

Equity markets have been hit hard over recent months as the world economy has slipped into a recession spurred by the global credit crunch. In past bear markets, savvy investors have often discovered ways to dodge the claws of the bear and offset losses. So why does it seem that even the brightest investors are struggling to perform in these markets? As a statement of the times, well respected money managers such as Warren Buffett of Berkshire Hathaway and Bill Miller of Legg Mason (who have historically been able to generate positive returns) had losses of 50% at one point over the past year.

The natural behaviour of investors as a bear market materializes is to seek shelter in bonds or interest sensitive stocks such as defensive and dividend paying financials. In the past, an investor following a similar strategy was able to minimize portfolio losses during troubling times, and even possibly capture some gains. As an example, after the tech bubble burst investors could have offset losses by moving from tech into industrial or resources stocks, selecting value stocks instead of growth stocks, or choosing small cap stocks over large cap stocks. The story this time is different. With nearly every major country or global index, aggregate commodity index, and sector index declining as the economic downturn deepens, it seems as if there is nowhere to hide.

Historically, many market crashes have been attributed to an easily identifiable, and in a sense isolated, occurrence. For instance, the market crashes of the 1970's were influenced by oil supply shocks, and the market crashed in 2001-2002 as a result of the tech bubble bursting. On the surface it may appear as if the inflated housing market in the US over the past 5 years is the only cause of the current market downturn. But in addition to the housing bubble, there are actually a myriad of interconnected factors underlying this bear market that have distorted its eventual outcome, confusing investors.

Cheap borrowing rates since the bursting of the tech bubble caused a run-up in housing prices and a demand for greater yielding financial products. This investment environment led to the engineering and permeation of toxic financial instruments known as asset backed securities, which were constructed to make payouts that greatly depended on the health of the overall economy – specifically the global housing sector. The globalization of the world economy allowed these products, which were extremely complicated in nature, to be sold to buyers far and wide. For these reasons, as the US housing market began to turn for the worse, investors panicked because they could not easily quantify or measure the dispersion of the risks associated with these financial products. This panic eventually led to an unprecedented global credit squeeze, and the effects are now being felt by the governments and citizens of almost every nation.

First, the investment banking model as we knew it changed forever with the de-leveraging of Wall Street as companies such as Goldman Sachs and Morgan Stanley, which were considered the cream of the crop only months ago, were forced to convert into bank holding companies. Then, a crisis of investor confidence took hold of Wall Street and the global capital markets, with the credit markets freezing as banks and investors alike became tentative to lend – and still remain so. As the possibility of a widespread global economic slowdown started to become a reality, stock markets crashed across all sectors and regions, drastically affecting the portfolios of institutional and individual investors. Now Main Street is feeling the pressure, as it has become difficult for consumers to access affordable credit, while millions of jobs have been lost or threatened with retailers, manufacturers, service providers, and resource producers all cutting costs.

Clearly 2008 was a difficult year for investors. With the average Canadian equity fund -30% and the average Canadian balanced fund -18% (YTD end of November), capital preservation was elusive. The best stocks have been those that have lost the least, and the worst stocks were once powerful and respected companies that have either folded or been absorbed by rivals. The financial stocks were decimated, and bonds have declined in value as credit spreads have widened even as government interest rates continued to drop. The outlook for the real estate sector is questionable as global housing prices are still falling, while the world's commercial real estate sector is beginning to feel the brunt of dwindling consumer confidence and tight global credit. Resource stocks have tumbled as investors are forecasting huge drops in demand as a result of a prolonged global slowdown, and it will likely take some time for governments to actually spend the money recently promised for infrastructure related projects. Growth stocks, value stocks, large cap stocks, and small cap stocks are all down. Even gold,

often the most preferred safe-haven during uncertain times, is failing to rally.

Going forward, while the market might appear to be cheap, investors will need to be patient until confidence is restored and the fundamentals kick back in. In the interim we caution that with equities trading at such low levels it is too late to sell. So we urge investors to hang on to quality companies with strong fundamentals and we remind them that it is reasonable to expect periods of volatility as the markets seek stability.

In closing, the volatility we witnessed in the last three months of the year was historic and unsettling for even the most seasoned investor. If you have any questions, please feel free to call your advisor.

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