

April 9, 2001

### When Will It End?

That must be a frequently asked question among investors these days. We are experiencing one of the most severe bear markets in generations. The only post World War II comparison to the market declines we have seen would be the bear market of 1973-74. While that bear market was long and painful, it was no more dramatic a percentage decline than we have seen in the last 13 months. In the calendar year just passed, we saw the weakest performance in the history of NASDAQ, and the second worst performance of the post-war era for the North American markets as a whole. The first three months of 2001 carried on the same course, turning out to be the worst first quarter in history for the S&P 500 index. The TSE300 has dropped from its September 2000 high by over 33%. Nortel is largely responsible for that decline, having fallen an astounding 83% from its September peak.

In previous correspondence I have stressed several themes: keep one's perspective when taking in media reports on market events; remain diversified; *think* long term as opposed to *feeling* the short term. I must stress these points again.

The media's role is *not* to act as your financial advisor. It is to sell advertising space. They do so by increasing the number of people who view what they publish. More people will view something exciting than something boring. The media therefore tries to make exciting that which can be quite boring. The process of wealth creation – i.e. building a quality business over decades that will generate increasing profits to shareholders over many decades – tends to be boring. The gyrations of the stock market over a period of decades too is boring. When one considers the progress of the stock market, tracking as it does the gradual increase in wealth of the businesses that trade stock publicly, over the time frames necessary to accurately measure wealth creation (i.e. five to ten year periods) it can be boring. Average five and ten year returns tend to be extremely close to the long term average return of the market – 10-12% average annual compounded. Rather boring. Not as exciting as the triple digit home runs people like to read about on the way up, nor the catastrophic collapses they like to read about on the way down.

To spice up such a story we have to focus on the short term, where irrationality reigns. Irrational behaviour seems to be more interesting. Imagine if you will the media reporting on some other field of human activity. It is a given that billions of rational people live each day calmly, routinely, going about the business of making a living, raising a family, etc. Yet the media focuses our attention on the handful of irrational people each day who murder, maim, cheat and steal. Is it a fair indication of the state of the human condition? No more so than focussing all the media's attention on the worst days, the worst performing stocks, or the worst story of someone losing their life's savings in some high tech gamble. Then again, would you be motivated to buy a newspaper whose headlines read: "Millions go to work without incident" and "North Americans successfully complete another day of their working life: Retirement goals on track"? These are the headlines of the reality in which we live, but they don't sell newspapers. Given sufficient time, the market will recognize the creation of wealth in the economy that is the result of the labour and innovation of billions of people around the world. In the short term, frightened investors may well focus on the juicier headlines, and may unfortunately allow short term corrections in the market's ongoing process of accurately reflecting the value of a company to derail their financial plans. By allowing a brief period of excessively high prices to allow one's financial plan to become too aggressive, or conversely, allowing a brief period of falling prices to shake the discipline of diversification and long term focus, one can be victimized.

Diversification remains a key component to any portfolio. Successfully diversifying requires expertise, discipline and planning. The rewards of diversification include lower risk and volatility, higher long term returns, and fewer sleepless nights. It is at times of excess in the markets, whether at great peaks or terrible lows, that investors run the greatest risk of inadvertently losing their diversification or of intentionally abandoning it. I would liken it to excesses within our

atmosphere. At great altitudes, humans cannot draw in enough oxygen to survive. Whenever you fly, the safety warning cautions you to remain calm if the cabin de-pressurizes. You must fight your natural impulse of fight or flight. If you don't calmly place the mask upon your face you are doomed. At depths, scuba divers are at great risk. When panicked, they tend to behave irrationally. They will try to ascend to the surface as quickly as possible. They must be trained to fight that response to adversity. By rapidly ascending they may die from the rapid change in atmospheric pressure, yet they believe they are acting to save their lives. In either extreme, remaining calm is necessary to survive. In investing, the natural reactions of investors can also be dangerous. Investors must be trained and conditioned to avoid potentially hazardous reactions to extremes. There is never a greater likelihood of people moving all their assets to high risk stocks than at market peaks, nor is there ever a greater chance of them moving all their assets to low-yielding GICs than at market bottoms. In either case, it is a self destructive action, but a behaviour that comes rather naturally it seems.

I often refer to the need to be rational in one's approach to investing. It is, I believe, perhaps the most vital component for investing success, yet it is surprisingly rare among the investing public – i.e. the people that make up the "market". In the short term the market is made up of millions of often irrational decisions. The aggregate, or sum total of these irrational inputs ends up being an extremely rational and accurate result, in that the markets do a good job of pricing the shares of individual companies, and the market as a whole, over time. However, in the short term we are left to invest our life savings in a rather chaotic market place with only the knowledge that it will all make sense in the end to guide us.

Given the assertions of the above paragraph, many people will agree with almost all the points, but will not believe that it is any reflection on them. Virtually no one will admit to being irrational, even if only for a moment's lapse, even if for good reason. It is our human nature to act in ways that can be considered irrational when put in the context of the stock market. We have the excuse that we are deluged with information that leads us to irrational conclusions. Yet few people will see themselves as irrational. So I will provide some examples of what I consider dangerous market behaviour, and you can judge how common you find them to be.

Faced with these headlines:

**"Markets plunge on evidence of recession"**  
**"Profits tumble in wake of tech collapse"**  
**"Unemployment on the rise across North America"**  
**"NASDAQ hits two year low – down 63%"**  
**"U.S. slowdown may cause global recession"**  
**"Bank stocks fall on fear of loan defaults"**

Would your first inclination be to borrow against your house to invest, or would it be to take all your money and put it under the mattress? I believe the rational decision would be to invest. History has shown that similar periods have been tremendous opportunities to buy. The important point to realize is that headlines are rarely full of news. By the time it hits the headline, it is no longer new. An anticipatory entity such as the stock market will have already priced much of this "news" in to stock prices. The news tends to lag the events currently transpiring. This is why markets often rise at the point when it is first realized that a recession is under way. By the time a recession is over, the markets are much higher. Profits are a lagging indicator as far as the market is concerned. Profits reflect sales of goods over the last year. The market is concerned with profits in the next few years. After falling, it is much easier for future profits to rise in large percentages, which the market likes to see. Unemployment is bad only for those laid off. Companies shed workers in slow times to maintain their profits. When many companies do so, it means that the price of labour is less likely to increase in the years ahead, helping to ensure higher profits for companies and their shareholders. This is why a company's shares often go up when they announce layoffs. They are fixing a problem the market has long ago recognized and discounted. As for NASDAQ, well, would you rather buy something at \$51 or the same thing for \$17? That is how far NASDAQ has fallen. However, this is not the rational question to be asked.

The old joke goes: a man will pay \$2 for something he needs even if it is only worth a dollar; a woman will pay a dollar for something she doesn't need if it is on sale from \$2. In the stock market, people exhibit the worst of both behaviours. Is there ever a great price for something you don't want or need? If a device that continually banged a mallet over your head were to go on sale for 90% off, would it be too good to pass up? In the stock market, such irrational behaviour is common. The first rational question to be asked of an investment is: Is this a good investment? The next question is: How much?

How many times have you heard that technology is the way of the future, that companies like Nortel are great companies and that they will *have* to do well? In the runup in the market, I heard it a lot. True enough, technology has great potential to change the way we live and Nortel has grown tremendously and by all accounts is a dynamic and competitive company. What I never heard asked was "how much?" It reminds me of the stereotype of the mega-rich. "Money is no object" and "if you have to ask how much, you can't afford it". If money is unimportant, or if you can afford to lose it, then you don't have to care how much you pay for something. For investors hoping to make a return on their investment, they need to care. Is a share in Nortel (take as given that it is a great company) a good investment at *any* price? Would a good, high quality car like a Honda Civic still sell if priced at \$120,000? Or would a top of the line Jaguar sell if it cost \$600,000? I think not, and yet this would be the equivalent of Nortel's peak share price compared with its price today.

Rational behaviour in the markets would be to buy high quality assets that one wants to own over the long term, and do so at a time when their price makes them an attractive purchase. Common behaviour in the markets would seem to be the opposite.

The short term focus of the typical investor often causes them to perform more poorly than the markets themselves. As an interesting aside, consider this quote:

"The nature of our investment style tends to generate above-average levels of volatility. In terms of our management of CI's funds, we are finding that the short-term focus on performance in the mutual fund industry does not allow us to position the portfolios as we would prefer in order to produce better longer-term returns. As we continue to develop our growing institutional business, I would like to thank CI and financial advisers for their tremendous support over the past eight years."

It is from John Zechner, who recently resigned from the management of public mutual funds. The typical mutual fund investor has in the past two years invested heavily in tech stocks at the market peak last March and steadily pulled money out of these stocks all the way down. Buying high and selling low is not rational behaviour, and as Zechner can attest, it is a short term road to losses.

For investors who are well diversified, and investing within the context of a plan that takes account of their objectives, this past year hasn't been fun, but hasn't been altogether disastrous either. It is part of a normal fluctuation and will not, I believe, cause any deviance from the five year average returns I monitor. It will, however, present an above average buying opportunity for those able to seize it.

There are those who would attempt to predict the short term fluctuations of the market. I am not among them. I believe that the current decline has presented opportunities for an investor with a long term horizon to buy at attractive levels. To try to predict the short term direction of the market is to try to make sense of nonsense. There is no order in chaos – the terms are mutually exclusive. I will never be able to make a rational prediction on when the irrational behaviour of millions of market participants will change. It is inherently unpredictable. However, there comes a time in every cycle when I may be prepared to take advantage of someone willing to sell me a

new Honda for \$5000, or perhaps someone who is willing to give me \$600,000 for a slightly used Jag. Unfortunately, I just can't predict when that special someone will come along.

- Alan Cameron