Real life needs active management

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E.Q Trendwatch™

November doesn't bounce

> *"So far, this has been one of the most severely destructive bear markets in history. Almost no asset class has been spared. Stocks, commodities, housing, bonds have been battered. All the famous investors have been slaughtered -- Buffett, Pickens, Icahn, Adelson. Of the 500 stocks in the S&P 500, only 13 are up for the year. The Legg Mason Value Fund, which boasts the longest streak of beating the S&P 500, is down over 65% this year, the third year that the fund has under performed the S&P. According to Investor's Business Daily's Mutual Fund Index, the average growth fund is now down for the year around 44%. My own guesstimate is that the average US investor has lost over 50% of his or her assets so far this year. And the bear market is not over. The pros are struggling, global diversification has proved to be costly the "buy-and-hold" method has been a disaster…"*
>
> *-Richard Russell, Dow Theory Letters Nov 24, 2008*

This quote struck us as a pretty good summary as at the end of November 2008. We know that many advisors and managers in the world today are using quotes like the one from Russell above as comfort for why they too have lost money for their clients. The logic goes "see it's not my fault, it has been brutal on everyone." In our case, this perspective makes us all the more grateful that we have not lost capital for our clients over this downturn. Year-to-date we have continued to collect positive gains. Not having lost is the key to our investing success. First of all, unlike others, we are not now desperately trying to make back years of losses. The significance of this cannot be over-stated. Because of losses suffered in 2008, most buy and hold investors have now made negative real returns for the past 10 years. No wonder people are feeling frustrated.

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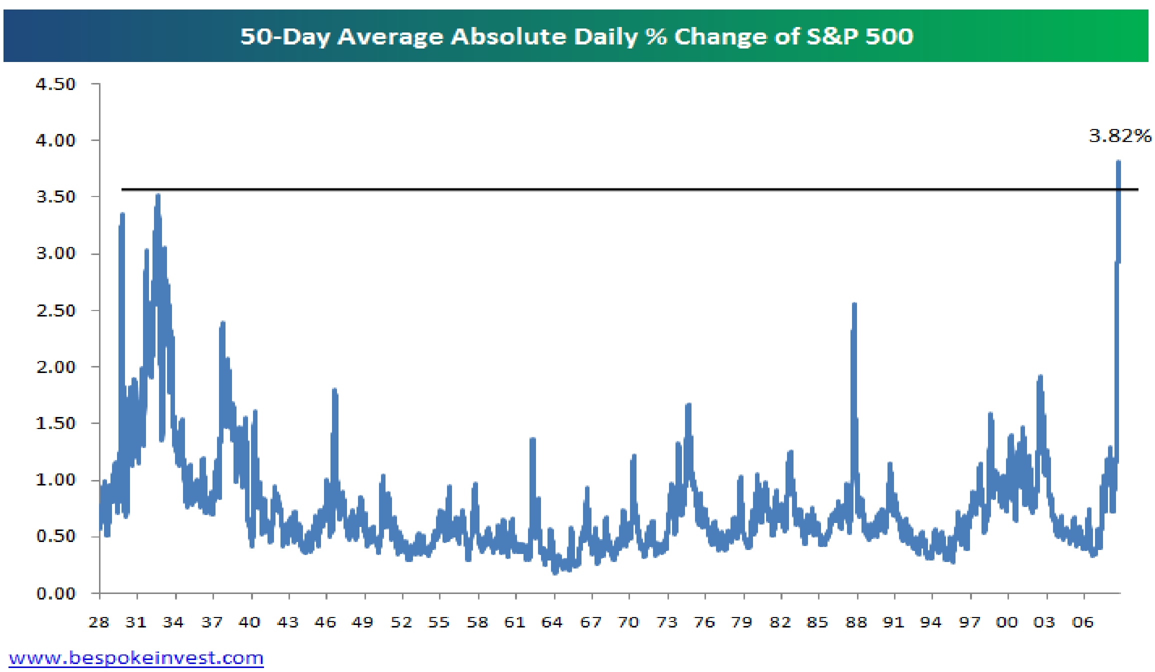
It is remarkable that even with its commodities and well-loved banks prompting double digit gains 2003 through 2007, off 40% in 2008 the TSX has now averaged just over 6% a year over the past 5 years and an anaemic 1.55% average annual return over the past 10. It has been a heart-thumping ride to buy and hold —lots of risk, relatively little return.

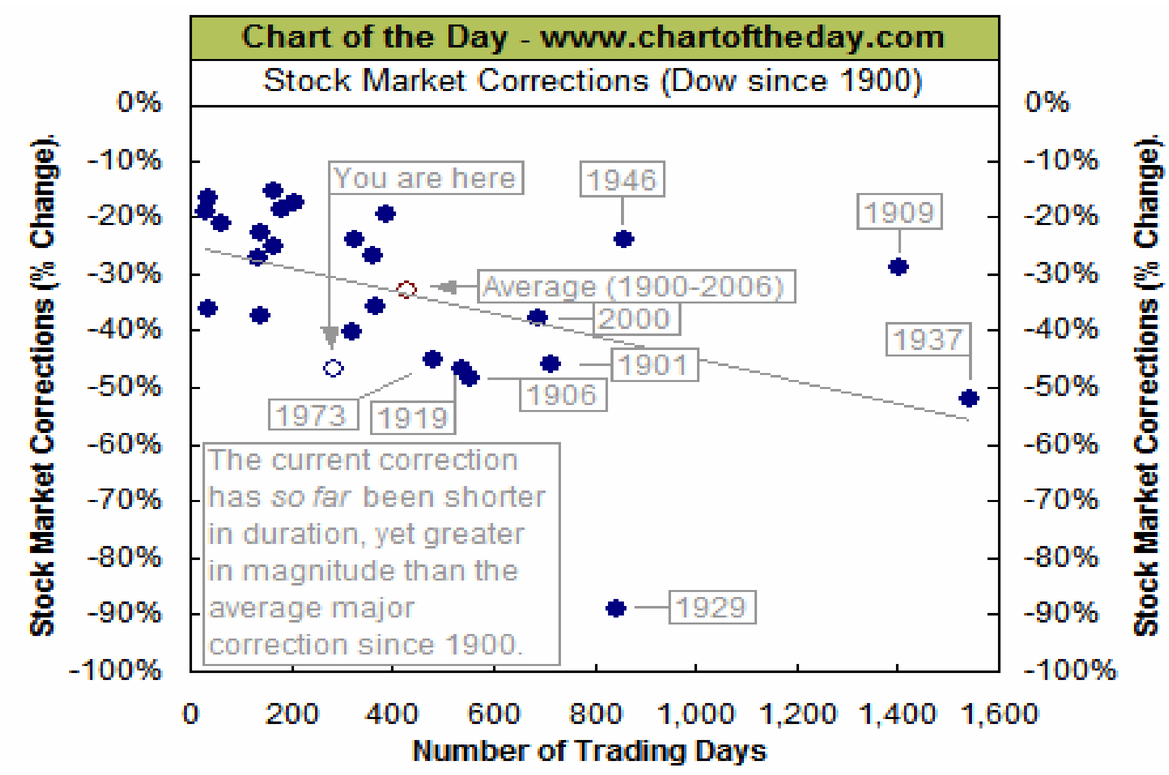
For volatility 2008 wins the prize for most crazy ever

Over the last 50 trading days, the average absolute daily percentage change of the S&P 500 has been 3.82%! That means the S&P 500 is averaging a daily move of up or down nearly 4%. Unfortunately, the majority of the daily moves have been down - a violent trip to less than nowhere. **In the history of the S&P 500, there has never been a more volatile period.**

Back in February of last year (when risk was huge but most were blindly snoozing), the 50-day average absolute change was just 0.33%. 2008 has been a rude awakening for the long always masses. As shown in the below chart of the average daily % change on the S&P since 1928-- 2008 wins the prize for most crazy.



Market losses for 2008 have so far been almost twice that of the -26% bear market average decline since 1900 as shown in the following graph.



But this oft-quoted average statistic includes cyclical bears within both secular bull and secular bear phases since 1900. When we compare this year's losses with other contractions within just secular bear periods (like we started in 2000), we find that losses of -45% are not unusual. We also note that cyclical bears within past secular bears *(such as 1901-1904, 1906-1909,1929-1932, 1936-1937, 1940-1942,1946-1948,1973-74,1981-1982, 2001-2002)* frequently averaged 2 years before the declines finally ended. So far, this bear has only been ravaging investors for about half that time. So while losses have been well within historical norms for this type of a downturn, history suggests that the length of this market rout may still have more to run. The trillion-dollar question is when will this cyclical bear end?

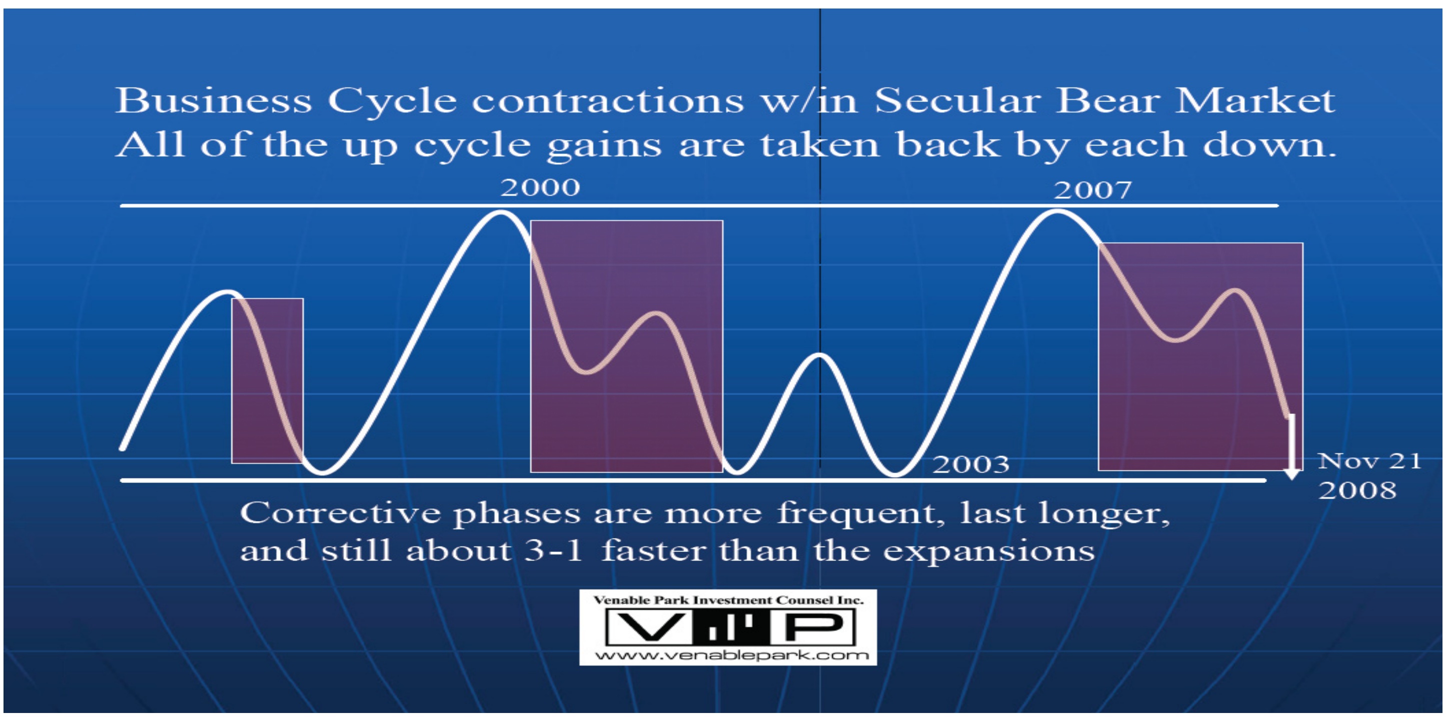
If we knew that with certainty it would make our job a whole lot easier. But alas, unlike the future Stock trader's Almanac that Marty finds in *Back to the Future*, we don't have the luxury of hindsight to predict the future.

Instead we must stick to our objective rules and measurements as we go. These are the same rules and measurements which have now allowed us to quietly outperform the overall markets and 95% of our peers with a fraction of their volatility over the past several years.

A rally into Jan or Feb 2009 is now probable

At this point we must be open to the idea that we may now see a market rally of several weeks or months. Given recent rapid declines, prices could rise substantially over the next several weeks. To offer context, a rally of 12% on the S&P and 13% on the TSX would just take the indices back to their Nov 4 high from the start of this month. It seems also probable that such an interim rally may well falter again once the fourth quarter earnings numbers begin release this February. If 2008 is similar to 2002, (and we see reasons why it may be) we may see a re-test of the market lows again this coming spring. Once that re-test is complete, we may then have a reasonable probability of starting into the next cyclical bull at last.

The pattern of this secular bear can be seen in the chart below, with the purple boxes showing the same market top each business cycle in 2000 and 2007. This month the US markets confirmed the secular bear thesis by re-testing the 2002/03 price low on both the S&P and the Dow as shown here:

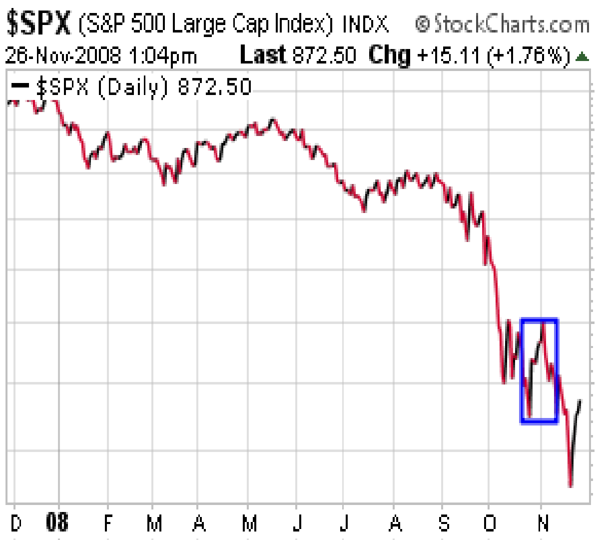


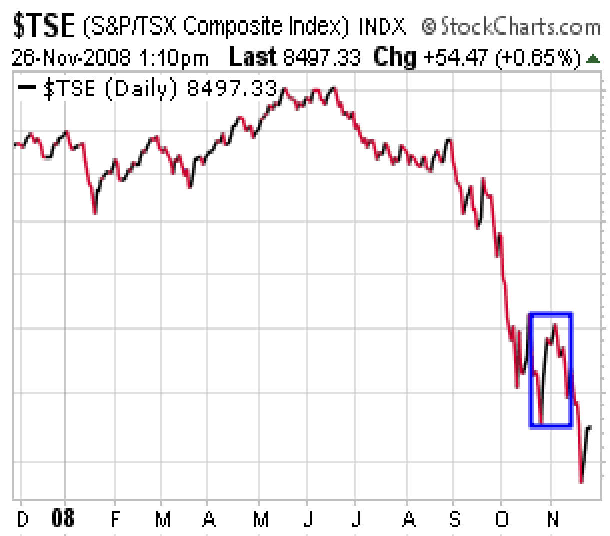
But just because these indices dropped to their 2002/03 low this month does not mean that we are now necessarily at the start of the next cycle bull. As shown in the chart above, this same low was hit first in 2002 and then re-visited in February 2003 for a double dip before finally launching into the cyclical bull that lasted until 2007. This pattern could feasibly unfold in 2009 as well, with markets rallying for some period over the coming weeks before breaking down yet again. There is also some risk that, as in the secular bear of 1966-1982, the markets could break through to a fresh lower, low this cycle - somewhere beneath the 2002 low as the final market bottom in the months ahead. We are prepared for all of these potential outcomes.

Once the next up cycle does start, passive investors will spend 3 to 5 years just trying to get their capital back to the previous highs. The up-market years surely are exciting. But as boring as it sounds, capturing the bulk of the up cycle means selling and minimizing losses in the down-market years. Executing this discipline provides the only lasting value of asset management.

It is also key to note that since this long secular bear is likely to continue all the way from 2000 to 2017 or so, the market highs of 2000 and 2007 are also likely to be the same market highs that will be achieved at the peak of the next expansion in 3 to 4 years (2012?). And that this peak will set up for the next contraction likely to re-visit the same market lows of both 2002 and the present cycle. Passive investors who have not learned a better method after capital losses of -45% in 2001-02 and 2008-09, may well have the opportunity to suffer the lesson yet a third time just a few years from now.

If an interim rally is tradable in the sense of sufficient volume and duration, we may get a buy on some part of our equity allocations in the near future. If that happens we will follow our discipline of toeing positions in again very gingerly. This break-out rally appeared to be happening at the end of October, when the buying pressure began to pick up markedly on our various indicators. The trouble was that the end of October rally was extremely short-lived, with markets breaking down and kicking us out again after only a week as shown in the blue box on the S&P 500 and the TSX below.





Although we incurred a small loss on that trade (taking back less than 1% of our account gains year to date), the indices broke down significantly after we sold. In this sense, our sell worked well.

We can't help but look forward to the time when equity markets calm down again, and daily gyrations resume some semblance of normalcy. In the meantime, we will continue to watch for any reasonable opportunities that present us with a good probability of a risk-adjusted reward.

Overall, on a fundamental basis, equity valuations are now the most attractive that they have been in many years. The impediment is that so far selling pressure in the markets has continued largely unabated. We suspect that a good deal of this selling pressure continues to come from the forced selling of many over-levered participants in world markets. So long as the margin clerks are in charge, fundamental valuations alone will be an insufficient catalyst to start the next up-cyclical in equities.

No one can say when the selling cycle will end. But we know that it will. We will see it in our work. One of these days, the sellers will be exhausted.

Closing snap shot on the Canadian financial Index: down -42%. Remember all the managers and investors saying how much they liked the financials over the past couple of years? Ouch!

Let us always remember that despite conventional babble, banks are not “safe” as buy and hold investments. Canadian banks are mere equities like all the rest. And when equities are falling- we must step aside.

As the American’s celebrate their Thanksgiving this weekend, we reflect on our own blessings. At Venable Park we are grateful for our health, family, friends and our many loyal clients. We are also grateful for work that we love, and for the wise technicians and market historians we have studied over the years that have helped us to prepare for and navigate through present times.   We are also grateful for some humour:

Best wishes for December…