



Live *your* dream.

Cool Heads always win in the long run

For anyone who has seen the Clint Eastwood movie *Unforgiven*, they will remember the scene in which Little Bill (the sheriff) was telling the reporter what it takes to be a good gun fighter. He said it is that you don't have to be the fastest or even the best shot, but the greatest gunfighters are always the ones who can keep a cool head when everyone around them is getting rattled. Investing is no different. The successful investors are always the ones who can keep a cool head when everyone around them is in a panic.

So what is going on out there?

For the first time since November 2001 (After 9/11), the global banks have come together and reduced interest rates around the world by 0.5%. This is Adam Smith (1723 -1790) at work. Adam said "when there is a global crisis, the world comes together to solve it." And this has happened every time! It's in the greater good that always comes out of it.

This credit crunch has been with us for 14 months. But it is only now that it has turned into a full-fledged panic for everyone involved.

Mutual fund outflow numbers show that shareholders are yanking money out of both stock and bond funds. So many investors have jumped into cash that the yield has dropped below one half of one per cent. In their rush to safety, they are guaranteeing themselves a substantial negative return after taxes and inflation.

And it's seeing such things that the governments and central banks have acted so quickly. The good news is that action has been taken. The bad news is that it takes time to take effect, and people want instant salvation and that is probably not going to happen.

But let's look at a few facts:

The S&P 500 is now down about 35% from its all-time high one year ago. Since World War II, the average bear market has taken the average down 31%. The two worst declines were the 1973 -1974 bear market when the market dropped 48%, and in 2000 - 2002 when the market came down 49%.

Yes, the market can fall further. And given that this credit crunch is far from over, it may well just do that.

But as some of the best money managers I know have said, "*Bear markets end when the news is at its worse, and long before the statistics and the numbers turn to the positive. We need to keep that in mind.*"

Yes, investors are fearful of what will happen to the economy because of the credit crunch. But when selling reaches this magnitude, some portion of it surely has to be disconnected from economic fundamentals.

Who is so desperate to get out? Many analysts point to hedge fund managers, who are believed to be facing another round of massive redemption notices from clients who want their cash back.

What you are now seeing is selling by people whose hands are forced, those whose margin accounts are being called in and don't have the assets to be put up to cover those margin calls.

The same goes for stock mutual fund managers, as retail investors join the exodus.

Many investors are now saying, *"I'll get out now and then get back in later at a lower level. That way I'll avoid the pain of a further decline and enjoy the next run-up when it comes."*

This is a fine theory except we all know that it doesn't work that way. We all know that when you move into cash you start to feel so pleased with yourself that you're sitting safely in cash - while your fellow investors are suffering - that you will more than likely stay in cash way too long.

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Eventually, we all know that the market will start to rally again, just as it has after every market break for the past 200 years. Often these upswings are sudden and violent. When you miss the rally, you're likely to tell yourself that you'll get in as soon as the market comes back down again.

But what if it doesn't? You get left at the station – earning a less-than-mouth-watering 0.5% – while the equity train rumbles on without you.

History shows that investors who buy into a bear market at this stage – or at least hang on to well thought out investment strategies – are well compensated in the years that follow.

We don't expect the majority of investors to agree with us. Even among the ones who do, few will step up to buy much (if anything) really cheap while the merchandise is on sale.

This story is as old as the markets themselves. As long as we have been in these markets, this story happens again and again and again. Each time we say to ourselves – this time it is different, it never is.

William Bernstein, author of “The Four Pillars of Investing,” once wrote that when it comes to investing there is only one eternal verity:

“Investing has always been, and will remain, an operation in which wealth is transferred from those without a working knowledge of financial history to those who have one.”

Historically, it's when the mood is blackest that share prices often start to scratch out a bottom.

At some point all of these bullets (lower interest rates, injection of \$700B, buyouts of investment banks) that the central Bankers and governments are using will have an effect on the overall markets.

Wall Street investment banks were built on leverage. It is a stunning turn of events that it now appears likely that only two will survive: Goldman Sachs and Morgan Stanley. Many hedge funds were built on leverage. A slew of hedge fund failures appear to be well underway.

So far, however, this is a financial crisis, as opposed to a broader economic crisis. Even a giant insurer like AIG has gotten into trouble not because of its insurance business, but its (highly leveraged) investments in complex derivatives and mortgage backed securities. The latest economic data still show the broad U.S. and Canadian economies expanding, and this is data from earlier this year when oil, gas and other commodity prices were soaring. Now that commodity prices are plunging, and the Canadian dollar falling, it should provide the economy a much more powerful boost.

No crisis is exactly like one from the past, but to us the current real estate and credit crises most

closely resemble the US S&L crisis of the late 1980s and early 1990s. The overall economy then proved remarkably resilient in the face of the failure of thousands of savings and loans trusts as well as falling real estate prices. Recall that the crisis also required massive central bank intervention in the form of lower interest rates and the Resolution Trust Corporation, which acquired the real estate, mortgages and other assets of the failed thrifts and disposed of them in an orderly fashion that helped put a floor on prices. Something like this is happening this time, too, with the bail out plan called TARP.

For investors, the good news is that a purely financial crisis can set the stage for strong future

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gains. Stocks rose moderately between 1990 and 1992 and rose very robustly from 1992 -1995. For the decade 1990-99, the Dow Jones Industrial Average gained an average of 18% per year, one of the best decades ever. We are not saying that's likely to happen again — the '90s encompassed most of the tech bubble — but it does show that a financial crisis need not cast a pall over future returns. Indeed, to the extent it curbs dangerous excess, it enhances future returns.

In our capacity we are repeatedly asked: Why are you recommending buying when the market is plunging? When we're in the midst of the worst financial crisis of our lifetime? When the bad news seems like it will never end? When so many people are panicking?

The answer is simple: **That's when good businesses are cheap.**

The job of a money manager is to look for long term opportunities, yet today most of our peers have fear of the short term. It's hard to avoid the fear, but we are taking advantage of the opportunities being presented for the long term.

We're hardly alone in this approach. Surely you've noticed that someone else has been on the hunt for bargains: **Warren Buffett**. True, Buffett is getting high-yielding preferred stock and warrants on terms that we can only dream of. But after years of complaining that those assets were too expensive, Buffett has opened his purse strings. As a stabilizing force he's being compared to legendary financier J.P. Morgan.

Is it going to be good for the next week, or next month? We have no idea - but for the next year/years definitely. We believe somewhere in here is the bottom and this could be the investment opportunity of a lifetime.

Meanwhile, remember this mantra: Don't panic; don't follow the herd. Be prepared to take advantage of any further declines. We are confident your discipline and patience will be rewarded.



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