Real life needs active management

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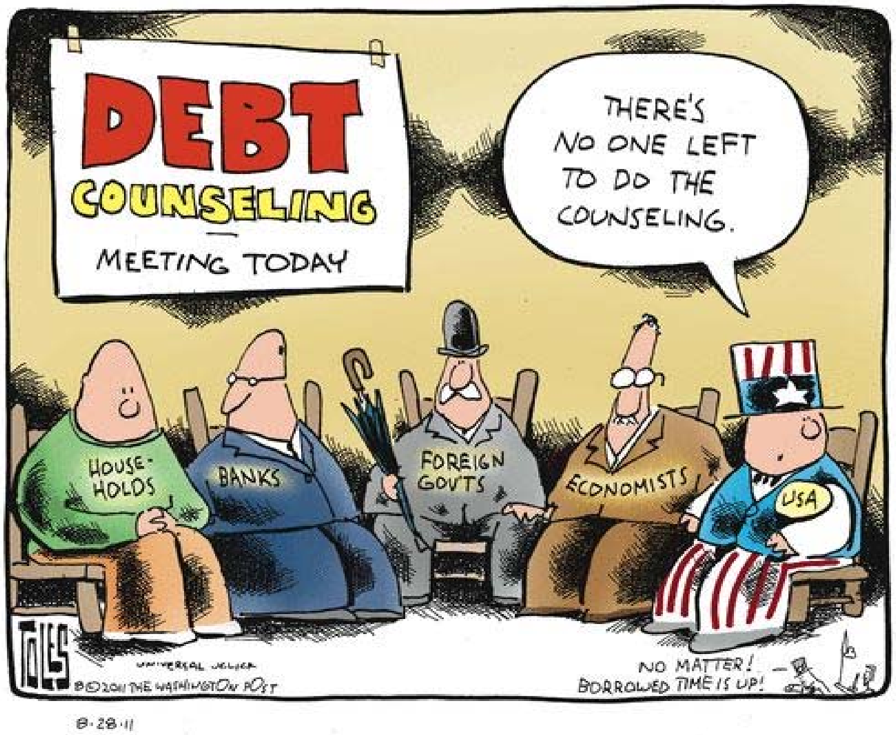
E.Q Trendwatch™

No market for the naive



"This is no market for young men. At least us old men remember what a real bear market is like, the young men haven't got a clue."

-Jeremy Grantham, chairman of Boston-based investment manager GMO, Sept 21, 2011

This month world markets officially entered the next and third cyclical bear market of the secular bear period which began in 2000 as 19 of 29 global markets closed down by more than 20% from their most recent peaks in early 2011.

According to research by Birinyi and Associates in the eight 20% pullbacks for the MSCI World Index since 1987, on average (over secular bull and secular bear phases) the index goes on to fall another 9 percent over an average of 80 more days of weakness. If this were an "average" cycle then we might expect a bottom in the stock market sometime this coming December after a total decline of about 29%.

Cory Venable CIM, FCSI, CMT
Technical Market Analyst

Danielle Park LL.B., CFP, CFA
Portfolio Manager

Venable Park Investment Counsel Inc.

Venable Park Investment Counsel Inc.
www.venablepark.com

33 Clapperton St.
Barrie ON L4M 3E6
Tel: (705) 792-3991
Toll Free: 866-792-3991
Fax: (705) 792-3992

During secular bear markets, however, the cyclical market declines are deeper and longer with total losses of more than 40% over 12 to 18 months. If this is a typical secular bear, cyclical down cycle then stocks and commodities could be about half way through their final decline. The art of navigating our way successfully through these periods is not to be cocky or overly-confident in forecasts but to keep a humble, level, open mind that prepares well in advance for various possible outcomes.

As we have written for the past several months, the seeds of this downturn were sown in the excesses of the credit bubble that preceded it. **Every banking crisis in history has been followed by a sovereign debt crisis approximately 3 years later.** You can almost set your watch by it. The government funding crisis now underway in most of the developed world is pretty much exactly on time.

Financial firms hurting from their own financial advice

Our readers know that we have been worried about the mounting deficits in pensions and retirement accounts since this secular bear began in 2000. We have spoken and written on it many times. Buy and hold of equities during this challenging period has resulted in flat to negative net returns for most funds and pension managers over the past 12 years.

To make matters worse, interest rates have been falling with each new cyclical recession as governments and central banks have stepped in to slash rates and try to jump-start consumers with even more debt. Interest rates today are now the lowest ever in human history with ten year bonds yielding less than 2% and shorter term bonds yielding significantly less. The horror of the situation for pensions and life insurance companies, however, still seems little understood by the masses.

Pension funds and insurance companies typically have a mandate to hold the large majority—up to 70% of their assets—in guaranteed instruments which pay interest income to match the monthly obligations they must pay out. Their yields are now being viciously suppressed by unnaturally low interest rates. On the other "growth" side, equity allocations have been missing the 10-12% a year return hope by a huge margin for more than a decade. In 2005- 2007 many funds tried to address their deficit by adding in commodities and hedge funds as an "alternative" investment class only to see losses of 50-70% in this area over the past 4 years. As a result, most pension funds today are dangerously underfunded. A decade of similar conditions starting in 1989 brought a wave of bankruptcies to Japanese insurance companies beginning in 1997. We should be concerned then about how these deficits and shortfalls are addressed now in the rest of the world.

Realistically there are a few ways that this problem can be fixed:

1. The plans will be restructured to cut benefits, increase contributions, and raise the retirement age for collecting benefits. Raising employer contributions is needed and will lower corporate profits.

2. For the last decade, more and more employers have been backing out of pension obligations. They have stopped offering guaranteed retirement payouts moving away from defined benefit plans to defined contribution plans and leaving employees to fend for themselves with high fee products in wild markets with no meaningful risk management. Workers are left to collect whatever they can from whatever funds they may have amassed by retirement. This trend is likely to continue, since the average funding deficit among the 1500 largest US companies was at 31% in April 2011. This deficit was before the latest plunge in interest rates (thanks to "Operation Twist") and before the latest bear market in stocks began this spring.

Following this trend then, it was predictable to see the Royal Bank of Canada announce this month that they too will be abandoning their defined benefit pensions for new employees now joining the company, "the changes are a responsible way for RBC to better manage the retirement program by ensuring more predictable pension costs in the future," a company spokesperson explained.

The hypocrisy in this admission is striking: the banks run hundreds of billions in money pools and funds. They have enormous "wealth management" divisions geared to providing professional money management and "advice" to their customers. They had been insisting that buy and hold and passive asset allocations are a prudent growth strategy throughout this secular bear. They have been insisting it is "time in the market" not "timing' that matters for investment success. **They have spent billions of marketing dollars establishing their brand as "financial experts" and yet here they are now admitting that they themselves manage risk so poorly that they cannot meet their own pension goals.** Everyone should think about that admission for a moment. Let it settle in.

The truth is that even in today's challenging conditions, banks and other companies can fund guaranteed pension plans, just as individuals can fund their own retirement security goals. **But the way to do so is not to take on more risk and drive capital hard regardless of the conditions. The key is to control risk, avoid loss and increase annual contributions where needed to remain on target.** Increasing contributions reduces present spending ability for individuals and it lowers profits for corporations. Apparently this is math that many just refuse to accept. As a result, most will find themselves under-funded in retirement. **The good news is that for those who can comprehend what is needed and follow responsible risk management for their savings, happy endings are still within our grasp. There will inevitably be better interest rates and equity markets ahead, the focus in the meantime, is to arrive there alive with our savings in tact.**

Another key solution to bridging the funding gap in retirement planning today is to extend the age at which people plan to stop working and start living on their savings. The truth is that for most people the idea of retiring in their 50's and even 60's is simply unrealistic given current yields and the standard of living they hope to maintain. It is important to note that in 1935 when Franklin Delano Roosevelt enacted the Social Security Act in America the retirement age selected was 65, but the average life expectancy of pension recipients at that point was just 61. The government was offering pensions that would not start until 4 years after most people were expected to be dead!

If we fast forward to today, the average life expectancy is just under 80 years. Starting at age 65 this means an average expected payout of 15 years! When we add to this the demographic burden of the baby boomers all wanting to collect off of a smaller, poorer, work force of contributors behind them, we can see that higher contribution levels as well as an increased retirement age of 70 and probably 75 will be necessary to make pension math work. The time has come for all of us to face the facts. Blithely lobbing deficits onto credit lines is so 2000's. The 2010 decade of re-balancing budgets is now upon us. And the world will eventually come out much better for it in the end.

Facing facts on earnings too

Another dangerous mindset popular today is asserting the relative "cheapness" of stocks at present prices relative to their expected earnings. The fact is that most analysts and market commentators always expect earnings growth to increase year over year and never expect a recession. For this reason they are notoriously unable to predict a downturn in the economy or the stock market. They are always "surprised" when it happens, rather like clockwork, every 3-5 years.

As we came in to 2011, the consensus vote—similar to 2007, 2000 and every other expansion peak in market history—was for more record earnings. In 2012, the consensus average estimate was for S&P 500 companies to earn $112 a share. $112 would be the highest earnings per share in market history. It would also be some 16% higher than the S&P companies earned at the peak of the US credit bubble in 2006. Hope springs eternal for the equity analyst community! When they plug in these optimistic numbers to their much revered price to earnings formulas they assure us that at an assumed trading multiple of 15 the S&P 500 Index is fairly valued at 1,680 (15 x 112= 1680). Presently priced around 1180 they then assure us that stocks are historically "cheap".

But those of us who prefer to not lose heavily in each market downturn must be a little more pragmatic with our hopes and dreams. First of all, whether we are aware of it or not, at every price stock buyers are paying a present value for participating in the anticipated future earnings of a company. How big a multiple we are willing to pay has everything to do with how big we expect those earnings to be, and how confident, depressed or irrational we feel about the future. If we are really excited (irrational exuberance), we may be willing to pay 15 or 20 times earnings (even 40 times in the Tech bubble!), or if we are really pessimistic like at the end of previous secular bear markets in history, we may be only enticed at prices that are 7-8x earnings expectations.

The commonly cited multiple of 15x earnings then is not a wise assumption as this is the average multiple calculated only when one includes the insane 30 to 40 times earnings that "investors" were paying for stocks at the tech bubble peak from 1997-2000. If we look at a broader subset of market data we note that a more common historic average multiple has been 10-12 times earnings. For more rational thinkers then, a reasonable valuation formula to work with would not be P/E = 15, but more like P/E = 8 to 12.

In addition, the amount of earnings we expect matters a ton in this assessment. Today the most reliable indicators suggest that the next global recession is in the offing. History tells us that during secular bear periods, cyclical recessions typically see a 50% decline in earnings per share (“EPS”) for the S&P 500 companies (the 2001 recession saw a 57% drop in EPS, 2008 saw a 51% drop in EPS from peak to trough). If we use history as our guideline then, it would be quite reasonable to assume that the presently expected $112 EPS could very likely turn out to be more like $55 to $65 EPS in 2012. If we plug this likelihood into our formula we arrive at a more sober assessment of present stock prices looking forward. At average earnings of $65 a share, our formula would look like this:

$65 of EPS x 10 to 12 = S&P 500 fair value of 650 to 780 give or take.

Today the S&P 500 is trading at 1155 or some 33-44% above fair value on our formula. Stocks have a strong probability of getting quite a bit cheaper in the foreseeable future. **Similar math applies today for pretty much every other major global stock and commodity index in the world.**

In the end, the earnings one expects and the price one is willing to buy or hold stocks at has everything to do with how much or little they understand about the global drivers of price. To assess price well in today’s deleveraging, post-credit bubble, deficit-plagued world, one must be open to the probability of lower growth and earnings outcomes for the next several quarters.

Today most investors are losing again because they are accepting bad advice and/or they cannot or will not adapt to present reality. At Venable Park we are committed to realistic assessments and math because they are the only way we have found to act proactively in protecting our capital from predictable, recurring losses—see through the madness of crowds— and be ready and able to recognize attractive opportunities when they inevitably present.

<u>What we need to prepare ourselves and our clients for now is the fear that will no doubt be palpable when our next buying opportunity arrives.</u> We remember clearly what past major market bottoms have felt like: there is terror in the air, both in media commentators, investors and money managers. The spring of 2003 and the spring of 2009 were the last two times that we confirmed buy signals across all of our method indicators. When we acknowledged this and began wading into our target assets (after they have fallen by 50%) many people expressed alarm and disbelief that this could be a reasonable course. Some of our clients also contacted us on these occasions to express their fear of buying. Pervasive fear and pessimism is an important contrarian indicator that a durable market bottom is very likely near. It is known as “capitulation” and stands in direct contrast to the denial and optimism that prevails near market peaks when most are buying and we at Venable Park are selling. **Today 5 months and -20% into this cyclical bear, the advisor community and most investors are still expecting a quick recovery of recent losses. This is one more indicator telling us that we are not yet near an important bottom**. It is human nature to be oblivious when we should be afraid and afraid when we should be opportunistic. Once we begin to register buys on our rule-set, there is always a chance that prices may decline a little further, but when we prepare a staggered execution plan in advance and understand that risk recedes with price, then we will be better prepared to act in strength when the opportunities are most favourable. We look forward to moving against the pack once more. *It is coming*.

Strategy update: for clients who like detailed strategy we offer the following month-end summary.

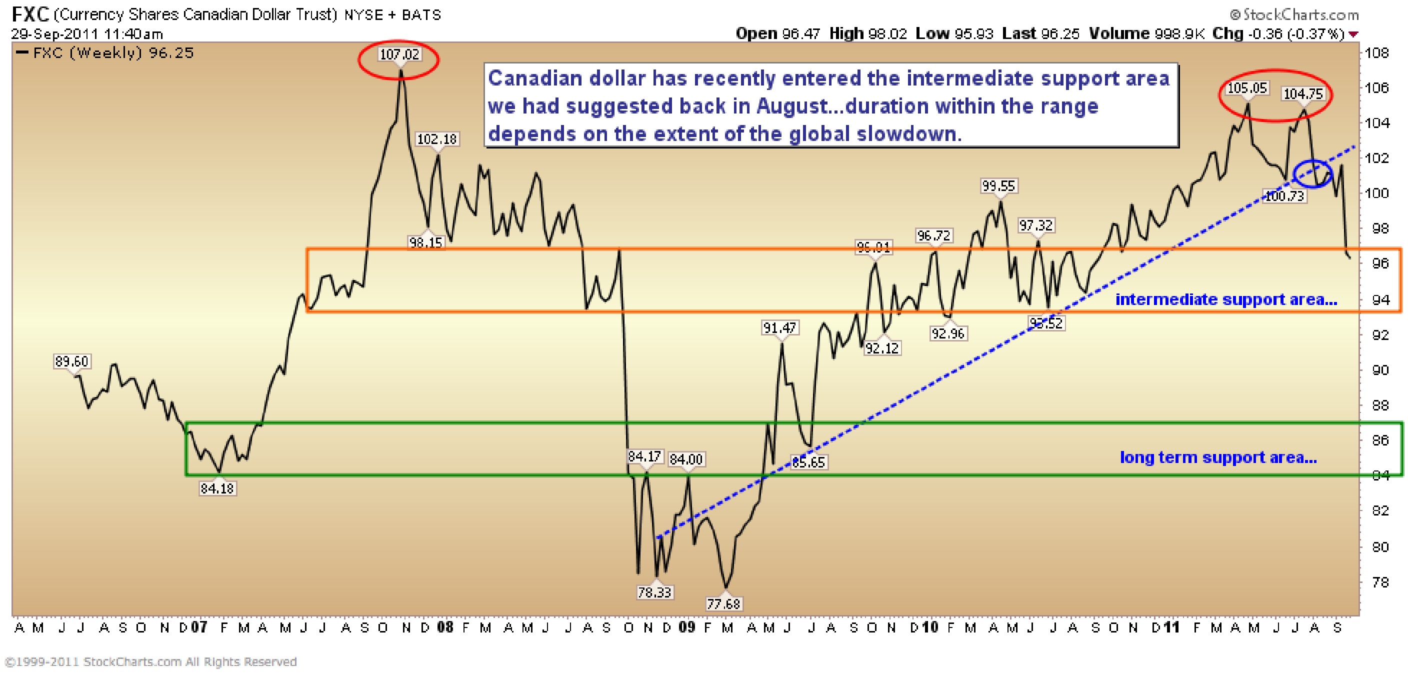
August continued to maintain support for our bond holdings and saw the US dollar bounce off support amid continued weakness in stock and commodity markets. Our defensive investment stance continues to gain support. Although prices did move down this month, risk measurements for stocks and commodities are still signalling significant risk of price declines. **We see the near term risk of contagion and shock to the global financial system as broader and potentially more dangerous today than at the start of the sub-prime debt crisis in 2007.**

Remembering our analogy of the global teeter totter with the bench mark currency— the US dollar—on one side and the rest of global asset markets—stocks, commodities, some of the other currencies—on the other:

US dollar Index 1990 to 2011: the greenback bounced off long-term support this month and broke out

As shown in the above chart, the US dollar index broke through near-term resistance at 75 against the basket of world currencies this month. From there it continued to rally above 78. For the month, the trend in favour of the US dollar and away from equities and commodities continued. The trading range up to 88 on this index remains our medium term target.

The Canadian dollar 2007 to 2011: this month the C$ tumbled below par

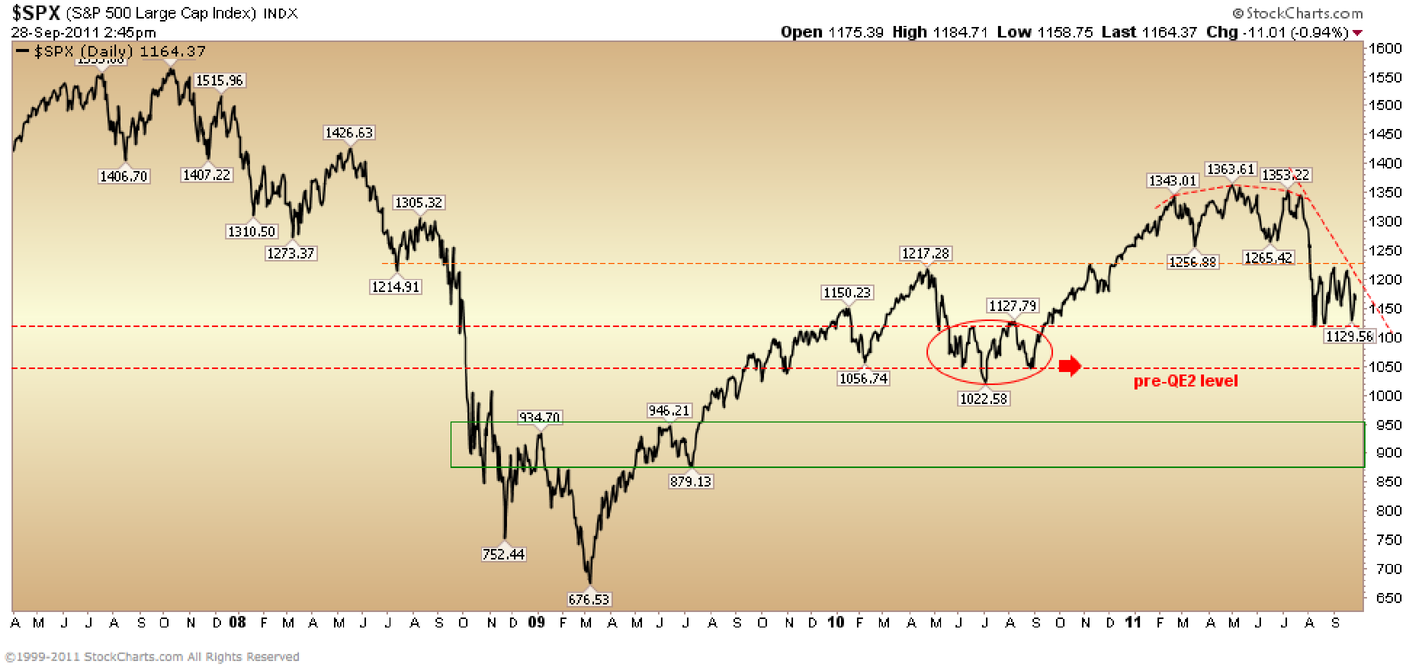


As shown in the above chart the C$ Index broke below key support of par at the start of this month against the US dollar. As a commodity-centric currency, the Loonie saw a wave of international selling throughout the month, much as it did in 2008. Closing the month below 96, the Loonie is now testing the first intermediate support line indicated on our chart above. We still think there is a probability of further weakness from here as the recession story takes its toll on world risk markets and demand for commodities.

Equities: Although downside progress has been made, on every reasonable and historically reliable valuation model, equities remain overvalued. The Fed's efforts to re-flate risk assets have come at a large price. Valuations across the board became overblown on high margin, low volume trading. This short-term side effect should dissipate as appetite for government intervention wanes and markets are left to find their own equilibrium.

Our estimate continues to be that pre-QE2 price levels could easily re-appear (about 1000 on the S&P, 11,000 on the TSX). At month end we are still about 13% and 5% above this test. It is also entirely plausible that most if not all of the speculative gains made since the QE's first began in the spring of 2009 will ultimately be given back before the next cyclical bull begins (this support is at 700 on the S&P and about 8500 on the TSX).

S&P 500 2007 to 2011: Pre-QE 2 levels now in sight, next near term support test at 1127



Canadian stock market: ….still fallin'

With commodity prices and risk appetite in retreat, the Canadian market continued to sell off this month. Now down 17% from its most recent high in April. The growing evidence of global recession including a major slowdown or hard landing in Asia has pushed over-priced global markets into a sell-off.

Both copper and the Chinese stock market have typically led the resource-centric Canadian market lower with a lag of a few months. Copper is now off more than 31% from its February peak and the Shanghai composite is down about 22% so far, neither are showing signs of a bottom. Both suggest global equities have further to correct.

Bonds: Our strategy continues to focus on high quality North American issues in the short to medium part of the yield curve. Our rationale was that in times of global crisis, investors would move out of many troubled regions abroad and migrate back to North American bond markets. This has proven correct and has been very supportive of our bond holdings to date. We see no reason for this to change any time soon.

For a good big picture barometer on this battle, we continue to monitor the US 10-year treasury yield.

10 year Treasury Yield 2001 to present- downtrend still supportive of bond prices

Our thesis of short-term deflation and growth slowed by government debt and consumer austerity was further confirmed this month by yields on treasury bonds falling to 100 year lows. The bond market is concerned that additional bailouts will only prolong the healing process as now debt levels of individuals and governments must be reduced before consumption rates can revert to more traditional levels. In September, the 10 year yield fell well below 2%. This pushed our bond prices up.

We will continue to watch the medium trend carefully. But so far the bond market is seeing tough times ahead. The trend of falling inflation is supported by a lack of wage pressure, continued weakness in housing, contracting GDP expectations and continued slack in economic capacity.

Best wishes for October, *head on out to the pumpkin patch*.

Quotes of the month:

"Nothing in the world can take the place of persistence. Talent will not; nothing is more common than unsuccessful men with talent. Genius will not; unrewarded genius is almost a proverb. Education will not; the world is full of educated derelicts. Persistence and determination alone are omnipotent. The slogan, 'Press on,' has solved and always will solve the problems of the human race."

—Calvin Coolidge, 1872–1933, lawyer, 30th President of the United States 1923–1929.

"There is no chance, no destiny, no fate, that can hinder or control the firm resolve of a determined soul."

--*Ella Wheeler Wilcox 1850-1919, Author and Poet*

"A good laugh overcomes more difficulties and dissipates more dark clouds than any other one thing."

--*Laura Ingalls Wilder, 1867-1957, Author*

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