

## Quarterly Commentary: Fourth Quarter 2006

Our normal portfolios (60% stocks, 40% bonds) were up 8.5% for the quarter and 13.3% over the year. The fourth quarter market surge proved to be a salvation for some equity investors, but surprised many money managers who had migrated to large cash positions after a sluggish year and as a result did not fully capitalize on the positive quarter.

As 2006 drew to a close, Barron's reported, "More than 70% of active large-cap fund managers were trailing the markets as of October 31. To have exploited the year's twists and turns fully, one would have had to bet heavily on a commodity boom until May, a sharp slowdown and commodity bust into summer and a recovery led by consumer spending this fall."

An alternative would have been to own a broadly diversified portfolio, participate in every "twist and turn" the markets presented and outperform most of the "experts." One could have easily spent the year enjoying some golf rather than preparing for an investment steeplechase with every sunrise.

### Wealth and well being in 2007 ... and beyond

The phrase "combining wealth and well being" captures my investment management philosophy and commitment to your financial future. It's based on considerable personal research, including the investment management seminars I attended last year, which I described in earlier letters. While generating steady and growing portfolio performance is always my main resolve, I also want to increase your comfort level with investing so that the pursuit of personal wealth becomes part of a balanced and happy life, not its *raison d'etre*.

Some investors can be very wealthy yet derive relatively little well being from it. For example, Oracle founder Larry Ellison was disheartened when he was out on his impressive 80-foot sailboat, *Sayonara*, with his girlfriend. She spotted a more impressive craft and announced; "Now that's a sailboat!"

Ellison quickly set out to purchase an even larger vessel. "My friend made me feel terribly inadequate," said Ellison. "I went on a search to reclaim my adequacy." Everything is relative. But balance in life is everything.

## Backed by lessons in behavioural finance

Flowing from the abundance found by combining wealth and well being are thoughts from Meir Statman, the globally recognized investment expert you may recall from previous commentaries.

In “Lessons in Behavioural Finance,” he notes, “Investors may have cared more about being rich in the late 1990s and more about fending off poverty in the early 2000s, but they always want both: wealth and well being. What can advisors offer them? They can offer greater wealth, better well being and a good balance between the two. And that’s done by using the tools of wise physicians: asking, listening, diagnosing, educating and treating.”

Behavioral finance is an important tool in helping you realize your investment goals.

## The gambler’s compounding dilemma: when to hold ‘em and when to fold ‘em

When asked what he considered the world’s greatest discovery, Albert Einstein replied, “compound interest.”

Taking the emotion out of investing is to deny the “gambler” instinct in many of us. It can be fun guessing outcomes, but I limit my guesswork to the outcomes of movies or sporting events.

One example of the negative role gambling can play in investing is how even a few negative investment returns can severely impact a portfolio’s total return. The following chart tracks the success of the “gambler” (who could be a market timer, day trader or an investor who is constantly chasing returns) and the “investor” (who takes a pragmatic, unemotional approach to creating wealth). You’ll see that the investor lets compounding do its work by aiming for consistent returns, while the gambler posts erratic returns, thus wreaking havoc with the end result. Bad numbers kill compounding.

Year	1	2	3	4	5	6	7	8	9	10
Gambler Returns (%)	30	(10)	40	(20)	30	(10)	40	(20)	30	(10)
Investor Returns (%)	10	10	10	10	10	10	10	10	10	10

The gambler and investor each invest \$1 million. Both have an arithmetic annual return of 10%. However, the gambler has a compounded growth rate of only 7.2%, and ends up with \$2 million as a result. This is because the negative returns temporarily reduce the value of the portfolio, which limits the returns earned through compounding until prices recover. The investor's compounded return is 10%, which ending up at \$2.6 million. The investor is undoubtedly more relaxed at the end of the cycle and views the next 10 years with anticipation.

I recall Warren Buffet's number one investing rule: Don't lose money. And the number two investing rule: Don't forget rule number one!

### **The spirit of the Nifty Fifty lives on**

The Nifty Fifty were fifty stocks listed on the New York Stock Exchange that gained their notoriety in the bull markets of the 1960s and early 1970s. Some examples are Hewlett-Packard, McDonalds and Walt Disney. They were known as "one-decision" stocks because investors were told they could buy and hold them forever. Analysts often use them as an example when describing how some investors choose to buy shares in high-profile companies at prices that simply can't be justified.

Seven years ago, Pfizer Inc. looked unstoppable. *Forbes* ordained it "Company of the Year" and advised that investors could be confident that "the people who brought us Viagra have more blockbusters on the way." In the same year, with a stock price of \$43, *Money* magazine announced that Pfizer "stands out among drug stocks" and deemed it "one of ten to count on" in building a retirement portfolio. Fast-forward to the *Wall Street Journal's* 2006 assertion that the company faces a "rockier future," although it is highly profitable and its shares may well outperform markets in coming years. The stock price is now \$27.

But recent lackluster performance indicates that investing in firms riding the demographic change wave offers no assurances of long-term investment success. As with everything else, demographic trends and fashions fade into yesteryears and what may have been a great investment then, may well be regrettable now.

## **What investors liked (and didn't like) in 2006**

### **Liked**

#### **The joy global exposure can bring**

The year brought joy to many equity investors with an international focus as 36 markets grew by 20% or more (in dollar terms) and 19 had a total return greater than 40%. Markets in 46 of the 50 countries that compose the Morgan Stanley Capital International Index posted gains.

#### **More corporate transparency**

In 2006, more companies prided themselves on their corporate ethics and governance and internal controls, which we believe has changed the U.S. business environment for the better. While the Sarbanes-Oxley Act of 2002, which focuses on governance, transparency and accountability, is still the subject of debate in some circles, it has helped renew investor confidence across North America.

#### **2006 was a feel-good year for Canadians**

Canadian consumers remained cheered by the lowest unemployment in three decades, another year of low interest rates and growing home ownership as the bells pealed in the New Year.

### **Didn't like**

#### **The profitability department at Loblaw is shrinking**

Loblaw Cos. Ltd., Canada's largest grocery chain and part of many Canadians' shopping routine, continued to suffer from supply chain problems amid an ambitious restructuring plan. Loblaw has been trying to streamline its operations in preparation for the arrival of Wal-Mart "supercentres" — giant stores that stock fresh produce as well as dry goods. Loblaw management changes conspired to drive share prices lower as 2006 closed, leaving shareholders with a bad taste in their mouths.

#### **Halloween held few treats for many income trust investors**

The minority Tory government sprung a Halloween surprise saying that it will tax distributions by newly formed income trusts, specifically targeting the proposed conversion of Telus and BCE. Existing trusts have a four-year grace period, after which they will be subjected to the new tax as well.

(Our portfolios were not affected, but we're interested to see how this drama plays out in 2007.)

**Relatively soft U.S. stock market performance**

In 2006, U.S. markets trailed the stock return parade in 42nd position out of 50 countries, to the dismay of investors who chose to focus largely on American investments.

**Odd weather**

Unseasonably warm weather confused investors when choosing between winter, spring, summer or fall wardrobes. Warm temperatures created consternation among retailers and resort operators contemplating near-Miami conditions during the holiday season.

On behalf of your investment team, I wish you an enjoyable winter and a prosperous and happy 2007. Please contact Prithy Serrao, Roger Lee or me should you have any comments or questions regarding your wealth or well being.

Yours sincerely,

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Associate Portfolio Manager