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2008 Review – History Made, Opportunities Revealed

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There is no shortage of material to discuss when one sits down to write about the year just passed. It was a year so full of major newsworthy events, so deservedly prone to superlatives, so rare and full of exceptional if not unprecedented events.

Record setting market highs came in the first half of the year, along with record rallies in virtually all commodity prices, but soon gave way to record setting declines. The speed and severity of the declines in stock, credit and commodity markets was breathtaking. It seemed that we had no sooner heard pundits opining that we were running out of oil and prices were justifiably headed over \$200 per barrel than we were hearing that the world is awash in oil supplies and prices were tumbling back down into the 30s and to levels not seen since 2004. The Canadian dollar lost its luster and took a spectacular plunge from parity back into the 70-cent range again. A year ago at this time we heard about a trading scandal that rocked the French bank Societe Generale. A rogue trader had cost the bank \$7 billion. In a normal year, Jerome Kerviel's name would still stand out and perhaps be the biggest financial story of the year – luckily for Jerome this was not a normal year and his place in infamy is rather more anonymous.

Here are the calendar year returns for some well known indices:

S&P TSX Composite Index: -35%

From peak to 2008 trough: -49.6%

S&P 500 (500 largest US companies): -38.5%

From peak to 2008 trough: -52.6%

Dow Jones Industrial Average: -33.9%

From peak to 2008 trough: -48.3%

Shanghai Composite: -65.4%

From peak to 2008 trough: -72.6%

Nymex Crude Oil 2008 range: \$147.27 to \$32.41 per barrel

A recent Merrill Lynch report released by NexGen Financial gave some historical perspective to what we have just endured. At the market lows of 2008 we had just been through a ten year period in which the world's major markets produced a negative total return.

That is to say that the major stock market indices, even including dividends, gave investors a loss over the past ten years. The study found only three other such time periods in the last 150 years. This would put the likelihood of such an event at less than 3%. That same study also showed the tremendous potential returns to investors in the decade that followed such sharp selloffs in markets. As is so often the case, stock markets exaggerate both to the upside and downside. Sharp declines such as we have seen are fueled by fear and can reveal some fantastic values as desperate sellers unload quality assets at any price. What makes this past decade all the more rare is that we have seen two 50% declines within the one decade. The first followed the tech market's collapse and the fallout of 9/11. This current decline began barely four years after the last market bottom was struck.

I don't believe that we could have had such a drastic downturn without a convergence of several factors. The difficulty of predicting the impact from any one factor is high, but it is nearly impossible to have foreseen the combined impact. Through much of the latter part of 2008 it was fear and forced selling as much as anything fundamental that was forcing the markets lower. The year was a whirlwind of news items. Starting in late 2007, U.S. home prices turned down and the first mentions of 'subprime' mortgage issues emerged. I have written previously on the subprime issue so I won't belabor the point here again (refer to <http://www.alanameron.com/services/subprime.aspx>). Suffice to say that a decline in home prices and some bad mortgage losses alone was not the sole factor contributing to our recent decline. I also wrote previously about the unprecedented spike in commodity prices, which I believe was largely based on a speculative push in the early summer (refer to http://www.alanameron.com/services/Jul08_commentary.aspx). The price spike from \$65 a barrel to \$147 a barrel in one year was a massive blow to the global economy as a whole, and may have been enough to tip us into recession (as has happened in the past following sharp energy price spikes), but was also a mortal wound to the domestic car makers. The fact that we were in an election year (most importantly in the U.S., but in Canada also) I believe contributed mightily to the market decline. Any degree of uncertainty hurts markets. It tends at the very least to push buyers to the sidelines with a 'wait and see' approach, and can increase the selling pressure. This election cycle happened to coincide with some of the most complex and urgent issues in decades. Governments are prone to partisan bickering at the best of times and can be slow to react, but in an election year all the more so. This particular year could ill afford the added risks and uncertainties of bickering, squabbling and delay. Despite a number of issues and clouds on the horizon in the spring and early summer, markets remained hopeful, and in some cases were making new highs. The collapse of Bear Stearns, rising bank losses, financial scandal and skyrocketing commodities had not by that time spooked markets. In hindsight, it appears that the collapse of Lehman Brothers was a turning point.

Lehman Brothers collapsed in mid September. On the Monday morning of September 15th the market woke to the news of the large firm's demise. The S&P500 had closed at 1251 the previous day. One month later it was 907, down 37.5%.

In March of 2008, Bear Stearns, another large US broker, ran into trouble and was rescued by government intervention and a structured arrangement to protect the financial markets from the systemic risk of its failure. The stock markets took note – it appeared that large financial firms which had systemic risk upon failure would be dealt with in an orderly fashion through government intervention. But the failing economy was the election issue of the last six months of the campaign. With much rancor and finger-pointing, there was a growing belief in the Democratic Congress that someone had to pay a price – ‘heads need to roll’. Republicans were barely in the mood for any kind of government intervention at all thus sending an inconsistent and confusing message to markets. Lehman Brothers was allowed to fail but no agreement could be quickly reached on how to deal with the systemic risk to other financial firms and no coherent plan for dealing with the dissolution of the firm was announced. The eventual passage weeks later of the TARP program was by then a bandaid on a severed artery. I believe that had we not been in an election year the uncertainty of having a lame-duck President in charge (any policies would therefore be subject to reversal or change just months later), along with the partisan bickering and lack of decisive action (or even decisive inaction) meant that Lehman Brothers was more likely to be allowed to fail, and that having made that choice, no backup plans could be set in place to deal with the repercussions. Banks were no longer in the mood to extend credit to one another since they worried about the other firm’s collapse. Financial market participants no longer knew the rules of the game. We had started the credit squeeze that only recently shows signs of improving.

In addition to the factors above – housing and mortgage problems, a commodity price spike and subsequent crash, and an enhanced level of political uncertainty – we can add financial scandal, also of the record breaking sort. Hedge funds may well have a place in the world of finance, but they had come to be too large and too highly leveraged for anyone’s good. Hedge funds grow best when fertilized by fear and greed and they had ample supplies of both in the past few years. Their trading helped fuel distortive moves in currencies, commodities, credit markets, and finally, when so many were in their death throes later in 2008, they also fuelled massive selloffs in what often were unrelated, and undeserving investments. With massive redemptions and margin loan calls forcing many hedge funds to liquidate to raise cash, many good companies and stocks have seen their value pummeled with little reason, and it is in these areas that investors can now find compelling value. Forced selling can cause a rapid price decline in markets. It is during such times when emotions run high, and prices run low. Unprecedented valuations in corporate bonds, and by many measures, stocks in general have emerged. If history serves as any guide, and markets recover as they have in the past, we may be witnessing once-in-a-generation opportunities for long term investors to buy. During the bear market of 1973-74, a much younger and less famous Warren Buffett was eagerly acquiring the bargains that would make his fortune and reputation as a savvy investor today.

The sort of sociopathic behavior exhibited by the likes of a Bernard Madoff – accused in a scheme that defrauded his investors (many of them charities and charitable foundations, university endowments, etc.) of perhaps \$50 billion – is best analyzed by psychiatrists, not financial planners. We can say that his sort does little to enhance the confidence of investors at what was already a trying time. I would also speculate that the biggest cost of his malfeasance will be impossible to measure. It will come from the damage he did to the reputation of the investment markets, and will be equal to the lost investment returns of those investors whom he has scared out of good investments or caused them not to purchase outstanding investment opportunities available now and in the future. While much of the reputed \$50 billion dollars involved in his scheme may well have been unrealized paper profits (money his investors thought they had gained, but not money they had given Madoff), I think the cost of his depravity will run much higher. By shaking the confidence of small investors in the financial markets themselves, the Madoff scandal will do what other scandals have done before him – cause small, unsophisticated investors to eschew risk and seek the safety of large, institutional guaranteed returns. The unfortunate result will be a very much larger figure than \$50 billion lost. By missing out on the opportunities available in this market for the perceived safety of record low rates of return on guaranteed investments, the costs to the scandal-scared investors of the world will dwarf the \$50 billion figure in the decades ahead.

I have written before that the only thing that matters in investing over the long term is the fundamentals. I will undoubtedly continue to do so in the future and I apologize for the redundancy, but it is a point well worth repeating. Fear and greed move markets to peaks and troughs. In the long run, they are not what matters. However, times of fear can cause serious pricing anomalies and allow the patient and disciplined investor an opportunity to buy good assets at compelling prices. I will spend some time discussing the fundamentals of investing and what this past year may mean.

You may have heard of Price/Earnings multiples (or PE multiples) before. Simply, it is the ratio of what you pay for what you earn. If a stock trades at a price of \$10 per share and the company earns \$1 per share in profit, it has a PE ratio of 10. This can also be expressed as an earnings yield. A \$10 investment yields \$1 of earnings, for a yield of 10%. This method of valuing an investment is basic yet extremely important. An investor must always ask the question: how much do I have to pay for \$1 of return?

Dividends are another important consideration. Over time they make up a very large part of investment return in stocks. When a dividend yield is high (e.g. a \$20 stock that pays a \$1 annual dividend has a dividend yield of 5%), the purchaser of that investment can be paid the dividends; once paid, a dividend cannot be taken back. Dividends are also subject to lower tax than other forms of income like payroll income or interest income, so the after-tax yield is even more attractive.

In times of crisis, fear and panic, investors often turn to what they consider safe. Government guaranteed returns top the list of safe investments since the return of the original investment and the promised yield are backed by the taxing power of the issuing entity.

When governments issue a bond, they have a maturity date and an interest rate. A \$1000, 30 year bond issued last year at 4% will pay the owner \$40 a year for the next 30 years, and then pay back the \$1000 at maturity. The yield on the bond is 4%, or as we noted with PE multiples above, a PE ratio of 25 (i.e. an investor has to pay \$25 to get \$1 of investment return). The day after its issue, government bonds are bought and sold on the bond market and their price fluctuates. Subsequently, if new government bonds are being issued at a higher yield, say 5%, then your 4% bond is less attractive and will not have a current market value of \$1000 any longer. It will trade at a substantially lower value since it is going to pay only \$40 per year versus other bonds available which pay \$50 per year. Your bond may fall in value by perhaps 20% in such a scenario. Eventually, if you held the bond for the full 30 years, the decline in value would be recouped and it will mature at \$1000. But for someone purchasing the bond from you at a discounted valuation, they would not only earn the interest yield but also a capital gain as the bond increased from its lower market value to its full value at its maturity date. When a great many people are interested in purchasing government issued securities, the amount they receive in interest tends to decline (even government debts are subject to the laws of supply and demand – a great demand for the limited supply of government bonds increases the price of a government bond, and therefore reduces its yield). This is part of the reason we have recently set new record lows in government bond interest rates. It is also part of the reason that these investments are not truly as “safe” as they appear.

Government bond yields have recently been striking all-time lows. Rates on the 30 year bonds issued by governments in developed countries like Canada and the U.S. fell below 3%. Should interest rates increase in the next year, just going back up to 4% on a 30 year bond, then the loss in market value to the holder of that bond today will be double digits. Bondholders will still get their interest payment as promised, but the market value of the bond will decline if rates rise.

In many ways, we are seeing unprecedented valuations in the investment markets today. Given that government bond rates (the ‘risk free return’) are so very low, the relative value of other investments has gone up. A stock that paid a 6% dividend, and traded at a PE ratio of 10 (10% earnings yield) in 1981 had to compete with double digit inflation, and a risk free return in government securities that was also in the double digits. GICs paid in the mid-teens. The stock’s relative value was debatable.

But today’s market has tremendous relative value. Given that inflation is near zero, and that the risk free rate of return is tiny, today’s dividend yields and PE ratios, once we subtract the risk free rates of return available, may be at once-in-a-lifetime bargains.

I believe that the biggest risk to investors achieving their long term goals now is to have their investment discipline tested to the breaking point. A move out of a diversified portfolio and into ‘safe’ investments will lock in the recent exaggerated declines and the low yield of such guaranteed vehicles make the time to recover the lost value stretch out a decade or more.

In past downturns of this magnitude, the bargains were there but relatively few were able to stick to the fundamentals and invest accordingly.

I have written in previous commentaries that volatility is a feature of modern markets and is here to stay. But this recent market decline has also made it clear that entirely new strategies are necessary to deal with the volatility; not just modified strategies. This will be the challenge going forward in a rapidly changing investment world. But, I repeat, the underlying fundamentals have not changed. We must simply develop strategies that allow us to more comfortably navigate the waters without shaking the disciplined approach to investing that will in time bring success.

We have all likely heard the phrase ‘the madness of crowds’, and perhaps many have also heard the old investment cliché ‘the crowd is always wrong’. I mentioned above that market peaks are created by greed and market bottoms created by fear. The best day, best two days, best week, worst week, worst month, worst quarter in market history, and quite a few other records on interest rates, volatility, valuations, etc. all were recorded in the past few months. Part of the reason we are now experiencing so many unprecedented market events is the dramatic change in the composition of investment markets in the past couple of decades. The majority of households now have some control over their savings and investment holdings. This was not the case at one time.

As recently as the 1980s, very few people controlled their own assets in the investment markets. This tended to be done on their behalf by pension funds and the like. Now, with a relatively quick evolution to self-directed retirement plans and inexpensive, simple trading platforms (no more 6% commissions to buy and sell a stock) millions participate in the stock and investment markets directly. It is a crowd much more than it ever was in the past. And it sometimes exhibits decidedly crowd-like behavior. The mass buying frenzy that was the tech bubble was madness. I also believe there was a degree of madness in the indiscriminate (or forced) selling at the end of 2008. Currently, safe, simple, secure, guaranteed investments (money market funds, GICs, etc.) are the choice of the vast majority of investors. If the past is any guide, the crowd is always wrong.

Whether or not one agrees that the past history of market downturns such as we have seen will be repeated, meaning that we will see a decade of strong, well above average growth ahead, or whether one believes that this downturn is truly worse than all those past and we will continue to struggle, market fundamentals, not fear or greed will continue to reign supreme. In time, markets make sense. Let’s hope that time is near. Only those with a disciplined and dispassionate plan to bring a suitable strategy to bear will reap the benefits of the boom to come.

- Alan Cameron