

Market Timing

The Major Markets Tell Us Cash Is King For Now...

Last week our indicators gave us the high sign to move major equity holdings out of the market to the safety of cash, while taking some profits off of the table. As you know from recent newsletters, we had been suspecting that this would happen sometime in early 2005 and it has.

We believe that there are several factors at work in bringing about the sell "signal", a few of the major influences are the rising yield of the 10 year US Treasury, the resumption of rising oil prices and the first year of the US Presidential Cycle. The Presidential Cycle is important as many of the heavy political issues are dealt with in the first and second year of a President's term, which usually leads to economic underperformance.

The Issue at hand for Bush today is how to pay out social security cheques to a growing number of people with fewer and fewer workers to support it. So far the proposals of raising taxes and privatizing are not considered business or consumer friendly.

All tolled these factors are weighing on the ability of the stock indices to break out to new highs. We believe that the recent price activity may well have signalled the twilight of the cyclical Bull market that started in October 2002. No one knows where we are headed next. However, corporate earnings guidance has donned a noticeably weaker bias, as CEO's forecast decelerating earnings thanks to higher input costs. If these earnings forecasts hit the mark it means share price declines are likely. As we noted last month, if the US Presidential cycle holds, it suggests a large trading range to a likely bottom in mid 2006.

The good news is that any sizeable price declines will create opportunity, and by keeping a close eye on the internals of the market we may get a chance to create some new capital in the interim period before we get to a possible market cyclical low in Oct. 2006. Only time will tell. For our part, we will continue to remain diligent in watching what is actually happening in order to protect your capital through this period and seek out those growth opportunities that are consistent with good risk-adjusted returns.

Income Investments

In the past couple of weeks the 10 year US Treasury yield from which all income investments are priced, increased 11.6% from 3.94 to 4.40, on its way to a key resistance range of 4.5 to 4.9%. If the 10 year yield does succeed in breaking through this crucial resistance level, it will accelerate losses for those still holding on to long maturity bonds, preferred shares, bank stocks, income trusts and other interest sensitive holdings. When yields rise on these critical bond markers, it means that the price of existing issues is falling. Coming out of a 5-year bull market in bond prices, we are poised for a significant correction in the price of interest sensitive investments from current levels. This is the reason we have not been able to add them to our portfolios in the past several months. We will not be seduced by the promise of higher



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yields only to chase them off of the inevitable cliff of capital losses once interest rates increase. Right now the greatest risk to the income investor is not having the patience to wait for this correction to take place before they add income-producing positions. We are looking forward to the opportunity to add higher yielding interest sensitives to your accounts when the time is right, and we have the patience to wait this out to your greater benefit. Stay tuned.

More Mutual Fund Scandals

Recently there have been more stories in the press regarding trading abuses and general dishonesty at some of the large mutual fund and insurance companies. One of the themes we have been writing on for some time, is the problem of a money management industry focused on salesmanship rather than on being a legitimate profession with the fiduciary responsibility to clients that entails. One of the veterans in this area is John Bogle, President of Vanguard's Bogle Financial Markets Research Center. In our recent Financial Analysts Journal, Mr Bogle wrote a retrospective piece on "The Mutual Fund Industry 60 years Later: For Better or Worse." In summary Mr. Bogle concludes that, "in the aggregate, the fundamental changes in the mutual fund industry during the past 60 years have benefited mutual fund managers, not mutual fund investors." Having been a leader in the money management field since the 1950's, we thought Bogle's article offered some important perspective for clients and advisors alike:

Sixty years ago, the mutual fund industry placed its emphasis on fund management as a profession—the trusteeship of other people's money. Today, there is much evidence that salesmanship has superseded trusteeship as our industry's prime focus. What has caused this sea of change? Perhaps trusteeship was essential for an industry whose birth in 1924 was quickly followed by tough times—the Depression and World War II. Perhaps salesmanship became the winning strategy in the easy times thereafter, an era of almost unremitting economic prosperity. (61 FAJ, Jan/Feb 2005, p.21)

Up until 1958, the Security Exchange Commission (SEC) in the US held that money managers could not profit by selling shares of their management company to outside investors. The SEC held that to do so would represent payment for the sale of a fiduciary office, if such sales were allowed the SEC feared that it would lead to "trafficking" in advisory contracts and abuse of trust for fund shareholders. But then a California management company challenged this SEC ruling in court in 1958 and won.

Thus as 1958 ended, the gates that had prevented public ownership since the industry began 34 years earlier came tumbling down. A rush of initial public offerings (IPO's) followed with the shares of a dozen management companies quickly brought to market...The IPO's were just the beginning. Publicly held and even privately held management companies were acquired by giant banks and insurance companies that were eager to take the new opportunity to buy into the burgeoning fund business at a healthy premium... The term "trafficking" was not far off the mark; there have been at least 40 such acquisitions during the past decade alone, and the ownership of some fund firms have been transferred numerous times. Today among the fifty largest fund managers, only eight remain privately held...Six firms are publicly held, and the remaining thirty-five management companies are owned by giant financial conglomerates—twenty-two by banks and insurance companies, six by major brokerage firms, and seven by foreign financial institutions.

It would be surprising if this shift in control of the mutual fund industry from private to public hands, largely those of the financial conglomerates, had not accelerated the industries shift from profession to business. Such staggering aggregations of managed assets—often hundreds of billions of dollars under a single roof—surely serves both to facilitate the marketing of a fund’s complex’s brand name in the consumer goods market and to build its market share. Conglomeration does not seem likely to make the money management process more effective, however, nor to drive investor costs down, nor to enhance the industry’s original notion of stewardship and service. (p.22)

Hopefully this helps to shed some light on where the money management industry has come from and why smaller, independent boutiques such as ours are not so much a new development, but rather a much needed return to the roots of a long standing profession of advice, not sales.

China

We have recently been reading an enlightening book on the economic rise of China and its likely impact on the rest of the world. We thought we would share with you some of the mind-boggling facts about this up and coming super-power:

- *China has 320 million people under the age of 14, more than the entire population of the USA.*
- *China has more speakers of English as a second language than America has native English speakers.*
- *Apparel workers in the US make \$9.56 per hour. In El Salvador, they make \$1.65 per hour. In China these workers make **68 to 88 cents per hour.***
- *One in 10 American jobs is at risk of being “offshored”.*
- *There are 186 MBA programs in China.*
- *More people use the internet in China than in the US.*
- *There are 220 million “surplus workers” in China’s central and western regions. The total number of people working in the US is about 140 million.*
- *Three hundred million rural Chinese will move to cities in the next 15 years, in order to accommodate them, China must build urban infrastructure equivalent to the size of the city of Houston, Texas, **every month.***

Fishman, Ted C. *CHINA INC. How the Rise of the Next Superpower challenges America and the World.* New York: Scribner, 2005.

Up until recently it has been very difficult for Canadian investors to make any type of direct equity investment in the Chinese economy, however Barclays has now created an new index share which represents the Chinese stock market, and we are tracking it as one of the country specific sectors in our investment universe.

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