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Summer Storms

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The news media continues the drumbeat of alarm with headline stories of imminent disaster: financial system failure, resurgent inflation, plummeting house prices, oil at $140/ barrel – and the media's ultimate emotional button - *it's going to get worse*.

Negative Returns

Many investors fear a catastrophic capital loss in a down market. Bear markets – declines of 20% or more - are indeed spectacular events, the airplane crashes of the financial world, capturing relentless headline media focus. The human mind extrapolates, and a temporary decline today becomes an airplane crash tomorrow.

Except that big market declines are temporary, infrequent events. Unlike a plane crash, they are also normal, natural, if unpleasant things. They are only a danger if they scare you into selling good assets (jumping out of the plane). We have not had a negative 12-month return since 2003, now five years ago, so we may have forgotten what they are like. After 5 good years from 2003, a negative year is a normal thing and is to be expected. It is not to be feared.

In investing, a bear market may be the plane crash, yet inflation is the real danger. Even today's inflation rate of 3% or 4% will silently cut your purchasing power in half over only 15 years. Equity investments are shown by history and experience to be the asset class with the best record of real, after-inflation growth.

But equity returns are not free. The occasional down markets are the price we pay for the long-term returns that allow your portfolio to stay ahead of inflation over the years.

Website

Please check out my website www.chrishoran.ca. Past issues of the Newsletter are easily available.

Please refer a friend who you feel might be interested.

Unprecedented

Significant declines occur because something important - *unprecedented* - disrupts the financial outlook. It may seem odd at first, almost an oxymoron, but the disturbance that kicks off a bear market is *always* unprecedented. If it weren't, it wouldn't be disturbing.

In 1982 the TSE declined by 49% when interest rates rose to 19% (unprecedented). In 1987 global stock markets declined by 23% in a single day (also unprecedented). In 1994 markets declined 20% as the Canadian dollar hit 60¢ (unprecedented). In 1998 bank stocks declined at least 25% in 3 months when the Far East currencies collapsed and Russia defaulted (unprecedented since 1917). In 2001 the tech stock crash was compounded by the 9/11 disasters (unprecedented).

Yet each of these storms was temporary. The Canadian market is now 16 *fold* higher than in 1982, and has more than doubled since 9/11.

The point is that each of these declines was unique, powerful, and alarming. Yet they did not inflict permanent or even long-lasting damage, either to the economy or to a diversified, professionally managed portfolio. Such is the resilience of human enterprise, industry and ingenuity that the problems of today give way, and we go on to progress. Each of the unprecedented market declines has been temporary, fleeting, and gone, except for memory. In this regard these declines fit a pattern: the alarm *du jour* always dwarfs the alarms of the past, only because they are uppermost in our minds.

The media barking at impending doom is also perfectly normal. They wouldn't have jobs if the headlines said 'World per Capita Income Growth Best 5 Years in Human History' - just think about that one for a moment *(Economist, July 2008*).

Or 'Toyota Invests $700 million in Cambridge Plant Expansion' or 'Honda Adds Third Shift at Alliston' or 'Trade Deficit Declines, As Expected' or 'Canadian Unemployment at 35 year Low' or 'Canadian Economy Weathers 9-year Housing Slump in 1990s'. All of which are perfectly and unarguably true, but warrant no headlines.

Remember the US trade deficit? The impending disaster of the past few years, clients were worried about it. Except it isn't a problem any more. Turns out the decline of the US dollar against all its major trading partners is having the expected effect, and the trade deficit has been declining steadily for almost 2 years. (see Dollars, Deficits, and Markets at www.chrishoran.ca)

Con't on page 3

Today's Troubles

The Credit Crisis

Today's unprecedented concern is the US banking crisis. The problems in the US banking system are undeniably serious. Recently US Treasury Secretary Paulsen received congressional approval to nationalize the two largest mortgage insurance institutions (colloquially known as Fannie Mae and Freddie Mac). The shareholders will likely lose their shirts – as they should.

Banks that have damaged balance sheets must rebuild them by issuing new equity to investors who are naturally skeptical. Banks with strong balance sheets are being careful about who they lend to.

The rebuilding process may run into 2009 or longer, and will probably require involvement by the US Treasury and Federal Reserve (i.e. US taxpayers) similar to the Savings and Loan crisis of the 1980s.

The Whipsaw

The question on many people's minds is: 'Shouldn't we sell our equities now and buy back after things settle down?'

Reasonable question. The answer is 'No'. Trying to trade in and out is one of the best ways to permanently destroy your capital. The people with the most money for the longest time (Warren Buffet for instance) all say they can't do it and they don't try.

Investment pros know about the 'whipsaw'. Here's how it works. On June 15th the banks looked like they were on their way to mending, and the markets had touched their highs. You did not think of selling until July, when things took a sudden turn for the worse and the markets had peeled off a quick 10%. Better get out now, until things blow over. Say you sold your equities July 17th.

Then by August 15th things seemed to improve, and the markets were back up at their highs. Not wanting to be left behind, you bought back in. Unfortunately, you were just in time for another round of bad news, and the markets declined 10% again. You sold on news of continued financial mayhem. You are now down 20%.

This is called a whipsaw. Repeat this a couple more times and you have destroyed half your capital.

There are countless variations of the whipsaw, but the common thread is that you simply can't tell a bump from a drop from a bear market until after its happened. It only looks like a good idea in retrospect.

The only people who advocate trading in and out are either selling theoretical newsletters to people who haven't lost enough money yet to figure it out, or they are charging trading commissions.

Bad News Good

The other reason you can't time the bottom of a market is that you have zero warning of when the crisis will be over. The investment markets will recover, possibly sharply, before there is any sign of improvement. As the saying goes, 'Nobody rings a bell'.

For example, in late July, Wachovia, a large US bank, announced a huge write off. Its stock price rose 27% *that day*.

To many people, it seems irrational to announce a monster write off of owners' equity and have the share price jump. The explanation is that the stock price was depressed because investors were uncertain of how bad the news was going to be. The announcement indicated that things weren't as bad as investors feared and the company was well on the way to recovery.

Summary and Conclusion

The headwinds faced by the US economy from declining residential real estate prices and banking problems should be countered to a large degree by the declining US dollar and low interest rates. The US Federal Reserve and Chairman Carney in Canada will keep interest rates low for as long as necessary to resist recession. They will increase rates to levels that are economically sustainable and noninflationary as soon as the banking crisis permits.

Fears of resurgent inflation are misplaced and comparisons to the 1970s monetary inflation are inappropriate. (see Economics Update)

Equity prices are closer to cheap than expensive, so downside risk is not severe. US bank stocks are already down 50% on average. Canadian banks, on a different planet than the US banks, were recently down 30%.

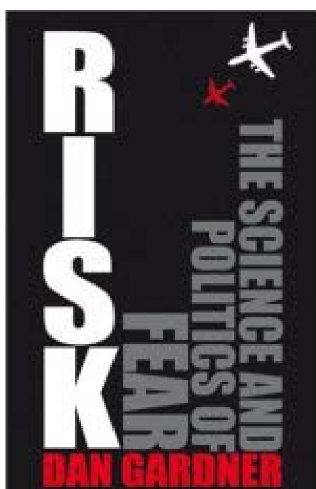
Dividend yields compare very well with bonds. Bonds are overpriced as investors flee to their perceived safety, and a rout in the bond market threatens when the credit crisis is brought under control and interest rates rise. Bonds do not compensate investors for inflation, even before taxes.

Oil prices should correct downwards as demand destruction continues. Energy stock prices are already discounting oil in the $65 - $85 range, so oil and energy share prices represent good value even as crude prices fall. Oil companies will remain profitable as a result for many years yet. Supply constraints in oil is a result of incompetence and corruption in oil producing countries e.g. Russia, not lack of oil reserves in the ground.

Emerging markets (and many US stocks) are reaching valuations that are cheap by historical standards, according to Mark Mobius, famed emerging markets investment manager. We will be looking at increasing portfolio allocations to these international markets in the coming months.

Your portfolio a) has sufficient cash or bonds to provide years of withdrawals b) is diversified according to your personal risk characteristics, c) diversified globally and across industry groups d) managed by top investment professionals who take action as required to reduce risks or capture opportunities.

All of which means your portfolio has been designed to withstand whatever surprises the world throws at it. Since you can never tell in advance which storm cloud will become the serious one, the best approach is to rig for the storm. So cancel the newspaper, ignore the talking heads on the evening news, and let the storms pass. Down markets are when the amateurs sell in fear, and seasoned investors pick up the bargains.



Book Review

'Risk: The Politics and Science of Fear'
Dan Gardner, McClelland and Stewart, 2008

Stories and examples of how various perception illusions, triggered by media that want to excite us, play with our generally poor training in statistics, and as a result we make serious errors in risk assessment.

Well written, great stories. Useful in conversation.

Economics Update: Inflation and Interest Rates

Price Shock

The increase in oil and worldwide food prices has kindled fears of inflation. Here's what's happening.

Interest rates are being held extremely low in the US to facilitate the financial rebuilding process and to counter the deflationary impact of the credit and housing crises.

The concern over inflation arises because if interest rates are too low for too long, growth in the money supply can lead to true monetary inflation. So today's very low interest rates, if held long enough, do carry the seeds of future inflation. Short-term interest rates, which are controlled by the central banks, will therefore rise to more normal levels – but not until the credit markets are in better shape.

However, we are not there yet. The oil price increase is a *price shock*. A double in the price of food - because Thailand stops exporting rice and Westerners are burning corn - is also a price shock. A price shock increases the price of everything that has oil (or rice) in it, so it might appear to be inflation. But a price shock is not inflation - as soon as oil stops going up, the related prices will stop going up too. If a product or service does not contain oil (or rice) its price will not go up at all. That is not inflation. This is why central bankers watch the difference between core and headline inflation rates.

Killing the patient

It is critical to know the difference between a price shock and money supply inflation *because the cures are the opposite*. The correct policy response to a price shock is to lower interest rates, (so the economy can absorb the shock) whereas the correct policy response to monetary inflation is to raise interest rates (to take money out of the system).

If the central bankers were to raise rates now, to suppress headline inflation caused by oil or food price increases, it would compound the contractionary and deflationary impact of the price shock. Consumers would be hit by gasoline prices, food prices and then interest cost.

In medical terms, the antidote for a monetary inflation will kill the price shock patient, and vice versa.

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