

E.Q Trendwatch™

Up, down, all around, and still losing

April had a typical counter-trend or “bear market” rally. Stock markets roiled back and forth from dramatic low points reached in January, but still failed to break out of their over-arching bear trend.



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TSX Canadian Index past 12 months



EFA International Index past 12 months



US S&P 500 Index past 12 months



NASDAQ 100 Index past 12 months

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Interim “counter-trend rallies” such as we saw this month, can be one of the most disconcerting and confusing factors of equity market investing for those that lack a clear measuring tool. In them, many market participants find themselves helplessly trying to decide whether the sky is falling or the sun is rising. When screens seem green for a few days or even weeks, those that were previously nervous may become happily lulled back to sleep. Long always market pundits are emboldened in their assurance that all is well and the bottom is now nicely behind us. This is one of the features that can make the next or second down-leg of a bear market correction all the more vicious and alarming.

Confusion is compounded by long-always market “experts” who perpetually tout the “buy and hold” virtue of stocks.

This week the Globe (Tues April 29) ran a revealing article called “Financials pay solid dividends in time of turmoil.” The article recites the nonsensical banter of recent years that all one need do is buy “stable”, “high yielding” stocks and passively hold. The columnist quotes BMO economist Sherry Cooper’s latest book and her argument that investors should buy such stocks “at all times”. In her latest book out last summer, Cooper offered readers her screened list of low-risk picks for conservative investors. The following chart from the Globe this week shows how investors have done with Cooper’s recommendations over the past 12 months and year to date in 2008.

Company Name	Symbol	\$ Price 25-Apr	% Yield at present price	52-wk low \$	52-wk high \$	YTD % Price chg	1-year % price chg	5-year div. growth annualized	Payout ratio
AGF Management Bank of Nova	AGF.B-T	23.50	4.1	19.00	39.89	-19.2	-39.2	25.8	39.9
Scotia	BNS-T	48.25	3.9	42.00	54.67	-4.0	-11.0	19.0	43.1
CIBC	CM-T	71.50	4.9	56.25	107.45	1.4	-27.1	15.6	33.1
Great-West Lifco	GWO-T	31.44	3.8	27.46	37.67	-11.6	-9.8	17.3	51.1
IGM Financial Power Financial Corp	IGM-T	46.94	4.2	40.11	56.34	-6.2	-12.8	15.4	53.4
Retimans (Cda) Royal Bank of Canada	PWF-T	36.49	3.4	30.74	42.69	-10.5	-8.0	17.4	41.7
Sun Life Financial Inc.	RET.A-T	17.10	4.2	15.02	27.15	-10.9	-29.0	46.7	40.8
TD Bank	RY-T	48.09	4.2	42.82	61.08	-5.2	-18.4	19.5	43.0
Telus Corp.	SLF-T	47.68	3.0	43.23	56.50	-12.7	-7.9	18.2	33.9
	TD-T	65.81	3.6	58.57	77.10	-5.3	-4.0	15.1	38.1
	T-T	45.99	3.9	41.05	66.45	-7.0	-27.1	22.4	41.4
SOURCE: BLOOMBERG AND GLOBE INVESTOR				Avg. loss		- 9.12	- 27.79		

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Here we can see that those following Cooper's advice collected dividends of less than 3% while losing an average of -27% of their capital so far to date. One can't imagine any conservative investors who would be happy with these results. Buying opportunity now? "With what funds?" one must ask. According to equity cheerleaders like Cooper, investors should always buy and always remain fully invested, so no one who listens to them would ever have cash parked and ready for sale prices.

Not to pick only on Cooper, her advice is the norm not the exception in the industry.

This month Danielle wrote an article for the Investor's Digest called "Market cycles—why timing is everything". We thought it helpful at this point to review the mechanics of market cycles and in particular the further downside-risk from here. A complete copy of the article can be found on our web site at <http://www.venablepark.com/documents/InvestorsDigestArticle.pdf>. Some key points are included below.

Keeping a watchful eye for the turn

In the late stages of each business cycle, consumption peaks, then slows, as revenue and profits contract. In response, stocks, bonds and finally commodity prices drop in unison around the globe.

Stock markets are a leading indicator of the business cycle, turning down and then back up some 4-5 months before the overall economy. Historically stock markets have bottomed roughly every 4 years, averaging 3 years of expansion followed by 10-12 months of contraction. During secular bear cycles like the one that began in stocks in 2000, cyclical downturns have averaged 17 months, or about twice as long as during secular bull cycles. "If" this pattern were to replicate this cycle, the downturn that began in December 2007 would last until about May 2009, with the stock market bottoming in advance sometime in the 4th quarter of 2008.

A full market cycle is comprised of the expansion phase when prices are rising and the contraction phase when prices fall back. Failure to comprehend and manage risk exposure to cycles is the primary reason the majority of investors fare poorly over time.

Managing risk exposure over the full market cycle

Since 1926, as measured by the S&P 500, there have been 23 up market cycles and we are presently experiencing the 23rd down market cycle which began in October 2007. Throughout this period, market cycles have averaged 31 months with a 117% gain, followed by a series of down market cycles averaging 10 months and a 26% loss. To make the impact of these stats clear we offer the following examples in real life dollar terms.

If an investor had bought the S&P 500 Index at the very start of an average up cycle and held it consistently throughout the entire 3 year, 117% return, and without adding more capital as prices rose, then the subsequent 26% loss might be considered a regrettable but relatively small consequence when compared to the overall gain. Following the average 26% loss, the investor in this scenario would still retain a gain of 60% over the full 4-year market cycle.

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S&P 500	Average up cycle gain	Average down cycle loss	End value
	117%	-26%	
\$1000 invested	\$2,170	-564	\$1,605.00
Total Gain over full cycle	60%		

However, real life experience is rarely so tidy. Typically investors are drawn or directed into a market or asset class after the up cycle has been under way for some time. If an investor did not happen to invest until half way through a typical up cycle, then gains enjoyed would be just +58% before meeting the 26% decline. In this scenario the full cycle gain would be a more muted 17% over 4 years.

S&P 500	Half Avg. up cycle gain	Down cycle loss	End value
	58%	-26%	
\$1000 invested	\$1,580	-580	\$1,169.00
Total gain over holding period:	17%		

Where an investor happened to buy near the peak of a market cycle enjoying only a little of the up cycle before the correction phase begins, results turn negative:

S&P 500	Up Cycle Gain	Loss	Capital Remaining
	10%	-26%	
\$1000 invested	\$1,100	-286	\$ 814.00
Total loss:	-19% or 1/5 th of capital invested		

Where an investor buys into a peak, it is more probable that they will participate in little or no gains before suffering the correction.

NASDAQ	Loss	Capital Remaining
	- 80%	
\$1,000 invested near the peak in 2000	-800	\$ 200.00
Total loss: -80%		

Little understood is the fact that once capital is lost, the gains needed to recover are much larger than may seem obvious. A loss of 80% requires a subsequent gain of 355% just to get the investor back to even.

Once large losses are suffered, it is often several years into the next business cycle and possibly the next secular cycle before prices may revisit prior peaks.

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The Chinese stock market ran up an unsustainable 500% over the last 2 years of the expansion, ending in 2007. It is not surprising then that recently investors in this market have been devastated. Those who got in during the past 18 months, or those using margin, have been effectively wiped out.

SHANGHAI Index	Loss	Capital Remaining
	45%	
\$1,000 invested at the peak 2007	-450	\$550.00

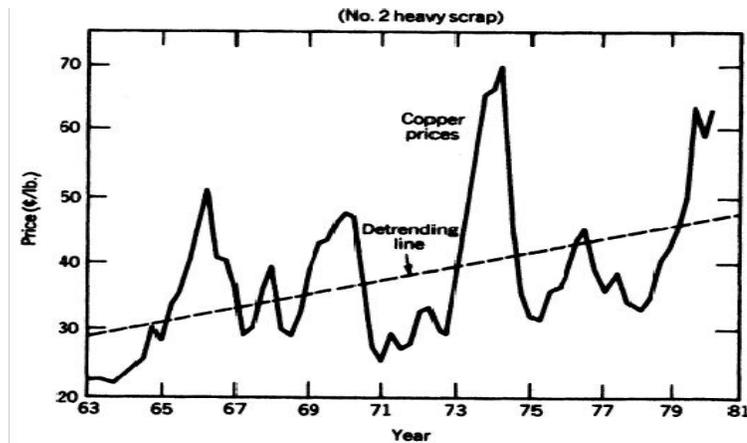


The loss of 45% now requires a gain of more than 80% to recover capital.

The above examples demonstrate why risk to capital always increases as prices move longer into an expansion. Although forecasting the exact price peak is difficult in advance, cycle corrections are as inevitable as gravity. The question is not if but only when they will begin.

Buying into secular themes without attention to market cycles is reckless

Valuable perspective on present lofty commodity prices can be gleaned from looking at the price action of copper during the last secular commodities bull from 1963-1981:



The last secular bull in commodities: copper price per pound 1963 to 1981

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Despite the long up trend in prices from 1963-1981, we see that copper went through a series of 5 peaks and troughs with each market cycle. Investors not prepared for these cycle corrections were exposed to great risk notwithstanding the secular bull over the 18-year period.

Few real life investors can or do actually hold through long market downturns. Few will hold losers for the years often needed to recoup prior prices. This is the reality of why most investors never actually earn the theoretical or historical returns of a buy and hold approach. There is no point saying that investors should ignore volatility and stay the course, history shows that the majority simply do not. Most investors (and their advisors!) react badly to market volatility, holding past market peaks and selling in disgust near bottoms.

Based on historical price behaviour, we should expect cyclical corrections in world commodities as the current economic slowdown plays out. Those who do not plan for the reality of market cycles leave themselves overly exposed to the contractions implicit in each.

The history of investor behaviour is clear. Those that invest capital early in an expansion cycle have a higher probability of making gains with the overall market. Those that buy in late or leave capital fully invested near price peaks have a high probability of losing capital with the overall market. Those that use leverage near market tops with no prescribed sell discipline have a high probability of permanent capital impairment.

Once losses are suffered, it is often several years into the next business cycle and sometimes the next secular cycle before prices may reclaim prior peaks. Think of the gold investors who bought into its secular peak in 1980, having to wait 28 years for their capital to recover. Think of those who invested in the Japanese market in the late 70's or the NASDAQ market in the late 90's, who if still holding even years later, are no where near back to entry points. Protecting capital from cyclical down markets must be our primary focus.

The math of loss shown above is all the more magnified once we realize that real life people typically receive the bulk of their life savings later in life and in lump sums as they sell property or business, receive settlements or inheritance.

For us to ignore the significance of the market cycle in asset management strategies is a form of reckless abandon. And yet this is precisely what the investment industry and the majority of its advisors and managers routinely counsel clients to do. In reality, few investors have more than a couple of secular cycles and a handful of business cycles to grow and preserve capital within their relevant life span.

ETF's on the radar

Having sold banks more than 2 years ago, we were able to avoid large losses over the past 12 months at the end of this cycle. Now we are watching for a favourable re-entry point on the IYF (US Financials share) and the XDV (Cdn Dividend Index Fund). While we do not yet have a buy on our rules, we anticipate a possible re-entry point in the weeks ahead.

In addition we are watching for leadership in technology to materialize over coming months.

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