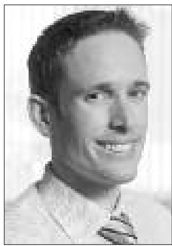


Andrew Baechler

Financial Planning

Volatile Markets – A Lesson Learned

Why you need to stop and consider long-term market trends before panicking.

In my recent article "Booms and Bubbles" (*Ontario Dentist* June 2008) I asked readers whether the bull market in commodities would continue unabated, and I'm sure many of you felt that indeed it would. Oil was climbing towards $140 USD a barrel and there seemed to be nothing stopping its increase. Now I wonder if you think oil will even trade above $100 in the next 12 months. Many of us suffer from a recency bias — projecting current market conditions too far into the future and forgetting about long-term market trends and cycles.

Major World Sell-Off

Presently we're experiencing a major sell-off in the world's financial markets. I cannot predict if they will correct themselves over the next one to three months, but I am confident that over the next one to three years we will look back on this crisis as just one of many that investors must endure in a capitalist economy.

The Key Issue and AIG

So what is the key lesson that we all need to remember in the next boom time? Consider the recent example of the world's largest insurance company, American International Group (AIG). This company didn't understand the risks that it was taking on its own balance sheet. AIG underwrote a huge number of derivative contracts, called credit default swaps (CDS), which work like insurance in that they guarantee against a company failing to pay back its debts. If I was concerned that Wal-Mart might go bankrupt, I could purchase a CDS to cover an investment I might have made in Wal-Mart bonds. AIG's CDS contracts insured a whopping $441 billion of fixed income investments, including $57.8 billion in securities tied to subprime mortgages. In boom times these CDS contracts were highly profitable for AIG, but when the circumstances changed, having a balance sheet containing a large number of complex, high-risk financial products spelled financial ruin. Here's a question to consider: how can you be certain that your investments are:

a) appropriately matched to your investment goals,
b) not liable to self-destruct and
c) have an appropriate risk/return profile for you?

Earning a huge return on your investments is great, but if you don't understand the underlying risk of those investments, you could be setting your portfolio up for economic disaster not unlike AIG.

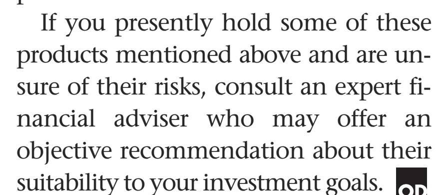
The list of structured, complicated products that are sold to individual investors each day is extensive and includes:

- hedge funds
- principal protected notes
- exchange traded notes
- index-linked GICs
- flow through shares
- labour sponsored funds; and
- guaranteed minimum withdrawal benefit annuities.

Remember to Read

If possible, read the prospectus or information statement that may accompany the above products or have your advisor fully explain all the associated downside risks. Ask how your advisor is compensated by the products he or she sells you. Some products, notably hedge funds, do not have to disclose a lot of information. To me this should be an immediate red flag — you may be marketed a product based on its previous historical returns.

If you presently hold some of these products mentioned above and are unsure of their risks, consult an expert financial adviser who may offer an objective recommendation about their suitability to your investment goals. OD



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The ideas, opinions, and recommendations contained in this article are those of the author and do not necessarily represent the views of PWL Capital Inc.