

Quarterly commentary: Fourth Quarter 2008

The fall of equity markets around the world to not seen in nearly a century negatively affected our core portfolios, which generated a gross return representing a decline over the previous quarter. Portfolios kept pace with key domestic and global indices, which were down.

While equity portions of the portfolios fell, the fixed income portions of the portfolios helped slow overall portfolio declines. Rather than focus on low quality bonds in search of higher yields in the face of uncertainty, I chose to remain invested in bonds assigned AA or AAA ratings in the face of growing market losses during the fall. This decision helped to buffer poor equity performance and reflected my goal of maintaining balanced portfolios to better manage risk. Bad news combined with shrinking portfolio values has always encouraged some investors to take flight from the equity markets, and last quarter was no different. I maintained equity exposure as history has shown that it is both dangerous and difficult to identify when markets have finally stopped their descent.

I want to reassure you that your investment portfolio is still well positioned for the longer term using the asset allocation strategy I implemented when I originally constructed your plan. This positioning is the best strategy to weather setbacks and realize solid gains when the markets and the economy turnaround.

Some timely thoughts on risk

I mentioned in my last letter that in light of the dramatic market drops over the past quarter, many might feel it takes great courage for one to say that the markets are doing precisely what they are supposed to do. I am reaffirming my view because as long as capitalism remains a motivating global force, markets will always move toward equilibrium. To reach equilibrium, prices have to be set, securities still need to be bought and sold and trades still need to clear. The discomfort over falling markets, which is growing within all of us, comes when markets don't always get the pricing right in the short term. Such is the nature of risk.

Some investors realigned their portfolios completely in an attempt to reduce the ravages the fourth quarter. They are clearly entitled to change their risk preferences, but many did so without understanding the consequences.

Here are some thoughts on the implications of making dramatic and hasty changes to an investment portfolio.

An effective wealth management solution addresses multiple risks across the entire planning horizon. This involves assessing the trade-offs that come when eliminating some risks and assuming others. Three risks need to be considered:

Market risk - the risk that stock prices will fall.

Inflation risk – the risk of losing long-term purchasing power.

Longevity risk – the risk that you will outlive your money.

“Any port in the storm”

Let us say an investor cannot tolerate declining equity prices any longer.

The investor may decide to forgo the pounding waves and move to a safe harbour until the sun comes out again. While free of the frustration that can accompany free-falling markets, the investor must realize that they are losing purchasing power as a market-risk-free investment is almost guaranteed to lose money after tax and inflationary effects. The loss of purchasing power could mean the investor outlives his or her money if frequent spending is depleting assets. By the time the weather clears and an equity market recovery heralds an economic recover, the tide may have already gone out leaving the investor aground in what was once “any port in the storm.”

The table below shows what can happen when you tire of waiting for higher expected returns and move your portfolio to market-risk-free assets that offer lower expected returns. For example, if you invested solely in Treasury Bills and earned a 2% annual return, 30 years would pass before you recouped a portfolio loss of 45%.

Expected Return	Approx. Number of Years to Recover a 45% Loss
2%	30
3%	20
4%	15
5%	12
10%	6
15%	4

There is no “correct” formula one can use to assess the trade-offs available to an investor. Your age, available assets, life goals and temperament all need to be considered as part of a long-term, pragmatic view.

Rather than dwell on historical data to re-enforce my views, let me summarize reasons not to abandon equity allocations.

Risk is multi-dimensional: Eliminating one risk may magnify another.

Stock prices and the business cycle: A recovery in stock prices tends to lead a recovery in economic conditions, and there is no evidence that risk premiums become reliably negative during recessions.

Risk premiums and economic conditions: Risk premiums tend to be lower when conditions are stronger and higher when they are weak.

Prices reflect all current information: Continuing bad news will not necessarily cause further stock price declines: it is news relative to expectations that counts.

Payback time: Weigh the upside of higher expected returns against the probability that equity markets will not reach previous highs within the payback period associated with a market-risk-free environment.

“Standing on the shoulders of giants”

That’s the way I feel when I share with you the ideas I have gained from financial economists Eugene Fama and Ken French. Both serve on the board of Dimensional Fund

Advisors and exhibit a rare humility combined with razor-sharp insights into the world of economics and finance. While financial economists abound, Fama and French are able to combine technical skill with an unwavering understanding – and patience with – the average investor’s psyche.

Here are some examples of their intellectual precision witnessed as they broach tough questions on some of today’s economic challenges. They are taken from their shared forum at www.dimensional.com/famafrench/

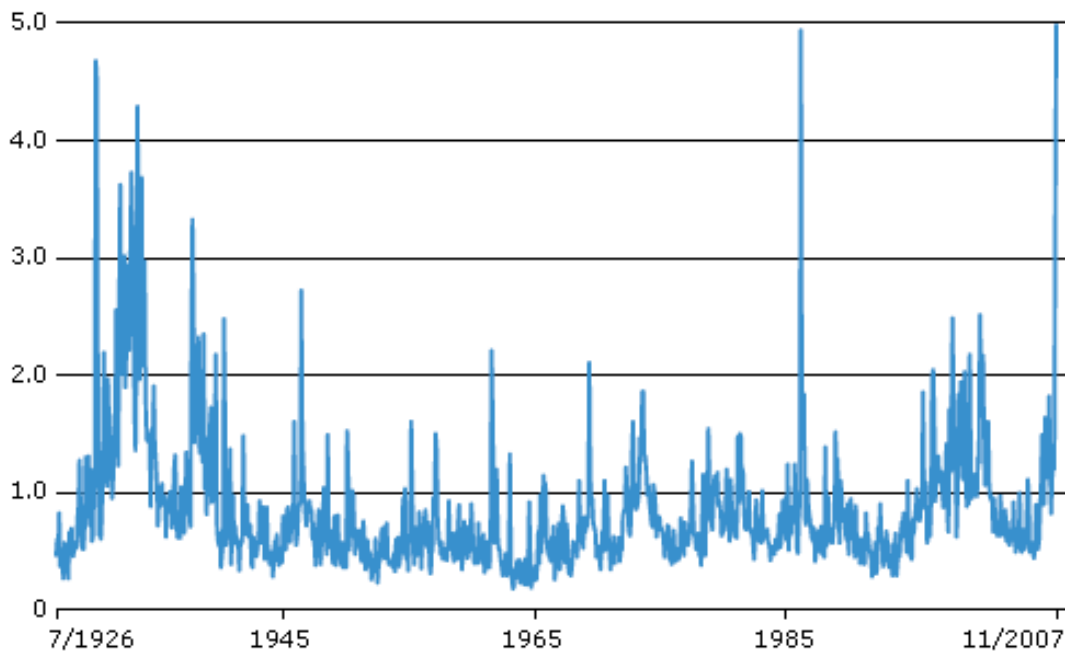
Is the market turmoil a sign that markets are not efficient?

The market turmoil is caused by some combination of (i) quickly fluctuating changes in expected cashflows (future profitability), and (ii) variation in investor risk aversion that leads to variation in expected returns (the discount rates for expected cashflows). Both responses can be rational. In short, a change in volatility, by itself, says nothing about market efficiency. Of course, it is interesting to ask why the volatility of expected cashflows and expected returns increased so much, but that requires a much longer analysis.

How useful is an approach based on historical data when the current situation appears to be unprecedented?

Any current situation is always somewhat unprecedented and somewhat old stuff. Large declines in stock prices occurred several times during the last 80 years. The nearby plot of the volatility of daily market returns shows that the current high volatility also has precedents in 1987 and in the 1930s, and to a lesser extent in 2000-2002. Periods of business uncertainty (for example, the onset of a recession) are typically associated with stock price declines and increases in volatility.

Intra-Month Daily Volatility, S&P 500, July 1926 to October 2008



What would happen if many investors decided to sell their stocks and invest in Treasury bills instead?

Stock prices would go down and T-bill prices would go up - the usual response of prices to changes in demand. Of course, when T-bill prices go up the yield falls. Similarly, a reduction in prices caused by a large number of investors moving out of stocks pushes expected returns up.

Stock market volatility is currently quite high. Does it make sense for investors to get out of the market until volatility settles down?

Fama (Excerpt): If the current high volatility makes you permanently averse to stock market volatility, and the inevitable variation in market volatility, you should get out. But you shouldn't have been in the stock market in the first place since fluctuations in volatility are the norm. If you eventually want to come back into the market, then you shouldn't leave. Bouncing in and out of the market is risky if your desired long-term asset allocation involves exposure to the market.

Bouncing in and out only makes sense if you can forecast increases and decreases in volatility before they occur, so you can miss the price declines associated with the onset

of high volatility and profit from the increases associated with the onset of low profitability. I doubt that anyone is that good at predicting changes in volatility.

French (Excerpt): So who should sell? Some investors have discovered that big losses hurt more than they expected, while others have concluded they are not as risk averse as they thought. If you are in the first group you might want to sell some equity, but if you are in the second group you probably want to take advantage of your high-risk tolerance and buy more. You might adjust your investments so they are more in line with your actual tastes, but once you do you should plan on sticking with your new portfolio.

Should I consider gold as a possible safe haven for some portion of my portfolio?

The volatility of gold prices (and of commodity prices in general) is much like that of stock returns. Gold is far from a safe haven.

Fearless Forecast 2008: Getting it wrong – at full speed.

For the past 17 years, Mercer (a blue chip global consulting firm) has surveyed Canadian and global investment managers to obtain their views on the direction of the economy and capital markets. The firm surveyed 48 investment professionals in the hope that their forecasts of what lay ahead in 2008 would help pension plan sponsors prepare for a year like few others.

The survey confirms just about everything did not go as planned. The managers were clearly unprepared for the head-on ‘unexpected’ news that came around the bend hurtling full speed down the tracks. The managers certainly did not expect the unexpected as indicated by these highlights from the January 2008 forecast. It shows the futility of trying to predict economic and market trends. I am betting that not one client is pleased with the survey results. But I also believe that their real fury is reserved for those who promised to do something they could not do – predict the future. I won’t embarrass those who contributed to the forecast by naming them. They know who they are and represent some leading financial institutions. Enough said.

Here are some highlights:

The Economy	Forecast	Actual
Canadian Exchange Rate (US\$/C\$)	1.00	0.82
Bank of Canada Overnight Rate	3.75%	1.50%
US Federal Funds Rate	3.50%	0.00-0.25%
Unemployment Rate	6.10%	6.30%
Actual Inflation Rate (CPI)	2.00%	2.00%
Real Canadian GDP Growth Rate	2.20%	0.70%
Real Global GDP Growth Rate	3.00%	3.60%
WTI Crude Oil Price (US\$/barrel)	\$85	\$44.60

Investment Benchmarks	Forecast	Actual*
S&P/TSX Composite	6.00%	-33.00%
S&P 500 (C\$)	7.00%	-21.20%
MSCI EAFE (C\$)	8.00%	-28.80%
MSCI Emerging Markets (C\$)	8.40%	-41.40%
DEX Universe Bond	4.00%	6.40%
DEX Long Bond	4.20%	2.70%
DEX Real Return Bond	2.00%	0.40%

*Total return in Canadian dollar terms for the 1-year period ending 31 December 2008

Top Performing Canadian Sector	Forecast	Actual
Financials	1st	9th

We all had quite an experience in 2008, so here's to a fresh 365 days full of promise, prosperity and peace.

Given this environment of bearish markets and weak economies, you may feel growing uncertainty about your own situation and the state of the world. Rest assured that you are not alone.

I would also like to let you know that although I am optimistic that we will eventually leave the worst behind us, I will continue to diligently monitor the present situation.

If you have any questions or suggestions, I would like to hear from you. Please visit davidrbruce.com and share your thoughts with me at your convenience.

On behalf of the rest of the Bruce Team, I wish you a restful and enjoyable winter season.

Yours sincerely,

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