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FINANCIAL STRATEGIES FROM

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Investing Lessons From the Worst Stock Market Correction in 60 Years

The 2008 stock market correction will go down in history as one of the worst ever. At the end of the year, the world's stock markets were down 35% to 55% depending on the country, with some pundits predicting three years of deep recession – a slowdown that will rival the Great Depression of the 1930's if it occurs.

The fall has been humbling to most stock market investors: it causes one to reflect on whether goals are still possible; the logic of the investing choices made and of course and the future investment choices necessary.

In our opinion, the world today is nothing like the 1930's. We will not wallow in misery for years. Poppycock. With coordinated government intervention, capitalism entrenched around the world, a reduction of debt levels set to occur and simply allowing some time to heal, the world's stock markets will once again turn up and head into the next economic boom phase as the world continues to grow long term. Perhaps this will occur by the end of 2009 – by 2010 at the latest in our opinion. There have been ten significant "end of world" stock market corrections since the 1950's – all of which lasted months to a few years – all of which were followed by significant boom phases once again.

But this recession feels different many say. Investing has changed forever. Let's look at some of the events that have occurred this year and what their impact may be on your future investment strategy.

The Death of Buy and Hold?

Investors in the American S&P 500 stock market index have earned a negative return over the ten year period ending October 31, 2008 . That will test anyone's patience. How long are you expected to wait for good stock market returns? But be careful here however: a measurement like this all depends on your starting and ending point. Measuring results with the endpoint at a record low can produce results like this – and you may also get a much more positive average result in two years if the markets spike up and you take the measurement again. I think the real message is that if a period of poor returns happens at key point in your life, (e.g a year before retirement or before a child starts university), the impact on achieving your goal can be significant. What is the answer? Never leave transitional planning to the last minute. A goal like retirement should include a five year transition of your investments to more conservative positioning in bonds in order to smooth the volatility of a stock market correction occurring at an inopportune time.

But should you try to hold a stock for 30 years according to the old buy and hold style? Possibly, but it should be couched with some additional risk management steps as well: own at least twenty stocks or buy indexed investments (dozens of stocks together in a bundle) which we will talk more about in this article, trim off profits occasionally (perhaps when you earn 15%) and reinvest the money and lastly, know what you own and stay in tune with the news about your products.

Is It Too Dangerous to Buy Individual Stocks?

In the last five years, many Canadians fed up with mutual funds decided that buying individual stocks was a better way to invest. Lack of transparency in mutual funds, high costs and possibly poor performance triggered a steady move by investors to preferring blue chip Canadian and global stocks – companies like CIBC, Suncor, Teck Cominco, Potash Corp., Sunlife and many more. But is buying stocks a better way to go? Let's examine some results from the last year:

CIBC – many investors felt that the Canadian banks were a "no lose" situation in the last decade of investing. With all five major banks down significantly in the last year, led by CIBC at -41% return on a one year basis ending November 13, 2008[1], this hardly feels like a low risk investment. Exposure to U.S. bad loans on the books at CIBC has sunk the stock. This is a business risk of the company that you could not have found out in advance. Even today we wonder if they have more write-offs to come that could drop the price even further. How can you trust any business that doesn't provide details of what they own? In one form or another, most or all corporations may lack transparency in their business model that could sideswipe you one day. Maybe now, maybe twenty years from now.

Suncor – the darling of the oil sands boom has fallen from $70 / share in the summer of 2008 to only $24/share in November 2008[2]. In this case, the fear of recession leads investors to believe less oil will be necessary to run the world and this caused the price of oil to dive which has created fears that the development of the tar sands is now too costly. Six months ago this oil development was going to save the world and the oil reserves in the ground may still be one of the largest deposits on earth. Investors in this blue chip, trendy business would have been financially devastated if you invested much of your savings in this one stock. Remember the promise of $200 / barrel oil in June 2008? What happened?

Teck Cominco – Canada's largest independent mining company had more than billion dollars of profit in it's most recent business year[3]. On a one year basis this stock has now fallen 83% for the period ending November 13, 2008[4]. In this case, falling prices for gold, copper and other commodities has left investors speculating about the company's ability to pay off the purchase of Fording Coal, a company they bought recently. This combination of a business investment coupled by the record fall of commodity prices out of the blue now threatens the very survival of one of Canada's mining jewels – another blue chip company that investors would have thought as a "guaranteed winner" only six months ago.

Potash Corp – you could not read a newspaper in the first six months of 2008 without hearing how the world was running out of food and everyone needed to own shares in this fertilizer manufacturer based in Saskatchewan. For a while, this stock even had the largest market capitalization in the TSX Stock Market exchange. How the mighty have fallen: after reaching $246 /share in June 2008 it now hovers around $90 / share[5]. Was this a case of the newspapers pumping another fad that blew up after investors bought in? Possibly, but it is also shows the dangers of buying
another individual stock that appeared to be a sure thing. Even some of the strongest businesses can be threatened.

Sun Life – one of Canada's largest insurance companies sideswiped investors in September 2008 with the last minute announcement that they owned hundreds of millions of dollars in the now bankrupt Lehman Brothers and Washington Mutual financial firms in the US. Yet another blue chip Canadian conglomerate that has fallen from a high of $55 / shares to a current price on November 13, 2008 of $25 / share[6] . The failure of the company to disclose their high risk investments much earlier shows a lack of transparency with public companies – they don't tell us what is on their books until it is too late for us to get out. \In our opinion, we feel this is a result of an incomplete regulatory and accounting reporting system in Canada and worldwide. It leaves us exposed to surprising bad news announced by companies that can destroy significant shareholder value in only minutes on the stock market. How can you buy a stock and feel comfortable, knowing this can happen at any moment? Worse, what if it happens the day before you retire?

All of these companies above are Canadian leaders. All of these companies are among the largest in our country. All of these stocks would have been found in blue chip portfolios for the average Canadian investor. But had you owned them in the latter half of 2008, you could be financially devastated today. It is not supposed to be this way.

[1] Source Globeinvestorgold website, November 13, 2008.
[2] Source Globeinvestorgold website, November 13, 2008.
[3] Source Globeinvestorgold website, November 13, 2008.
[4] Source Globeinvestorgold website, November 13, 2008.
[5] Source Globeinvestorgold website, November 13, 2008.
[6] Source Globeinvestorgold website, November 13, 2008.

When you buy an individual stock, you concentrate investment risk into just one business or a few businesses. If they have any bad news – they miss an earnings expectation, they find water in a mine, employees go on strike, they fall victim to falling commodity prices, a food product has poison in it, the CEO is fired or any other major issue occurs, and the stock could get whacked. If you invest in just a few blue chip businesses, the so-called blue chip businesses above would have taken you closer to bankruptcy than to prosperity this year. What is the lesson here? There is no such thing as blue chip anymore.

Never buy just a few blue chip stocks – you need to buy twenty or more to diversify risk – you need to effectively build your own mutual fund with many investments to mitigate the risk of a few falling hard unexpectedly.

Never hold a large amount of money in any one stock. While this has been one of the secrets of success for Warren Buffett, the world's most wealthy investor, an individual investor who is not wealthy should not gamble with their life savings by holding much of their wealth in one position. The risk of financial devastation from the failure of this one business is a risk the normal investor cannot afford to take. This can be a particularly dangerous threat to employees that receive stock or stock options from their employer – make sure you take steps to diversify the position over time, even if there is a tax and fee cost to do so.

Traditional Diversification Out the Window

Diversification in your investments means that you purchase many securities with little correlation so that when some drop in value, others rise in value and smooth your average volatility. In the 2008 stock market correction, traditional diversification has not worked. German stock markets, Japanese stock markets, Russian stock markets, American stock markets and Canadian stock markets have all fallen in value together. Further, commodities have fallen in value, actively traded bonds have fallen in value and real estate is falling in value. Everything has gone down together – this isn't the premise behind diversification as a risk protection tool.

In the future, I do believe that geographic diversification is mostly pointless. Buying a European equity mutual fund and US equity mutual fund and a Canadian equity mutual fund is going to produce similar results due to close correlation between developed nationally and sophisticated stock markets. The secret in finding good diversification is putting together assets with little or no correlation to each other. Cash or bonds are a core asset holding for stability, cash flow and liquidity. A second category is personal real estate which can give you the comfort of a paid off, tax free home to live in. A third category of diversification is hedge funds, but they are best held by sophisticated, wealthy investors only due to their limited access, complexity and high investment minimums to access the best managers. A fourth category is traditional stock market investing – with a new twist. Focus on stocks by industry, not by country. Some businesses like Research in Motion, based in Canada, operate in more than 100 countries already. Same with Exxon, the oil company. If you buy international businesses by industry lines, you will get geographic diversification automatically. One lesson to be learned from the 2008 correction is that many international mutual funds owned the same bank stocks. If you bought three global equity funds thinking you were diversifying, in fact you may have been concentrating your money in a few banks without knowing it.

Let me show you the same issue a different way. Buying emerging market products was hot in 2007. Investors thought they were diversifying into new regions of the world. You were, but many of the emerging market products were dominated by a few big oil and mining stocks situated in an emerging market country. In effect, some emerging market funds acted more like natural resource funds. If you already had resource investments, this was unnecessary duplication that increased risk.

Competing with Hedge Funds

The real question is "can we compete with them?". Hedge funds are largely unregulated billion dollar pools of money that operate on the fringe of regulation, allowing them to bet big on the markets everyday. Many of them use borrowed money in 2008 to increase their stakes in specific investments. I will never forget John Mack, the CEO of Morgan Stanley, pleading with the U.S. Congress to stop short selling to curb the hedge funds from destroying his company during September 2008. Short selling allows an investor to bet the stock will fall – enough investors start to believe this and a snowball effect can drive the stock down allowing the short sellers to make money as this happens. Many experts believe that Lehman Brothers and other U.S. companies were driven out of business in the Fall of 2008 this way – while the hedge funds profited as the companies sunk.

So can you imagine owning a stock for forty years, betting your retirement on it, only to have it crushed in four hours one day by a hedge fund investor? This appears to have just happened several times to some of the largest financial firms in the world. How can you bet your financial future with the possibility this could happen? How do you manage this risk?

I believe there are several strategies: i) don't invest a lot in one stock; ii) if you can't beat em, join em: buy a hedge fund as part of your portfolio; iii) buy index investments instead of stocks – your risk of loss from one stock is reduced if you own 200 stocks in a bundle; iv) know what is in your portfolio and be aware of current news; and v) stay out of the stock market permanently with at least half of your savings.

A New Look at Mutual Fund Flaws

If you hire a money manager, whether it is a mutual fund manager, a pooled fund manager or a high net worth portfolio manager, you are often paying a much higher fee for them to actively trade your account to generate returns that exceed common index returns or the returns of peers.

In the fall of 2008 as the stock market crashed, we noticed that some mutual funds did not act the way we would have expected: i) Some mutual funds did not hold significant amounts of bonds or cash and help you to avoid much of the fall. No, some of these money managers have done the opposite shockingly – they bought even more stocks at what they view as cheap prices, leaving little cushion of cash and ensuring you will ride the stock market correction right to the bottom. Even though you are paying them for defense and protection of capital, some of these money managers appear to be only playing offense. Respectfully, if I had wanted them to like a fully invested indexed fund, I would have saved the fees and bought an index fund (an index fund holds no cash and is always fully invested by definition). I expected them to protect me, not product -40% returns or worse; ii) some money managers chased what they viewed were hot sectors to invest in, causing them to overload in resource stocks or commodity stocks or financial stocks. Instead of diversification, they concentrated your money into fewer sectors (making bets on what works within the limitations of their fund prospectus) and in the end costing you higher losses because of your poor diversification; iii) some mutual funds will not tell you what they hold in your accounts on a timely basis. We asked some big mutual fund money managers to send us a list of the fund stocks in September 2008 and they sent us holdings at June 30, 2008, refusing to provide anything more current, citing proprietary information. So we could not even tell what we owned in the fund during one of the worst months in stock market history; iv) on a daily basis the stock market in Canada has swung by hundreds of points in mere minutes. If at 10am in the morning you noticed the stock market was up and called your broker to sell a fund on an up day, keep in mind that mutual funds only trade at the end of the day. You cannot sell a fund at 10am. So if the market fell all day long after a 10am high, you may actually sell it for much less than you thought. We now view this limited trading ability with funds as being inferior to stocks and index exchange traded funds; v) in a falling stock market, when investors redeem mutual funds, the fund manager may have to sell stocks it would prefer to keep in order to fund the redemptions. If you are still in the fund, these sales of stock could whack you with extra taxes next February when they end up as distributions on a T3 slip with your name on it – isn't that beautiful? You lost money on the fund and now you also have this big tax bill because of someone else's trading; vi) the value of the Canadian dollar has moved up and down vs. the world's currencies in the last year. Mutual funds investing globally have decisions to make about whether they play the currency changes or whether they hedge (offset or negate) the currency changes. Many money managers chose to ignore currency moves in 2007 and 2008, resulting in a currency loss that may have wiped out your entire stock market gain. This was their choice. You have no control over what they do except to sell the mutual fund.

Mutual funds had taken a lot of heat previously because of high costs and some mediocre returns. We can now add lack of defensive tactics, poor transparency of holdings, hard to sell in a timely fashion and adverse tax consequences to the list of reasons to reconsider using mutual funds for investment portfolios. Are all mutual funds bad? No, of course not, there are many excellent products. It must means you need to pay more attention to the details before you agree to purchase.

Is it the Death of Mutual Funds?

You know it is bad when you can't even rely on the safety of your fixed income investments. Fall 2008 has seen panic over money market funds, bond funds and corporate bonds. We have always felt that your bond money is your safe low risk money and this is not the place to take chances. Investors who bought higher risk corporate bonds to chase higher yields now hold bonds with depressed prices and a few have even gone bankrupt and the investor has lost it all. In money market mutual funds, while short term, they don't all hold low risk government bonds. In reviewing several money market funds at September 30, 2008, we noticed large investments in commercial paper and asset backed securities. We don't view this as low risk. We aren't worried about it, but over time we would suggest you review the quality of your fixed income investments, understand what they really are buying inside the product and take steps to keep the risk in your bond products as low as possible.

Even Bonds Aren't Safe

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Fads Haven't Worked Out

In looking back over the last ten years, investing in all the hot fads pumped by the newspapers and media may have lost you more money than you made. Here's our list of past hot topics that investors chased: tech stocks, hedge funds, gold, income trusts, emerging markets, green technology, bio pharma, agriculture, commodities and China/India. Our position on chasing fads is don't do it. The more you fragment your portfolio and overweight specific sectors based on a story in the news, the greater the risk of a magnified loss if you are wrong. Plus, by the time the sector is hot and makes the news is usually after the price has shot up – in other words, you may have missed the majority of the gains in the short term.

In our opinion, the more you fragment your stock market portfolio, the more you are making bets on sectors that could prove to be wrong. Best to buy them all and win with an average returns that we feel has better odds than you do on your own. Ideally, to accomplish this, purchase a single stock market investment that owns every stock in the world together. Rather than trying to pick the fastest horse in the race, invest in every horse to ensure you win.

How Do You Invest From Here?

We do believe that the year of 2008 will be remembered in history as the year investing changed forever. This means your investment plan for the future may need some changes, provided you agree.

Here are some of strategies to consider as you move forward, keeping these 2008 stories in mind:

- Build a real investment plan, stick to your investment plan and maintain it within your overall financial plan. This is the backbone of your investment strategy and should provide targets, ranges and rebalancing guidelines according to what you need to achieve with your money. Don't chase fads and don't get "sold" into fancy products by an aggressive sales agent. If you don't have a written investment plan, your investment portfolio may end up being nothing more than a hodge-podge of yesterday's winners. Never randomly buy products – you need an overall plan that you and your advisor create together, write down to formalize, sign and then update and review yearly.

- If you are young, maintain a permanent base of bond products (low risk) totaling 1/3rd of your savings. No these won't be big performing investments, but the will bring stability to an overall portfolio with more than enough firepower in the other two thirds of what you buy. If you are older, raise that permanent bond products total to 50% to 75% for peace of mind in retirement but still leaving a bit of growth to fight the ravages of inflation and to provide extra spending money over time. We don't believe anyone should ever been 100% bonds or GICs or cash – over the years the cost of living rises to fast for bond returns to provide adequate cash flow, when measured after inflation and after tax. Simply put: everyone should have a bit of stock market investments for life.

- For the stock market portion of your portfolio, start with a base of indexed investment products (index mutual funds or index exchange traded funds) that cover the entire world, and add to them over time during period of weakness. Buy broad indexes, not sector indexes to create a blanket of equity ownership worldwide. Effectively you are buying the entire stock market, not trying to make bets on stocks, sectors or countries.

- If you feel comfortable with stocks, either buy many or none at all – it is too risky to pick only a handful and hope they can avoid trouble to their business forever. Many stocks means 20 to 30 stocks. This means a small investment account (below $100,000) should not buy stocks in our opinion. The commission cost of buying many small stock positions is prohibitive.

- If you own mutual funds, rethink them all. First, understand their buy/sell strategy with stocks. Second understand what defense means to them in a falling market. Third, know their currency strategy in foreign markets. Fourth, find out if they will take big bets in a few stocks that can ratchet up risk. Fifth, look for overlap among the strategies of several funds if you own more than one. Sixth, keep track of their top ten holdings on a quarterly basis. Finally, let me be clear here however: I am not blacklisting mutual funds as investment products. There are many excellent money managers you can enlist to manage your money – one just has to select very carefully!

- Embrace new defensive investing strategies that are evolving out of the stock market correction of 2008:
  - Hold a portion of your long term investment portfolio in guaranteed return equity products that will cover your basic expenses in retirement – segregated funds, variable annuity products, regular annuities, performance annuities and target return products. Consider a one third, one third, one third investment strategy: one third of your money in bonds, one third in the stock market and one third in guaranteed return products. The guaranteed return products offer stock market upside with limited downside – peace of mind knowing you can never run out of money for core expenses (food and shelter) in retirement when it feels like the stock market will never stop falling. In our opinion, everyone should have some of this peace of mind knowing that the stock market will continue to have strong corrections every few years forever.

- Put a collar on your downside risk by adding inverse return products once you hit -15%. These products earn returns when the market falls and lose money when the market rises. Use them merely as a hedge against further falling markets once you reach a point of maximum tolerance for you. You will require new investment money to buy them however as they will stand alongside your existing investments. Be careful with these tools: if you don't remove them in time, when the market rises again they will negate the recovering returns of your core products. In the end, they are a reverse form of market timing and provide no guarantee that they can be applied successfully.

- With individual stocks, put stop loss orders in place alongside the stock position when you fear the markets will fall and any gains you have earned may be eroded. A stop loss order is a sell order that sits silently on the trade system in wait. If a stock falls to a set price, the stop loss sell order automatically kicks in to sell the stock and prevent further loss. Think of it like an emergency brake. Note however that is not fool proof – if a stock opens in the morning far below your stop loss order price, the sell order will go through, but possibly at a much worse price that you had set. So the stop loss trade helped nothing. As well in another situation, if a stock drops suddenly and then bounces right back up, the stop loss sell order will trigger, liquidate the position as the prices falls and you miss the ability to recover when the price goes back up. This is often the biggest argument against using stop loss orders.

- Recognize that you will never be able to successfully time the market to buy at the bottoms of corrections and sell at the tops of booms on a continuous basis. Sure you might get lucky now and then, but that's it. Few money managers worldwide in history have been able to master this. Instead, try to be practical in your expectations – buy products when they appear inexpensive based on market standards and sell down products when you have made a reasonable return. Avoid fads and complicated products. Diversify in a way that makes sense. Control costs and taxes. Don't be greedy. Follow a financial plan that speaks to your broader financial goals and stay on plan. Work with a financial advisor that embraces your goals, provides a plan, documents everything, communicates regularly and regularly measures your progress over time.

Conclusion

It will likely be no more than a year or two before we turn the corner on the latest recession and start into the next phase of economic growth and stock market boom. When that happens it is easy to forget about the pain of 2008 (like many have forgotten the investment mistakes of the tech wreck of 2001) as we enjoy the 18% plus returns of the TSX again. We would suggest that a balanced investment approach be maintained in good times and bad, and that the common sense techniques in this article should be maintained when the markets boom as well. Don't tailor your investment strategy to your emotional state of the day. In good times and bad, emotional reactions are a poison against successful long term investing. Stick to the plan you create today (for example, don't tell all the bonds and GICs when it feels like the markets take off again).

Use the stock market correction of 2008 to learn from. Your financial well being is too important to fly by the seat of your pants .

\Contact us to answer your questions, schedule a meeting, get a second opinion, refer a friend, order a book, receive a brochure on services and fees, create a financial plan and more. Manulife Securities Incorporated is a member of CIPF.

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