



Markets This Week

May 6, 2006

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Investment Idea

Question:

What does it mean to sell shares short?

Answer:

Short selling is done by investors who want to make money as a stock goes down (the opposite of going long when investors benefit as a price goes up). For instance, if you short a stock at \$10 and it declines to \$9, you made 10%.

Investors can short a stock they do not own by borrowing it from someone who owns it (the brokerage house arranges it) and returning the stock back to the original owner after they cover the short position.

Short selling carries a higher risk and may not be for an average investor. However, it is a very useful tool in the arsenal of risk management.

Let us look at a practical example of Google (Chart 1). Google's shares started trading at \$100 in August 2004. If an investor sold Google short in November 2004 at \$200, by January 2006, the investor would have lost 137.5% (for every \$200 going up, an investor loses 100%). Unlike buying shares long, short sellers can lose more than 100% of the capital.

Chart 1. Google's Share Price



Chart courtesy of StockCharts.com

N.B. Short selling can be very effective at risk management at the portfolio level e.g., securities sold short can offset market declines and reduce volatility.

Quiz

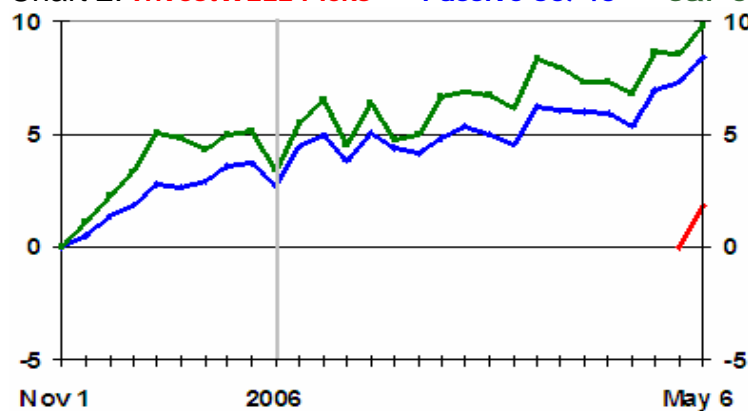
You sold ABC short as it was trading at \$10 per share. It is currently at \$12. What is your return thus far?

- A) 10%
- B) 20%
- C) -20%
- D) -10%

Answer at the bottom of the newsletter.

Our Results (Cumulative %)

Chart 2. **InvestWELL Picks** **Passive 60/40** **S&P 500**



Symbol	One-week %	Since Inception %	We Bought On	We Sold On	Expected Return %	Risks	Reasons
Members Info	2.45	2.45	May 1, 06	-	Market + 4	Medium	Trend investing
Members Info	1.11	1.11	May 1, 06	-	Market + 2	Low	Investment style
InvestWELL Picks (Average)	1.78	1.78					
Passive 60/40	1.08						
S&P 500	1.26						

Our **InvestWELL Picks** had a very successful debut with an average gain of 1.78% in the first week, outperforming both the Passive 60/40 Model and the Almighty S&P 500. Of course, past performance is no indication of future returns, but, our fingers are crossed.

Market Highlights

April 30 – May 6, 2006

- This week, the US market finished on a high note. Analysts attributed the upswing to strong gains in productivity and better-than-expected employment data (Charts 3 & 4). The market advances are welcomed news but we are not convinced they are sustainable.

Charts 3 & 4. S&P 500: 10 Years and Last 10 Days



Charts courtesy of StockCharts.com

- The Canadian markets finished the week where they started (Charts 5 & 6). The Canadian employment data was relatively strong with 22,000 new jobs added and a corresponding unemployment rate of 6.4%.

Charts 5 & 6. TSX Canada: 10 Years and Last 10 Days



Charts courtesy of StockCharts.com

- Bond prices continue to weaken as a declining US dollar and increases in commodity prices add to inflation worries.
- The 30-year mortgage rates in the US have reached 6.63%, the highest level since June 2002. In addition, Toll Brothers (symbol TOL), one of the largest home construction companies, has cut its 2006 deliveries for the 3rd time. The company said it expects lower demand because many speculative buyers have quit the market.
- The Canadian dollar has climbed to 0.9047 per US\$1. The rise is related to strong macroeconomic fundamentals, expectations of rising interest rates and weakness in the US currency.
- Gold prices have continued their upward march reaching \$684 per ounce, fuelled by worries about the nuclear standoff with Iran and the weakness of the US dollar. At the same time, many analysts are competing with each other by trying to predict how far gold will go. The truth is nobody knows. Right now, gold prices are driven as much by fundamentals as human psychology.

Worth Watching

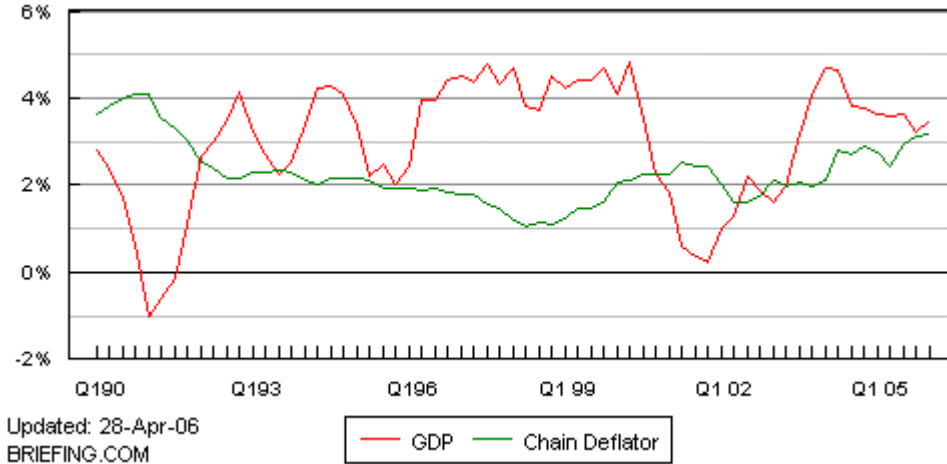
- Curbs on energy usage and fuel-efficient technology have aided many Asian and European countries to absorb the impact of rising oil prices. Perhaps other countries have some learning to do.
 - As the US dollar continues to weaken, many Wall Street firms are encouraging their clients to put portions of their assets into foreign currencies. We are reminded of the proverb "Generals are always preparing for the previous war".
-

Economic and Valuation Indicators

Economic Performance

The US economy has picked up pace with a recent 4.8% economic growth (year-over-year), the fastest since Q3 2003. The expansion was led equally by personal consumption and business investments. The Chain Deflator, often used as a benchmark for inflation, has been on the rise since Q2 2002.

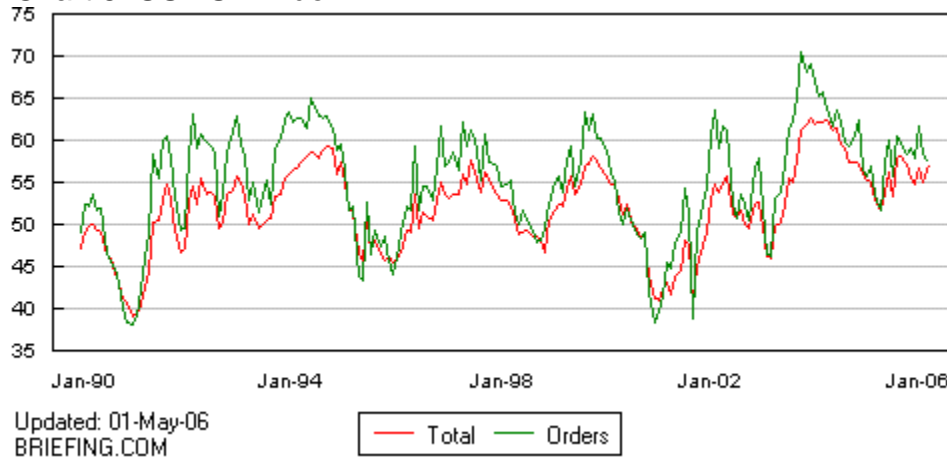
Chart 7. US: GDP and Inflation



ISM

The ISM index is one of the best leading indicators of US economic activity and is viewed as a swing factor preceding economic upturns and downturns (Chart 8). New orders provide the forward read on production and employment. Currently, the ISM index and new orders signal a continuation of economic expansion.

Chart 8. US: ISM Index



Yield Curve

The shape of the yield curve is often a leading indicator of both economic activity and the stock market. The current upward slope indicates the continuation of economic growth. [View yield curve](#)

Price-to-earnings Valuation

The most common valuation measure for equities is known as the P/E (price to earnings) ratio. Presently, the S&P 500 is somewhat overpriced, but not too overpriced at its current level of 18.54 (Chart 9). The current low inflation rate environment is more supportive of higher valuations because earnings are not reflecting a high inflationary component.

Chart 9. P/E Ratio for S&P 500



N.B. Our analysis focuses mostly on the US economy given its size and importance. Comparable Canadian data can be found in the Statistics Canada and Bank of Canada databases.

Behavioral Finance Indicators (see explanation)

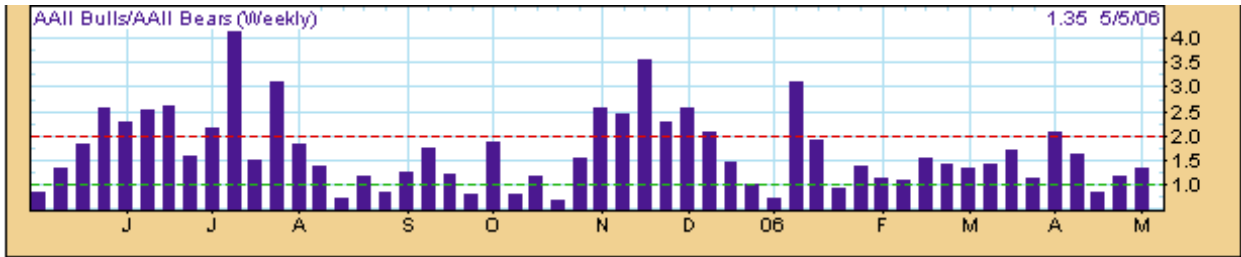
Last Friday, the equity market broke through to the upside. But, we are not convinced the upward swing is sustainable. Further, we believe, we may be facing what is known as a false breakout (i.e. at first stock break out upwards and then decline rapidly).

The advancing/declining line continues to signal a divergence between prices and fundamentals, while the majority of investors are showing a rising degree of confidence that the market will advance. For an historical comparison, please look at August 2005 on Charts 10, 11 and 12.

Please consider the following factors:

- Chart 10 – the divergence between prices (went up) and the advancing/declining ratio (red line)
- Chart 11 – 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 of small investors)
- Chart 12 – the declining put/call ratio indicates that small investors are showing confidence that the market will advance (red line)

Charts 10 - 12: Advancing/Declining Line, AAll and Equity Put/Call Ratio



Charts courtesy of StockCharts.com and DecisionPoint.com

Our Model Portfolios

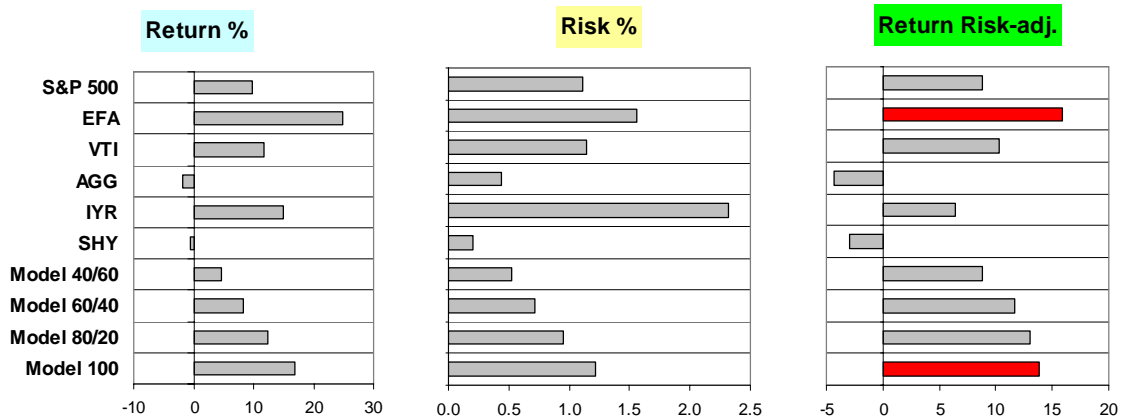
US Model Portfolios

Conclusions based on Charts 13 - 15.

Since inception, the EFA (Morgan Stanley Index for Europe and Asia) has been the best investment on a risk adjusted basis. Because of the international exposure, three of our Passive Model portfolios have managed to surpass the almighty S&P 500 index. It is quite an achievement given that 84% of mutual fund managers cannot outperform an index.

Note: The names and symbols are provided at the bottom of this section.

Charts 13 -15: US Model Portfolios



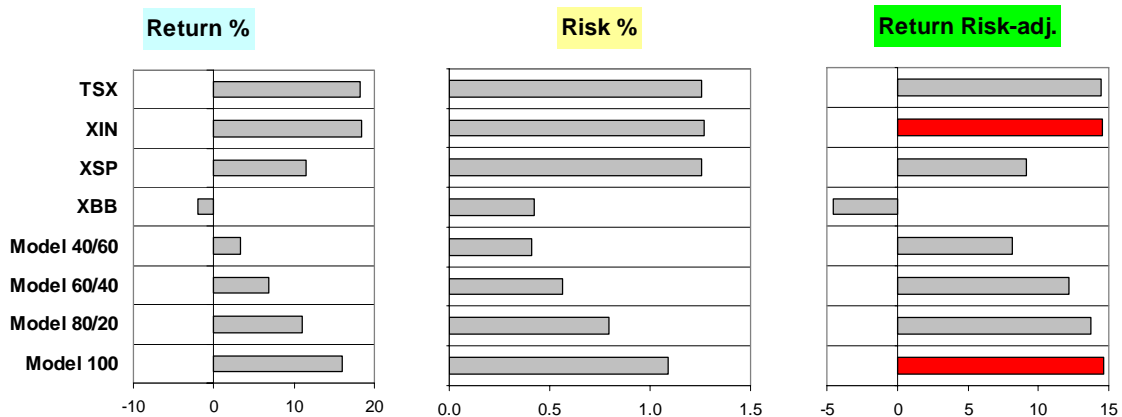
Canadian Model Portfolios

Conclusions based on Charts 16 - 18.

Since inception, both the XIN and the Model 100 have surpassed the TSX on a risk adjusted basis. As in the US Portfolios, the out-performance is due to the international exposure.

All of our model portfolios are proving that higher returns come with higher risks.

Charts 16 - 18: Canadian Model Portfolios



Name	Ticker Symbol
S&P 500	SPX
ishares MSCI EAFE	EFA
Vanguard Total Stock	VTI
ishares Lehman Aggr. Bond	AGG
ishares Real Estate	IYR
ishares Lehman 1-3 yr Treasury	SHY
TSX - Canada	TSX
Canada - Fixed Income	XBB
Canada - S&P 500	XSP
Canada - MSCI EAFE	XIN

Answer to the Quiz:

C is correct.

You sold it short at \$10. So if it goes up by \$2, you lose 20%.

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