RBC Wealth Management™

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Dear Readers,

Since financial markets fell to bear market lows last March, there have been four significant corrections. The first of these took place from mid June to mid July, 2009 resulting in declines of roughly 8% for the DJIA and S&P 500 with leadership groups such as the Russell 2000 (small cap stocks) and cyclical stocks losing over 10%. The second occurred from mid October through mid November, 2009; the third from late January to mid February 2010 and we are in the midst of another conviction testing correction now. As I have written recently, the current downtrend was precipitated by concerns about the high level of debt in Greece, Portugal, Spain, Italy and Ireland. Please note: there is little new information in recent media coverage of the European debt issue (see attachment 1: debt/gdp by country) except that the EU is seriously attempting to fix the problem. European policy makers and financial market regulators are doing their job: stabilize the financial system and position it for future growth. That is precisely what we went through here in the United States beginning in late 2007 and signs of sustainable recovery are abundant. As our economy grows that will position us to reduce the deficit and overall debt level of the country. Over time, this will be replicated elsewhere in the world.

During each of these fear inducing corrections, I received phone calls from investors wondering what I was doing to protect them from risk and that is the concept I want to focus on today. Risk is essentially the variability of possible outcomes and is not particularly well understood. For example, as we navigated through the financial crisis, markets priced in total catastrophe as the likely outcome. When the DJIA was trading at 6500 and some market pundits were suggesting it could fall to 5000, few people realized that would mean pricing 5 or so of the Dow components - companies viewed as the strongest and most stable in America - at zero. At that time, expectations were extraordinarily low and the possibility of improved future economic activity and corporate earnings growth were being dismissed. Panic had priced the market at a level where reasonable risk had been eliminated creating tremendous opportunity for disciplined investors. While markets have enjoyed a substantial rally over the last year, I believe they are still priced for low expectations and therefore the potential for good investment returns is significant. At some point, as in previous market cycles, expectations will become too high and a stampede to participate in excess returns will develop. Risk will climax because the likelihood of disappointment will be great.

Strangely, I don't get many worried phone calls on days when stocks rise sharply - those calls only come on down days. This is because fear manifests much more rapidly than greed, so volatility tends to appear when markets are trending down. Volatility is roughly equivalent to price dispersion and as markets rise this tends to gradually diminish.

When giving presentations, I often refer to the attached chart (2) "The Cycle of Market Emotions." This chart reflects the unfortunate reality that most investors follow a herd like instinct to buy when the news is good and sell when it seems bad. In order to avoid falling into this pattern, it is critical to have both an informed view about the economic and financial picture and a disciplined investment strategy which you can rely on when emotions are pressuring investment decisions. Price is a tactical consideration in this process - and if you have an optimistic outlook of future economic conditions, lower prices only present more opportunity. Feeling confident in your investment strategy requires years of experience, a consistent approach to security selection, patience and enormous amounts of reading and analysis.

There cannot be a bias to only read sources that support your outlook - all perspectives must be considered and no one voice can resonate more loudly than others or judgment becomes compromised. This research process is rigorous and never stops.

Concluding on the topic of risk: in a NYT article in October of 2008, Warren Buffet was quoted as saying "People who hold cash equivalents feel comfortable. They shouldn't. They have opted for a terrible long-term asset, one that pays virtually nothing and is certain to depreciate in value." Despite this, mutual funds flows continue to be biased towards bonds and money market funds rather than equities which have provided superior returns over the long term and are priced at a substantial discount to future prospects. S&P 500 earnings in 2011 should come in at around $96 per share which means the current market multiple on forward earnings is about 11.8x compared to a historic average of 16.4x normalized earnings. Meanwhile, the 10 year treasury yields approximately 3.4% - a measly return over inflation. We have had a 30 year bull market for bonds (attachment 3) and, with short term interest rates hovering near zero you can certainly argue that there is a risk of bond prices trending down as rates inevitably rise over the course of the cycle.

In my opinion, the current rough patch will pass and we will resume a longer term market uptrend before too long.

Regards,

Terry