



Markets This Week

April 1, 2006

In This Issue:

Investment Idea
Quiz
Our Portfolio
Market Highlights
Behavioral Finance Indicators
Answer to the Quiz

Investment Idea

Question:

Can a survivorship bias impact my returns in mutual funds?

Answer:

Yes, if you hold actively managed funds.

What is the survivorship bias?

The tendency for poor performers to drop out while strong performers continue to exist. This results in an overestimation of past returns.

A recent study, sponsored by Morningstar, indicated that survivorship bias accounts for about 1.6% return per year. Here is a direct quote from the study "Hidden Bias in Morningstar Data Systematically and Significantly Overstates Managed Mutual Fund Performance".

Here is how it works. A mutual fund company has a number of funds on the market. Some of these funds are clearly underperforming the market. The mutual fund company decides to liquidate the underperforming funds. Down the road, the mutual fund company reports the performance of its fund excluding the performance of the funds which did poorly and no longer exist. If you held the liquidated funds, your investments did poorly, yet the marketing material does not show it.

Quiz

Assume that the long-term index return is 10% per annum and a mutual fund company claims that its funds returned 9% on average.

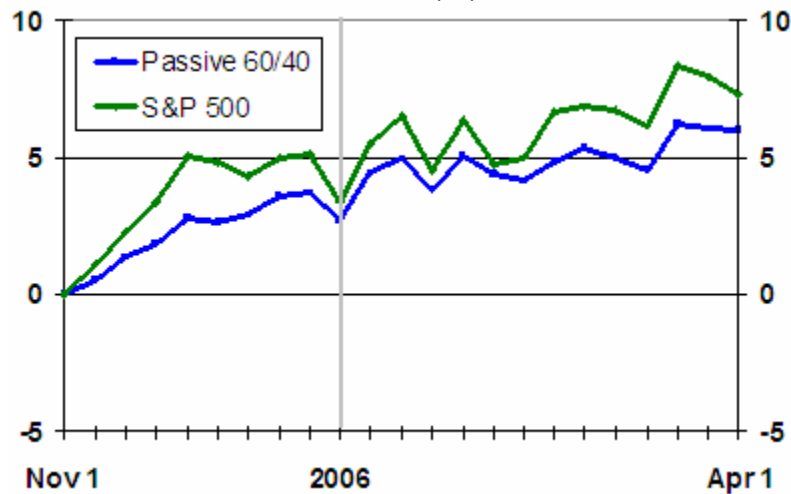
If the mutual fund company has a survivorship bias of 1.6%, by how much did an index really outperform?

- A) 2.6%
- B) 2.1%
- C) 1.9%
- D) 1.7%

Answer at the bottom of the newsletter.

Our Portfolio

Chart 1. Cumulative Returns (%)



Since inception, the S&P 500 has outperformed our passive and conservative 60/40 portfolio. Last week, however, the S&P 500 index declined while our portfolio was largely unchanged.

Market Highlights

March 25 – Mar 31, 2006

- This week, the US market declined (charts 2 – 3), however, during the first quarter of 2006, the S&P 500 index increased by 3.7%, its largest quarterly gain since 1999.

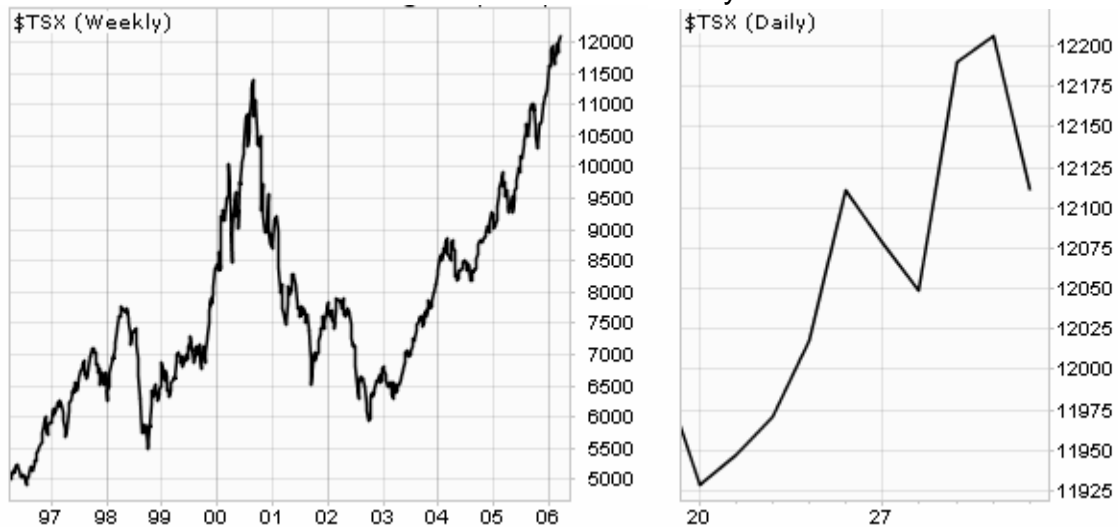
Charts 2 – 3. S&P 500: 10 Years and Last 10 Days



Charts courtesy of StockCharts.com

- The Canadian markets finished the week marginally lower as energy stocks retreated from their recent highs (charts 4 – 5).

Charts 4 – 5. TSX Canada: 10 Years and Last 10 Days



Charts courtesy of StockCharts.com

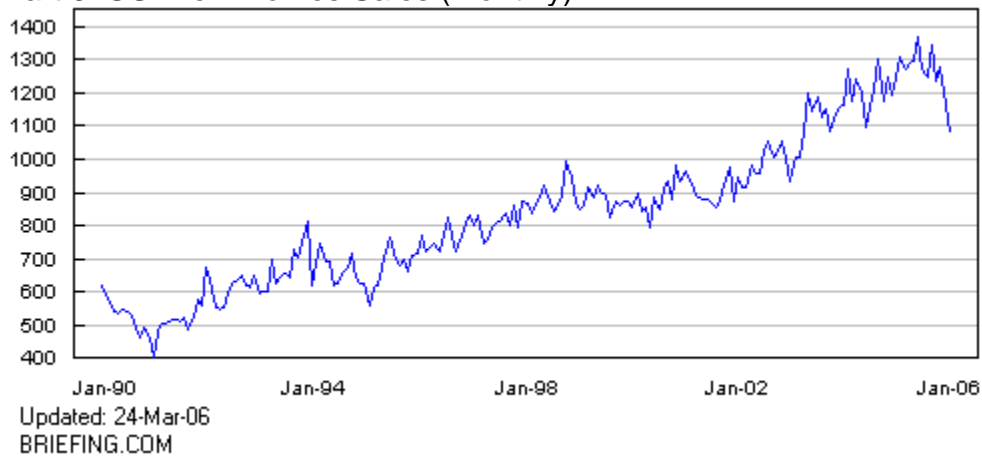
- The prices of gold reached \$585 per ounce, its 25 year high. Gold was trading at over \$800 per ounce in 1980.
- Ernst & Young reports that last year more than 29 countries issued IPOs (Initial Public Offerings) valued in total of at least \$1B. The IPOs are thriving in emerging markets as Egypt, Greece, Kazakhstan, Malaysia, and Poland have joined the club. Further proof that globalization is set to continue.

- The US Federal Reserve Bank (Fed) raised its benchmark rate by a quarter-point to 4.75%. It marks the 15th consecutive increase and the Fed is not done yet.

Worth Watching

- The current US administration follows a very risky path of unsustainable twin deficits in trade and federal budgets. The rules of economics and history teach us that in the long-run financial constraints apply to everyone. The eventual financial market adjustment will be orderly (We hope).
- Lately, the demand for real estate has slowed significantly (Chart 6). We leave it up to our readers to decide if the recent drop is only a pause or a beginning of something bigger. However, it is worth noting that the present real estate boom is one of the longest in history and as we all know economic cyclicality has existed since the beginning of history.

Chart 6. US: New Homes Sales (Monthly)



Behavioral Finance Indicators (see explanation)

We are starting to get mixed signals on our main indicators. Normally, as markets decline more investors start to worry and the best buying opportunities emerge as investors' fears reach a peak. The process is reversed on the upside i.e. a high confidence level usually mark the market tops.

Right now, the markets appear near their top (based on the advancing/declining line) while the majority of investors are showing signs of fear. This does not happen very often, but it is occurring right now.

Please consider the following factors:

- Chart 7 - divergence between prices (went up) and advancing/declining line (declining)
- Chart 8 - high degree of fear by small investors as represented by AAI i.e. the ratio of bulls/bears is low
- Chart 9 – steadily growing put/call ratio indicates that small investors are showing signs of fear

Charts 7 - 9: Advancing/Declining Line, AAI and Equity Put/Call Ratio



Charts courtesy of StockCharts.com and DecisionPoint.com

Answer to the Quiz:

A is correct.

As stated, the index outperformed the company's funds by 1% (10% - 9%). In addition, the survivorship bias is 1.6% per annum. The calculation is as follows: $1\% + 1.6\% = 2.6\%$.

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.