

Market Timing

A look under the hood on the TSX...

It is always important to look under the hood before making a purchase. This metaphor is not only useful in the purchase of everyday items, it can be extremely useful when buying index investments especially that of “diversified” baskets of assets like the TSX 60.

During the run-up in price of the TSE 300 index in the hay days of 1999-2000, Nortel quietly became 40% of the index’s value. As Nortel’s share price began to rise beyond \$100 many talking heads were expressing their views that the company’s share price was going to \$200+. At the same time there was considerable press about the level of the TSE. We are all well aware of what happened soon after.

Flash forward to today and we find a similar situation when looking under the hood at the constituent weightings of the TSX60. A careful look shows us that this Index is not so diversified presently:

Weighted Contribution to the TSX Return from Sub-Indices

Year ended Dec 31/05		% of TSX Return
Energy	14.6%	67%
Financials	3.27%	14.93%
Materials	1.09%	4.98%

As we can see from the above summary, 67% of the Canadian markets return in 2005 came from the Energy group. Putting this another way, the other **73% of the Canadian market only returned 5% in 2005**. This places the broader Canadian market more in line with the returns experienced in the US markets over the same time frame, where to the end of Sept 2005 in C\$ terms the S&P 500 lost .2%, the DOW lost 1.99% and the NASDAQ lost 1.8%. So 2005 was not a stellar year. The good news is our clients avoided the losses on the US markets over this time frame, and experienced a good portion of the gains on the TSX until the energy sector pulled it out of reasonable valuation territory



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causing our risk management rules to move us out.

In order to give some perspective on the Canadian market and our returns over the past 5 years, we thought it important to include for your reference the below chart:



From this you can see that the TSX Index is just now flirting back at the peak reached during its last bull cycle in September 2000, just before the 2-year prolonged decline that followed to a bottom in 2002. Since 2002, it made some very strong gains, and we were there to enjoy most of the gains that it offered. The two legs we were in the market are outlined in blue channels on the chart. What we have missed in the past few months amounts to the energy led spike at the top. Spikes at the top of a market can be dangerous places to be. It will not be unless this market breaks through the previous and current peak, with sufficient breadth and strength that a new bull cycle will be signalled. In the meantime, we must continue to be cautious and

protective of your capital, so that we have cash available to take advantage of the next trough when it presents itself.

We know that some people have been feeling that they are missing out on the spike in the energy led Canadian market over the past few months. Some are thinking of piling more of their funds into last year's winning sectors or the TSX itself. But to do this at this time is to exhibit the classic pitfalls of risk-seeking behaviour based on greed and fear of missing out. Most people do not realize the true nature of the Canadian market at present or the risks inherent at its current levels. We do, and that is what you pay us for. Fear not, we are on the job. The most lasting market gains are made off of market bottoms, not market tops.

Another great book is out by Peter L. Bernstein:

Capital Ideas. The Improbable Origins of Modern Wall Street (New York: Wiley & Sons: 2005)

One of the most brilliant minds in the investment field, Peter L. Bernstein has been studying and writing about human history and investing for over 50 years. Peter now in his 80's is still recognized as one of the brightest and wisest and his recent work in no exception. Peter's father had an investment counsel practice back in the 1930's and Peter went on to be a successful portfolio manager for many years as well as a prolific author and educator. In this latest book, Peter tells the story of his own evolution as a money manager in both the easy times of the 60's and the market "disaster" of 1974, an experience which he thanks for having changed his approach forever and for the better with a focus on risk management first. He tells the story of six innovators in market history who brought to the salesmanship of Wall Street some crucial academia needed to enlighten those interested in servicing rather than selling to their clients.

After all his years of experience, Bernstein recognizes like us, that Behavioural Finance is an important adjunct to inform traditional finance theory:

"The only competing doctrine to modern finance theory is in the behavioural finance literature. Behavioural finance is where alpha [above average returns] flourish. I sat next to a famous hedge manager at dinner the other night, and I said, "How much of modern portfolio theory is involved in what you do?" He said, "its tremendously important. Those guys are the guys we pick off every day."

HAPPY NEW YEAR!!

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