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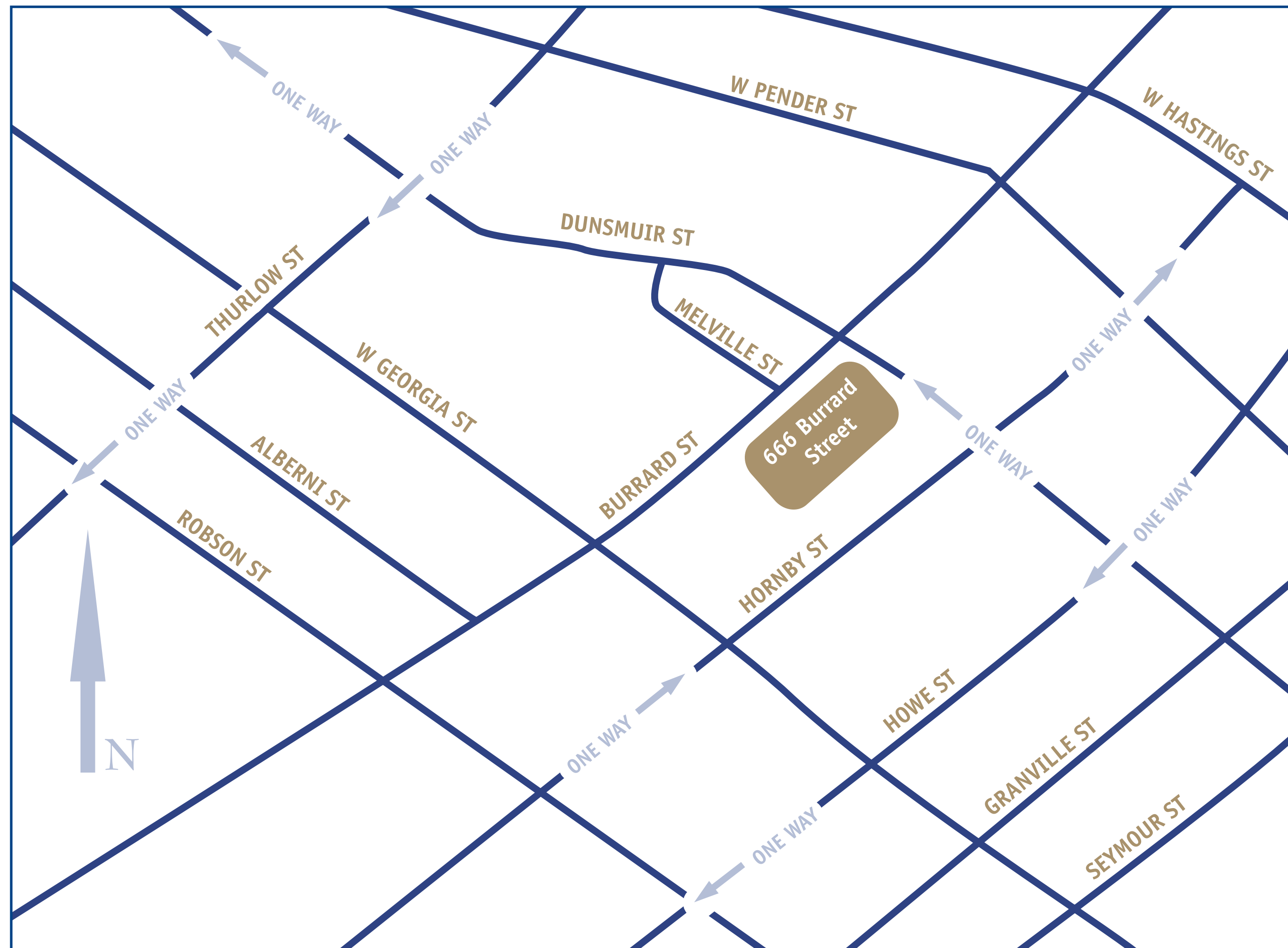

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HIGH NET WORTH JOURNAL

An Investment Update

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What's News

By Neil McIver

A Brief Review of Recent Events:

Since the credit crisis began some 14 months ago, governments and central banks have injected billions into financial institutions, absorbed troubled assets off some bank's balance sheets, and bailed out or outright nationalized financial institutions with the overall goal of stabilizing the financial system.

Despite these measures, the situation continued to deteriorate as economic confidence collapsed in September. Even with the liquidity from central banks, commercial banks stopped lending to each other and the global banking system effectively froze. What began as a credit crunch primarily in the U.S., became a full blown global financial solvency crisis.

It also became clear in September that the U.S. economy, which had been slowing but looked as though it was going to avoid a recession, had finally been nudged over the line into one.

The collapsing confidence in the credit markets struck the global equity markets particularly hard. A combination of panic and mechanical selling occurred, each feeding off the other, in rapid succession. Confidence drives both economies and markets, and that confidence evaporated.

Most stock markets have now fallen between 38% and 45%.

Stability Sought

Your carefully constructed Asset Allocated portfolios have helped to insulate you from the worst effects of this down turn and to avoid the scenarios experienced by many investors. Our Due Diligence Process, which reviews each position in your asset allocated portfolio to ensure the highest quality asset is owned, worked to ensure we didn't own any securities directly damaged by the credit crunch.

Despite the losses in the markets experienced before September, our Asset Allocated portfolios had managed to make it from January to September on a roughly even to positive basis. The profit taking we did in the Spring Re-Balancing, which we do annually as part of our asset allocation process, combined with a move into the U.S dollar when it was at par, helped build value in a negative year. However, faced with waterfall panic selling of all assets, residential real estate included, from late September until now, the market value of all assets have now declined significantly.

What we do from this point forward will determine our longer term rate of return.

Going Forward

While the economy and markets can often conspire to make the brave look foolish, it does appear that the equity markets are near to or have already created a form of a base from which they can consolidate. This doesn't mean that they will V bottom and spiral up – quite the contrary. In most cases the bottom creation takes months and we still have, what will very likely be, a heavy tax loss selling period in front of us.

Cyclical bear markets last 10 to14 years. Keep in mind that the U.S markets have been in a bear market now for a decade and the very end of bear markets are typically characterized by waterfall sell-offs and that collapsing confidence. Those waterfall sell offs themselves are usually characterized by sharp, vicious upward rallies which are then hammered down by mechanical selling by those still required to liquidate due to debt obligations, as we've recently been experiencing.

Also keep in mind that markets fall before recessions and generally rise part way through them. Recessions typically last an average of 10 months.

There are two compelling indicators which suggest that the selling has reached a climax. Firstly, current market valuations, based upon price/earning ratios of just 10 to 12 times earnings and resource companies trading from 0.7 to 1.1 times book value, are consistent with market bottoms. This suggests that the market is currently cheaper than it has been in 20 years.

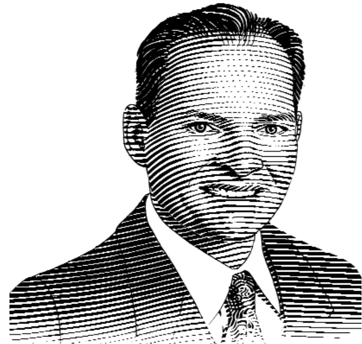
Secondly, market bottoms are always indicated by panic selling and all sentiment measures have moved to historically extreme levels suggesting that selling pressure has reached its climax.

Steady

We need to hold steady over this period of extended volatility. History has shown us over and over again that when panic selling takes over, markets tend to over shoot to the downside. Panic selling usually comes from corners of the market where investors (institutional and individual) are leveraged into the market and forced to sell into a falling market. Investors who are not leveraged into the market and don't have to sell can weather these inevitable storms. We need to adjust, re-balance (you will receive a letter about this), take advantage of selected tax losses and look for potential opportunities.

On the Mark

By Mark Jasayko



Déjà vu all over again (1982 that is)

As frequently mentioned in this column, we have been in a secular bear market since March 2000. For years this has been an uncommon view. Not anymore.

With the accelerated sell-off during September and October, the U.S. markets have gone through a retracement back to 1998 levels. The 2003-2007 advance can now be seen for what it was: a cyclical advance within a long-term secular bear market.

Examining the recent collapse in prices within the context of the long-term bear market, a few worthwhile insights can be gained. The average length of the previous four secular bear markets since 1900 was 11 ½ years. The current bear market is 8 ½ years old which would indicate that we are three-quarters of the way through it.

Another consideration is to analyze the hallmark characteristic of a secular bear market: a steadily declining Price-to-Earnings (PE) ratio for the market as a whole. Bear markets end when the figure is under ten. The previous bull market ended with the market PE in the mid-thirties. The current PE is around ten by most measures. This metric tells us that the bear market is entering its final stages.

Despite the certainty of upcoming daunting headlines that will test investor resolve, the market is nearing a point wither it will ask very little of investors. When the PE falls to single digits, history indicates that investors will earn reasonable returns. Investors are not required to take a leap of faith and believe in stories of fantastic earnings growth, fabulous new technologies, and opportunity-creating paradigm shifts. A belief that markets and economies will exist over the horizon is all that is required.

The market PE appears to tell us that we are entering a bottoming range. Most of the peak-to-trough magnitude has already transpired. However, there is still one very important question to ask: How long will it be until the bear market ends and the markets begin a new and sustained march back to record levels again? There are two signs that I consider important in this regard.

The first requirement is that policy-makers and investors have to let go of the past. Flooding the global financial system with money in the hope of reigniting the frenzy of lending and borrowing that existed up until two years ago is misguided. There has been a generational shift to deleveraging; the paying down of debt and the reduction of risk. In light of this, bloated financial institutions need to downsized, not re-inflated.

Secondly, financial institutions need to abandon their fatal attraction to book value accounting for risky assets. Although there has been progress in the implementation of mark-to-market accounting, the financial industry is fiercely lobbying to go back to its old ways. The industry figures that if it is able to keep shareholders, prospective shareholders, counter-parties, and depositors in the dark, the added flexibility will increase the potential to generate higher profits. In truth, this dramatically decreases trust and escalates the suspicions of interested parties, leading to a seizing up of credit. The previous 15 months have provided stunning and breathtaking evidence of this.

Once policy-makers and financial institutions realize the need for orderly downsizing, and once the financial industry embraces the fact that disclosing the truth is an enlightening and invigorating process, the initial advance of the next long-term secular bull market may well be behind us.

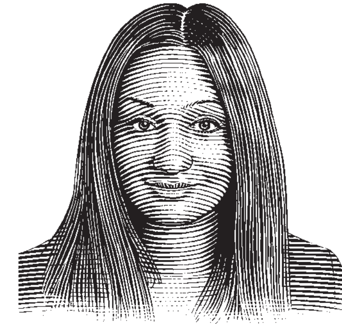
Calling the bottom is a self-serving exercise. There are people who have been credited with calling bottoms in the past. The financial press has overlooked the obvious luck factor involved and proclaimed these analysts as geniuses. The temptation to be the next hero is overwhelming for some. Three times this year (in January, May, and August) there has been a rush by many to call bottoms only to be proven wrong. History says that we are near a bottoming range, but that is as surgical as one can get.

One positive note is that the three-month span from November to January has been the best three-month span annually for the U.S. markets since 1950. Conversely, August to October has been the worst three-month span. Although the markets don't repeat historical annual patterns every year, there is some distinctive seasonal trends.

When looking forward, there is much genuine concern expressed by investors. However, even though some of the details of the last stretch of the bear market ending in 1982 were different, the emotions and the psychological state of investors are the same. I know that first-hand. As an amateur investor and a budding new student of financial markets in the early 1980's, I was there.

Good Karma

By Karm Bhatti



Re-balancing

Our rebalancing of the portfolios typically takes place annually in the Spring: however with the recent market volatility we believe that this is a prudent time to accomplish this. The re-balancing will be taking place from mid-November to the end of December. All our Asset-Allocated portfolio positions will be put through a comprehensive due diligence process and will be re-evaluated. Both Neil and Mark will be reviewing each and every one of the current positions as well as seeking out new profitable and strategic opportunities. The main focus is to ensure future investment potential and that your risk tolerance remains in tact.

Tax-loss Selling

In conjunction with the re-balancing, we will also be evaluating your investment holdings from a tax perspective. Positions which have decreased in value may be sold and used as tax loss (tax asset) against any future capital gains. Additionally, they can be used against capital gains taxes aid in the pervious 3 years if you re-file an amended tax return. However, in order to achieve this, the Federal Government requires the investment that is providing the capital loss to be liquidated for at least 30 days before it can be repurchased. If you have any questions please call me directly at 604-678-6563.

Preserve and Protect

By Tricia McIver

New rules for accessing federally locked-in funds

We all wish flexibility in when and how we use our savings, including our registered retirement savings. Flexibility is important in the context of changing economic, financial and health needs. With this in mind, and to give Canadian retirees choices, the Conservative government introduced measures to significantly enhance the flexibility to withdraw funds from federally-regulated life income funds (LIFs) and locked-in retirement savings plans (LRSPs). Prior to these measures, LIF's and LRSPs allowed withdrawals subject to strict annual maximum and minimum limits.

Individuals holding qualifying LIFs and LRSPs may access their funds in three circumstances:

1. One time unlocking

The most dramatic measure is a newly created flexibility allowing individuals who are at least 55 to unlock up to 50% of their federally regulated LIF or LRSP holdings. The unlocked portion may be cashed out or transferred to a RIF or RRSP, both of which do not have annual maximum withdrawal limitations. Any funds not transferred may remain in the RLIF, which is subject to the same limits upon minimum and maximum withdrawals imposed on a LIF. Alternatively, the remaining balance may be transferred to a newly established Restricted Locked-in Savings Plan (RLSP), which is generally treated as an RSP.

2. Small Balance Limit

This measure will allow individuals who are 55 years or older to wind up federally regulated LIFs, RLIFs and RLSPs where their total federal locked-in RRSPs, LIFs, RLIFs and RLSPs are worth less than the "small balance limit". For 2008 the small balance limit is $22,450. Individuals may cash out their accounts, or transfer that the balance to a RIF or RRSP. Note this measure does not apply to LRSPs, and as such no withdrawals or transfers may be made from LRSPs.

3. Financial Hardship

This measure applies to all individuals facing financial hardship, regardless of age. Where financial hardship exists, withdrawals up to a maximum of the small balance limit (for 2008, $22,450) may be made from federally regulated LIFs, LRSPs, RLIFs and RLSPs. Financial hardship must be demonstrated under at least one of two conditions: (i) medical or disability-related expenses: where an individual expects to spend more than 20% of their income on such expenses, and (ii) low income: where an individual expects to earn less than the "low income limit" defined as 75% of YMPE (for 2008, $33,675).

A more detailed discussion, "Regulatory Changes Related to Federally Regulated LIFs and LRRSPs Effective May 8, 2008", may be found in the library section on our website (www.mciverwealth.com). Richardson Partners Financial is working hard to establish the new documents required to put the measures into action. These should be ready in November. In the meantime, should you have any questions regarding the new changes, please do not hesitate to contact me by phone or email.