Real life needs active management

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E.Q Trendwatch™

The secret of lasting gains? Avoid down market returns!

"The Intelligent Investor is a market realist who sells to market optimists and buys from market pessimists."

-Benjamin Graham

February has been a rocky-month for buy and hold investors. In the last week of February, actually in one day -Tuesday February 27- broad market indices around the world, lost pretty much all the "gains" they had made to date in 2007. We are not the kind to gloat or feel good when others lose money, but this correction is long overdue. There will be more to come before the excesses of the past couple of years are wrung out of the world financial system.

As is always the case, many people will be caught by surprise in this correction. Many will blame it on some exterior catalyst that they will say was unpredictable and unfair. Some will look for others to blame for their losses. It has always been this way throughout market history. The cycles are as inevitable and persistent as human nature.

That is why long-term successful investment managers all know the *key to lasting success: focus on avoiding downmarket losses and the upside will take care of itself*. Each year the investment sales industry spends millions of marketing dollars convincing people to stay perpetually invested in equities in order to have the opportunity to make gains. "No pain, no gain" is their mantra. But real life does not agree with the marketing machine of this overly optimistic industry.

The truth? : "Less pain, more gain" is the more accurate mantra. **If we can avoid the big market downturns at the end of each market cycle, we need only be in the market for 30% of the upturn that follows in order to make the same returns as our perpetually invested friends and neighbours**. If we are able to capture 50-70% of the next upmarket cycle, we outperform the market returns. This research and other key market data can be found on line at www.crestmontresearch.com

Hard to believe? Lets look at the math. First we will consider the returns to a buy and hold TSX 60 investor over the past 6 years of this extra long, long (over-extended by widespread credit) business cycle:

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Buy and Hold TSX 60 Index (*starting with $1,000 initial investment in January 2002)*

(actual gross annual returns from 2002 to 2006):			**Gain**	**Year end value**
Recovery/expansion:	2002	$1,000 invested	-12.2%	$ 878
	2003	878 invested	26.1%	$1,107
	2004	$1,107 invested	14.3%	$1,265
	2005	$1,265 invested	23.7%	$1,565
Peak:	2006	$1,565 invested	16.3%	$1,820
Contraction:	**2007?**	**$1,820 invested**	**(-15%) ?***	**$1,547**
Gross gain over 6 years:				547
Annualized 6-year rate of return:				***7.54%***

***this return for 2007 is a "what if" based on a less than average market downturn in 2007. If the economy were to recess in 2007 the average market downturn would increase to more than –30%. Bond markets are currently pricing the probability of a recession this year at greater than 50%.**

In a –26% correction (the historical average decline for the S&P 500) the numbers would look like this for the buy and hold TSX 60 investor:

Contraction:	***2007?***	***$1,820 invested***	***(-26%)?***	***$1,346***
Gross gain over 6 years:				346
Annualized 6-year rate of return:				***5.09%***

If the bond market is right and a recession does materialize in 2007, then the buy and hold TSX investor could end up back almost where s/he started 6 years earlier. But let's be optimistic, hopefully no recession will materialize. The point is you don't need a recession to hurt the returns of a buy and hold investor, just a regular, now overdue "correction" or "consolidation" or "pull-back" of 15%, sets the buy and hold investor back considerably from here.

Now let's compare the above returns to a more price sensitive TSX 60 investor (O.K., take us as an example) who bought near the start of the last expansion in 2002 but had to leave the TSX party early when valuations became too rich for their established valuation rules:

Active timing of the TSX 60 Index: *(starting with the same $1,000 in January 2002)*

(VP's actual gross annual returns 2002 to 2006):			Gain	Year end value
Recovery/expansion:	2002	$1,000 invested	.4%	$1,004
	2003	$1,004 invested	25%	$1,255
	2004	$1,255 invested	10.5% `	$1,386
	2005	$1,386 invested	6.5%	$1,476
Peak:	2006	$1,476 invested	2.7%	$1,515
Contraction:	**2007?**	**$1,515 invested**	**4%?**	**$1,576**
Gross gain over 6 years:				576
Annualized 6-year rate of return:				***7.88%***

*this return for 2007 is a "what if" we were only able to earn the risk free rate in 2007 while markets were falling.

The above annual returns look less exciting, and yet by avoiding negative return years, the annualized return to the investor would still be higher in this case than for those who stayed in for the whole wild market ride over 6 years. The wild ride would not only return less, it would do so with much higher risk since capital was left perpetually in the market. So the point we hope you take from the above: you do not need to be invested for the entire business cycle in order to make and keep above-market returns over time. It is most important that you avoid big losses.

So why don't more people try to time investing? *Because it's hard*. You need to develop a sound methodology, which takes work. But that is actually the easier part. The second part is that once you develop a method you need to stick to it even when the markets go roaring past and make it look like you are standing still at the peak of a cycle. You need to stick to it even when some clients lose patience and think that you are causing them to miss out.

There is another key factor in support of timing your entry and exit points for investment. Real people usually amass their savings not gradually month over month but rather in lump sums as they receive a bonus, make an RSP contribution, sell a business or property or receive inheritance. Since lump sums tend to be sporadic you need to have a strict rule for when you invest the proceeds. What if a person inherits a million dollars near the peak of a cycle? What if they take the advice of their broker or planner and buy equities right away on the idea that the best time to invest is whenever you have the money? And they jump in just in time for the average run of the mill bear market (-26%), or even "just a correction" (-10 to -15%). Ouch. Timing is everything. Patience and discipline are the only way to invest money for lasting returns. But then we at VP are not paid to sell our clients risk, we are paid to protect and grow their money safely over their lifetime.

REPORT ON BUSINESS TELEVISION (ROBTV- Channel 49 on Cable)

For those that are interested, **Cory** will be the **guest Technical Analyst on *The Chart Room,* Friday March 2, at 3:40pm,** and **Danielle** will be the **guest Portfolio Manager on *The Street* at 9:20am on Wednesday March 28.** The clips can also be viewed for the week following the appearances on the ROB website at http://www.robtv.com/shows/past_archive under past video archive for the date and time in question as well as through a link on our web home page at www.venablepark.com.