How Has the Stock Market Correction Affected Your Investment Plan?

The last ten months have produced some of the worst investment returns since the tech wreck of 2001 and 2002. At the lowest point within this correction so far, the world's stock markets were off 15% to 30% depending on the country[1]. Even the rock-solid Canadian bank stocks were down severely for the first time in a decade. Investors are scared and wondering if the US housing crisis and sub prime mortgage fiasco will bring down the world economies to a state not seen since the dirty 30's and the Great Depression. "Should I sell all my stock market investments now? Is this the end of the financial world?"

History of Stock Market Corrections

Since 1956 there have been 16 ends to the financial world[2]. During these times, stock markets have dropped from 11% to 39%. The average duration of the bear market was eleven months. Each time the media stoked people's fears with eye catching headlines and stories of disaster. Each time your monthly investment statements would have reported lower and lower values for an entire year or more. Stress galore, particularly if you are over age 50.

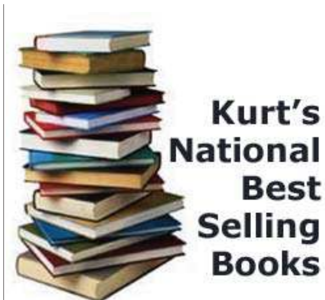
In every one of these financial end of world situations in history, the markets have come back to rise higher than ever before. For example, looking back to the September 2000 to September 2002 bear where the markets fell 45%, this was quickly followed up with a 60 month stock market rise of 66%[3]. In the last one hundred years, this has always happened if you have patience and weather the downturns when they occur.

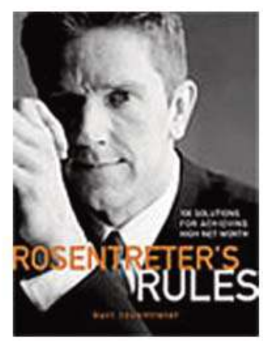
Your Investment Plan

How you react to a stock market correction can be a function of the stage of life you are at. Factors like your annual income, financial sophistication and experience with investing, time horizon until you spend the money, size of your portfolio, age and appetite for withstanding downside volatility are all variables that matter in deciding the investment plan suitable for you. And once a plan is created and you have invested, effective and regular communication and education are essential to maintaining the plan and keeping you comfortable with it. With all of our clients, we strive to create and manage such common sense investment plans if you let us.

Oppositely, the following variables can all contribute to irrational investing behavior that can hurt your returns and stress you out: judging your investments too frequently, buying products you don't understand, investing based on flashy headlines or hot tips, expecting to make 15% every year, "cocktail talk" between friends comparing

[1] Source: Globeinvestorgold.com, TSX, Amex, NYSE, Bloomberg.
[2] Source: Franklin Templeton
[3] Source: Franklin Templeton





investment results, using inappropriate benchmarks to compare results against, watching the business news every day and believing you can time the market to buy and sell better than everyone else. These factors are a recipe for a heart attack or a divorce or both, but likely not consistently good investment returns.

Follow the Investor Crowd Mentality

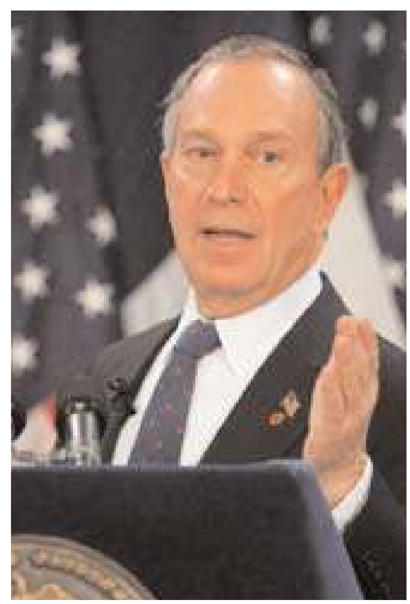
There is a lot to be learned from the psychology of crowds. One only has to look at the cash flows into and out of the stock market in the last year to see how the majority of people think. When the stock markets rise, people invest more and more money to buy increasingly expensive equities. When the stock markets fall, many of the same people rush to sell their investments as they fall in price in order to get to the sidelines.

Is this really the right way to invest? Actually it is backwards in our opinion. If the stock market is truly expected to recover like it has every time in the last 100 years, we should be buying more every time it falls and selling when it hits record prices. The lower a blue chip security falls should mean the more you buy. Warren Buffett is just such a value investor – and he is the most successful and wealthiest investor in the world.

The problem is that to actually “buy low and lower” is emotionally gut wrenching. Investing in securities to see them decline every day for six months is hard for any investor to take. Yet if you are going to be a stock market investor, this is the way to make money long term.

What the Research has Shown About Market Timing

According to Bloomberg, December 2007, if you have stayed fully invested in the S&P/TSX Index for the ten years ending December 31, 2007, you would have achieved an average annual return of 9.47%[4]. During this time you would have had to weather the massive tech correction as well as the 2007 market correction. In both cases, you would have not sold a thing as the market tumbled.



However, if you had tried to avoid the stock market corrections by selling and then repurchasing, and you happened to miss a mere twenty of the best days in the market over ten years, your average return falls to 1.91% over the ten year period![5]

And if you missed the sixty best days in the markets out of the 3650 days (10 years), your average return falls to -7.43% per year, every year for ten years.[6]

Since no one can predict when the good days and bad days will occur, the message is clear: get in the market, stay in the market, and don’t let any broad stock market correction change your mind – ever.

Another way to look at market timing is this: if you sell half way down the correction and then buy in again half way up the recovery, your net return is zero. Since it is impossible to guess the market tops and bottoms, this scenario is far too likely, where you earn close to zero returns over the long term if you try to jump in and out over time. To generate the best returns you need to stay in the entire time, or at least buy back in when the market is still falling to ensure you don’t miss half of the recovery.

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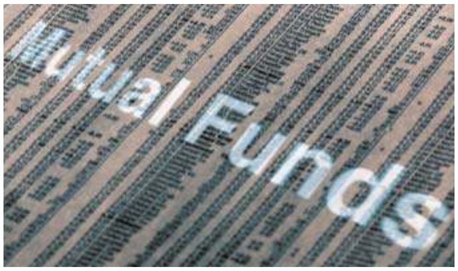
[4] Source: Bloomberg and Franklin Templeton.
[5] Source: Bloomberg and Franklin Templeton.
[6] Source: Bloomberg and Franklin Templeton.



Darn Mutual Funds

Often we find that investors love to blame mutual fund products as the source of their bad returns. This is often misplaced as professional money managers inside mutual funds offer expertise, research and market timing hard to replicate on your own. "I want to buy stocks instead" has been a common theme over the last few years among investors in Canada. In our practice we have obliged, provided the portfolio is large enough to create a diversified mix of stocks (generally $500,000).

As Financial Advisors go, we are about as anti-mutual fund as one can be. Kurt has long ago praised indexed investing and individual stocks in several of his nationally published books, and our practice is full of clients where we only buy stocks, bonds and index ETFs. However we may utilize mutual funds in the following situations: for small accounts to provide thorough diversification; for specialists in unique sectors like emerging markets, small cap and precious metals; and for global equities to get cost efficiency and currency management.

Good and bad stock market performance is less a function of the product structure you buy (stock vs. index vs. fund vs. pool vs. wrap) and more a function of investment style, philosophy, mandate of the product, cost, quality of the money manager and currency treatment. Further, give the money manager time to perform over various market conditions and then judge against relevant benchmarks at least three and five years away. Also recognize that in a portfolio of ten products it is common for four to be in a negative return position at any time: this is why the concept of diversification is essential to portfolio construction. Spread your money around to ensure that your average return is on target, among a portfolio of up and down products at any given time. Do not sell off the negative ones to chase the currently hot ones. In a properly constructed portfolio each product will have its day in the sun over an economic cycle. Hold them all.

Several of Canada's leading dividend equity mutual funds had their worst year in a decade in 2007, led by the decline of their Canadian bank holdings which have been strong dividend paying stocks in the past. We do not think it is logical to sell off a dividend mutual fund that has offered double digit returns for nine years and one year of negative returns. The money managers have not turned dumb over night. Selling them during a market low will likely mean you will miss the majority of the upside when the bank stocks recover.

Many individual stock investors also learned in 2008 that putting money into a single business carries a lot of risk with it. Even Canadian banks, the bluest of blue chip, offered as much as 40% declines[7], rocking even the most stable investor's passion for individual stocks. Most mutual funds and indexes didn't come close to such a fall thanks to diversification among many different stocks.

Overall there is no good or bad investment product type, and often the right answer in our opinion is a blend of all: some stocks, some funds and some indexes. With this approach you get the best of money management, at a lower cost, in a portfolio that is tax smart, risk managed and easy to understand.

Where Do You Go From Here?

There is no better time to build an investment portfolio than in a falling market. First, falling markets show your true investor personality – a portrait of what risk level you can stomach and one that should not be changed when the markets get hot again. Together we can revisit with you the target average returns your portfolio is designed to produce, the minimum returns you need to get to stay on your financial plan and the worst case returns that you can personally tolerate. This last one is the most important – nothing is more important than preservation of capital.

Second, revisit your financial plan and how your investment plan fits within your broader financial plan. We are happy to review your "big picture" goals for retirement, real estate, careers, debt repayment, cash flow, insurance, estate, children's savings and other needs, attach financial costs to each one and then link that what your portfolio needs to do to reach these goals. Only with a truly integrated financial plan can you develop the best solutions for your needs.

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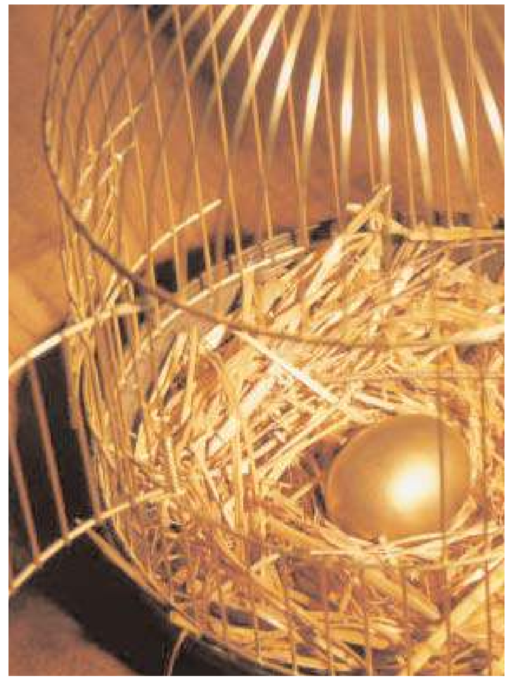
[7] Source: TSX

Third, understand how your portfolio has been affected by the 2008 stock market correction. Are product changes warranted or will the existing products eventually turn around and roar back? Understand the intricacies of each product to understand fit into your portfolio. Communicating this with you in an easy to understand format is core to our service to you.



Four, if you have cash on the sidelines waiting to get into the market, let's set a common sense plan for investment. Since there is no way to predict the market bottom and waiting too long could mean missing a lot of upside return, you are best to start investing now and invest gradually over time. We are not a fan of investing all of your cash immediately in a volatile market. Instead, dividing up the money into a series of purchases that occur regularly is a way to step back into a rocky market with a reasonable average cost.

Fifth and finally, together let's benchmark your financial goals and your portfolio by setting standards of expected results and then measuring against these. Only with such focus, can you objectively analyze results and act on them properly. Between these evaluation points turn off the business news and daily "noise" that is irrelevant to proper long term investing.

Overall, we are committed to helping you achieve your desired investment results. Give us a call or email in the office if you have any questions or to schedule the rest of our 2008 planning and review meetings together.

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