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Issue #17 - "Big Ben's Warning Bell"

Interesting Links from Around the Web

Bonds : The Risks of Low-Risk : Globe & Mail
Finance : How to avoid a mutual fund salesman : Video
Other : Why 30 is not the new 20 : TED Talk

Since the chairman of the Federal Reserve Ben Bernanke's announcement that he would 'taper off' quantitative easing (supporting the economy by printing money), the markets have been retreating. Given the market's reaction, it is difficult to wade through the negative headlines to get an idea of what is actually going on in the general economy. At the end of the day, Mr. Bernanke's comments could have been surmised as such: "The economy is doing a lot better, and if it keeps going like this, we can take it off life-support". Rather than rejoicing in this news, short-term investors took this opportunity to scare investors into making bad decisions by loading the markets with sell orders.

In times like these, I always think of investors as being monkeys foraging in a field. In an attempt to keep the food all to themselves, a group of monkeys surreptitiously coordinate to scare the other monkeys into believing there is a lion coming. Following the herd mentality, many monkeys bolt for safety before even turning to examine for themselves if there was an actual threat.

According to the Oracle of Omaha, Warren Buffett, investors must learn to 'be greedy when others are fearful and fearful when others are greedy'. I share his sentiment that investors are motivated by two primary emotions; greed and fear. When greed takes hold, bull markets charge to unsustainable levels only to be reversed when the bears sink their claws into the markets. Over the last six months, I believe greed has been the driving force on the US markets which have pushed the DOW and S&P near all-time highs.

Truth be told, the Dow Jones' recent losses have only reversed the gains that were generated during the bullish month of May, and therefore do not represent much of a correction. Due to the fact that the Canadian markets saw only limited capital appreciation during the month of May, the gains were quickly reversed by the recent push back from the market bears. With this latest market pull-back, the S&P TSX has returned to the same values it reached in 2006, some 7+ years ago.

I view this recent pull-back as healthy given that the markets had gotten ahead of economic fundamentals. Now motivated by fear, investors are letting their emotions get the best of them and so good long-term investments are being sold wholesale. Disconnecting your brain from your pocket book can be an expensive exercise.

I am by no means saying that there aren't serious concerns with the world economic engine, as I feel that there are serious endemic issues that are far from resolved. Youth unemployment in Europe will be a generational issue that will likely take the better part of a decade to remedy while I don't see any major forces that will push commodities up in the near term. These are realities that were no better or worse during the month of May while the markets were rising. As such, it is clear to me that the only thing that has changed during this time is the perception of the economy and the mood of investors. The fact that most economic data to be released during the month of June was positive or neutral for most of the world, does not seem to have influenced market activity.

Without a doubt, it has been a difficult time period in which to be a 'buy-and-hold' investor. On our end, the volatility has presented us with excellent opportunities to execute our 'Tactical Asset Allocation' strategy in which we moved between stocks and bonds based on market conditions. To reference the monkey example from above; when the monkeys are all in the field, our strategy is to stay back in the trees to scout for oncoming threats. When we feel that we've adequately monitored the situation, we wait for either greed or fear to dominate the markets and shift assets to take advantage of such movements. I believe the time for an asset allocation shift is near and should the markets continue their retreat, we will gladly take advantage of an opportunity to pick up quality companies at discounted prices.

How this affects you

Bernanke's announcement will mean that we will likely see inflation and interest rates rise in the next year. This will mean increased pressure on the consumer both at the grocery store check-out counter and on their line of credit statements. I believe these two factors will lead to a slow-down in the Canadian recovery effort, while the US will continue to build steam. This will lead to a depreciation of our currency versus the greenback over the next two years.

How this will affect your investments

Expect volatility and market corrections to produce some negative returns in the near term before rebounding before year-end. Our strategy of buying profitable companies that pay dividends will mean that we will continue to buy shares while the markets are depressed, and thus lower the overall cost of our investments. Should the markets fall below what we deem fair, we will gladly take advantage of market conditions to 'buy-low' by shifting out of bonds in favour of equity.

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