

Reflections on a Difficult Year

By late September, markets around the world had entered into “bear” territory (defined as a decline of 20% or more from the previous high), with the S&P 500 down 25% and Canada’s composite index S&P/TSX off 22%. While this was bad, the headlines of the day suggesting an impending total collapse of the global financial system were a good deal worse, indicating that more volatility was in the offing. And volatility was certainly what characterized the markets in October and November – by November 20, both North American indices were roughly 50% below their previous peaks. On December 12, as pen is being put to paper, things have improved slightly (see table below), but we are still deep into bear territory.

VOLATILITY AT THE END OF 2008

	Peak	Bottom	Peak/Bottom	Peak / 12/12/08	YTD 2008
S&P TSX	06/18/08	11/20/08			
	15,073.13	7,724.76	-49%	-44%	-38.8%
S&P 500	10/10/07	11/20/08			
	1,552.47	752.44	-52%	-44%	-39.2%

DIVERSIFICATION WORKS!

The bleak picture presented in the table above gives the performance of equity indices, and would only reflect your own portfolio’s return if you were 100%-invested in this asset class. Proper portfolio construction involves not only diversification within a given asset class to reduce individual security risk, but also diversification across all asset classes as a means of managing the portfolio’s overall risk. And while cash equivalents and government-issued bonds haven’t delivered stellar performances in 2008, they have at least done a good job of insulating a portion of your portfolio from the ravages of the stock market.

Some would argue that another form of risk management and performance enhancement – geographic diversification – has failed, since virtually all of the major stock indices around the world are deep into negative territory. However, the return a Canadian investor earns by purchasing securities listed on foreign exchanges is a mix of two things: the actual increase or decrease of the stock price, and the impact that the fluctuation of currency exchange rates for the Canadian dollar and the home currency of the foreign stock exchange has on that increase or decrease of the stock price, as well as on any dividends paid. Taking the U.S. as an example, while the S&P 500 has done just as poorly as the S&P/TSX composite index so far this calendar year in absolute terms, the greenback gained 20% on the Canadian dollar during 2008, which essentially added 20% to the performance of a Canadian investor’s U.S. stock holdings when expressed in Canadian dollars.

So as you can see, your personal results may differ somewhat, or even significantly, from the doom and gloom we see in the media daily, depending on the composition of your portfolio. These difficult times are an excellent opportunity to sit down with your advisor for a portfolio review, to see just how your investments have done on a relative basis. At the same time, you can also consider bigger picture things, such as where you stand in terms of your longer term financial goals, and what, if any, adjustments need to be made.

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WE'VE SEEN THIS BEFORE

We don't want to appear flippant, but markets tank on a regular basis, and realistic investors should expect stocks to lose money one year out of four, on average. Even bear markets are a fairly regular event: since the Dow Jones Industrial Average was launched in 1896, we have experienced no fewer than 34 market declines of 20% or more. Granted, there are bear markets and Bear Markets, and the one we are currently living through is certainly a Bear Market. But even so, the peak-to-trough decline we have just experienced is not unique.

Using the Dow Jones as a reference point from the turn of the century to 1926 and the S&P 500 thereafter, we can identify no fewer than nine other instances where stocks lost 40 percent or more of their value. Yet, in spite of those numerous and dramatic market meltdowns, the average annual compound return for U.S. stocks over the past century greatly exceeds that of government bonds and short term treasury notes. More specifically, if we look at the period from 1926 to 2006 – a period that includes the stock market crash, the Great Depression, World War II, the Korean War, the Cold War, the oil shock, the 1987 market crash, the Savings and Loan crisis and countless other periods of tension – U.S stocks produced a nominal annual compound return of 10.1%, considerably higher than the 5.5% that government bonds returned over the same period and the 3.8% generated by cash and cash equivalents¹.

MARKET DECLINES OF 40% OR MORE

Start	End	Loss	Duration
June 1901	November 1903	-46%	29 months
January 1906	November 1907	-49%	22 months
November 1916	December 1917	-40%	13 months
November 1919	August 1921	-47%	21.5 months
September 1929	July 1932	-86%	34 months
March 1937	March 1938	-54%	12.5 months
November 1938	April 1942	-46%	41.5 months
January 1973	October 1974	-48%	20.5 months
March 2000	October 2002	-49%	30.5 months

Source: Dow Jones Industrial Average 1901-1926, S&P 500 1927-present

BUT IT'S REALLY DIFFERENT THIS TIME... ISN'T IT?

So we see that markets regularly head into bear territory, and that even the kind of precipitous collapse witnessed in 2008 is far from unique. But, could things really be different this time? After all, the big three Detroit auto manufacturers are teetering on the brink of bankruptcy. Lehman Brothers was forced to close its doors. Merrill Lynch and Bear Stearns have disappeared as independent entities. The price of a barrel of oil has plummeted 70% in six months. It took a \$20 billion injection of government funds to keep Citibank's doors open. The white-collar crimes that have begun to surface are of such magnitude that U.S. capital markets are beginning to look less well regulated than their emerging markets counterparts. Finally, individuals from all walks of life as well as corporations big and small are being denied access to the financing necessary to their economic well-being. The cumulative impact of all this puts us in uncharted waters... doesn't it?

We invite you to read the following quote from Jim Fullerton, former CEO of Capital International Asset Management, one of the world's most venerable investment management firms: *"One significant reason why there is such an extreme degree of bearishness, pessimism, bewildering confusion and sheer terror in the minds of investors is that most people today have nothing in their own experience that they can relate to which is similar to this market decline. They have a feeling that no one's ever been there before, because they haven't been there before."* This quote certainly describes the current prevailing mood to a T – but Fullerton actually uttered these words some 35 years ago, back in November 1974. He went on to conclude: *"My message to you is that we have been here before. Bear markets have lasted this long before. Well-managed investment portfolios have gone down this much before. And investors in those portfolios survived, and prospered."* Fullerton was right of course, and, as measured by the S&P 500 index, U.S. stocks have risen twenty-fold over the ensuing 25 years, ensuring that those with the fortitude and patience to remain fully invested over this period were richly rewarded.

1. Stocks for the Long Run, Jeremy J. Siegel, Russell E. Palmer Professor of Finance The Wharton School, University of Pennsylvania McGraw Hill, 2008

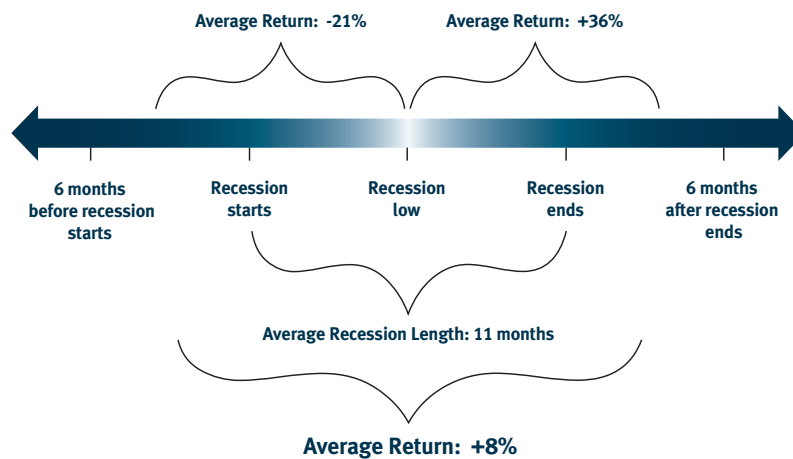
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THE RECESSION – A REASON TO AVOID THE STOCK MARKET?

The prevailing consensus among economists is that most of the world is already in a recession, and the countries that have escaped so far can expect to begin experiencing an economic slowdown soon. The question for investors is whether this recession is cause to avoid common stocks. And the answer is no.

U.S. institutional money management firm Jennison Dryden has extensively studied the nine previous recessions (from 1953 onward), and found that stock markets tend to anticipate recessions – typically by about six months. In other words, markets are already heading south up to six months before the economy enters a recession. Then, stock markets tend to discount the certainty of a future economic recovery and begin heading up, typically when economic conditions are at their darkest. Based on the diagram below, we see that markets declined by 21%, on average, leading into the recession, but rebounded by 36% from the trough. The danger of using recessions as market timing tools is that you have already experienced much of the loss by the time the recession begins, and will miss out on a major part of the markets’ recovery by waiting for the recession to end before getting back in.

AVERAGE STATS BASED ON PREVIOUS 9 RECESSIONS AND THE RETURNS OF THE S&P 500 INDEX



Source: JennisonDryden

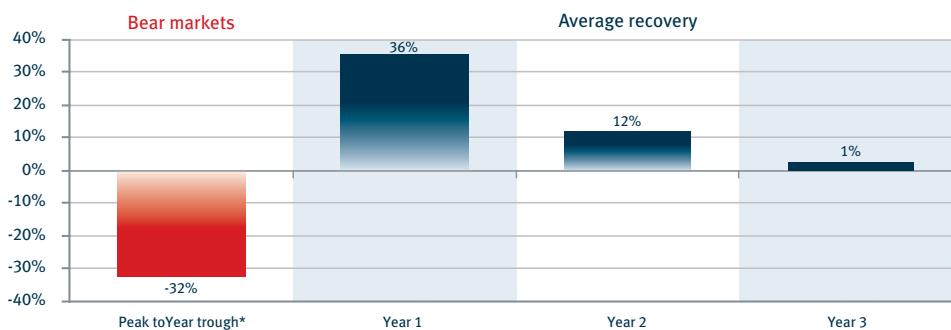
Of course, there are adjustments to be made to the equity component of a portfolio to allow for a recessionary environment, favouring more defensive sectors and underweighting those that perform well only in periods of strong economic growth. We suggest that you discuss this with your advisor.

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THE COST OF MISSING THE MARKET'S REBOUND

For those who have sold out in order to limit losses or who are contemplating doing so, we would like to make one final argument. An analysis of past bear markets reveals that the recovery from the trough is abrupt and anything but linear. What typically happens is that somewhere near the deepest part of the recession, the stock market anticipates a recovery and begins pricing this recovery into its valuations. When this occurs, returns have historically been quite substantial in the first 12 months, but much lower in the following two years. Jennison Dryden's analysis of the last nine bear markets based on the S&P 500 shows an average rebound of 36% in the first twelve months, followed by 12% in the second year, and only 1% in the third year following the trough. It is crucial to be invested in the market when the trend does reverse in order to reap the superior long-term performance that equities offer. You've all heard stories about how being out of the stock market for just 10 or 20 of the "best" days will make the difference between a very attractive long-term return and one that barely preserves your purchasing power after taxes. These "best" days typically occur at the turnaround point referred to above.

AVERAGE RETURNS BASED ON THE PREVIOUS NINE BEAR MARKETS AND THE RETURNS OF THE S&P 500 INDEX



*Average bear market duration: 384 days
Source: JennisonDryden

GOING FORWARD

Have we hit the bottom? No one knows. But one thing is certain: if we haven't seen it yet, we are certainly a lot closer now than we were last June when the TSX/S&P was over 15,000.

Rather than trying to guess whether or not now is the optimal time to invest, you should be asking whether or not equity investments are appropriate for you – now, tomorrow or two years from now. As Fidelity's Peter Lynch often said, stocks are quite predictable over 20-year periods, but over short periods such as a year or two, you might as well flip a coin. One of the consequences of this market meltdown will be a reconfirmation of the fact that stocks are good investments for those with an appropriate investment horizon – and by appropriate we mean something like 7 years or more, the length of a typical business cycle.

It all starts with knowing yourself, and making sure that your advisor knows you. Why are you investing? Financially speaking, what is the goal you wish to reach? What is your time horizon? What is your attitude towards risk, i.e. to what degree are you willing to expose yourself to the potential for short-term capital loss in order to earn a higher long-term return?

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The International Monetary Fund (IMF) recently published a research document that analyzed 113 periods of financial upheaval in 17 countries over the last 30 years. In order to arrive at the best comparison with the current crisis, the IMF isolated 6 of these situations that were particularly disruptive to the financial services sectors (Finland, Norway, Sweden, the U.K. and the U.S. at the beginning of the 1990s, and Japan all through that decade). The IMF felt that these crises had strong parallels with the current situation, and would constitute a good reference point for making comparisons. Using the same methodology, we found that stock markets pulled back 46%, on average, during these periods of economic contraction and stress to the financial services sector - in other words, market collapses very close in magnitude to the current one. After such severe declines, the rebound is usually very strong. Coming out of these six situations, markets had regained, on average, 25% of the lost ground within three months of the bottom, 48% after six months, and 86% after one year. Of course, the past is never a guarantee for the future, but it does suggest that there can be a light at the end of even the darkest tunnels.

You have probably discussed these things with your advisor before, but have your circumstances changed since that discussion? Have the recent events caused you to rethink any of this? The next step is to see how well your portfolio matches your investor profile. If you sat tight through the storm, you will probably find that your portfolio underweights equities and overweights fixed-income and cash compared to your benchmark. Now is as good a time as any to make whatever rebalancing transactions are required to bring your portfolio back into line with this benchmark. Of course, it takes courage to sell the very asset classes that have protected your capital during the downturn and buy more of asset classes that have performed poorly, but this discipline is an essential component of successful portfolio management. Finally, there is an exciting new tool available on the financial planning front – the Tax-Free Savings Account (TFSA).

We leave you with the following thought: On the valuation front, we are approaching price/earnings ratios not seen since 1974. The big difference is that 25 years ago, in the midst of the oil shock, investors who wanted to stay out of the stock market could invest in 30-year U.S. treasuries yielding 14%. Today, 30-year U.S. government bonds are barely yielding 3%. There is a lot of cash sitting on the sidelines today, and the alternatives to the stock market are not that exciting, comparatively. Just as the door is never wide enough when the stampede wants to leave the building, the same can be true when the party resumes and everyone wants to get back in.

Without a doubt, 2008 was one of the toughest years, financially, in human memory. But, as we've explained here, it is perfectly reasonable to anticipate better days ahead. And that's what we wish for everyone once the recovery finally takes hold.

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As you've seen in this leaflet, strong market fluctuations may dictate portfolio rebalancing in view of the impact on asset value and on your investment objectives.

The challenge is to find an optimal mix based on your investor profile. At National Bank Financial Group, our advisors can propose investment solutions suited to your needs. Contact us.

Useful Links:

2009 Investment Strategies - What You Should Know:

http://info.nbf.ca//fbn/files/fbnfbnpdf/en/2/strategies_investissement_en.pdf

IMF:

<http://www.imf.org/external/pubs/ft/weo/2009/update/01/index.htm>

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