$your wealth$

BY J. PETER HODGSON CFA

It is the best of times; it is the worst of times for equity investors. As I write this the Toronto market is testing new recent lows in the current bear market. It is a difficult and painful experience for most investors. The bear market of 2000 was a little easier to take, not so much that the decline was softer but more-so that the technology companies that led it seemed to deserve the misfortune. This time there is no solace from the pullback and the concept of diversification has not seemed to help as all markets, save cash, are down markedly. Investors that have stuck to asset allocations and sensible plans are feeling the pain of a market pullback.

Bear markets are a natural, relatively frequent, and necessary part of the equity markets. Some may chastise me for that comment; however the past returns that everyone likes to point to, and the enduring out-performance of equities, are a direct result of bear markets and the appropriate pricing (or repricing) of risk. In other words to get above average returns and returns better than GICs and bonds you need to be able to buy securities at below average prices. This means you need to find someone who lacks the conviction to hold them at times like this to sell them to you at a reduced price. Long run equity returns are given to the patient, persistent and resistant.

This market is tearing money and companies from weak hands and placing them into strong hands. Berkshire Hathaway laid its stellar foundation in the depths of the 1973-74 bear market and it supplied liquidity to the frightened and fragile during this time period. It bought great companies at throw away prices. It is happening all over again.

For those of you who have committed allocations to equities, here are what I think to be good reasons to stay the course. I am firmly in the camp that the world is not coming to an end. It is not the depression and I am doubtful there be will one. There is a recession and it could be a difficult one but there are some very significant positive things going on. We are seeing massive injections of liquidity in the system and as a result there is plenty of cash around. During the thirties the Governments of the world actually constricted cash and put up trade barriers. We know now that this multiplied the duration and magnitude of the financial pain. Right now we have the exact opposite. We traveled to the US to visit with one of the Global investment managers. We interviewed a number of their portfolio managers and they told us that there is roughly two thirds of the value of US equities sitting in cash earning 1% at the moment. They could not recall the last time they had seen this, if ever. I do not know the Canadian figure but cash levels are high here as well. This cash will want to work at some point, rather than earning 1% and having tax and inflation turn it into an enduring negative return.

There is and will be a change in the behavior of consumers. They will and are spending less. That said, I could not help but note during our trip that the plane was full, there was a line up at the taxi stand, lunch counter and we could not get a seat for dinner. Life is going on and so is general commerce, yes at a reduced pace, but certainly not consistent with the magnitude of this market decline.

Interest rates are low historically speaking and going lower. For the moment it is much harder to get credit, this will change and credit will begin to flow again. The savings and loan crisis in the early 80's is a good model to consider. There were far more failures of financial services companies then than there are now. There will be more failures for certain but not to the extent of the S&L crisis. The US government appears to be committed to the sector.

As a result of the decline in oil prices we see in the US a reduction of household costs that approach that of the amount of funds committed by congress to boost the economy. This money will reduce debt, increase savings and fill the wallet of the average American. All of these things are important parts to getting the system going again and it didn't come from a government program.

Equities are inexpensive on a historical basis, we are seeing price earnings multiples for equities below 10. This means for every $1 earnings I have to pay $10. It does not mean that it will not go down further, however the market has a record of recovering strongly from these levels. It indicates that the market has discounted heavily the approaching earnings decline.

You may have heard or read many of the above points. In aggregate I hope they provide the mettle you need to hang in there. I want to provide you with some additional thoughts and techniques to keep you in the game and avoid being fodder for the bargain hunter. If you are a bargain hunter then we will try to provide a few thoughts as well.

Think for a moment that in your neighborhood you have the unlikely situation that your neighbor on either side of you has to sell their home and quickly. They were forced by a job move, divorce, or money problems. What is your house now worth? Well, of course, that depends entirely on if you need to sell your home now or you see yourself holding the home for the indefinite future. This is exactly what is going on in a large part of the global marketplace at the moment. As banks reduce the amount of loans they are prepared to have outstanding and call in those loans, hedge funds and speculators are being forced to sell securities now with little or no regard to price. The amount of leverage outstanding was breathtaking and the unwinding is as well.

You have many good quality businesses with good cash flows, low debt, and good management. If you do not need the cash, this is simply the worst time to consider selling.

Another way to resist the temptation to sell and provide a bargain for someone else is to make sure you have enough cash in reserve. A well constructed financial plan and sensible asset mix will help greatly with this. In our practice we have our clients define their risk tolerance in terms of how many years of cash reserve for expenditures do they want. The concept is that if equities are down they do not have to consider selling even one equity security for 5, 7, 10 years; depending on the amount of cash/fixed income reserves they desired. A specific example was when we were able to say to a client they had seven years of cash in reserve without counting dividends and coupon payments. It also allow us to have the discussion around bargain hunting at these low levels by considering dropping our cash in reserve down to 5 years.

We make a practice of trying to place the bulk of our fixed income in Rsps to shelter the interest from the tax man until such time as withdrawals are required. We have been able to swap bargain equities that we do not want to part with for bonds in the Rsps depending on the initial asset mix of the specific client we can do this for many, many years.

Finally, if you do not have these options available to you, and it still makes sense not to be the person to provide the return for someone else's bargain hunting, you can use equity securities as collateral for a loan.

Ironically at time of writing some of the financial stocks are actually yielding more on the stock than they are charging on the loan. In twenty years I have never seen that. You may be able to make the interest tax deductible as well but please consult a tax professional. This is an aggressive strategy and investors should consider all risks.

For those of you sitting on the sidelines looking at the opportunities here are a few thoughts. To be able to achieve above average returns you must be able to buy at below average prices. Many people will fight tooth and nail for a bargain on a piece of clothing, a car or furniture. Stocks are the only thing I know of that it plain just feels bad to buy them when the prices are down. Ponder that at length.

Here is what we have been doing currently. For our new discretionary accounts we have committed a third of our portfolio's equity allocation to the market. We have looked at companies with a history of strong dividends and pick them up on the cheap. We have had a preference for recession resistant industries such as telecoms and pipelines. There are also some very good bargains on preferred shares right now. There are some securities that are yielding close 9% on a pretax basis. There are solid companies with a long history of dividend payments and increases on the common stocks making the preferreds that much more attractive. There have also been attractive values in the corporate debt markets that we have not seen in years.

There have also been opportunities to use some of the market losses to offset against taxable capital gains earned in the last three years and reduce your tax burden. There are strategies to realize a loss without being out of the market. For example you can switch from the corporate class of a specific mutual fund to the trust structure to realize the loss. You can also pair securities with very similar characteristics and achieve the same result.

It still may be all too much for some and the only choice is to avoid the market altogether. Risk tolerance and time horizon should drive that decision. A key point to consider is that if there is intent to hand on the portfolio to heirs or a charity the time horizon may actually be much longer.

All of this should be considered in the context of an overall financial plan. It is a pleasant surprise to realize that, notwithstanding the market pull back, you are still on track for your long term goals. This can give a real sense of peace. The bear market is a detour on the way to your destination; not a full stop. It can give you the courage to take advantage of the bargains and have someone else be the one to provide you the excess returns over time. It can allow you the ability to not look at your account daily. I compare this to going out to your garden and pulling up the carrots everyday to see how they are growing. It is not a successful strategy.

People easily forget that as the market declines future expected returns actually go up. It just does not feel like that. For investors that is a very good thing. Warren Buffett has been waiting for this market for a very long time. It has been almost 40 years since the last great sale. I do not want to be Pollyanish about this and say that things will roar back. They may not, but these prices are consistent with earning above average long term returns for investors. Right now the speculators have been kind enough to provide opportunities to some of us who have a plan and strategy mixed with patience and a little courage. This is a very difficult time and it will likely continue to be so for the next while but there is opportunity out there.

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