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Trying Times

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Assante WEALTH MANAGEMENT

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

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This newsletter is prompted by the extraordinary collapse of share prices during the week of October 10th. It is now the 7th in a series of newsletters dealing with the credit crisis. Since many of the points build on the earlier newsletters, you might take some time and review them on my website www.chrishoran.ca, or call me and I'd be happy to send them to you.

Your September statements will have arrived recently. Most clients thus far have found that the damage to their portfolios is not as great as they had feared. Your portfolio decline will most certainly be within your "Lifeboat Test" risk tolerance. However, the timing of the September month end coincided very closely with the sharp market declines so your year-to-date numbers will not be pretty.

Thank you very much for remaining calm (if tense) during this historic and difficult time. So far, no clients have done anything rash. Be warned, though, that at this point it looks like October will be ugly, too.

Category 5

The financial crisis accelerated rapidly on September 15th when it became apparent that the US banks were not able to take over AIG, an $85 billion insurance company, and Lehman Bros was simultaneously forced into bankruptcy. The storm became a Category 5 hurricane through the week of October 6th, with the first selling panic in markets since October 1987, more than 20 years ago, driving markets down by 20% in the week.

The financial crisis has now prompted a number of policy responses from governments around the world. These actions bring to bear – in the opinion of many analysts - the 'big guns' that are the solution to the crisis.

These are very serious actions that are commensurate with the severity of the situation. They are similar to the actions implemented by the Scandinavian countries in their financial/housing crisis in the mid-90's; those actions promptly ended the fall in asset prices in those countries and restored normal operations to the financial industry.

Tax Free Savings Accounts

The last Federal Budget introduced Tax Free Savings Accounts.

Starting in January 2009, individuals (age 18 or older) may deposit $5,000 per year and investment gains are not taxed even on withdrawal.

Unused contribution room accumulates and withdrawals create new contribution room.

It's the most important change since the RSP.

Please contact me for details at choran@assante.com

Is This Time Different?

Short answer: No. The stunning decline of share prices from September 15th to October 15th, 2008 ranks as a true bear market. However, overall, the decline (so far) is on par with the average of the 13 bear markets since WWII (average decline 31%, average duration 15 months).

The urgent selling of September and October 2008 was significant because it was indiscriminate: shares were sold *regardless of the price or value*. The urgency of the selling probably resulted from hedge funds and individuals forced to meet margin calls.

I have experienced the bear markets of 1982, 1987, 1998, 2000/03 and now 2008. I have seen this movie before. Of course the setting and the actors are different, but the part that is the same is the fear and anxiety. Fear is a powerful motivator for emotional decision making, and emotions are generally the worst possible ingredient in investment decisions.

The fear galvanizes the widely diverse range of opinions that usually prevail in markets (which is why for every seller there is a buyer). Studies on social conformity clearly show that people will conform under pressure to views that they can see are obviously incorrect. The fear and uncertainty in times of crisis tremendously increases the odds that people succumb to the prevailing view.

Today is one of those times. People are gravitating to the view of impending economic disaster. Everyone is running to one side of the ship. And investment professionals know that when everyone runs to one side of the ship, the wise thing to do is to go the other way.

The fear creates lifetime investment opportunities. Half the top 100 companies in Canada now have dividend yields of 5% or more, or Price/Earnings (P/E) ratios of 10 or less. The dividend yield on Canadian banks is now about 4% while government bonds yield only 3.5%.

Why is the crowd wrong? Because the economic futures of the world's best companies are not nearly as bad as the market price declines suggest.

The future profitability of Petro-Canada or Royal Bank or any of the other great companies over the next 5 years has not likely fallen by 40%, although the stock price may have. TransCanada Pipe earns a profit regardless of the price of oil in the pipeline. Royal Bank's profitability should improve after the crisis, according to Chuck Winograd, head of the investment banking arm, because it will be able to charge higher interest for lower quality loans.

History has shown time and again, that the market turns up well before either sentiment or the economy improve.

Designed to Take It

Your portfolio has been designed for these shocks.

If you are accumulating assets for retirement, you have been through the 'Lifeboat Test' and are prepared for the market declines. This storm will test the downside limits of the portfolio, but will not break it.

If you are retired, you have 3 or more years' of withdrawals already in bonds or cash. We will try and withdraw primarily from those stable segments of the portfolio, to avoid selling the equities at low prices.

The market behavior today is like heavy turbulence on an airplane flight – you may feel sick, you won't get your coffee or dinner, and you may be very unhappy. But I am confident that the plane has been built to take it. The wings are not about to fall off. If you stay seated, with your seatbelt on, you will reach your destination.

Glimmer of Hope

A gloomy client asked recently, 'Can you give me one thing that is positive?'

Yes. Several.

1) The US dollar has been firm. According to the Bank Credit Analyst, an independent analysis firm, the strength of the US currency gives Chairman Bernanke and the US Government maneuvering room to deal with the crisis.

2) Warren Buffet put $5 billion into Goldman Sachs and $3 billion into GE in late September. Buffet has moved about $38 billion in his personal account from bonds into US stocks in recent months. Buffet has earned his reputation as a savvy investor over many years and remains the wealthiest man in the US. This observation alone should give you confidence.

3) The situation is moving fast towards resolution: strong US and European banks are now stepping up to buy the troubled ones.

4) The amount of cash building up on the sidelines in money-market funds worldwide is at all-time highs, and now stands at US$5.7 *trillion* according to research by JP Morgan. This wall of cash will be invested at some point, since money market yields are so low.

5) US house prices have fallen to levels that correct much, if not all, of the recent imbalance. According to the Case-Schiller Home Price Index, US home prices have fallen about 16% in the 12 months to May 08. This decline brings house prices to levels representing increases over the last 7 years of about 4% per year. In other words, if there had been no housing bubble, and US house prices had risen at 4%/yr for the last 7 years, they'd be where they are today. They may still drop further of course, but they may not: it's hard to argue that 4%/yr price appreciation over the past 7 years is too much.

6) Fear marks the bottom of a market. The VIX index (Chicago options volatility) is a well-known measure of fear. (Options are more expensive in scary times). In the last 18 years it has gone above 30 only 6 times; only once has it been over 40. Friday October 10th it went to 70. Fear marks the bottom of a market.

Where to From Here?

A financial crisis is not an economic crisis. A financial crisis involves banks and other financial institutions, and does not have to spread to the larger economy.

This is not 1982 when interest rates of 19% crippled everyone that had a loan. This is not 1974 when inflation destroyed financial assets and distorted economic decisions. Those were economic crises. This is more like 1987 or 1998 where specific financial events threatened the economy, but were contained.

The problems in the banks today were not brought on by a deteriorating economy; they are the result of bankers doing stupid things to themselves. The economy, although weakening, is still growing. Unemployment in Canada remains at generational lows, and is only 6% in the US as well.

Recession?

The question obviously is to what extent the financial crisis might damage the real economy. The media is screaming about a replay of the 1930s with a certainty and exaggeration that is unsubstantiated and inappropriate.

I fully expect we will see a sharp drop in the economic data. It should be no surprise that, similar to 9/11, economic activity contracts suddenly and sharply, given the level of alarm. After 9/11, the world froze. Yet we recovered and carried on.

Today, given the rapid and massive policy response, there is no reason why the operation of the financial system will not return to normal.

The credit markets can be thawed as soon as bankers become confident that other banks can meet their obligations normally. This appears to be happening now.

Looking Forward

I recall in the mid 1990's a presentation by Sir John Templeton, the famous investor. There were 900 people in the room and the mood was gloomy as you can imagine. The Canadian dollar was at 62¢, was widely believed to be headed for 50¢, and Quebec was pretending to head for the exit. Someone asked what Templeton thought of the future of the Canadian dollar. His answer was roughly, 'The Canadian dollar is low because of the fiscal and political problems. But the markets know about those things so they are already factored into the price. I will bet anyone in this room $1,000 that the Canadian dollar is significantly higher one year from today than it is now'. I was stunned by his confidence. And he was right.

The World

World governments have put in place the policies for the resolution of the financial crisis. As the problems subside, the world will continue to advance. More people in the world today than ever before are free from the dead hand of communist and socialist control. More people in the world today are free and able to trade with each other to obtain the things they need to move up the economic ladder. These people yearn for, are striving for, and fully deserve the improved welfare and standard of living that economic freedom promises. Science and medicine are able to control more diseases and improve the health and living environments of more people worldwide than ever before. Communications technology allows more information, more facts, more knowledge to be available to more people worldwide, at lower cost and with less interference from manipulation, than ever before.