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Black Swans and Falling Chainsaws
Posted: March 17, 2008, 4:00 PM by Jonathan_Chevreau
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Every market meltdown has its colorful new image. The one that caught my eye today in a Reuter's feed was about trying to catch a falling chainsaw. As similes go, this was quite a bit more colorful than the "falling knives" image generally used to describe the hazard of trying to bottom fish for bargains in a falling market.

You can just see the hapless investor spewing the red stuff all over, somewhat like that Monty Python skit where the knight fights on after losing four limbs.

But is this really an apt image? Wasn't it more dangerous to be buying at the highs last summer than at new lows today? If indeed the blood is flowing in the streets -- via chainsaws, knives or subprime navery -- isn't that when the Rothschilds counselled us to be buying?

True, I'm not buying myself today although AIM Trimark Investments is. If I had some cash handy, I'd be tempted but there are a few consumption bills to be paid from last week's March break, which I spent

in Mexico. But nor am I selling, even though the reaction of many retail investors following today's global rout was basically a version of "get me out of here." In his latest Internet Wealth Advisor, Gordon Pape passes on the all-too-human reaction of one reader who summed up the general psychology with this: "I am really getting fed up with the mess the markets have been in lately. When are things going to straighten out or should I just take my losses now? I know the advice that is routinely given is to ride it through but quite frankly I am tired of all this."

"So are we all," Pape replied, "But the solution is most certainly not to sell good-quality securities into a plunging market. I've said it many times before, but it bears repeating at times like this: panic is no answer to anything. It only contributes to the downward spiral and allows astute investors to pick up bargains at your expense."

If you did not reduce your equity exposure, this is not the time to do it, Pape added. "Ride it out" may seem a cliché but "in the circumstances, it is the least damaging course of action."

Here's what David Bruce of ScotiaMcLeod told me today in an email: "This is the best opportunity in 30 years to own equities. This is apparent by observing bond yields which will not meet most people's goals in retirement. Is this the bottom for stock prices? I don't know, however, I think it is close. Seven years from now a dollar invested in a broadly diversified, low cost equity portfolio will likely be worth two dollars."

And here's the calming words of wisdom from Clay Gillespie, portfolio manager and vice president of Vancouver's Rogers Group Financial Advisors Ltd:

"If you are in a properly diversified portfolio then this type of event should not have a long-term effect on your portfolio. However, if you are in a concentrated portfolio that is not well diversified this type of event can be devastating. I expect some more bad news such as this to come. However, not all companies are Bear Stearns. This means that many financial companies that are not in the same shape will be unfairly compared to Bear Stearns. This is just the subprime mess working its way

through the system. There will be some additional shocks before it is over. But trying to time and make portfolio decisions in a time of panic and indecision is next to impossible because stocks are going up and down with investor sentiment rather than underlying fundamentals. I would be worried if you were not in a diversified portfolio and you were making a bet. Otherwise, I would ignore it until rational behavior returns back to the market."

Fund analyst Dan Hallett says a number of people are coming back to us and nodding their heads saying, "now I understand why you want us to have bonds". Hallett says many were questioning this advice as markets roared higher and people became used to double digit returns.

A year ago Hallett wrote an article entitled, [Ignore Bonds at Your Peril](#) which said that after four years of rising markets bonds are a necessary portfolio component. As for investor action, Hallett can only suggest people "get back to basics, if you're not there already."

As for leaving the big decisions to your fund managers, Hallett notes that some are losing faith in value managers like Brandes or Saxon."Capital markets are indeed cyclical and involve risk. But you can't take risk without it materializing once in a while. The best time to buy is supposed to be at the point of maxim pessimism; when blood is in the streets. The streets aren't bloody just yet but we certainly appear to be moving toward that point."

If you feel better already, that's good and why many investors use a financial advisor to help them overcome their own emotional reactions to losing money in down markets. But I'd also be remiss if I didn't pass on some of the more negative commentary coming out today. You don't have to look far for that. BMO Financial Group's Sherry Cooper issued a "red alert" today that began with the following:

"We are in the midst of the most pervasive financial crisis in a generation, which has destroyed untold sums of wealth in housing and financial assets and has driven the U.S. economy into recession. Financial shares have fallen this morning to an almost five-year low on concern that the Fed will be unable to prevent credit-market losses from spreading. The implications for a further slowdown in the U.S. and global

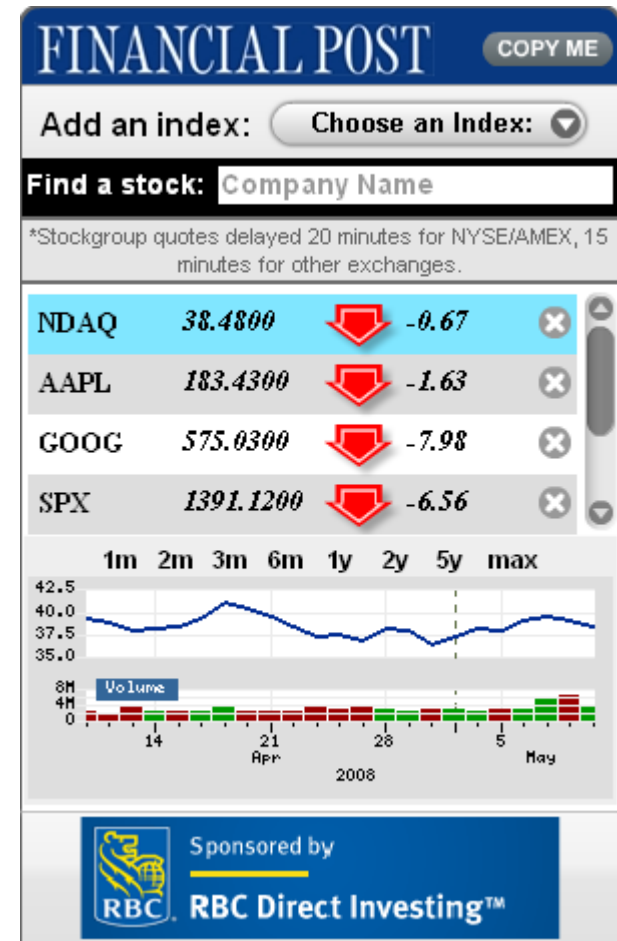
economies and for declines in the U.S. dollar are playing out in real time. The Fed's primary role right now is as lender of last resort. They will ignore for the moment the effects of their actions on inflation or the moral hazard of bailouts. The Fed is in Emergency Mode."

Or consider the following analysis from Tamris Consultancy's Andrew Teasdale. He tells me that in a normal economic and market cycle the allocation to cash, bonds and equities is usually affected only by reallocation of demand between the asset classes. "This can be caused by a rise or fall in interest rates and/or a rise and or fall in return expectations for any one asset class due to changes in economic outlooks (growth and inflation)."

The most important determinant of asset prices is the overall growth in money supply and the demand for money within a portfolio, Teasdale continued, "If we were in one of these normal cycles all that would currently be happening is that the demand for money would be increasing and cash or lower risk assets as a percentage of a portfolio would be increasing and equities would be falling. Sooner or later once economic and market conditions stabilise people would demand less money and other lower risk assets within their portfolio and would start to increase their equity holdings."

This is why in normal times market timing may not be useful. But Teasdale argues the subprime crisis is not normal and that therefore we are in an unprecedented era of risk.

"If the current event were only limited to a panic about securitised debt and their impact on bank earnings I would say buy, buy, buy at current levels," Teasdale says, "The trouble is we have yet to see the true economic impact of the current risk event. While many consumers in many economies are highly leveraged it is the US consumer that is of the greatest concern ... A collapse in US consumer demand would see much greater strain on banks and leveraged (non financial, i.e. hedge funds and private equity firms) entities further reinforcing the potential for a decline in money supply growth. It is the structural economic weaknesses that lead me to believe that the current crisis has much further to run." (See



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also the Wealthy Boomer video interview with Teasdale which ran last month.)

As Fred Kirby of Dimensional Planning Inc. (like Teasdale, an occasional commenter at this blog) suggests, it's possible that the current environment is one of those supposedly rare but possible "Black Swan" events described in the popular book of the same name by Nassim Taleb. "We can protect ourselves from these events by first recognizing that chance, not deliberate choice, plays a greater role in our lives than we may care to admit," Kirby says, "We rely too much on 'experts' who tend more often than not to be simply extrapolating from the recent past or have their own agendas. Look no further than the top executives at Bear Stearns who as late as Friday of last week were uttering bromides to soothe investor unease."

The Black Swan is admittedly a more pleasant image than the Falling Chainsaw. I won't attempt to draw an investment conclusion from all this but invite those who believe they know what comes next to comment below.

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