



# Markets This Week

March 11, 2006

In This Issue:

**Investment Idea**

**Quiz**

**Our Portfolio**

**Market Highlights**

**S&P 500 Charts**

**TSX Canada Charts**

**Economic and Valuation Indicators**

**Behavioral Finance Indicators**

**Our Model Portfolios**

**Answer to the Quiz**

---

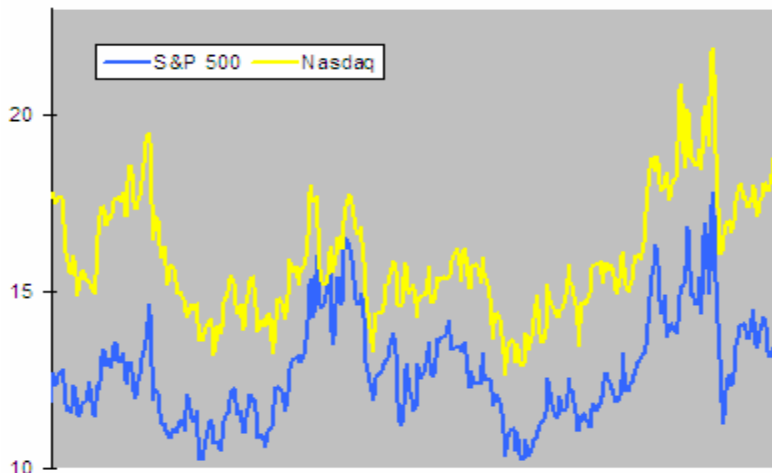
## Investment Idea

Q: Is it better to buy stocks with low or high volatility?

A: A lower volatility is preferred assuming that returns are the same. In simple terms, a lower volatility means a lower risk and a better sleep at night. Additionally, if an investor has to quickly sell a stock that has a high volatility, it is possible that he/she would have to accept a much lower price if the stock is in a downtrend.

For example, let's compare the volatility of the two main indexes, namely the S&P 500 (volatility symbol VIX) and Nasdaq (volatility symbol VXN) during the last year (Chart 1).

Chart 1. Volatility (Standard Deviation %)



The average volatility for the S&P 500 was 12.7%, while Nasdaq's was 15.9%. Hence, an investor would correctly conclude that investing in Nasdaq is riskier than investing in the S&P 500.

N.B. Nasdaq is based on high-tech stocks and, unlike the S&P 500, does not offer benefits from diversification by different industries.

---

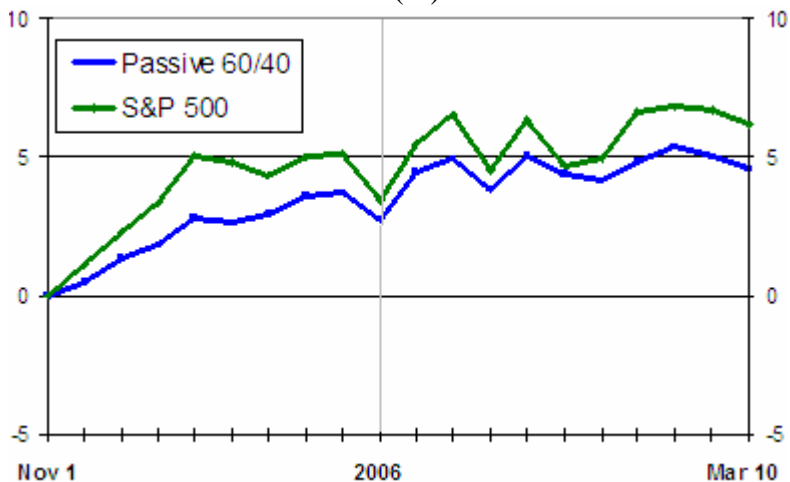
## Quiz

Which of the following investments would be expected to have the lowest level of volatility?

- A) A bond issued by a company that faces bankruptcy
  - B) A technology stock with a high expected return
  - C) A well-diversified portfolio of stocks and bonds
  - D) S&P 500 Index
- 

## Our Portfolio

Chart 2. Cumulative Returns (%)



Since inception, the S&P 500 has outperformed our passive and conservative 60/40 portfolio by 1.6%. Still, our portfolio realized a lower volatility and a respectable 4.59% return (after commission).

---

## Market Highlights

### March 4 – Mar 10, 2006

- This week, the markets managed to end the week with a small loss (Charts 3 – 6). We continue to believe the market will have a fairly tough time breaking through the resistance level set in the middle of January.

- The Bank of Japan has finally ended its ultra-loose monetary-policy stance. This move signals a greater degree of confidence for the yen and Japan's economy.
- The US employment data was largely in line with expectations while the Canadian unemployment rate went down to its lowest level in 30 years.
- The 213-year old New York Stock Exchange finally went public. Its debut comes amid investor enthusiasm for the shares of exchange operators, due to growth in transaction volume and increased profits.
- The London Stock Exchange rejected Nasdaq's takeover bid. The combined exchanges would be the world's largest with over 6,000 companies listed.
- The US mortgage rates are at the highest level since September 2003. The rates are expected to go steadily up as the Central Banks respond to strong economic growth around the world.

### Worth Watching

- A very interesting twist occurred with the Google and Yahoo search engines. After refusing to disclose the IP addresses of potential pedophiles to the US authorities, Google and Yahoo are cooperating with the Chinese government in blocking information related to human rights. Access to the vast Chinese market must have played a role in the decision.
- The report by Citigroup claims that the avian flu pandemic could reach North America within a few years. In the meantime, the producers of pork hope that a rise in consumer anxiety will translate into higher sales of pork.
- The upcoming week is full of economic releases (e.g. retail sales, inflation and housing) that may have a significant impact on the capital markets.

### S&P 500 Charts

Chart 3 – 4: 10 Years and Last 10 Days



Charts courtesy of StockCharts.com

## TSX Canada Charts

Chart 5 – 6.: 10 Years and Last 10 Days



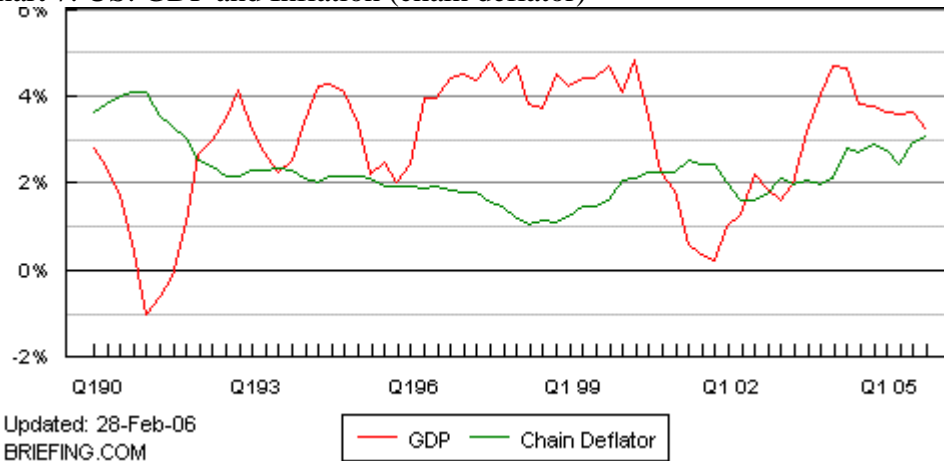
Charts courtesy of StockCharts.com

## Economic and Valuation Indicators

### Economic Performance

The US economy continues its steady course, albeit at a slower rate than that seen a couple of years ago (Chart 7).

Chart 7. US: GDP and Inflation (chain deflator)

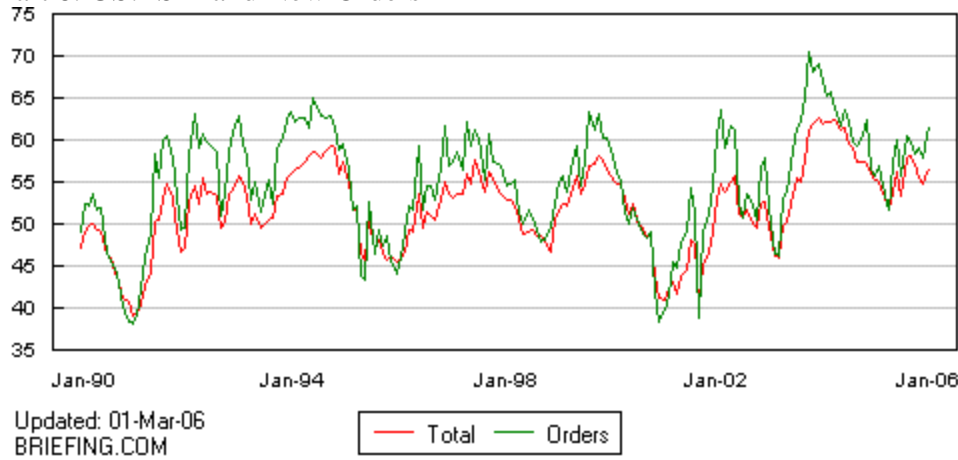


### ISM

The ISM is one of the best leading indicators of US economic activity and is viewed as a swing factor preceding economic upturns and downturns (Chart 8). New orders provide

the forward read on production and employment. Currently, the ISM index and new orders signal a continuation of economic expansion.

Chart 8. US: ISM and New Orders



### Yield Curve

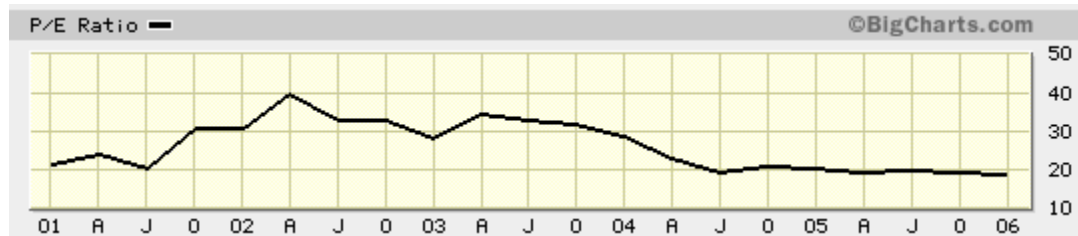
The shape of the yield curve is often a leading indicator of both economic activity and the stock market. The current upward slope indicates the continuation of economic growth.

[View yield curve](#)

### Price-to-earnings Valuation

The most common valuation measure for equities is known as the P/E (price to earnings) ratio. Presently, the S&P 500 is somewhat overpriced but not too overpriced at its current level of 19.25 (Chart 9). The current low inflation rate environment is more supportive of higher valuations because earnings are not reflecting a high inflationary component.

Chart 9. P/E Ratio for S&P 500



N.B. Our analysis focuses mostly on the US economy given its size and importance. Comparable Canadian data can be found in the Statistics Canada and Bank of Canada databases.

---

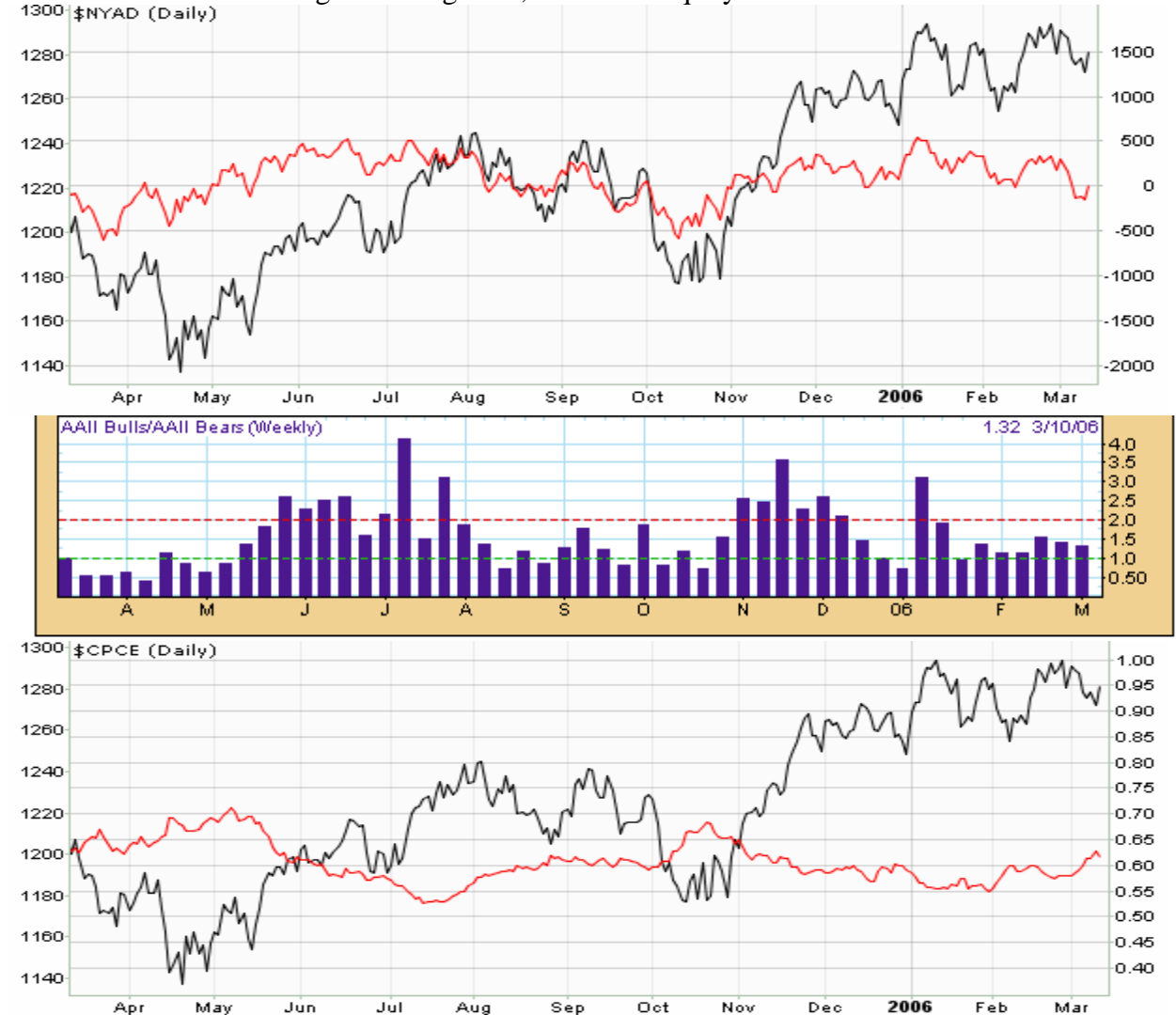
## Behavioural Finance Indicators (see explanation)

We continue to believe that equities reached an important peak in the middle of January 2006.

The following factors support our conclusions:

- Chart 10 - divergence between prices (went up) and advancing/declining line (declining)
- Chart 11 - high degree of optimism (at the beginning of January) by small investors as represented by AAI
- Chart 12 - confidence exhibited by equity option buyers (in January) who tend to be reliably wrong at important market junctures

Charts 10 – 12: Advancing/Declining Line, AAI and Equity Put/Call Ratio



Charts courtesy of StockCharts.com and DecisionPoint.com

## Our Model Portfolios

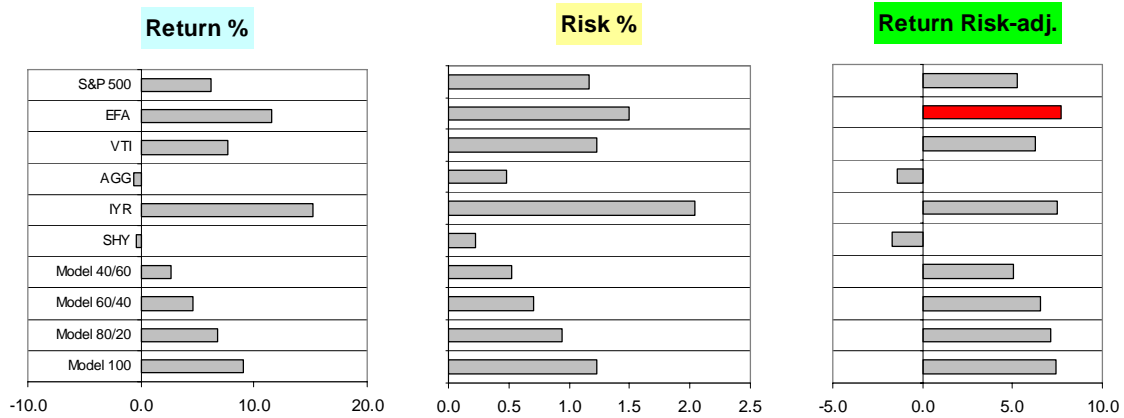
### US Portfolio

Conclusions based on the Charts 13 - 15.

Since inception, the EFA (Morgan Stanley Index for Europe and Asia) has been the best investment on a risk adjusted basis. In the absolute-return category, IYR (Real Estate Index) has had the highest return although its volatility has also been disproportionately high.

Our model portfolios re-confirmed that a higher return usually comes with a higher risk.

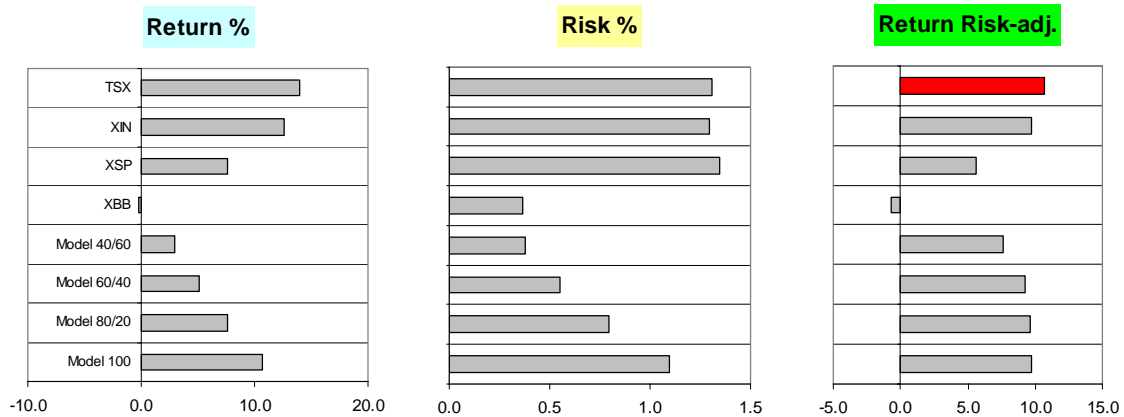
Note: The names and symbols of securities are provided at the bottom of this section.



### Canadian Portfolio

Conclusions based on the Charts 16 - 18.

Since inception, the TSX has been the best investment on a risk adjusted basis, surpassing our four portfolios which continue to deliver respectable gains combined with a lower volatility.



Name	Ticker Symbol
S&P 500	SPX
ishares MSCI EAFE	EFA
Vanguard Total Stock	VTI
ishares Lehman Aggr. Bond	AGG
ishares Real Estate	IYR
ishares Lehman 1-3 yr Treasury	SHY
TSX - Canada	TSX
Canada - Fixed Income	XBB
Canada - S&P 500	XSP
Canada - MSCI EAFE	XIN

---

### Answer to the Quiz:

C is correct. The well-diversified portfolio lowers volatility by combining two asset classes (e.g. stocks and bonds). Such a portfolio benefits from the low correlation between stocks and bonds (i.e., at times, the stock prices will go down while bond prices go up). To view a practical application of this concept, please go to the section that described our model portfolios.

---

#### Copyright

The contents of this publication are the property of InvestWELL Financial and may not be summarized, reproduced, or rebroadcast in any fashion without our written permission.

#### Disclaimer

InvestWELL Financial's first priority, as a provider of independent and unbiased financial information, is to educate our clients. Not only do we provide practical information about securities, but we also coach our clients to become successful independent investors. As such, InvestWELL Financial does not assume any responsibility whatsoever for the use of any information from the website or related publications. Although all sources of information are vetted and the information is believed to be reliable, it is not provided as investment advice. Past performance is not an indicator of future performance in securities. Each portfolio must be balanced and based on personal circumstances. High-risk investment decisions should be made in consultation with a professional.

InvestWELL receives no commission or benefit of any kind from the companies whose securities InvestWELL Financial showcases. We do not necessarily own shares in the showcased securities, but if we do, these shares would only form a very small part of widely-held and publicly distributed companies. There is no intention whatsoever of profiting in a manner where the price-impact of trading or holding of a security might arise. The website and related publications of InvestWELL Financial are intended to only be used for educational purposes.

Thank you for reading Markets This Week.

Please feel free to share it with your friends.