

December 18, 2008

Economic Indicators

Canada

	Dec. 2007	Nov. 2008	
GDP ⁽¹⁾	2.7	0.5 ⁽²⁾	↘
CPI ⁽¹⁾	2.4	2.6 ⁽³⁾	↗
Unemployment	5.9	6.3	↗

United States

	Dec. 2007	Nov. 2008	
GDP ⁽¹⁾	2.2	0.8 ⁽²⁾	↘
CPI ⁽¹⁾	4.1	3.7 ⁽³⁾	↘
Unemployment	5.0	6.7	↗

⁽¹⁾ Year-over-year % variation

⁽²⁾ September 2008 ⁽³⁾ October 2008

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

Equity Indices

% Change	2008 in local currency	2008 in C\$	
S&P/TSX	-38.9	-38.9	↘
S&P 500	-38.2	-25.4	↘
Russell 2000	-36.1	-22.8	↘
Nikkei	-43.4	-14.9	↘
S&P 350 Europe	-45.1	-35.0	↘

THE ANATOMY OF SAVING AND INVESTING – PART 4

The first part of this series demonstrated how decisions about saving and portfolio risk are intertwined. Parts 2 and 3 reviewed how asset-class risk determines the hierarchy of expected returns. This final section will touch on another key element of investing: *risk*.

While many definitions of risk may be pertinent to the world of investments, in general, investors are concerned with the probability of losing large amounts of money. Part of this risk can be eliminated. The risk of losing money due to the collapse of a single company or sector (“concentration risk”) can be reduced to zero through diversification.

In contrast, the risk of losing money due to a general decline in the equity markets (“market risk”) can only be eliminated through risk avoidance, which has a cost: the investor has to settle for short-term government bonds and GICs. This choice, while legitimate, will inevitably lead to low returns and a more frugal lifestyle in the future.

As investors feel the pinch of the current bear market, they are painfully reminded how significant market risk is. Witness the loss inflicted on the S&P/TSX during the worst periods since 1956 (dividends included):

S&P/TSX Index Worst Negative Periods 1956–2008

August 2000–September 2002	2 years	-43%
June 1981– June 1982	1 year	-39%
May 2008–November 2008	7 months	-36%

Source: Ibbotson Associates

The most difficult thing about being invested during a bear market is that no one can predict when it’s going to end and how long it will take to recover the previous high. Historically, the early part of the recovery has been strong, with the first six months following a bear market returning an average 20%. The recovery process is also typically long. On average, it takes about twice the amount of time taken by the decline to recapture the market peak. So if the bear market lasts one year, it will take an average of 2 years to return to the historical high. But these are only averages. They provide an indication of what the future may look like, not a guarantee.

In conclusion, losing money during bear markets is the expensive price paid by investors for the extra expected return of stocks over bonds. Investors have had their share of pain this decade, with two of the worst post-war stock-market declines affecting the financial situation of individual investors and institutions alike. Ironically, as the patience of more and more investors wears thin, this decline is also making stocks more affordable, per dollar of dividend, than they have been over a decade—perhaps setting the stage for sustained positive returns in the future.

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