



# Markets This Week

March 25, 2006

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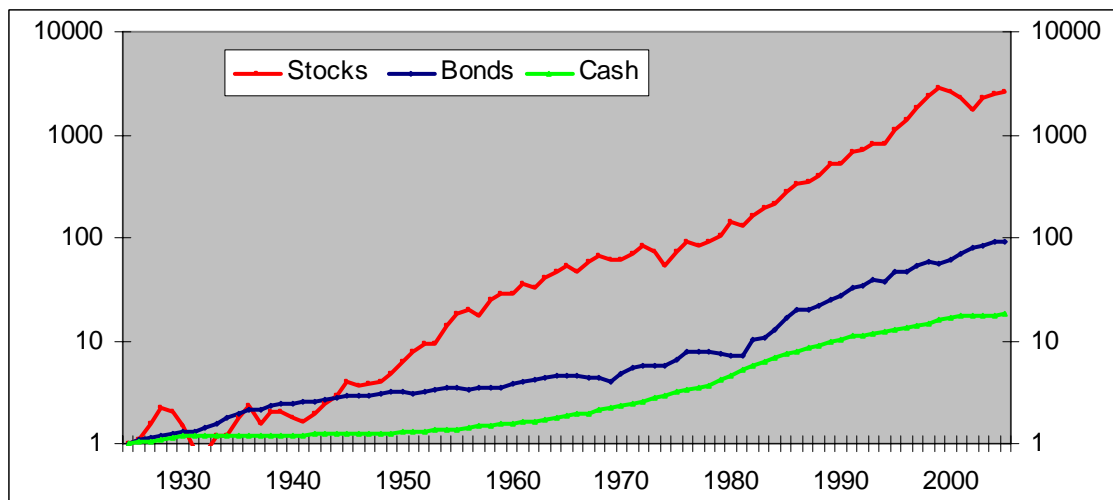
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## Investment Idea

Question: Can investing be safer than keeping money in the bank?

Answer: Yes, if done properly. There are two reasons for it. 1) the magic of compounding; 2) the eroding power of inflation. For instance, let us assume that an investor bought three different asset classes in 1925. Namely, stocks, bonds and cash. Please see chart 1 to view the cumulative effect after 80 years.

Chart 1. \$1 Invested 1925 - 2005



Source: Ibbotson (US Data)

In 80 years, \$1 in stocks would grow to \$2658, in bonds \$93 and in cash \$18. During the same time, inflation was 3% per year which amounts to \$11 after 80

years. Thus, we should subtract \$11 from the above quoted numbers for stocks, bonds and cash.

The growth from \$1 to \$2658 in stocks was not an easy ride. There were years when stocks declined by over 40% (during the great depression) or rose by the same amount. However, stocks not only provided superior gains in the long run, but also a solid protection from inflation. To reduce volatility of stocks, it is recommended that investors combine stocks with other asset classes (e.g. bonds) in their portfolios.

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### Quiz

Why do stocks offer the highest potential gains if held over a long period of time?

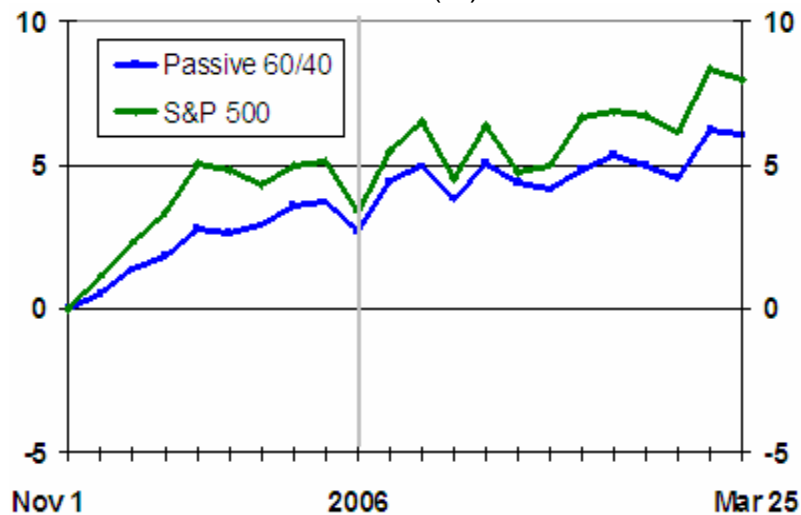
- A) Due to dividends paid to shareholders
- B) The effect of compounding
- C) The government intervention
- D) The impact of liquidity

Answer at the bottom of the newsletter.

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### Our Portfolio

Chart 2. Cumulative Returns (%)



Since inception, the S&P 500 has outperformed our passive and conservative 60/40 portfolio by 1.89%. Still, our portfolio realized a lower volatility and a respectable 6.06% return.

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## Market Highlights

**March 18 – Mar 24, 2006**

- This week, the US market went slightly down (charts 3 – 4) as the stocks were trying to find their new support and resistance level within a narrow range which has persisted since January 2004.

**Chart 3 – 4. S&P 500: 10 Years and Last 10 Days**



Charts courtesy of StockCharts.com

- The Canadian markets finished the week higher on the strength of commodities (charts 5 – 6).

**Chart 5 – 6. TSX Canada: 10 Years and Last 10 Days**



Charts courtesy of StockCharts.com

- Wal-Mart has announced that it will hire 150,000 employees in China over the next five years. While the number appears large, one should keep in mind that China has a population of over one billion.
- The housing sales data was mixed. It appears that demand for housing is still holding ground in the face of an upcoming slowdown.
- Critics of mutual funds have maintained that the mutual funds' incentive structure is not aligned with investors. Simply put, mutual fund managers get paid even when they do not do a good job! Mutual fund managers get paid even when they do not do a good job (we repeated it just in case our readers missed it the first time). However, brand new funds are beginning to put a twist on that proposition, creating a fee structure that actually could leave management getting absolutely nothing if it can't deliver expected results. We will be paying attention to these new developments.
- Vanguard Group has rolled out new target retirement funds. These products are quietly gaining popularity with investors due to their simplicity and predictability. In general, the funds pick a target year for retirement (e.g. 2020) and gradually adjust the risk level as the retirement date approaches.
- The Canadian darling – Tim Hortons (symbol THI), a coffee shop closely associated with the Canadian identity, went public on Friday. The trading was brisk with a volume of over 17 million shares in Toronto. The IPO (Initial Public Offering) was priced at \$27 per share. It opened at \$37 and closed at \$33.1 (see chart 7). The research indicates that stocks tend to decline slightly after the IPO. During the strong bull market, however, IPOs also do well since people buy anything that moves and pay little attention to the value (this comment is not necessarily related to Tim Hortons).

Chart 7. The First Day of IPO of Tim Hortons



## Worth Watching

- Homeowners and real estate investors nervous about a bursting of the housing bubble will soon be able to hedge the value of their homes. S&P announced that on April 10<sup>th</sup>, it will unveil several home-price indexes which can be traded on. This is a very welcome development as houses represent the largest and often most illiquid asset for many people. The indexes will initially include 10 large US metropolitan cities.
- Some hedge funds are warning that the industry returns will likely decline. In general, hedge funds rely on exploiting market opportunities. As the amount of hedge fund assets go up, hedge funds have to chase after a finite number of opportunities. Consequently, their returns suffer as opportunities are not easy to find in efficient capital markets.

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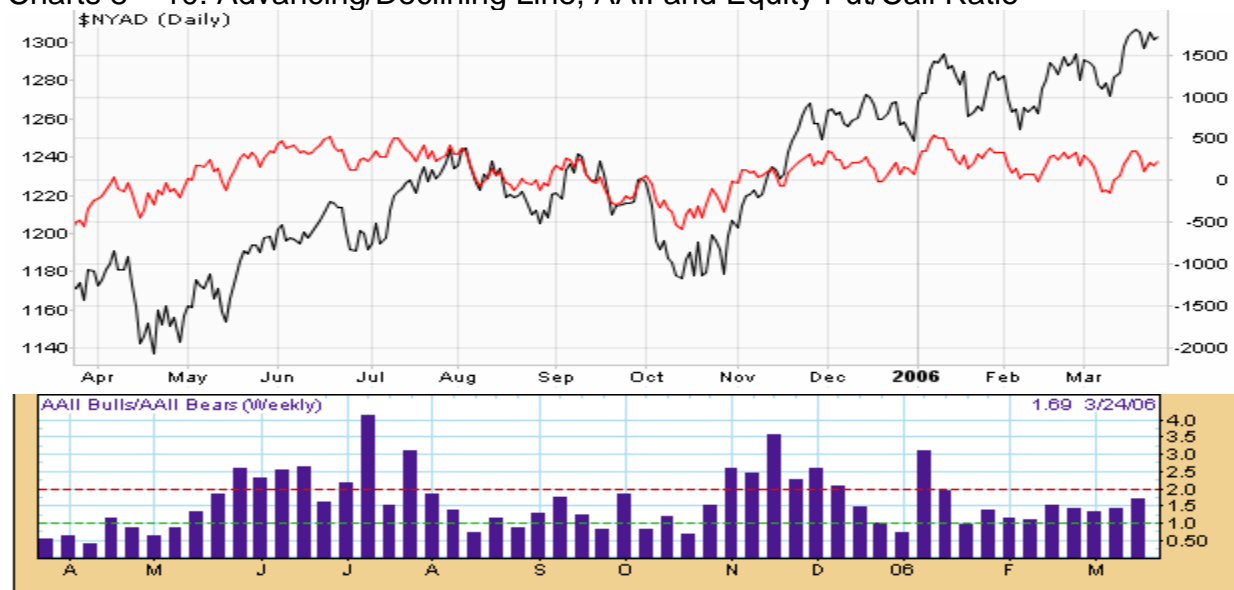
## Behavioral Finance Indicators (see explanation)

Last week the market pulled back from the recent high. The indicators are getting more mixed but overall it appears that the market will have great difficulty pushing higher.

Please consider the following factors:

- Chart 8 - divergence between prices (went up) and advancing/declining line (declining)
- Chart 9 - high degree of optimism (at the beginning of January) by small investors as represented by AAll
- Chart 10 – low put/call ratio, confidence exhibited by equity option buyers (in January) who tend to be reliably wrong at important market junctures

Charts 8 – 10: Advancing/Declining Line, AAll and Equity Put/Call Ratio





Charts courtesy of StockCharts.com and DecisionPoint.com

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### Answer to the Quiz:

B is correct. The effect of compounding gains on previous gains, etc.

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