



April 27, 2008

Are we having fun yet?

Dear Client:

If history has taught us anything about the stock market, it is that it is a lot more enjoyable opening your account statement when your portfolio has increased in value from the previous month than when the reverse is true. But after almost five and half years of consecutive yearly increases in equity portfolios, investors are now being reminded that stock markets do not go straight up and from time to time bear markets emerge. Often this occurs because of unforeseen events and usually investors, analysts and commentators are caught off guard when it happens. In 1995, a study¹ was done and it showed that the Dow Jones Industrial Average had 53 corrections of at least 10% during the first 95 years of the twentieth century. That results in a correction of 10% occurring once every 2 years on average. On 15 of these 53 occasions the Dow declined 25% or more which works out to 1 every 6 years on average. Coincidentally enough, the TSX corrected by approximately 25% after the terrorist attacks of 9/11 which is approximately 7 years ago. Statistically speaking, the decline that we are currently experiencing is right in line with averages found in this study. Almost every large decline in the stock market averages is met by a seemingly never-ending parade of prognosticators predicting dire consequences with doomsday scenarios. Admittedly, the current events are often very troubling, sometime overwhelming and not very much fun. We have housing prices plunging in the US, the asset-backed commercial paper (ABCP) crisis, oil prices reaching record highs almost on a daily basis, and inflation concerns caused primarily by the high-powered commodities market.

It seemed like almost everyday during the first quarter, there was news of companies warning of lower profits and exposure to the ABCP fiasco. The bad news seemed to peak with the Bear Stearns announcement. Bear Stearns was a New York based investment banking firm in business for over 83 years. They survived the Great Depression, World War II and countless other difficult economic circumstances but in March 2008 they were bailed out by J.P. Morgan and the US Federal Reserve after their financial collapse. Bear Stearns, whose stock traded at approximately \$140 last summer was sold for at \$2 per share (later revised to \$10 per share). Events such as this Bear Stearns bail-out send investors into panic mode and often lead to poor investment decisions. The Bear Stearns fallout had a big effect on the Howard, Barclay portfolios. It made investors worry about all financial stocks and the result was a large decline for financial stocks all over the world including those in Canada. The large Canadian banks

¹ "Fear of Crashing", Peter Lynch, September 1995

were already under severe pressure and the Bear Stearns fallout only made things worse. For example, Bank of Montreal traded in the low \$70's last summer and then traded as low as \$38 in March of 2008 (essentially a 50% correction). There were rumors in the market that Bank of Montreal would need to do a common equity issue and that the company might have to cut their dividend. The heavy exposure to the financial sector in our portfolios has hurt us over the last six months but this is not the first time that Canadian banks have come under some severe selling pressure.

A recent study² by CIBC noted that since 1983 there have been six occasions (including the current decline) where Canadian banks have declined by 25% or more. In other words, once every four or five years the banks have decreased by at least 25% on average. The last time the banks declined by 25% were in October 2002 or approximately 5 years ago, almost right on schedule. Undoubtedly, investors feel it is different this time. However, you may recall the sentiment when Royal Trust, Confederation Life and Olympic and York went bankrupt. The same uneasiness we felt then is certainly being felt again. The real estate collapse of the early 1990's had investors wondering if CIBC would survive. Again in 2005, CIBC took a \$2.5 billion right off because of Enron and concerns for the overall health of the bank were raised. This is not to suggest we should not worry about the Canadian banks. However, we feel they are terrific businesses and operate essentially as an oligopoly. In addition, these banks also pay good dividends with all of large Canadian banks yielding over 4% and Bank of Montreal yielding over 6%. Finally, since the date of the last decline of 25%, the large Canadian banks had a five year annualized return of 19.7%.

In summary, there are plenty of events that are worrisome. The US Federal Reserve is fighting inflation, while at the same time fearful of a slowing economy. China and India continue to grow but threaten to take away good North American manufacturing jobs and we cannot forget about the war in the Middle East. However, while we are no doubt experiencing a slowing economy and a slowdown that may extend longer than anticipated, we feel we have invested in solid companies, with most paying a healthy dividend that will see us through this rough patch and over the next 3 to 5 years should turn out to be prudent investments.

Sincerely,

Stephen Sisokin
President

² "Monthly World Market Report" CIBC Wood Gundy, April 2008