticket fell 50% between 1978 and 2011 – due to deregulation, free enterprise and technology.
10) According to the Federal Reserve, the number of lifetime years spent in leisure – retirement plus time off during your working years – rose from 11 years in 1870 to 35 years by 1990. Given the rise in life expectancy since then, it's likely close to about 40 years today. The average American spends nearly half his life in leisure today.
11) The average American workweek has fallen from 66 hours in 1850, to 51 hours in 1909, to 35 today, according to the Federal Reserve. Enjoy your weekend!
12) According to AT&T and the Dallas Fed, a 3 minute phone call from New York to San Francisco cost the equivalent of $341 in 1915, and $13 in 1960, adjusted for inflation. Today you can Skype for free!

[9] Taken from a posting on The Motley Fool by Morgan Housel. '50 reasons we're living through the greatest century'.

Share Buybacks Boost Inequality?

The Inanity of Financial Journalism

Also, check out the hilarious little rant as Louis CK explains to Conan O'Brien why 'Everything's amazing but nobody's happy'. My favorite is the one about sitting in a chair going 1000 kph.

Hey, Rick Mercer gets to do one, and this is my newsletter, so …

Clients know that news media is no friend of mine (or yours), and most of financial journalism is at best a waste of time, and at worst misinformation. But once in a while a journalist writes something that is so bereft of intelligence that it deserves comment, just so you can shake your head. Here's a beauty: Recently the Globe published a piece claiming that 'the way to ease inequality was to end share buybacks'[10]. The article is a masterpiece of non-sequitur and unsubstantiated claims, all of course designed to get the reader angry about how company management is contributing to economic inequality.

Share buybacks are when a company buys back its own stock on the market. Companies issue stock to raise capital from investors, and it is perfectly legitimate to return capital by buying (called 'retracting') stock when they have surplus cash. Buybacks are simply one of two ways - the alternative being a dividend - to return surplus cash to shareholders.

Buybacks differ from dividends in ways that make them useful - they reduce the number of shares outstanding so the remaining shareholders own more of the company, thereby making the shares more valuable. And yes, making the shares more valuable is one of management's primary and most legitimate goals. Buybacks also provide choice for the shareholder because she can decide whether to sell or not, whereas a dividend is paid to every shareholder whether they want it (and the taxable income) or not. So buybacks actually benefit remaining shareholders: they own more of the company, their shares become more valuable and they don't incur any tax until they sell.

Share buybacks were restricted in the old days (before 1982) because it was possible, back then, for unethical managements to manipulate the price of their stock. But now, computers can track trades efficiently, and regulations have made manipulation irrelevant.

The article's purported link to inequality is simply silly: it claims that since executives earn so much, and their pay often consists of grants of stock, that buybacks should be eliminated. This is as devoid of logic as saying that money should be eliminated because rich people have money.

Not only does the article confuse means and ends, it is widely agreed that executives *should* own stock in their business – precisely to align their interests with shareholders. What drives the inequalistas nuts is the magnitude of executive pay - which has nothing to do with whether executives are granted shares or given cash.

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[10] Globe and Mail, 'One way to ease inequality: Put an end to share buybacks', Eric Reguly, April 5th, 2014.

But that's not the worst. The idea that economic inequality would be eased by paying executives cash instead of shares demonstrates a gross misunderstanding not only of corporate finance and executive pay, but inequality as well.

Inequality is not the rich person's fault. A poor person is not poor *because* a successful person is successful. Justin Beiber does not take money out of the pockets of other entertainers (you can argue that a society that makes Justin Beiber successful has problems, but that isn't Beiber's fault).

As Robert Samuelson wrote in the Washington Post (February 2nd, 2014), the poor are not poor because the rich are rich. The two conditions are unrelated. Financially successful people tend to have post-graduate education (medicine, law, engineering, business), rare talent (actors, athletes), or run a successful small or medium size business (pure hard work and huge risk). They are often with their first spouse. These people's success does not make poor people poor, and it is a terrible insult to insinuate that successful people don't deserve their financial reward.

The problems of the poor are serious and vexing. But it simply doesn't follow that successful people should be punished for their success, as the 'Occupy' protesters with the placard 'Arrest the 1%' seems to think.

In a knowledge economy, if you don't have education or a valuable skill, you are simply at the bottom. Data shows that financial rewards from education continue to grow: between 1980 and 2010 the difference in annual earnings between people with post-secondary degrees versus those with Grade 12 diplomas, doubled from about $12,000 to about $24,000/year[11]. Since GDP per capita in the US is about $47,000, the difference is big. But is it unfair?

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[11] Skills, education, and earnings inequality among the other 99 percent, Science, May 23, 2014, p843-850