



Pacific Spirit | Investment Management Inc

1100-800 West Pender Street
Vancouver, BC Canada
V6C 2V6

Tel: (604) 687-0123
Fax: (604) 687-0128

“Surprise is the Mother of all Panic”

Peter Lynch, the famous manager of the Fidelity Magellan Fund, once said, “The key to making money in stocks is not to get scared out of them.” And, in our opinion, the best way not to “get scared out of” stocks is through knowledge.

Stocks are a volatile investment. They fluctuate in value more than bonds and real estate. You earn a higher long-term return in stocks than in bonds because of this volatility – the higher return is your compensation for accepting the short-term price volatility. But don’t confuse volatility with risk! They are different. Volatility is not risk.

Volatility is the fluctuation in the price of an investment. Risk is a measure of the probability of a permanent loss on your investment. Fluctuations in market price (volatility) are only of consequence if you fail to hold through the down cycle because you get “scared out of stocks” or you are forced to sell when the market is down because of cash flow requirements. In both cases you convert a benign fluctuation into a permanent loss of capital.

The S&P 500 (the equity index of the 500 largest companies in the United States) has advanced in 24 of the last 31 years. This is about the norm; over 12 month periods the US market is up 77.9% of the time (74.6% for the S&P TSX – Canada) since January, 1950. However, even in the up market years, the stock market does experience significant intra-year declines. The average intra-year decline since 1980 (up calendar years and down) is 14.3%. So, the long drawn out market pull back from April to September of this year, which brought the market down by 19.4%, is roughly in line with the historical average intra-year pull back that can be expected.

But this is not what is reported in the financial press. Rather it is reported as the “onset of Armageddon”, which it is not. Unfortunately, the popular press will always present intra-year declines as the end of the world. This journalistic failure is repeated year after year. Nick Murray calls this “The Annual End of the World”. For the record, the financial press is 0 for 31 over the past 31 years in predicting the end of the world.

The markets decline roughly 1 year in 4. The average bear market decline is roughly 30%.

DATES OF MARKET PEAK	DATES OF MARKET TROUGH	% RETURN	DURATION	MARKET PEAK	MARKET TROUGH
05/29/46	06/13/49	-30%	36.5 Months	19.3	13.6
08/02/56	10/22/57	-22	14.5 Months	49.7	39.0
12/12/61	06/26/62	-28	6.5 Months	72.6	52.3
02/09/66	10/07/66	-22	8.0 Months	94.1	73.2
11/29/68	05/26/70	-36	18.0 Months	108.4	69.3
01/11/73	10/03/74	-48	20.5 Months	120.2	62.3
09/21/76	03/06/78	-19	17.5 Months	107.8	86.9
11/28/80	08/12/82	-27	20.5 Months	140.5	102.4
08/25/87	12/24/87	-34	4.0 Months	336.8	223.9
07/16/90	10/11/90	-20	3.0 Months	369.0	295.5
07/17/98	08/31/98	-19	1.5 Months	1186.8	957.3
03/24/00	10/09/02	-49	30.5 Months	1527.5	776.7
10/09/07	03/09/09	-57	17.0 Months	1565.1	676.5

Source: Nick Murray Interactive, Volume 9, Issue 9, September 2009

During bear market periods it can be difficult to see the long-term; just as the amusement park roller coaster rider focuses on the plunge while plummeting down the first drop. Both the investor and the roller coaster rider can't see ahead to the inevitable next rise. Even given the large declines experienced in bear markets, the stock markets have been able to achieve long-term rates of return of 10.3% per annum in Canada and 11.0% per annum in the US. Sitting at the bottom of a bear market, most unsophisticated investors cannot accept that they will ever get back to where they were at the previous peak, let alone be able to capitalize on bull market periods that generate 10% to 11% annualized returns over long time periods.

Pacific Spirit manages the risk of permanent loss through solid research, proper asset allocation (between, equities, fixed income, and cash), and by building portfolios to provide the required cash flows when needed. We also provide the vision and support that our clients may need from time to time to stay true to their long-term plan. To paraphrase Nick Murray, **Media end-of-the-world sensationalism is like the rain** – it is a part of our environment - and we have no choice but to live with it. **We protect ourselves with an umbrella of knowledge and rational optimism** (the two go hand in hand; if you have knowledge you can't help but be rationally optimistic). **The way we protect our clients is to keep them close, and to hold that umbrella over both of our heads.**

With a rigorous plan and a rational strategy there should be no need to sell during weak market periods. Equities can be left untouched during down cycles while dividends, interest, and the fixed income side of the portfolio provide required cash flow. At worst, volatility is benign. Volatility creates opportunities to buy investments at very low cost. Forearmed with knowledge our clients will not be surprised and will not panic into making wrong decisions.

End of the World – Part 2

Greece will not cause the collapse of the world's financial system. I cannot accept that a country with a Gross Domestic Product equivalent to that of the State of Maryland, and which has been in default on its sovereign debt for 105 of the past 200 years, will bring the world's financial system to its knees. It won't!

The significance of the Greek situation is that it is the canary in the mine shaft. It is a wakeup call for the western world. The United States, Italy, the United Kingdom and other western countries should be thankful that Greece's problems are receiving headline coverage, because it draws attention to the state of the developed world's finances in time for them to take corrective action. The age of a country living beyond its means and of unsupportable entitlements is over. Greece just happens to be the theatre where this play is being staged, before it hits the road for appearances in other countries.

Europe is a mess. It is a mess of their own design. France and Germany have the money and the economic clout to bring about the required economic changes, but the French and German political leaders have to let events reach the crisis stage before acting. If German and French Leaders act too early they risk being seen by their voting public as weak. The German worker will not prop up a Greece where workers can retire years before the average German worker and enjoy full pension and benefits. If there is any hint that Merkel and Sarkozy are being soft on Greece, they will be gone.

The End of the World – Part 3 – On the Shoulders of Giants

Gold is in a bubble. There I have said it, and I feel better for having said it.

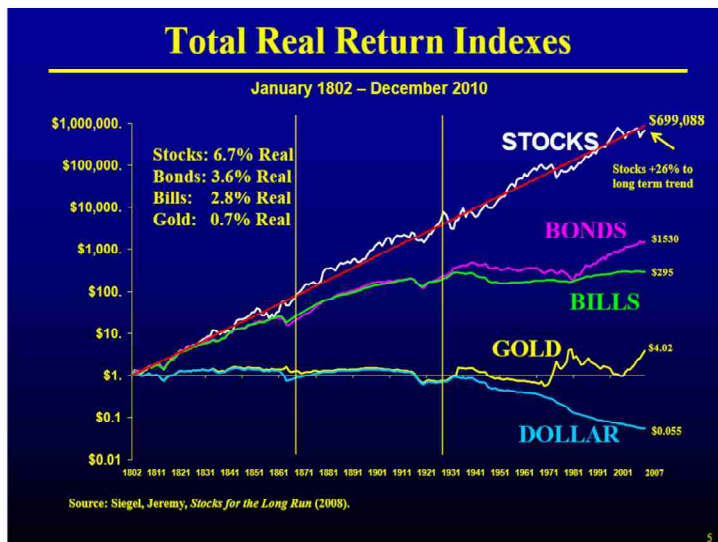
Warren Buffett, the head of Berkshire Hathaway and perhaps the greatest investor in history, opines that at current prices all of the gold that was ever mined is equal in value to all of the agricultural land in the United States, plus 10 Exxon Mobils (the largest company in the world), plus a trillion dollars of petty cash. Ask him which he would rather have, and he unequivocally would take the producing assets and the cash.

George Soros, the famous hedge fund manager, recently stated that gold is in a bubble. He continues to hold gold because he believes that he can sell his positions before the bubble bursts. I know I can't, so I don't try; and neither should you.

Jeremy Siegel is a Professor at the Wharton School of Business at the University of Pennsylvania. He is most famous as the author of the classic book, "Stocks for the Long Run", which examines the returns

over the long-term from various asset classes. Siegel discussed the following graph at a presentation in San Diego in February, 2011, which I had the pleasure of attending.

The chart illustrates just how far Gold and stock prices have diverged from their respective norms.



This chart shows the real returns (i.e. after removing the effects of inflation) from various asset classes over the past 209 years. I draw your attention to the lines for Gold and for Stocks. You will note that a dollar invested in Gold in 1802 would be worth \$4.02 today. Gold kept pace with inflation over the past 209 years. A closer look, though, shows that the investment in Gold basically treaded water, staying at an inflation-adjusted value of \$1.00 for 200 years until 2001, when it began its climb to its current \$4.02 inflation-adjusted value. So, for Gold, all of the inflation-adjusted return in the past 209 years came in the last 10 years. In our opinion this does not bode well for buyers of gold at today's prices. Siegel predicts that current Gold buyers will be disappointed.

Stocks on the other hand, soared over the past 209 years. Your \$1.00 investment in 1802 would be worth an inflation adjusted \$699,000 today. But look at how consistent the long-term trend line for stocks has been. Stocks have fluctuated around a long-term trend line of 6.7% inflation-adjusted growth over this long-period.

This brings to mind an illustrative story I was once told about gold and stocks. Back in 1802 an ounce of gold would buy a good men's suit. Today, an ounce of gold will buy a good men's suit. Gold has done well in keeping up with inflation. With that same initial investment, but in stocks rather than Gold, you would today own the suit store and all of the suits in the store. That is the order of magnitude difference between the performance of stocks and Gold. Unfortunately, those marketing gold investments do not tell you this.

What has been the world's refuge during recent financial turmoil – the US Dollar. Not Gold.

Where's The Risk? Where's The Reward?

Siegel also has a track record for providing sage advice. At the February 2011 presentation, Siegel indicated that at then current stock market levels, the S&P 500 was 26% below the long-term trend line. On the day of the presentation, the S&P 500 closed at 1307.10. Today it stands at 1192.55. The market is an even better buy today than in February when Siegel was pounding the drum for stocks as a long-term investment.

It is expected that the companies in the S&P 500 will report all-time record earnings of \$98 in 2011 (this is probably a pretty reliable estimate given that we are now 11 months into the year). At 1192 on the S&P 500 stocks are trading at an earnings yield (earnings divided by the index level) of 8.2%. Government of Canada 10 year bonds are now trading to yield 2.11%. This may be the first time in history that the earnings yield on stocks has been 4 times the return on 10 year bonds. We may, in our lifetimes, never again see an earnings yield four times the bond yield.

At today's prices, equities have less risk than bonds. Long-term bonds may be the most risky investment class, providing a negative after-tax, after-inflation return, with the risk of permanent capital loss if interest rates go up.

Please feel free to forward this newsletter to others who may benefit from it. The umbrella of knowledge and rational optimism is large enough to protect them too.

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