REAL LIFE NEEDS ACTIVE MANAGEMENT

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Market Timing

The Currency Conundrum

What do we do about the declining US$ and its effects on our US holdings? How do we isolate ourselves from the effects of negative currency trends? The short answer: limit our exposure and invest primarily at home, and we do. But realistically, we are hard pressed to ignore the reality that a country like the US contributes roughly 40% of the world's GDP, while Canada contributes only 3%.

The need for diversification in managing portfolios has its own set of complications. Not only is there the issue of market liquidity and investment selection, but we must also recognize the increasing implications of global trade. Large institutions that warrant investment, are themselves exposed to the same currency risks associated with international trade. Large parts of their Income Statements are often translated back to or from the US dollar for the purposes of reporting year-end results. The effects of fluctuations in currency during the year are inescapable in the final analysis.

Efficient Portfolio Theory has done a great deal of work in trying to define the optimal foreign currency weight for a domestic investor, and the theory proposes a 40% weight. In practice, we generally find this higher than we are comfortable with from a risk management perspective. While there is no magical blend that is just right for every Canadian investor, what we do know is that by excluding exposure to faster growing foreign economies, we are also inevitably limiting investment opportunities, and so a currency mix is a necessary compromise. Bottom line: We will continue to hold some US dollar investments on the expected geographical benefit of a recovering US economy. But will be on alert about the possibility of a weakening economy and a possible recession again should the drag of current oil prices fail to relent.

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Oil

This brings us to oil again. Many manias have similar characteristics. One of them is the human tendency to ignore the weight of evidence that is building up against one's position. A case in point would be the recent confirmation of an increase in oil inventories. Now that the negative supply trend has turned positive, it is still not enough to elate the fear mongering on long-term supply concerns. It is interesting to us few pundits have mentioned the inevitable supply increases brought on stream by the influx of higher cost producers. Once oil speculators large enough to influence the group begin selling their holdings to lock in profits, it will become a fight for the exits.

Newton's law: ***An object in motion stays in motion until an equal or greater force acts upon it***. When enough oil traders begin to think oil has gone high enough then it will turn and trend lower. How long this takes will be a major determinant in how the economic recovery transpires both here and abroad.

Our recent buy signals:

As of the Oct 1 market close, we received a buy signal on three of the major equity markets namely the TSE 60 (XIU), the International Index (EFA), and the NASDAQ 100 Index (QQQ). At the same time we had a sell on the long sleeping Pharmaceutical Index (PPH). This will explain the transaction slips you will receive in the mail this week re buys in your accounts. In leaving September behind, we have now passed through one of the historically worst performing equity months since market data was recorded (1883). What our filters have picked up on in recent weeks is an increase in buying activity from the institutional side. We note that at the same time, the retail investors (Mutual Funds unit holders) have been net sellers of their equity funds, ie.., there have been more equity fund redemptions than buys for the past 6 months. It seems that not seeing any progress in the markets since the February 2004 peak, equity fund investors have been moving to the sidelines and/or continuing to flock into bond funds hoping to capture the recent return numbers of the past bull bond run. In retrospect, as is so often the case, this may prove to be painful timing for the masses.

Although we maintain our consistent posture of not using emotion in driving investment decisions, we too would like to see a nice equity rally from here to mid-winter. Alas this is not within our control to say, but whatever does happen we will continue to be diligent and disciplined in managing your accounts.

Connecting these dots: A theory about the strong Canadian $, coupled with higher commodity and energy prices.

Emerging countries of the world are buying our resources, which in turn strengthens our dollar and makes our goods more expensive and ultimately less attractive globally. What happens when the largest and fastest growing economies of the world namely China and Russia have finished using our materials to build their own ports and infrastructure? They will sell us and the rest of the world, their wealth of untapped resources with lower labour costs, no union intervention and less regulation. The result will undoubtedly be oversupply and lower prices. An economic irony to say the least…

Some things in our world are taken so for granted that we quite forget there was a time when they were not. One of these things is the "zero" so crucial to our present day counting system.

"The centrepiece of the Hindu-Arabic system was the invention of zero…The concept of zero was difficult to grasp for people who had used counting only to keep track of the number of animals killed or the number of days passed or the number of units traveled. Zero had nothing to do with what counting was for in that sense…the concept of zero unleashed more than just an enhanced method of counting and calculating….[A] proper numbering system would enable mathematics to develop into a science of the abstract as well as a technique for measurement. Zero blew out the limits to ideas and to progress*."* *Peter L. Bernstein. Against the Gods. The Remarkable Story of Risk. New York: Wiley & Sons, 1996, p. XXXIII.*

The invention of the zero meant that numerical sequence could now be predicted as in 1, 10, 100 indicates that the next number in the sequence is 1000. Zero makes the whole structure of the numbering system immediately visible and clear.

This invention was the cornerstone of all our present day risk management strategies such as portfolio theory and insurance, not to mention our ability to quantify and project outer-space and galaxies beyond our view.

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