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Mr Market's Manic Depressive Ways

In the investment bible, Security Analysis, written during the Great Depression of the 30's, Dr. Benjamin Graham laid down the principles of value investing. This discipline of investing has been followed and created the most highly respected and successful investors of the past 80 years, including Warren Buffett.

Most of Dr. Graham's work involved analyzing individual companies and determined that looking at the market in general is a waste of time. He simplified this conclusion by looking at the market as a rich man whom he called "Mr. Market".

The key to understanding Mr. Market's behavior is to see him as a manic-depressive. On his manic days, Mr. Market is full of optimism. He's willing to pay whatever is necessary just to own equities. Some refer to this behavior as the greater fool theory. The manic foolishly buys equities simply because he believes somebody will pay even more for them.

Mr. Market also suffers days of severe depression. On these days, he wants to get rid of his holdings so badly, he'll sell at any price simply to get out.

Value investors don't spend any time trying to understand or predict Mr. Market's behavior. Rather, they attempt to determine, by way of thorough number crunching, the fair value for companies that are well-managed, have strong market positions and are likely to continue their success (ie. Microsoft, Nestle, Toyota, Johnson & Johnson etc.)

When Mr. Market, in his despair, seems willing to sell shares in these companies for substantially less than their fair value, the bargain-hunter buys. He'll then simply wait until Mr. Market's mood swings back to euphoria. It is in his euphoric state, that he can't stand to be on the sidelines and eventually bids prices up far above their fair value. These mood swings inevitably come and go repeatedly.

This way of thinking will inevitably lead the wise investor, which include virtually all of my clients, to hold the high quality, value investments they have already accumulated. It will also lead these wise investors to take advantage of Mr. Market's depressive state by intelligently investing new cash they may have sitting on the sidelines. When Mr. Market is depressed it is more a time for buying equities than following along with Mr. Market and selling them.

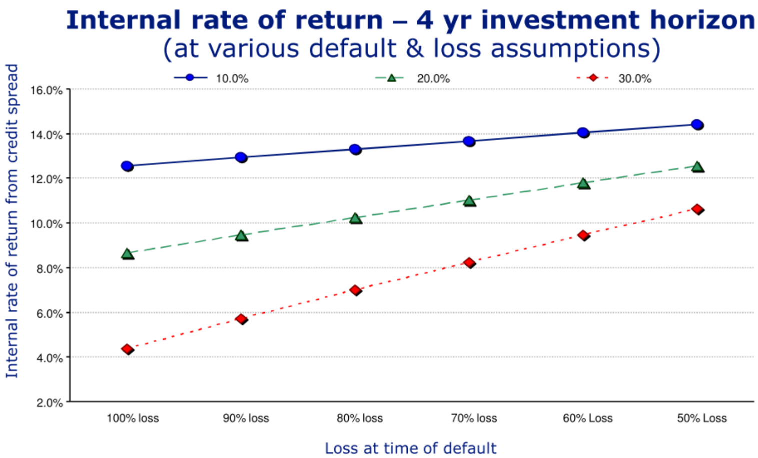
So, is Mr. Market still depressed today? I'd definitely say yes, however let's look at some hard data to get a better emotional reading.

According to Economist Stéfane Marion of National Bank Financial, investors in the U.S. hold $800 billion more in money market funds (cash) than they do in equity mutual funds. Equity funds now make up only 34% of the total assets of mutual funds in the U.S. This is the lowest level since 1992. Money market funds (cash) is at its highest level since 1991. It is estimated that there is just under 4 Trillion dollars in cash accounts in total in the U.S. At virtually 0% interest it is only a matter of time before this money starts looking for a new home.

HIGH YIELD BONDS - TODAY'S COMPELLING INVESTMENT OPPORTUNITY

Times like these are painful, uncomfortable, uncertain and yes even a bit scary, however it is in times like these that absolutely fantastic investment opportunities present themselves. High Yield Bonds are a significant investment opportunity today and as, with most like it, only those who act now will reap the rewards. I am convinced the "intelligently bold" who use the cash they hold, will benefit greatly. As you will see, this opportunity can be taken advantage of with relatively low risk, and while you wait you get a high (5 to 13%), interest yield on your investment.

Much bad news priced in



Single B credit spread at 12/31/08 - 16.18%

These bonds were sold my "Mr Market" without him really considering the financial strength of the company who issued the bonds. Because of this, the bonds are currently selling at substantially less than their "Par Value", the amount you get when the bond matures. This gives you, the intelligently bold investor, an opportunity for significant capital gains. And again, while you wait for that, you are paid a very healthy interest yield on your investment.

So what is the main risk? Default rates. This is laid out in the chart on the left. The vertical access is the annual rate of return over and above government T-bills. The horizontal access is the amount of loss on the bonds that do default.

Most often, when a company defaults, the bond holders don't lose everything. They recover a part of their investment. In the chart on the left, the "100% loss" points on the farthest left (red diamond, green triangle and blue circle) are assuming that investors recover nothing from their defaulted bond investments. This in itself is highly unlikely.

Now lets look at all the points on the red, green and blue lines. These assume that, at the very far left of the scale (100% loss on the defaulted bonds) that investor will get, over a 4 year period, an annual rate of return of anywhere from 4 to over 12% per year. The 4% average annual return projection (red triangle) over the next 4 years uses an assumption that 30% of the companies held in a high yield bond portfolio will default on their bonds and thus be forced into bankruptcy. How likely is that? The depression of the 30's" only got to 17% default rates.

Let's bring these 2 risk primary risks down to the nuts and bolts. Assuming 30% of the companies held within a bond portfolio, where substantial work has been done in assessing credit / default risk for each of the corporate bonds held, are forced into bankruptcy (a scenario almost twice as bad as the Depression) and there is 0% recovery on the bonds (100% write off), an investor will earn a little over 4% per year over the next 4 years. <u>Any scenario more positive than that will produce a higher return</u>.

With this kind of thoroughly analyzed default risk you can sleep and know your investment should be more than just okay.

Note: Through January and February this year the equity markets around the world were down by 20% and are still down from the end of 2008. Of the 76 Canadian dollar denominated High Yield Bond Funds only 6 show negative performance for the first 3 months of 2009. The worst performance for that time period is –1.4%. The best is +8.7%. (Morningstar)

<u>IF YOU DON'T HAVE THE CASH BUT WANT TO CAPITALIZE ON THE OPPORTUNITY</u>

The interest income paid on High Yield Bond Funds is generally more than enough to pay the interest costs on a loan used to fund the investment. Positive cash flow is key in reducing the risk in borrowing for investment purposes:

Example: $100,000 INVESTMENT IN A HIGH YIELD BOND PORTFOLIO USING BORROWED MONEY

Interest Expense @ 2.5% (Prime Rate) **<$208 / month>**

Interest Income @ 9.4% (Current Interest Income) **$783 / month**

Not taking into tax considerations, you are receiving $575 per month of positive cash flow. This can be used to pay down the investment loan, or better still (from a tax perspective), pay down debt that is not tax deductible (a principal residence mortgage or other debt). Note: Investment Loans can be done in almost any amount so as to fit comfortably within a financial plan.

Source: Investment manager conference calls, Mackenzie Feb 12 & Natl Bank Feb 24, AGF meeting Jan 21, Invesco Trimark, Rex Chong PPT Feb 11

Everyone, Yes EVERYONE (18+) Should Have A Tax Free Savings Accounts (TFSA)

The TFSA, which became available on January 1st still has a few misunderstandings about it and thus I will try and clear some of those up.

First misunderstanding is that a TFSA is simply a savings account so the comment is made, "with such low interest rates the tax to pay on that money is more negligible than the negligible interest rates. What's the point?".

A TFSA is simply the name of the bucket in which you put your savings account or any other investment you may hold. This bucket lets you earn interest, dividends and capital gains TAX FREE as long as it stays there. The TFSA is much like another "Plan" that has the word "Savings" in. The Registered Retirement SAVINGS Plan which too, can hold almost anything. (Technically, they should have called the TFSA a TFSP—Tax Free Savings PLAN—to reduce confusion, but I digress). In other words, a Savings Account is only 1 of many available things you can put into your TFSA bucket.

Another error I have come across is that someone will open a TFSA by transferring money from a savings account with miniscule interest. If you will soon be making an investment or already hold an investment with potential for strong capital gains or one with higher interest (like High Yield Bonds), then those should be put into your TFSA before anything else.

A very common question is what is better, a TFSA or an RRSP? They are in fact very different from each other. For most people, the RRSP should be maximized first. Any additional monies should go into the TFSA. If you expect to be retiring on a very low income (under $15,000) or on a healthy retirement income ($67,000 or more) then the TFSA could make sense as a partial or whole replacement of future RRSP contributions. If you expect to have less retirement income than you are earning during your working years and you expect that amount to be between $15,000 and $67,000 then the RRSP will give you more tax savings. Having said all of that however, a financial planner will help you decide the best route to take… for your unique situation.

If you have a money in a savings account or an investment outside of an RRSP or RRIF, yes, you should open a TFSA this year. In fact, if you have money sitting in a chequing or saving account, hold investments outside your RRSP or maximize your RRSP contributions you should open a TFSA this year. The tax savings will snowball with each passing year.

You Can Secure Your Pension Plan

With company layoffs and corporate bankruptcies in the news, the question of the safety of your pension plan may be pressing on your mind. This has been brought home especially with the talk of GM and Chrysler potentially filing for bankruptcy and with it the risk that your pension plan may not pay out as you expect or have always been relying on. A company going through bankruptcy at anytime in the future could mean benefits being received by those already retired could very well be cut significantly. As well, those currently working could see their expected future pension benefits greatly reduced.

Pension plans, no matter how you slice it are not guaranteed. Much of their stability is directly linked with the financial health of the companies who have put them in place for their employees.

Over the last 22 years I have transferred many pension plans to locked in RRSP's. Before that route is decided on, calculations are first done to determine if that makes sense, ALL THINGS CONSIDERED. In the past, when it did made sense to transfer a pension to a Locked In RRSP the investment options were not as wide as they are today.

Currently, there are insured plans which offer guaranteed income for life with the potential of your income increasing more than it would with a pension plan. They start at a guaranteed 5% per year and can increase every 3 years based on the market. If 3 years from now your portfolio is higher then you have an increase of your income by exactly the amount of the market increase. That becomes your new guaranteed income level.

Since a number of life insurance companies offer these "Guaranteed Minimum Withdrawal Benefit" (GMWB) plans, and if you are feeling ultra cautious you can even spread your Pension Plan proceeds across 2 or more life insurance co's. Although it isn't necessary, it is an option.

Along with that, the money in a Locked In RRSP can be transferred to your heirs upon your death. This can't be done with a pension plan, even if your company manages to survive. Pension plan assets disappear with the last surviving spouse.

Web Gems

CANADA REVENUE AGENCY (CRA) ACCOUNT FOR INDIVIDUALS— go to www.cra-arc.gc.ca/myaccount/index.html to track your refund, check your government benefit payments, your RRSP limit, Home Buyers' Plan, Lifelong Learning Plan or to set up direct deposit for your income taxes, instalments change your address, apply for various benefits etc.

ELECTRONIC RECYCLING ASSOCIATION (ERA) - Whenever I have an electronic item that is past it's useful life I put it in a box and hope at some point, I will be able to send it somewhere other than the garbage can. These items include cell phones, computers, monitors, TV's or computer parts. These can be brought to their Vancouver warehouse on East 69th in Vancouver or for computers and laptops The Bay and Zellers will accept them at a few locations. ERA is currently in urgent need of donations of computers and laptops in particular. These are refurbished and sent to various charities and families in need and they are currently getting 5 times as many requests for computers as last year. Companies willing to donate old equipment can contact ERA for pickup. For all the details, including ERA's other locations go to www.era.ca

Hhhmmmmmmm......

Residential real estate prices in the most "highly desirable" (sunny) cities of the U.S. (Phoenix, Los Angeles, San Diego, San Francisco, Las Vegas, Miami, Tampa) have seen their prices drop by 39 – 48% from their peak in 2006. Case Shiller

As of February, the average house price in Canada stood at $282,000, down 13% from its peak. TD economists expect the average Canadian house price to fall to about $246,000 in 2009, down 24% from the peak of $324,000 in 2007. It is also expected that this slide will last for several years as the demand for homes slowly eats away at the ample supply of housing. National Post and Globe & Mail, April 2009

Vancouver is at the top of the list of 'severely unaffordable' markets on the continent, and the 4th most 'severely unaffordable' market of all cities surveyed. (Demographia 5th annual housing affordability survey) http://www.demographia.com/dhi.pdf

A record 1 in 9 U.S. homes are vacant. USA Today, Feb 2009

In the first 6 months of 2008, demand for oil around the world fell and supply rose yet the price of oil shot up from $90 to $147.

In February, American Express announced an incentive program under which it will pay cardholders $300 to bring their balances to $0 and close their accounts because unlike most credit card issuers Amex takes the credit risk. In contrast, Visa does not expose itself to its clients' ability (or inability) to pay off their debts. In Visa's case, default risk is assumed by the card issuing bank. Dixon Mitchell Investment Counsel, March 2009

Investment markets of countries in which daylight varies dramatically due to changing seasons show some surprising investment return results. The southern hemisphere (ie Australia) tends to do better in the last half of the year while those investment markets in the northern hemisphere (ie Sweden) tend to do better in the first half of the year. This is a phenomenon that shows investing is directly related to ones mood, where people tend to feel more optimistic when the weather is better.

If I want to sell my investment there is someone on the other side who ultimately wants to buy it. Who is right?

For the first time since the beginning of commercial jet airline travel, two consecutive calendar years have passed without a single airline passenger death due to a crash. There were 1.5 billion passengers carried. (USA Today, Jan 2009)

China's number of internet users has risen to 298 million, a 41.9% increase from last year. China's Internet penetration rate is still low, with just 22.6% of its population. The U.S. has an estimated 223 million Internet users. USA Today, January 2009

In 2008, SocGen (a large bank in France, one which many of my clients hold in their portfolios) posted a net profit of €2.01-billion, compared with €947-million a year earlier.

David Swensen, the manager of Yale University's $23-billion (U.S.) in endowment funds advises against gold which is no longer linked to major currencies. Gold's returns in the past 200 years have been worse than cash. Globe & Mail Feb 2009,

Many companies in mature industries, from banks to airlines and autos, stand to benefit once the recession ends, because there will be less competition. This points to a spectacular opportunity for value investors. Rob Arnott, chairman of investment research firm Research Affiliates

Personal savings rate rose to 5%, the highest since March 1995. A year ago, the personal savings rate was 0.1%. Consumers might go back to saving about 9% of their disposable incomes, the savings rate that prevailed from the 1950s through the early 1980s. MarketWatch, March 2009

A cheap seat at Coors Field to watch the Colorado Rockies. "Rockpile" tickets in center field are just $4 apiece. 12 and younger or 55 and older only pay a buck.

Carey