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The Black Swan

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Assante WEALTH MANAGEMENT

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Chris provides financial planning, investment planning and full implementation services to about 100 families.

We are pleased to welcome new clients.

For more information, please call (416) 216-6532 or email at choran@assante.com

Media reports of the 70% gain in the equity markets[1] from the March 2009 lows have many people worried about a bubble. Even *The Economist*, normally less prone to sensational speculation than most papers, has a bubble on its January 10th cover.

The notion of a bubble in the major world equity markets is not supported by facts. A bubble is marked by spectacular high prices rationalized with 'this time it's different' (see Narrative Fallacy below), followed by a crushing collapse.

Today the S&P500 in the States is 25% *below* its high of 2007, while the Canadian market (TSX) is still 20% below its 2007 high. In fact, the end of 2009 marks one of the worst ten-year periods in investment history: many major world stock markets are below their levels 10 years ago, representing a 10 year negative return of almost 3%/yr for a Canadian investor (MS World, C$,12/09). These are not spectacular high prices. The NASDAQ index, the world's darling 10 years ago, is still less than half its peak of March 2000. The Japan index languishes at one quarter its peak of 1989. *That* was a bubble.

So the 70% return since March 09 is more a rebound of the stunning 57% peak – trough decline in the S&P500 from 2007 – 2009 than an indicator of any bubble. We may yet experience choppy waters, as always, but major markets are nowhere near bubble territory.

[1] S&P500, March 09 – mid Jan. 10 = +71%

RSP Reminder

The deadline for 2009 RSP Contributions is Monday, March 1st, 2010. The limit is $21,000 for the 2009 tax year and for 2010 it rises to $22,000. (Please call Barb McKenzie to make arrangements!)

Your personal limit is on your Notice of Assessment from your 2008 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.

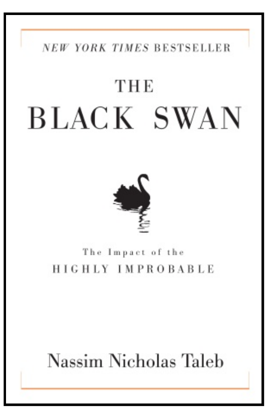
Fortunately my clients have not suffered anything like these numbers, because we have been weighted to Canadian equities (TSX 10yr + 5.6%) and many conservative clients have had significant weighting to bonds (ML Canada 10 yr + 6.7%). I am very grateful for the good fortune of having been underweighted to US and global equities and to have included bonds and resources in client portfolios over the last decade.

Your advisor is one of the very few to have his client results measured by an outside consulting firm over more than 10 years. I have been the Investment Advisor to a $1.8 million pension fund that is representative in many respects to other client accounts[2]. The returns of that fund to December 2009 below compare very well with the index and with many of the largest funds in the country, placing it in the top quartile over 1 and 10 years.

	1yr	3yr	5yr	10yr
Pension Fund	24.5%	-2.0%	3.0%	5.2%
RBC Balanced Fund	13.4%	-2.0%	3.7%	3.6%
Index[3]	16.9%	-1.1%	2.9%	3.4%

Note the index does not include costs or fees whereas the fund returns are after fees.

Forecasting is difficult, as Mark Twain said ‘especially about the future’, so before we get to the 2010 outlook we’ll look at *The Black Swan.*



The Black Swan

At first read *The Black Swan*, by Nassim Taleb[4], seems built on the Gladwellian-simple ideas that hindsight is perfect and you don’t know what you don’t know. However, in light of the asteroid-hit surprise of the financial crisis, he makes some interesting points.

People in the Old World believed that swans were white, and could not be any other color. Thousands of swans had been observed over hundreds of years, and all were white. Then one day a ship returned from Australia with a black swan, and ornithologists had a big surprise.

[2] Of similar objectives and risk tolerance of course. Asset mix includes bonds, International, US, and Canadian equities, in the same funds as many other client accounts.
[3] Index and quartiles = Globe Cdn. Balanced Fund (Neutral)
[4] The Black Swan, by Nassim Nichola Taleb, Random House, 2007. Since the book deal extensively with highly improbable events, the choice of publisher must be coincidence. His writing tends to self-congratulatory, but the ideas are important. See also “Fooled by Randomness’, Taleb, 2001

A Black Swan is a highly improbable event; so improbable, like airliners flying into office towers, it cannot be thought of in terms of probabilities.

The key attributes of a Black Swan event are: it carries extreme impact, it is totally outside the range of expectations, and explanations after the fact make it seem to have been predictable. The last two points are actually related by the Narrative Fallacy.

The Narrative Fallacy

The narrative fallacy is the oversimplification from fitting a story to observations that may or may not be connected. The story line provides an easy path for your brain to follow along, but develops a 'consequential distortion of reality'[5] that prevents the brain from recognizing a danger until it is too late. The internet bubble was a classic false narrative.

The narrative fallacy is reinforced by 'confirmation error', which is the mistake of thinking that 'No evidence of Black Swans' is equivalent to 'Evidence of no Black Swans'. People tend to think that the longer something goes on, the more likely it is to continue. Sometimes this is very wrong: to a Russian Roulette player, *no evidence of bullets* is not the same as *evidence of no bullets*.

Taleb's example is the domestic turkey. The turkey, fed daily by a friendly farmer, believes that life is good. Every day, more data (feedings) confirm the turkey's belief. There is no evidence of a problem. Then one day, two weeks before Thanksgiving, the picture changes abruptly and the turkey's life is over.

Note that the turkey's demise was not a Black Swan to the farmer. Black Swans are, to a large degree, information errors: it's what you don't know that wrings your neck.

The severity of the financial crisis of 2008/9 was certainly a Black Swan: Dick Faulds of Lehman Bros didn't consider for a millisecond that his US$600 million personal stake in the bank could be gone with the wind. In fact, to argue before August 2009 that Lehman would be gone by October would have seemed preposterous.

Preposterous Predictable in Retrospect

The third attribute above of Black Swans, and most interesting for me, is that *they appear in retrospect to have been predictable*. Taleb describes it as a 'naïve interpretation of the past as predictable when it is not'. This is not 20/20 hindsight.

It is more dangerous. By erroneously believing the world is predictable, we develop a blind spot to future unpredictable events. We are drawn like bugs to the light bulbs of forecasts; we think we know more about the future than we actually do.

The crash of October 1987, the collapse of the Soviet Union in 1989, interest rates at 21% in 1982, the tripling (twice) of oil prices in the 1970s, are all Black Swans – total surprises for which there were no warning signs.

The Far East currency crisis of 1998 blew up Long Term Capital Management (a $6 billion hedge fund) because emerging market bond spreads increased 6 standard deviations from 'normal'. The geniuses that ran the fund didn't think a 6-sigma event was possible[6].

In fact the LTCM geniuses were partly right – *that particular* 6-sigma event might occur once in a thousand years[7], but unfortunately, in the meantime, we will experience hundreds of completely different total surprises.

[5] Taleb, p75; The media provides a narrative to everything, most of which is irrelevant to the investor, or at worst, viciously misleading, but our brains are highly susceptible e.g. 'forecast data indicates turkey feedings to continue'.
[6] *When Genius Failed*, Roger Lowenstein, 2000
[7] Actually, emerging market bond spreads blew out in 1982 with the Mexican debt default; so the LTCM principals just didn't bother to notice where the other turkeys went – they didn't look that far back.

Referrals

Thank you all for your trust and loyalty through the past year. I am very grateful that my client attrition rate over the past year or so has been insignificant – thank you all for staying the course. This note is to let you know that I am happy to accept new referrals.

How to refer a friend or colleague:

Listen. Be aware that someone making comments about bad markets or investments are often asking indirectly for help. Many investors have suffered permanent losses, (see PPNs on page 6), or their representative may have left the business, and now the friend doesn't know who to trust for advice.

Make a suggestion. You can help with a low-key suggestion that they may appreciate. Just say 'You are welcome to speak to my advisor. He would be pleased to speak to you and see if he can help'. It may sound like a sales pitch to you, but to the friend it's a lifeline.

My only firm criteria for accepting a new client is that they be the sort of person that values good advice – like you. Although the average of my top 20 accounts is over $1 million, and marketing gurus say I should have a minimum account size of at least $500,000, my policy is to happily speak to a personal referral of $100,000 or more from an existing client.

Guarding Against The Black Swan

Most of us intuitively recognize that simple and well-known rules such as diversification provide robust protection against surprise events. Most people need only a gentle reminder to see that interest rates can go back to 12%, house prices can fall (30% in the 90s), or that stock markets can fall 30% or more (1974, 1980, 1987, 1994, 1998, 2002, etc.).

The fascinating thing to me is how some people develop the blind spot. Some people with large mortgages look incredulous when I say that 5 years from now interest rates could be at 10%. People like Dick Faulds with all their assets in one company often think diversification is dumb because they can't imagine what could go wrong – which is precisely the point!

Be skeptical, introspective, and aware that there may be something that you don't know. A little humility is good. Study history, Taleb says, but study it cautiously: the 'naïve observation of the past as representative of the future', when it may not be, is the primary reason we underestimate the Black Swan problem[8].

Looking forward, China is susceptible to a Black Swan. Someone confident in the rapid and uninterrupted modernization of China should recall Charles II, Louis XIV, Robert E. Lee, and Mikhail Gorbachev[9].

Am I saying 'Don't invest in China'? Not necessarily. We just want to ensure that we aren't surprised if China's modernization doesn't go smoothly. My job is not to keep you from crossing the street; my job is to not let you cross the street *blindfolded*.

With that, the 2010 outlook.

[8] p42; for example, after the October 1987 crash, the media and some traders have braced for a crash every October, 'not recognizing there was no antecedent for the first one'. In other words it is naïve to think that a highly improbable event has any reason to reoccur at all, never mind in the same month as before.

[9] Investors interested in China should first research the possibility of turkey farmers/Thanksgiving by reading about the *Treaty of Nanking*. Also look up 'shanghai' in the dictionary (it's a verb).

2010 Outlook

The outlook for 2010 is reasonable: US corporate profit margins have held up well, manufacturing volumes are recovering, and job losses have peaked and are beginning to fall, says Dan Bubis, manager of the United Canadian Value Fund, in a December meeting. According to Morgan Stanley, a (strong) US bank, forecasted US corporate earnings are being revised sharply upwards, providing evidence of recovery and support for valuations. And the Bank Credit Analyst, an independent research firm, says that aside from US banks, corporate balance sheets are in good shape.

The crisis may be over, but it isn't clear sailing yet in the equity markets.

US Market

The combination of reasonable valuations – not high, not low – in the US market, combined with likely tepid recovery in consumer spending, means the broad market indexes will not likely power ahead strongly to new highs. Consumer spending in the US is weak, as consumers have been jolted out of complacency and are beginning to save again.

In addition, the decline in house prices puts many banks at greater risk of defaults as all US borrowers are incented to walk away from mortgages, protected by the non-recourse system in the States. [The good news here is that consumers can carry on quite quickly, leaving the banks and the government to haggle over the losses and the guarantees.]

We will likely – in my opinion and the opinion of many experienced professionals – see a choppy or sideways market.

In a sideways market, some companies do very well, and some not so well. Caterpillar, Hewlett-Packard, Boeing, P&G, Colgate, and others are world-class companies deriving significant if not the majority of their revenues from around the world. Many of these companies sell at very reasonable valuations and their stock prices can do well independently of the direction of the broader market.

A sideways market is perfect for professional money managers. A sideways market is a stock-picker's time to shine because great companies with strong fundamentals, long term economic sustainability and good prospects for growth, can do well even as the broad market languishes.

Look for a money manager with concentrated holdings – these people, like George Morgan of Cundill Investment Management, or Dina DeGeer and Dennis Starritt at Bluewater, or Gerry Coleman at Harbour have 50% or more of their portfolio in their top 10 holdings, and maybe only 30 or 40 stocks in the portfolio. No overdiversification from these pros. They have done their homework, and they have the guts to make decisions.

I believe that, of any decade of my career, the next 10 years will be the decade for the individual money manager over the passive or index formula approach. (see ETF below)

ETFs

Exchange Traded Funds will have to be the subject of a future letter, but suffice to say for now that a sideways market is not one for passive index investing. Buying a broad market index makes no sense if half the market is going up and half is going down. ETF and Index funds look great today because the market convulsions of the past 3 years had all securities moving in unison, but this is not likely to be the case in the next few years.
I am licensed and would be happy to discuss ETFs and passive investing if you are interested. I am familiar with the subject having followed it since my pension fund days in the 1980s. ETFs may well have a role to play at some point but none of my personal money is in ETFs.

What is Good Advice?

The bullet that misses you.

Sometimes good advice is difficult to see at the time, like avoiding the tech stocks in 1999, because sometimes good advice is what *doesn't* happen in your portfolio.

Principal-Protected Notes (PPNs), and their cousins, index-linked GICs, were sold by the billions to Canadian investors keen for safety of principal after the tech crash. A PPN guarantees return of principal on maturity, while providing some upside from various markets, the TSX for instance. Sounds good – a guaranteed return of your principal, and the possibility of some additional return from markets.

Here's a super-brief on how they work. The PPN takes roughly 65% of your principal and invests it in a type of bond that matures at a specific amount on the maturity date, typically 10 years. That guarantees your principal - down the road.

The PPN then takes the other $35, deducts a bunch of fees, and invests what's left to try and generate the return on the entire $100, using leverage in various forms, such as index options and futures.

Unfortunately, the spectacular drop in markets over 2008/09 had a fatal impact on the growth component of the PPN: if you are levered 3:1 and the investment falls by half, your capital is wiped out, forcing many PPNs to close out the growth positions to zero. Now all the investor can expect is the principal, on maturity, in 10 years or so, or currently worth about $70 today.

The PPN, down by 30%, has given you the downside of markets but now zero upside. Your portfolio may have fallen by 30% (or more) but the integrity and potential of your portfolio to recover and prosper over the next 10 years has not been compromised.

Plus, in the meantime, the bond portion of your portfolio actually went up through the crisis, offsetting the declines on your equity holdings, and providing obvious diversification. Just as it was supposed to do.

My assessment of PPNs was that the index-linking mechanism, as with many option-type strategies, was more costly and less certain than commonly thought.

The implosion of the PPNs was a Black Swan to their investors and the naïve salespeople that sold them. I am happy to say that not one client of mine had one nickel in PPNs.