



Markets This Week

March 18, 2006

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Investment Idea

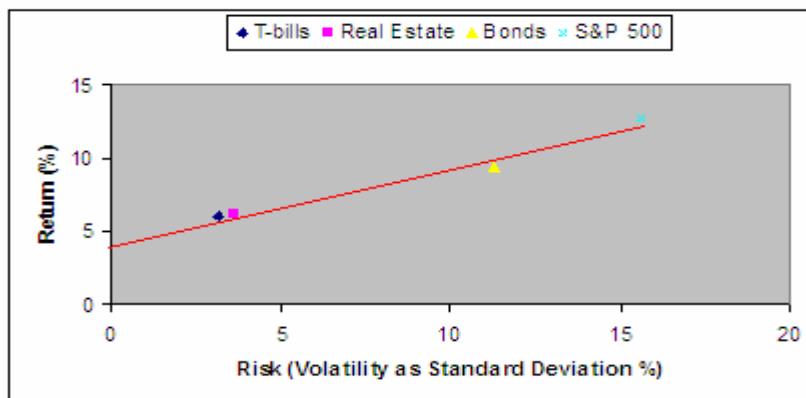
Q: What is the trade-off between return and risk?

A: The return-risk trade-off can be illustrated in a return-risk diagram. For instance, let's consider the performance of the following asset classes during the last 30 years (Table 1 and Chart 1).

Table 1. US: Returns and Risk (in % Annualized) 1975 - 2005

	T-bills	Real Estate	Bonds	S&P 500
Return %	6.00	6.19	9.37	12.70
Risk %	3.20	3.65	11.30	15.60

Chart 1. US: Returns and Risk (in % Annualized) 1975 - 2005



Source: Ibbotson (T-bills, Bonds and S&P 500) and OFHGO (Real Estate)

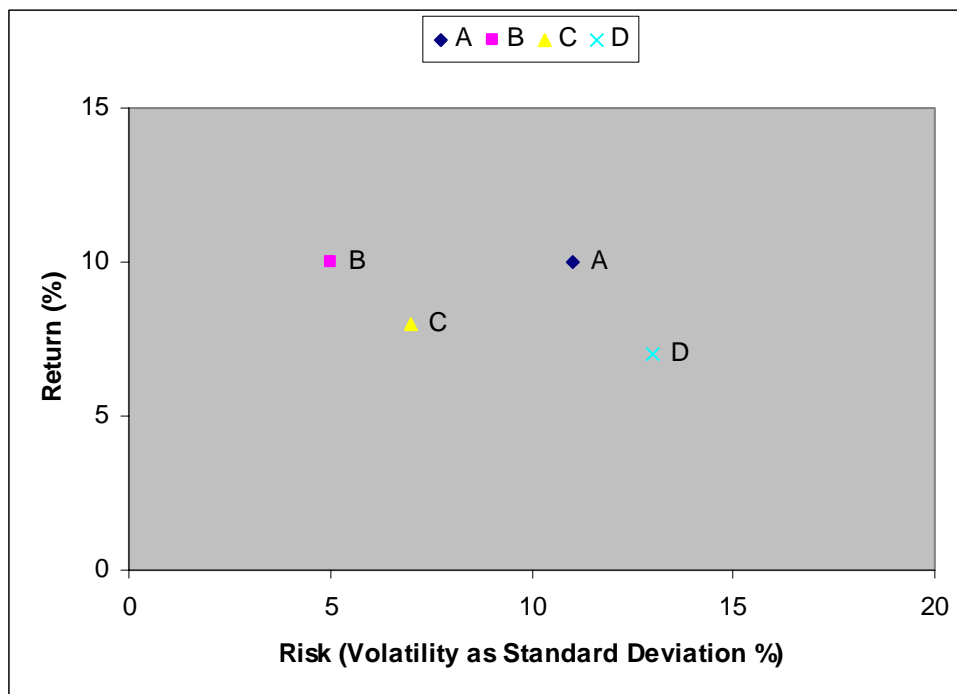
The straight red line illustrates the trade-off between return and risk. As our potential returns increase, our risk rises accordingly. Although we are using US data, the comparison is quite valid in the international context.

N.B. The low numbers for real estate are not a mistake (please refer to the OFHGO source). The performance of real estate has been outstanding over the last five years, but mediocre when measured over 30 years. Please keep in mind the numbers do not account for the effect of taxation (some forms of real estate are tax exempt) and interest deductibility (in the US, interest rates on mortgages are tax deductible).

Quiz

Which of the following investments shown in Chart 2 represents the most optimal return-risk trade-off?

Chart 2. Return-risk Trade-off (in % Annualized)

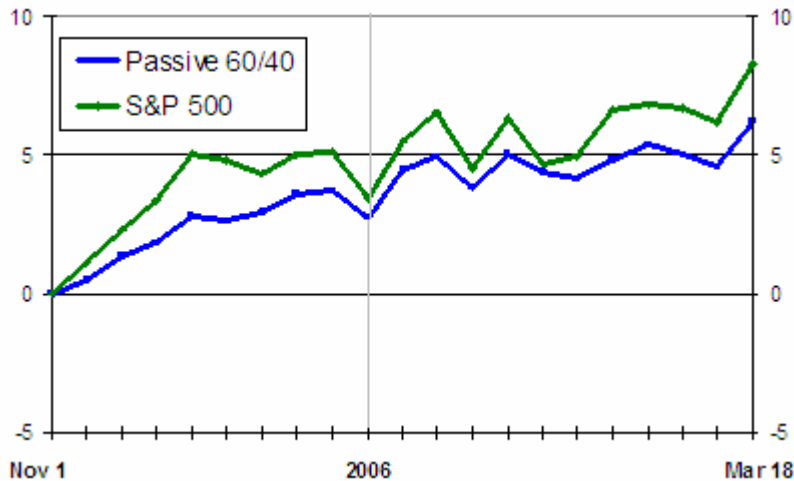


- A) A
- B) B
- C) C
- D) D

Answer at the bottom of the newsletter.

Our Portfolio

Chart 3. Cumulative Returns (%)



Since inception, the S&P 500 has outperformed our passive and conservative 60/40 portfolio by 2.06%. Still, our portfolio realized a lower volatility and a respectable 6.24% return.

Market Highlights

March 11 – Mar 17, 2006

- This week, the markets moved strongly up (Charts 4 – 7), reaching their highest level in almost five years. The market strength was related to the low inflation data and high profits reported by financial companies (e.g., Bear Stearns, Lehman Brothers and Goldman Sachs).
- The S&P 500 index surpassed its high of January 11, 2006 by 1.01%. It is still uncertain if the market can hold the gains. As we stated before, the market has been trading in a channel since January 2004 (see Chart 8) and the recent action suggests the market is looking for either an up or down breakout.
- H & R Block shares plummeted over 10% as New York Attorney General Eliot Spitzer charged the company in a lawsuit claiming that its retirement-savings product generally depleted account balances instead of building nest eggs. Indeed, the set-up fee, re-contribution fee and termination fee exceeded the interest paid for 85% of account holders.
- The housing starts statistics reached a new high in February. We are waiting for this Thursday's housing sales data to check if demand matches the new supply. The housing market may soon enter interesting times.

Worth Watching

- We are concerned about the Toronto Stock Market (TSX) setting new highs without broadly based stock participation (Chart 9). Note that the prices shown in Chart 9 are moving higher (black line) and the advancing-declining ratio (red line) has been flat since March 2005. The situation reminds us to some degree of the Nortel price surge that propelled the TSX index to its new high in 2000 and then pulled it down fiercely. There is a similarity here given that many of the resource stocks are trading on high expectations rather than actual profitability. Could it be that the resource stocks have become the new Nortel?
- Since February 2006, despite high oil prices, the equity markets in the Middle East have taken a pounding, with declines as much as 30%. The fall in share prices was preceded by unrealistic expectations (with a P/E ratio of over 30). The traders in Dubai called for government intervention to reverse the decline (interestingly enough, a few years ago the same traders asked the government to free up the financial markets). We are reminded once again, “Investors of the world – diversify!”

S&P 500 Charts

Chart 4 – 5: 10 Years and Last 10 Days



Charts courtesy of StockCharts.com

TSX Canada Charts

Chart 6 – 7: 10 Years and Last 10 Days



Charts courtesy of StockCharts.com

Chart 8: The Trading Channel – S&P 500



Chart courtesy of StockCharts.com

Chart 9: TSX and Advancing-Declining Ratio



Chart courtesy of StockCharts.com

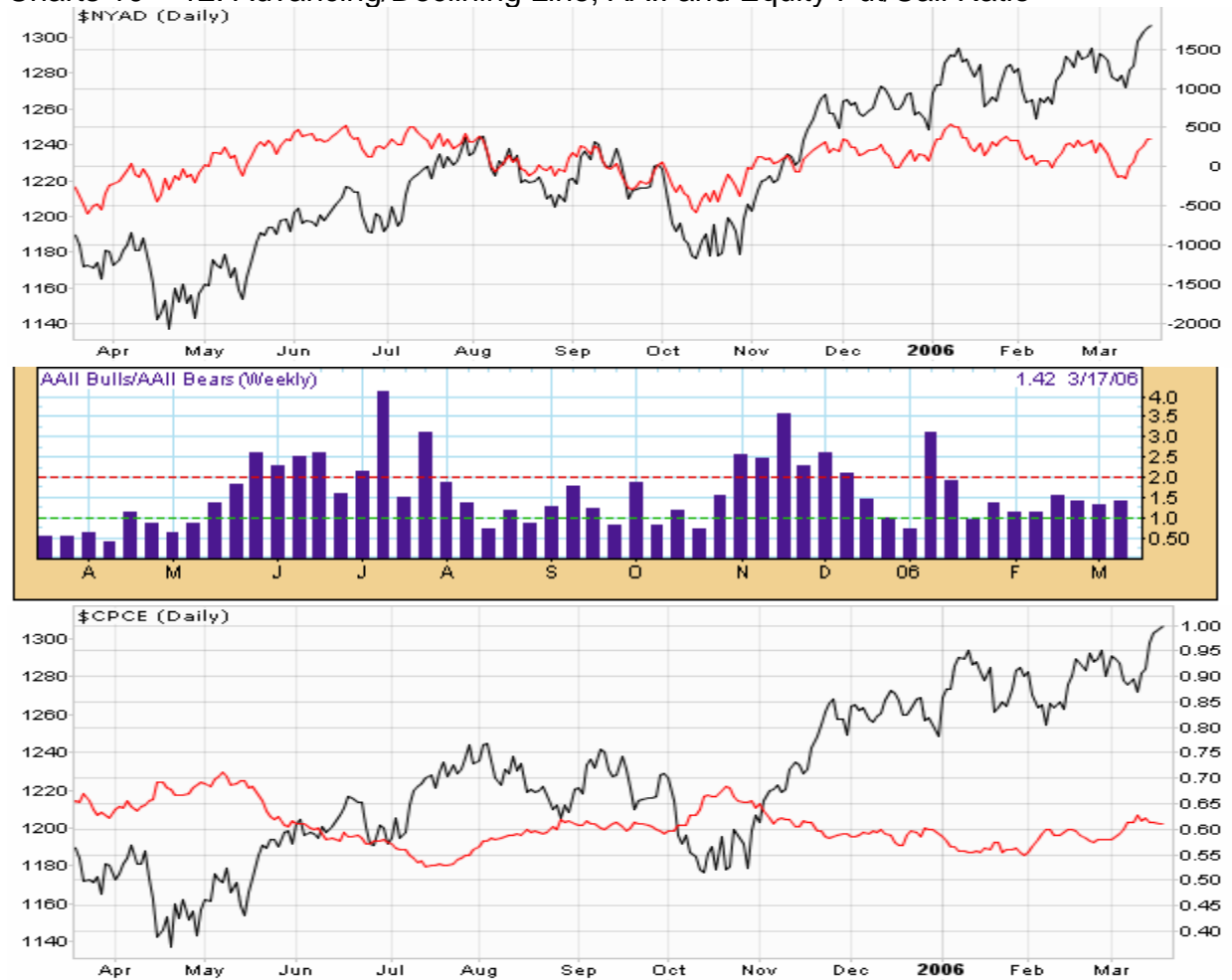
Behavioural Finance Indicators (see explanation)

The market has surpassed the January 11th high by 1.01%. The indicators are mixed (some pointing to the continuation of the advance, and others showing that the market is heading down). For now, we continue to believe that the new high is not sustainable but we are ready to change our mind if the situation changes. Investing is more about return-on-investment than being right.

Please consider the following factors:

- 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 – low put/call ratio, 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

Answer to the Quiz:

B is correct. B offers the highest return combined with the lowest risk. D is clearly the worst option as it has the lowest return and the highest volatility.

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