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DEALING WITH NEGATIVE ECONOMIC HEADLINES

Written by Larry Jacobson, Senior Partner of Macdonald, Shymko & Company Ltd.

As one of Canada's leading Fee-only Financial Planners/Investment Counselors, Macdonald, Shymko & Company is well aware of the recent volatility in the world equity markets; we see the same news broadcasts and read the same headlines, and yes, we are human and they do concern us as much as they must concern you.

Many quotes from "chief economists" of major financial institutions have been predicting meltdowns and catastrophic economic ruin because of the collapse of Lehman Brothers, the bargain basement sale of Merrill Lynch to Bank of America, two cash infusions for AIG Insurance Company, not to mention the 700 billion dollar "bailout" recently approved by both US houses and signed by President Bush. Unfortunately, the politicians, the press and the professional pundits have used the inappropriate nomenclature "bailout" to define exactly what the Federal Reserve and the Secretary of the Treasury did to help ease the credit squeeze. One should understand that it is not a bailout, but an asset purchase. The US taxpayers (let us not forget who pays for these financial strategies) purchased or will be purchasing large mortgage pools at significant discounts. They also will be buying equity; mostly preferred shares in US Banks to help recapitalize them similar to what some Canadian banks have done albeit with private, not public funds. Not every mortgage in the United States is in foreclosure (about 2%) and most have value.

It is likely over time that these purchases could yield a significant profit for the US taxpayers. Banks have had to account by way of "mark to market", which means they have to value assets almost daily at market value, not book value. The eroding values of assets they owned are one of the main reasons why the banks are in a liquidity crisis. Their eroding values made it harder for them to attract and almost impossible to raise money, either by inter bank borrowing or re-capitalization. A great example of a bank collapsing almost overnight was Washington Mutual, the largest single bank failure in US history. JP Morgan took over the bank with the help of 5 billion dollar loan guarantees from the US Federal Reserve. These are serious times; times we have not experienced before, times when we have seen trillions of dollars eroded from our collective wealth, which most have taken as perceived entitlement. However, now is not the time to look for villains. There are far too many to go around and I am sure the FBI will be vigorously investigating. It is, however, the time ***not to make long-term decisions because***

of headlines. The message that I gave all my clients is clear—no crystal clear: "One should not over-react to headlines, but rather always have in place and follow a long-term investment strategy." Even with the world markets in a panic mode, even with benchmarks of all indices, the Dow Jones Industrial Average, loosing close to 25% of its value in three months--DON'T OVER REACT! Many of you will remember Black Monday, October 19, 1987 when the DJIA fell 508 points and closed at 1739. Over the next 21 years, holding a portfolio of large cap US equity stocks would have increased by about 9% per year. Also, history has taught us that bear markets tend to be much shorter then bull markets. Since 1957, the average bull market of the S&P TSX Composite Index has been 26 months, whereas the average bear market only 8 months. During the period between 1997 and 2002, the bear market lasted 25 months and declined some 43%. However, in the following 63-month period (to 2007), the market increased by 149%. History offers compelling evidence that capital markets are resilient. "Stay the course" is a mantra we should all adopt and live by, although we recognize at times it is difficult.

Macdonald, Shymko & Company does not know and never professes to know what tomorrow's headlines will say. Most economic experts would agree that the credit crunch's genesis was unquestionably the sub-prime mortgage fiasco. No one knows for sure what the total impact will be on world economies, or more importantly, when it will end. However, many experts will agree that markets over-correct on both good news and bad news, and selling when headlines scream doom and gloom is certainly a poor strategy. A better strategy would be to add to your portfolio on days when the market is heading down, adding to your asset classes that may have been out of balance due to market declines. Every year since 1985, Dalbar, a well-respected research firm that specializes in ranking fund managers, has found that investors who stay invested long term well outperformed market timers. Dalbar found during the period from 1987 to 2005, that the average mutual fund investor who bought and sold while chasing returns grew assets of $10,000 to $21,422 (3.52% annual compounded return), whereas an investor who bought and held the same $10,000 grew to $94,555 (10.75% annual compounded return). Macdonald, Shymko & Company's philosophy certainly echoes a strategy of taking a long-term view of investing. Warren Buffet recently was quoted as saying; "Equities will almost certainly outperform cash over the next decade, probably by a substantial degree. Those investors who cling now to cash are betting they can efficiently time their move away from it later. In waiting for the comfort of good news, they are ignoring Wayne Gretzky's advice 'I skate to where the puck is going to be, not to where it has been.'"

Economics 101 – Given we believe in the free enterprise model, we must then understand what drives free enterprise. In my view there are three components:

1. Entrepreneurship
2. Risk and risk takers
3. Capital

The common shareholders, regardless of the size of the enterprise, reflect Entrepreneurship. Corporate capital is raised either from borrowing or from issuing of common shares. Risk is reflected in how one invests in the enterprise. Bonds are safest as they have first charge on the assets, whereas common shareholders are unsecured. If a bank were to lend money to say, a Microsoft, the bank would probably lend at Prime or possibly at a rate less than Prime. If the same bank were going to lend to say, a GM, they probably would charge a premium to what they charged Microsoft. That differential is called the risk premium and that risk premium drives capital markets. The risk premium is why we need the stock market to allow investors to take advantage, speculate if you will, on the risk premium being reflected in the market value of the enterprise's common stock. Taking the same example, in theory, if one invested in two common stocks, one being Microsoft and one being GM, wouldn't one expect to receive a higher return on GM than Microsoft? The banks do in their lending practices; therefore, the investor should do in their equity investing. It is because of the risk premium associated with equities that the stock market must, over the long term, reflect a return higher then the average bond return. Please remember that does not mean the market will return to its all-time high, but given the stock markets are efficient, then the premise holds that one should, over time, receive that risk premium.

Having said that, no one should be too heavily weighted in one asset class. Yes, our portfolios this quarter are down, but our clients are surprised at how little their overall values have been eroded, as our philosophy of asset class investing has been proven over and over again. We are using these dark clouds as a silver lining to rebalance portfolios. If you believe in free enterprise, and believe that free enterprise will survive these volatile times, stay with a well diversified asset class approach. If you believe the world is collapsing, sell every asset you own and keep cash. Remember that the stock market is not going down to zero; these companies have collective value regardless of the headlines!

For those whose portfolios are predominately dominated by real estate, you are both fortunate and unfortunate. The sobering news is that, in my personal view, cap rates have risen and will continue to rise. If one bought an apartment building today at a 4% cap rate, it best be terribly under rented because serious investors will want a risk premium of anywhere from 200% – 275% greater than Government of Canada Bonds, which for a 5-year maturity, are yielding about 3.00%. In my view, futures will no longer be paid for up front. The good news is that with a slowdown in job growth and an increase in unemployment, demand for rentals will be increasing, allowing apartment owners to increase rents. My advice to clients that are too heavily weighted in real estate is to dispose of some holdings. Like any other commodity, pricing is vital especially in tough markets. When pricing your buildings, I tell my clients, "Don't be a Maven", allow your real estate professionals to price and market your asset.

Maybe it is time your portfolio was reviewed by someone who understands market psychology and asset class investing. If your advisor has not called you, perhaps it's time you call Larry Jacobson at Macdonald, Shymko & Company.

Vancouver native **Larry Jacobson** received his Diploma of Technology (Administration and Finance) from BCIT in 1971 and a Master's degree in Business Administration (International Management). He joined Macdonald, Shymko and Co. in 1975 and became a principal in 1976. Larry holds the Registered Financial Planner (R.F.P.) designation, the highest and most prestigious designation in the financial planning profession within Canada.

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