

Quarterly commentary: Third Quarter 2008

As a result of escalating global market volatility throughout the quarter, our core portfolios generated a gross return representing a decline over the previous quarter. Your portfolio was not down as much as key domestic and global indices.

In light of the dramatic market drops over the past quarter, you may feel it takes great courage for one to say that the markets are doing precisely what they are supposed to do. That is my view because markets will always move toward equilibrium. To reach that state, prices have to be set, securities need to be bought and sold and trades need to clear. The discomfort comes when markets don't always get the pricing right in the short term – which is the nature of risk.

History in the making ... again

As that painful move to market equilibrium continued around the world, many seasoned investors and analysts viewed this as history being made (again). Sentiments from media commentators such as, “Investing will never be the same again” brought back memories of previous downturns endured during October 1997, January 1988 or September 1986. The comments shared on those occasions were no different from the ones trumpeted across the media on Monday, September 16 when the S&P500 Index registered its 14th largest fall among all trading sessions since January 1950. The world is an uncertain place,

and sharp fluctuations in asset prices bring pain to many people, not to mention Lehman Brothers employees, shareholders and their families. The Wall Street Journal estimated that the 24,000 employees of Lehman Brothers saw \$10 billion in personal wealth evaporate as shares in Lehman Brothers fell in value. Long-term employees of Freddie Mac and Fannie Mae have experienced similar losses, which is dreadful to contemplate when you recall *Money* magazine's March 2006 celebratory assertion that Fannie Mae was "America's safest stock." When you add American International Group, (also in dire straits) to the mix you have four firms under daily media scrutiny that represented less than 1% of your diversified US equity portfolio (May 31, 2008) and far less for your globally diversified portfolio.

I want to state before going further that I have great empathy for these and other people who suffered catastrophic financial losses at the hands of the September markets, and those leading up to them. After weighing the evidence presented by market forecasts and certain media commentators and seeing money flowing into organizations they were told could not fail, they made decisions based on what they felt was best for them and their families. They ultimately adhered to a different investment philosophy from mine, which is their right as investors.

"The only function of economic forecasting is to make astrology look respectable." – John Kenneth Galbraith

Avoiding Future Derailments

Weston Wellington, Vice President of Dimensional Fund Advisors, summed up my views perfectly when he wrote on September 16: "The key issue for investors is to make sure their financial future does not get derailed by events at a handful of firms, and that their portfolios are properly positioned to capture all the rewards the markets have to offer when the next upcycle begins. Recent events have provided an unusually harsh lesson of the importance of diversification."



“We must never take for granted the precious gift of hindsight.”

This cartoon appeared within a *New Yorker* article (January 22, 2001) chronicling the wildly fluctuating fortunes (and careers) of former Wall Street icons including Ivan Boesky and Michael Milken. It could well have been (re)written today.

That was then ...

You may recall Bill Miller, the renowned manager of Legg Mason Value Trust. He is known for beating the S&P500 Index each year for 15 consecutive years. His run came to a halt when returns plummeted between 2006 to August 2008. While earning a good portion of the value premium from the start of his winning streak in 1991, his recent misfortune has effectively wiped out any advantage over a passive value strategy during this time frame. Between 2006 and 2008, Legg Mason Value Trust fell 12.12% (annualized) versus DFA US Large Cap Value and S&P500 Index, which rose 1.98 and 3.02, respectively.

Brad Steiman, of Dimensional Fund Advisors Canada has long followed Miller's ascent into what I term the "active advisors' hall of fame." Steiman noted recently, " The point of this example is not to necessarily single out a particular manager. Doing so would be anecdotal, just as it was to single him out when he was on a long hot streak. Nonetheless, this example serves as a reminder of several key points. Distinguishing luck from skill is a challenge because of the inherent volatility and statistical noise of the equity markets; it is easy to pick winners with hindsight but very difficult to identify them in advance, and; hiring an active manager with a great track record still exposes you to the risk of either bad luck or bad management."

"If you think an expert is expensive ... wait until you hire an amateur."

– Red Adair (World Famous Oil Field Firefighter)

I think it's particularly valuable to again revisit why I invest as I do.

Diversification reduces uncertainty. Concentrated investments add risk with no additional expected return.

Risk and return are related. Exposure to meaningful risk factors (such as small companies) determines your expected return.

Asset allocation drives the return of a broadly diversified portfolio.

Individual stock picking, market timing or manager or industry selection may negatively influence expected returns.

On an ongoing basis, I make adjustments to your portfolio. This includes reducing exposure to expensive groups of stocks and buying cheaper ones, as a bear market (such as now) can yield the best buying opportunities. Lower-priced "value" stocks offer higher expected returns than their higher-priced "growth" counterparts.

Your input is vital to my business. If you have any suggestions I would like to hear from you. Please visit davidrbruce.com and share your feedback with me at your convenience.

On behalf of my colleagues, I wish you a restful and enjoyable fall season.

Yours sincerely,

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