

Market Timing

Major markets deal with worry

This newsletter we thought it might be helpful to give you an update on both economic and technical developments. First and foremost, our risk management system has protected us from some pretty hefty volatility over the past few months as we have waited out of the market.

Since our sell was triggered, (February 1 for NASDAQ and March 12 for the TSE, S&P and EFA), these markets have not been able to sustain new highs. In fact while we have sat out, the NASDAQ declined -10% from peak to trough, the S&P 500 -7.5%, TSX Composite -9.2% and the Intl. Index -8.9%.

Lately some of the markets have been trying to regain a foothold at the levels we exited. This activity is constructive, but there are still many issues yet to play out. And as we know, securities markets detest the unknown. Some of the larger questions: the success of the hand-over of power back to the Iraqi's this month, and economic drag created by the enormous terror premium on oil. OPEC has suggested that they will be able to satisfy the increase in demand. In keeping with historical habits, both OPEC and non-OPEC members have been pumping furiously given the \$40. + oil price. Historically this incentive has led to over-supply, with all the members of the Cartel denying that they were the country over-producing their quota.

Current oil prices have certainly impacted the largest users of the commodity: transport and airline companies. The question is how much of this impact has already been discounted by the markets. Currently market participants are trying to digest the extent to which hikes in fuel costs have impacted profit margins and how this should be translated into the fair value of security prices. Many believe it is not crude oil supply but rather refining capacity that is the problem. Not having added new refineries since the 1970's greatly compounds this issue. It seems that until someone agrees to add one in their backyard, price volatility will persist for the foreseeable future.

As you have been made aware, we are not in the habit of projecting world events or market directions, but rather we monitor the actual votes (dollars) of the collective intelligence. Only time will tell whether we are in for a summer rally or kept on the sidelines as the market continues to nervously quantify all the unknowns.

BENJAMIN GRAHAM

In a world that professes the worship of buy and hold, we can find some comfort in other successful money managers that went before us. One of the most famous of these is Ben Graham, a forefather of even Warren Buffet. Graham wrote a revolutionary book called the "*Intelligent Investor*" that was first published in 1949 and has recently been re-published in its 5th revised edition, edited by Jason Zweig. In reminding us that Graham was one of the most brilliant minds and successful investors of all time, Zweig writes:

"Graham is often regarded as a kind of judgmental or formulaic market timer...in the sense that one should get out of stocks when they are over-valued and stay in cash or bonds until stocks get cheap again.



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A lot of the chapters in Graham's book are given over to his ruminations on when investors should be in the market and when they should be out."

Regarding his use of the word "intelligent" in the title of his book "The Intelligent Investor", Graham wrote in his first edition in 1949:

"Intelligent "will be used throughout the book in its common and dictionary sense as meaning "endowed with the capacity for knowledge and understanding." It will not be taken to mean "smart" or "shrewd" or gifted with unusual foresight or insight. Actually the intelligence here presupposed is a trait more of the character than the brain." (P.4)

That last sentence is key when talking about investment intelligence, Graham is talking about personality: patience, independent thinking, discipline, eagerness to learn, and self-control, not IQ.

In a similar vein, another disciplined manager Fred H. Speece, Jr., founder of Speece Thorson Capital Group, Inc. wrote an article in this month's AIMR professional Journal entitled "Overview: An Opportunity to Add Value:

"The rise of 401K plans is an enormous North American phenomenon that is concentrating assets in the hands of individuals who tend to be less structured, more emotional, and unfortunately act like the Wildebeest: they follow trends. In 1999, they plodded into stock funds that were heavily invested in high tech, and now, they are chasing bond funds that have been on the rise for some time. This behaviour is having two impacts. First, it is another pressure to extend the extremes (momentum investing) and add to the emotional volatility of the market. Second, and more subtly, it is forcing managers to follow those trends even more than in the past. That is mutual fund managers are paid for the assets in the portfolio as well as the performance of the fund. If they do not stay with the momentum, they will lose assets and they will lose income. The result is that they have a strong incentive to extend trends. Another impact is that it discourages mutual fund managers from being style purists and staying the course when their style is out of phase. This style shifting creates a great opportunity for managers who can resist this pressure and add value by staying with their style at such times. **But it requires a more sophisticated client base that is willing to accept these out-of-phase patterns to gain higher long-term returns.** (P.1)

And so we are grateful for both our disciplined approach and our sophisticated client base!!!

Have a Safe and Wonderful Summer.

An investment operation is one which, upon thorough analysis, promises safety of principal and an adequate return. Operations not meeting these requirements are speculative.

—Benjamin Graham, The Intelligent Investor (2003 Edition, p.18).

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