



Markets This Week

March 4, 2006

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Investment Idea

Q: Is it a good idea to buy mutual funds with high MER (Management Expense Ratio)?

A: No, as a general rule. The Globe and Mail has studied US mutual fund managers over the last decade and concluded that only 16% of them managed to outperform the S&P 500 index (more importantly, they outperformed an index only marginally!).

There is overwhelming evidence that passively managed funds (indexes with low MERs) outperform actively managed funds (funds with high MERs). Consider the following:

- The equity markets are very efficient, which means that professional money managers find it very difficult to beat an index consistently
- Actively managed funds have higher costs (by 2% on average)
- Passively managed funds allow investors to postpone taxes

In conclusion, buying funds with high MERs makes sense only to brokers who sell them to earn commission.

Quiz

When could you consider buying an actively managed fund (with high MER), despite evidence that such funds underperform an index?

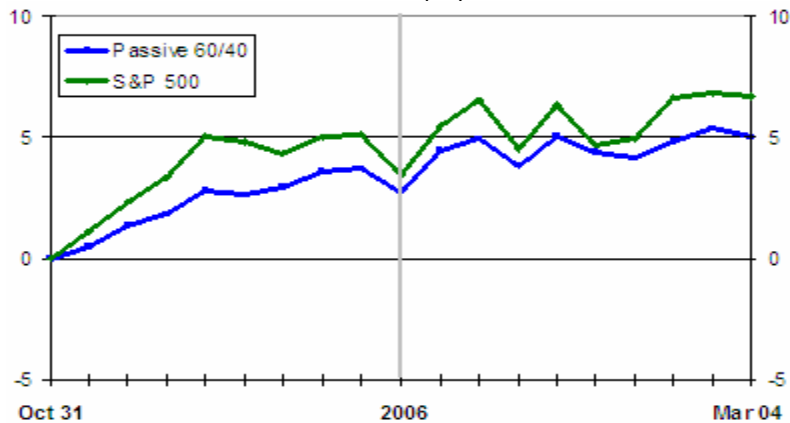
- A) You like the name of the fund
- B) Your neighbor believes it is a sure winner

- C) You like their advertising campaign
- D) Benefits of diversification by management style
- E) The fund has done really well recently

Answer to the quiz at the bottom of the newsletter

Our Portfolio

Chart 1. Cumulative Returns (%)



Since inception, S&P 500 has outperformed our passive and conservative 60/40 portfolio by 1.72%. Still, our portfolio realized a lower volatility and a respectable 4.98% return.

Market Highlights

Feb 25 – March 3, 2006

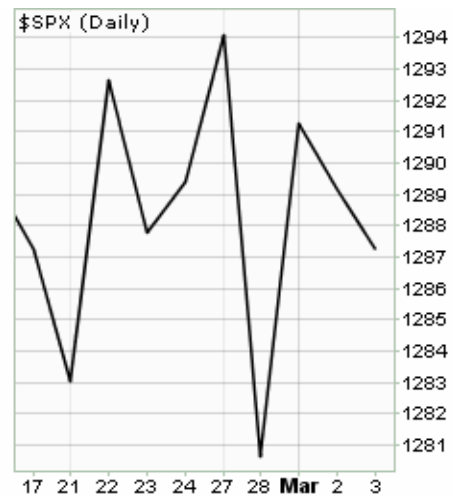
- This week, the market tried again and could not break through the resistance barrier set on Jan. 11, 2006. We continue to believe that equities will not be able to break into a sustainable higher level in the short term (Charts 2 – 5).
- The European Central bank raised its key interest rate to 2.5% due to the strong momentum of the Euro economy.
- The assets of the US Exchange-traded Funds (ETFs) broke through the \$300 billion. The ETFs have experienced tremendous growth since 2002 when their asset stood at \$82 billion. The ETFs are one of the best instruments for individual investors due to their cost and tax efficiency.
- In 2005, the average home in the US appreciated by 12.95%. However, the signs are emerging that the real estate market is ready for a sizeable downturn (although real estate agents are starting to call it “buyers’ market”).

Worth Watching

- Mutual funds that resemble hedge funds (i.e. market neutral with long-short positions) are gaining popularity in the US. Despite their higher fees, investors view them as safer than hedge funds due to the tight mutual fund regulations.
- Since the beginning of 2004, the US equities have traded in a narrowing tunnel (Chart 6). We expect that the narrowing of the range will soon lead to a significant breakout which can set a stage for a new trend.

S&P 500 Charts

Charts 2 – 3. 10 Years and Last 10 Days



Charts courtesy of StockCharts.com

TSX Canada Charts

Charts 4 – 5. 10 Years and Last 10 Days



Charts courtesy of StockCharts.com

Chart 6. S&P 500 Narrowing of the Range



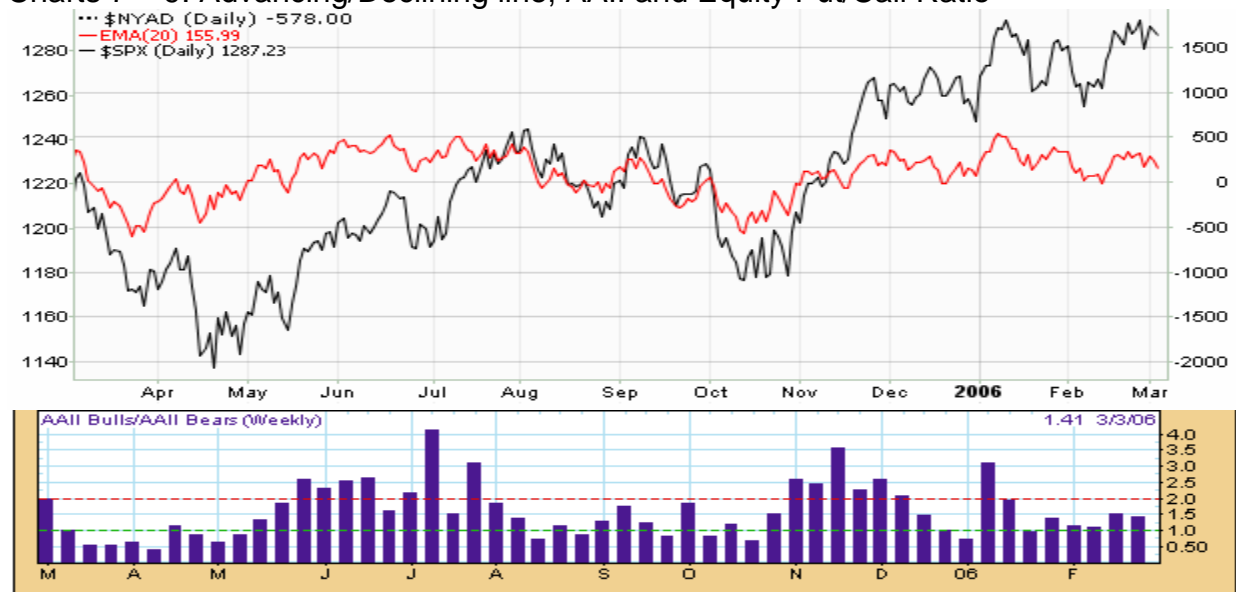
Charts courtesy of StockCharts.com

Behavioral Finance Indicators ([view explanation](#))

In the last week, equities attempted to rally several times. They failed to pass the resistance level of January 11, 2006. Usually, when the market cannot go up, it comes down. (Please keep in mind that buy-and-hold, long-term investors are better off without trying to time the short-term market up and down moves). Our three favorite indicators show that the high of January 2006 resembles August 2005:

- Chart 7 - divergence between prices (went up) and advancing/declining line (flat)
- Chart 8 - high degree of optimism by small investors as represented by AAll
- Chart 9 - confidence exhibited by equity option buyers who tend to reliably wrong at important market junctures

Charts 7 – 9. Advancing/Declining line, AAll and Equity Put/Call Ratio





Charts courtesy of StockCharts.com and DecisionPoint.com

Answer to the Quiz:

D is correct.

If the great majority of your portfolio is already invested in low cost, passively managed instruments, one could make an argument for potential benefits of diversification by management style.

N.B. Actively managed funds do poorly in efficient markets (e.g. US and Canada), but have a better performance in less efficient markets (e.g. the emerging countries). Hence, an argument could be made that money managers are able to add value if they invest in less efficient markets.

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