

October 31, 2007

## ECONOMIC INDICATORS

### CANADA

	Dec. 2006	Sept. 2007	
GDP <sup>(1)</sup>	2.7	2.5 <sup>(3)</sup>	↘
CPI <sup>(1)</sup>	1.6	2.5	↗
Unemployment	6.1	5.9	↘

### UNITED STATES

	Dec. 2006	Sept. 2007	
GDP <sup>(1)</sup>	2.9	1.9 <sup>(2)</sup>	↘
CPI <sup>(1)</sup>	3.2	2.8	↘
Unemployment	4.5	4.7	↗

(1) Year-over-year % variation

(2) June 2007 (3) July 2007

Sources: Statistics Canada, U.S. Dept. of Commerce, U.S. Dept. of Labor Statistics.

## EQUITY INDICES

% Change	2007 in local currency	2007 in C\$	
S&P/TSX	10.8	10.8	↗
S&P500	8.3	-10.5	↘
Russell 2000	4.3	-13.8	↘
Nikkei	-4.2	-17.4	↘
S&P 350 Europe	5.3	-5.7	↘

PARKYN  
WERMENLINGER  
LAYTON  
CAPITAL INC.

## PERFORMANCE EVALUATION

Last week, a study released by Fidelity Investments Canada revealed that Canadians, on average, are set to replace only 50% of their working income at retirement. While our readers may have different views on whether this represents a sufficient retirement income, the study brings us back to a basic fact: saving and investing for retirement is an act of managing not only assets, but also liabilities.

Let's look at a basic version of the balance sheet for an average investor. It has two key assets: human capital (the present value of all future working income) and investments. It also has two key liabilities: lifestyle expenses until retirement and living expenses after retirement.

Two important rules apply to this balance sheet. First, human capital will deplete over time, as our investor moves closer to retirement. Second, providing for current lifestyle expenses is easier than providing for retirement liabilities, for the simple reason that saving and investing carries little immediate gratification compared to consumption. Obviously, savings and investments are there to provide for retirement. But it raises a fundamental question: Does the investment industry measure investment performance properly relative to investors' retirement objectives? We advocate that the answer is "no".

The investment industry analyzes performance in two ways. The first is called "relative return"- how well the portfolio has done relative to a benchmark index. While this method is useful for gauging whether a manager is doing a good job over short periods of time, it completely misses the point about long-term wealth creation - it does little good to beat the S&P/TSX by 2% if the index returned -30%. The second performance evaluation method is called "absolute returns" (for example, setting a return objective of 7%). This method addresses the key flaw of the relative return technique (it measures asset return), but it still has a huge drawback. By concentrating solely on asset returns, the investor still misses the objective of providing for retirement liabilities. It is counterproductive to grow assets if liabilities grow even faster. Moreover, neither relative nor absolute returns address the issue of portfolio risk.

In our view, investors should evaluate performance based on the evolution of their net financial position. A simple way to express financial performance (yet complex to calculate) is the income replacement ratio. Has it improved in the last three years or deteriorated? Is it on its long-term target, or way off? While we recognize that relative and absolute returns are useful in monitoring investment performance, their importance is only secondary to the net financial position. Portfolio return volatility must also be monitored in order to ensure that its risk level matches the initial objectives and constraints of the investor.

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