



Markets This Week

April 22, 2006

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Investment Idea

Question:

Should I be scared of the reversion to the average?

Answer:

No, do not be scared, but be prepared (to manage risks).

Reversion to the average (a.k.a. reversion to the mean) is based on the idea that what goes up will likely come down, and what goes down will likely bounce back. In other words, it will “revert back to the average.” It is an important concept that should serve as a reminder that the force of gravity could easily pull “hot” stocks back to earth.

Let us compare the returns of stocks and real estate over the last 30 and 5 years (Charts 1 & 2).

Chart 1. Average Annual Return (%) Stocks vs. Real Estate (**last 30 years**)

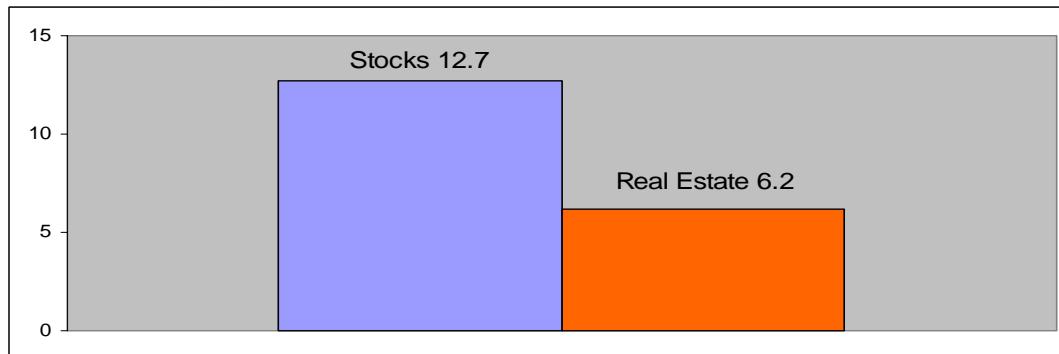
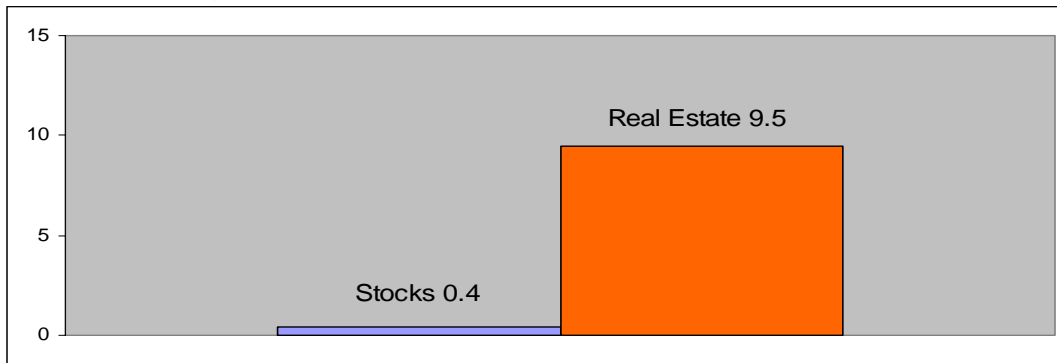


Chart 2. Average Annual Return (%) Stocks vs. Real Estate (last 5 years)



During the last 5 years (in comparison with the last 30 years) stocks underperformed while real estate outperformed. Hence, according to the idea of reversion to the average, stocks are likely to rise and real estate will probably go down, in the next few years. When it happens, the returns of both stocks and real estate will revert back to the average.

Quiz

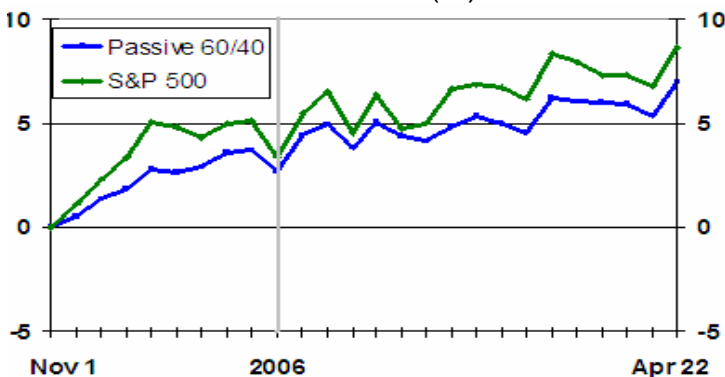
Let us suppose, hypothetically, that during the last 5 years all asset classes (i.e., stocks, bonds, cash and real estate) had the same return of 10% per annum. According to the reversion to the average theory, which of the following is expected to have the largest drop in the next few years?

- A) Stocks
- B) Bonds
- C) Cash
- D) Real Estate

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 in terms of return. Last week, both the S&P 500 index and our portfolio moved up strongly.

Market Highlights

April 15 – April 21, 2006

- This week, the US market moved up strongly with some indexes hitting a five-year high (Nasdaq and Dow Jones). Equities rose after earnings from companies, including Google and GM, topped analysts' estimates and the US Fed gave a signal it is nearly finished with raising interest rates (Charts 4 & 5).

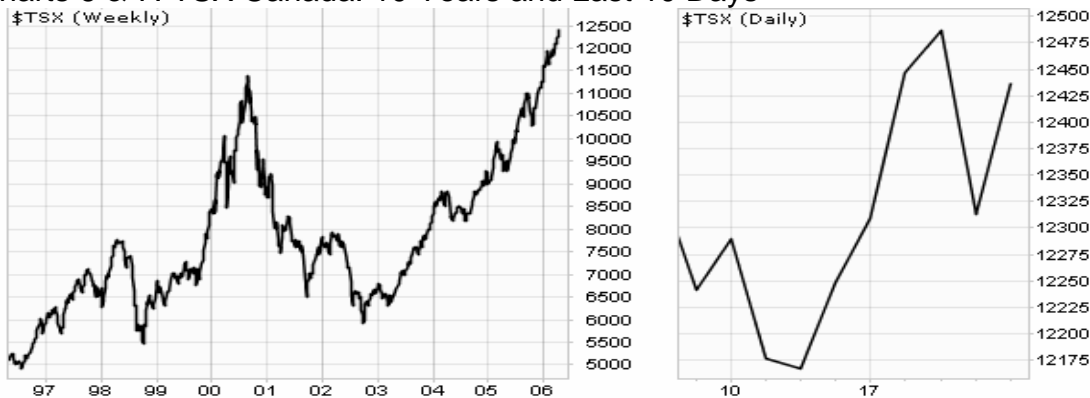
Charts 4 & 5. S&P 500: 10 Years and Last 10 Days



Charts courtesy of StockCharts.com

- The Canadian markets finished the week higher on the strength of crude oil, gold and base metals (Charts 6 & 7).

Charts 6 & 7. TSX Canada: 10 Years and Last 10 Days



Charts courtesy of StockCharts.com

- Crude oil broke through \$75 per barrel, its new all-time high (the prices were much higher in the 1970s if adjusted for inflation). The prices rose on concerns about the situations in Iran and Nigeria, and the tight US gasoline supplies ahead of the busy summer season.
- Brazilian President Luiz Inacio Lula da Silva has opened a vast new oil rig which will enable the country to be self-sufficient in oil production. In the past, Brazil was heavily dependent on oil, which proved disastrous during the two oil shocks in the 1970s. Then, as prices soared, the country borrowed heavily to meet its energy demand, which led to a destructive cycle of debt and inflation.
- Rising mortgage rates, weaker demand, and a growing inventory of unsold homes have pushed home builders' confidence to its lowest point since November 2001. We believe the home builders' optimism will likely be tempered for a while.
- Gold prices are surging, reflecting the growing tensions in the Middle East, higher demand by the growing middle class in emerging markets, and concerns that high commodity prices may influence inflation.

Worth Watching

- Recently, Time magazine pointed out an obscure passage buried deep inside the pending 324-page US budget. A new tax break allows the makers of "synfuel" energy tax credits worth over \$9B. US lawmakers envisioned the synthetic fuel tax credit would help the country ease its dependence on foreign energy sources. Many companies have tried to create new fuel sources from coal; others, unfortunately, have merely sprayed already marketable coal with pine tars to prove it was chemically altered in order to collect the tax credit. We are reminded of a famous quote from the film about Wall Street, "Greed is good."
 - Former Republican strategist Kevin Phillips examined the rise and fall of great nations. He believes many former empires lost power following a convergence of three trends: diminishing resources, ballooning debt and militant religions. The mix of the three creates a blind obsession for world domination, which ultimately leads to self-destruction. It begs the question, are we going to see the end of another empire in our lifetime?
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Behavioral Finance Indicators (see explanation)

Equities have been quite strong lately but we continue to believe we have reached an important market top. The indicators are somewhat mixed but there is a high probability that the markets will start to decline and look for a new support level.

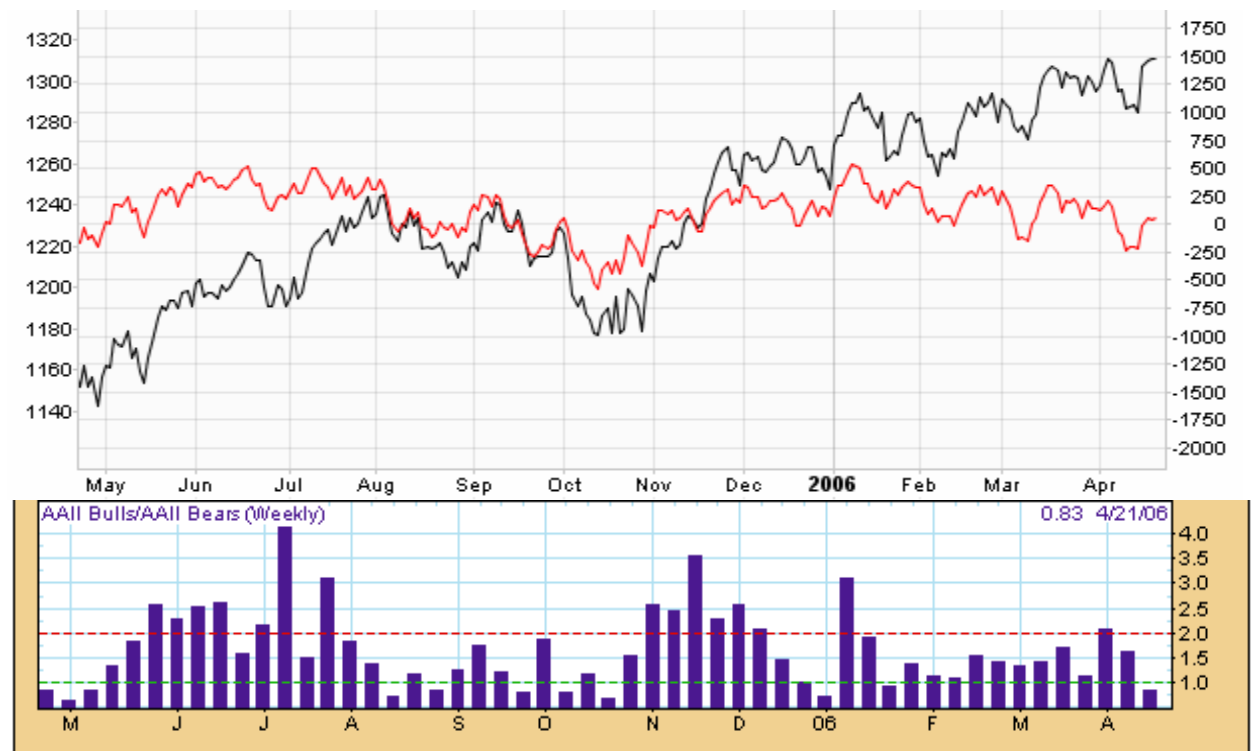
Please keep in mind, the market is always right. If we make a mistake, we should quickly acknowledge it and move on. Our objective is to preserve capital and get ready for the next battle.

For a historical comparison, please look at August 2005 on Charts 8, 9 and 10.

Please consider the following factors:

- Chart 8 – the divergence between prices (black line) and the advancing/declining line (red line) since January 2006
- Chart 9 – the confidence of small investors (as represented by AAll, i.e., the ratio of bulls/bears). This indicator provides a signal which contradicts other indicators (i.e., low confidence)
- Chart 10 – the declining put/call ratio indicates that small investors have confidence that the market will advance (red line)

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





Charts courtesy of StockCharts.com and DecisionPoint.com

Answer to the Quiz:

C is correct.

Given that cash has had the lowest return historically, it will likely experience the biggest drop since its latest return (10%) is much higher than historical averages.

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