

February 27, 2001

"Those who do not remember the past are condemned to repeat it."

- [George Santayana](#)

This famous phrase has been ringing in my mind lately. Every year without fail on Remembrance Day, and at random and unpredictable moments throughout the year, I force my children to endure my lecture and remind them of the significance of this quotation. It has stuck with me mostly because of its significance with respect to great conflicts and human events, but it is a well-known phrase throughout the world mostly because it applies to virtually all endeavors great and small. With every news report and every comment I hear from clients, prospective clients, radio show listeners, friends, passing strangers and my fellow elevator-riders these days, it rings more loudly. As the world's stock markets go through a rather wrenching downturn I am again struck by the lack of perspective people maintain. In the investment markets, we should never fear that history will repeat itself; we should plan on it and pray for it.

My job description changes with the times. At times of market excess, when optimism runs rampant in the investment world, my job is to warn of slower times, to continue to maintain diversified portfolios despite the fact that this means not all investments will be performing at the time, and to remember the history of past market peaks so that my clients can benefit from the lessons of the past. Generally speaking, I am the rain on the parade. At times of market declines, when pessimism is the order of the day, I must point out the positives, continue to diversify despite the fact that people might prefer to embrace the safety of guaranteed, low yielding (and guaranteed-to-be low yielding) investments, and remember the history of market declines so that my clients can benefit from the lessons of the past, and the inevitable recoveries that come when least expected. I am a professional silver lining locator at the cloudiest of times.

Given that the perspective of the media and most market commentators spans barely a few months, and that the average investor will be harmed by a perspective any shorter than three years, I would like to offer up a history

lesson. Investors who learn the lessons of history are not condemned, but empowered.

Performance is not just an important thing in investing; it is the only thing in investing. However, the typical investor does a truly horrendous job of measuring performance. By measuring an investment's performance, without considering its role in a diversified portfolio, one does oneself no favour. Overall portfolio performance, the bottom line, is the most important consideration. But whether evaluating individual investments or whole portfolios, people tend to measure their performance unwisely. By selectively choosing the time frames of measurement, almost all investments can be made to look bad. To justly evaluate an investment, performance should be measured from peaks to peaks or from troughs to troughs. It is of little value to consider performance over a period that spans the time between a market bottom and a top. To judge the Canadian market (as defined by the TSE300) based on its performance from the lows of October 1998 to the highs of September 2000 (5320.9 to 11423.7, for an average annual return of 46.5%, and a total return of 114.7%) would be of no more use to an investor than to measure it from the highs of April 1998 to the lows of October 1998 (7837.7 to 5320.9, for a six month loss of 32.1%). The typical investor, armed with such data tends to draw precisely the wrong conclusion. I can track the flow of money into Canadian equity funds. It confirms that the majority of Canadians buy at the wrong time and sell at the wrong time. Markets are propelled to these excessive highs and lows by the fact that so many investors assume that good returns will continue on the way up, and bad returns will continue on the way down. How does this fit in with another favorite quotation: Buy low and sell high? It doesn't. *When measuring investment progress, be sure to measure from peak to peak or from trough to trough.*

Canadian investors generally assume that the U.S. market *always* outperforms Canada. It is another odd perception that develops as a result of a shortened historical view. The TSE has outperformed the S&P from the monthly low of January 1999 to the monthly low of January 2001 (TSE average annual return: 14.2%; S&P average annual return: 2.9%).

Nevertheless, let's consider the U.S. for more lessons from history. As you might guess, I am currently decreasing our rather high exposure to Canada, and increasing our exposure to the depressed foreign markets.

The S&P500 hit a monthly high of 421.18 in January of 1992. It hit a monthly low of 442.88 in December of 1994, some 35 months later. This would have yielded an investor an annual compounded rate of return of approximately 1.73% (the TSE did 4.9%). The market performance for 1994 was the culprit for both markets. After a good year in 1993, the markets dropped in 1994 out of fear of recession and as a correction to the excesses of 1993. At the time, interest rates were quite low. After a rough market in 1994, investors ran for the safety of guaranteed returns at rates as low as they had been in a generation. The Canadian mutual fund industry had a terrible RRSP season in 1995 as investors assumed that the bad markets would continue. History of course has proven them wrong. The low for the S&P in January of 1997, a five year period from the low of January 1992, and including the decline of 1994, was 729.55. This five year period yielded investors an annual compounded rate of return of 11.61% (the twenty year average return from Ronald Reagan's inauguration to George W. Bush's inauguration averages 12.2%). This is to say that the last two years of the five year period generated almost all of the return. As a point of interest, in the four years since then and up to today, the S&P returned a shade under an average of 15% per year. Now that the S&P has declined by 20% in the six months since September 1, 2000, it would need to grow at an annualized rate of 18.4% for the next four and a half years in order to reach the average of the last five year period. However, that is only a possibility for those able *and willing* to buy at these levels. Historically, it is a great time to buy. The history of investors in Canada would suggest that they will wait until the market has risen at least 25% before they begin buying en masse.

I see clear parallels between today's markets and the markets of early 1994. Had you invested \$10000 in the TSE at that time, you would have \$19487 at January 2001's low, for an average annual return of exactly 10%, trough to trough. In the U.S., your \$10000 invested at the lows of January 1994 would now be \$27420, for an average annual return of 15.5%, trough to trough. For those still impressed with technology as an investment, even after this year's 60% decline in Nasdaq, the average annual return from January 1994-2001 has been 16.6%.

The last five year period for the TSE has seen some substantial volatility. Events such as the Asian Flu and the Russian debt default were among the many shocks to the markets. However, the story remains the same. Had you invested at the January 1996 low of 4706, you would have an annual

compounded rate of return of 12.4% up to the lows of January 2001, when the TSE was at 8466. Contained in that five year period was a decline of similar magnitude to the one we have just experienced. From April 1998 the TSE suffered a decline from 7837 to a low of 5321 that October. This represented a decline of 32%, however the five year period containing that decline still provided a quite acceptable return. Better still would have been to add to one's investments at the time of that decline. An investment in October 1998 would have returned an average annual 16.75% to the lows of January 2001 – and this would include the effects of the 26% decline the TSE suffered in the six months leading up to January 2001.

There will be those who prefer to focus on the worst possible interpretation of the market's performance of the past few years. Had you invested at the peak of April 1998, and measured from that peak to the trough of January 2001, you could focus on the meager return of 8% or an average of 2.75% per year and may therefore decide that GICs offer a better investment opportunity. Those who base their investment decisions on this kind of analysis will have missed out on virtually every bull market in history, will have vastly underperformed the double digit long term average of the stock markets, and will almost certainly miss the opportunity presented by the markets' recent decline. Comparing the markets at a period of overvaluation to a period of deep-seated pessimism will only do financial harm.

In early March of 2000 I wrote a commentary titled "It's Different This Time". It is still posted on my web site in the Commentaries section under Thoughts on Recent Market Events. For those without internet access I will gladly mail a copy. I wrote that commentary to remind investors that the heady markets of that past year could not continue indefinitely. The premise of the article was that it is never different – that history does in fact repeat itself – and that those who do not remember the past are condemned. The same point must now be made. There have been other declines. Markets have recovered and prospered. I do not believe it is different this time. For those who prefer to ignore the history of the markets, fear not because I can get you 5.55% on a five year GIC if you have 5000 to invest.

That's it. History lecture over. But next Remembrance Day, take a moment to remember those who have sacrificed so that we may live and prosper, and another moment to pity my poor children for the lectures they must so often endure.