



# Markets This Week

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June 3, 2006

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## Investment Idea

Question: Are growing correlations between stocks good for my portfolio?

Answer: Unfortunately, rising correlations (i.e. two stocks rise / fall in tandem) result in higher risks for a portfolio. For instance if a correlation between two stocks is 90%, the two go up and down at the same time, 90% of the time. Hence, these two stocks cannot be used as an effective hedge. In investing, the volatility of a portfolio will decrease, which is a good thing, if some assets go up while others go down.

To grasp the full extent of the issue, consider the fact that small US stocks and the S&P 500 index currently have a correlation of 94% (62%, six years ago). Even more surprising, emerging markets and the S&P 500 index have a correlation of 96% (32%, six years ago). It is another clear sign of globalization in capital markets.

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## Quiz

Which of the following offers the most optimal protection from rising correlations between stocks?

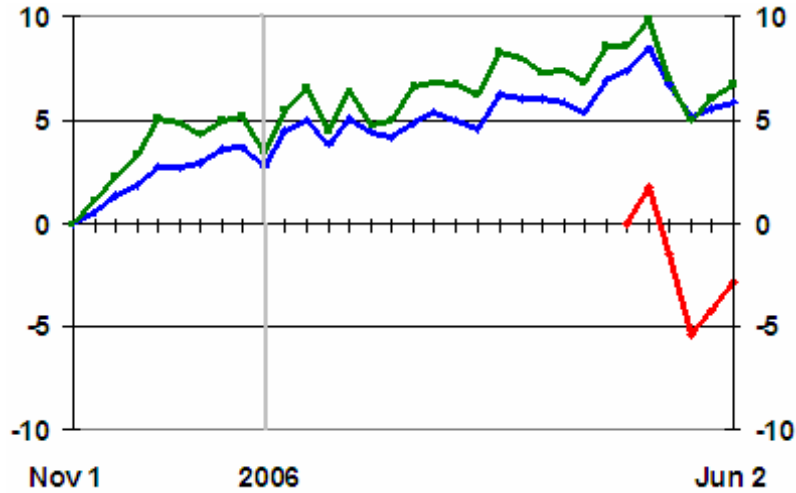
- A) Cash
- B) "Junk bonds"
- C) International stocks
- D) Short stock positions

Answer at the bottom of the newsletter.

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## Our Results (Cumulative %)

Chart 1



Symbol	One-week %	Since Inception %	We Bought On	We Sold On	Expected Return %	Risks	Reasons
Members Info	1.90	-3.59	May 1, 06	-	Market + 4	Medium	Trend investing
Members Info	0.98	-2.12	May 1, 06	-	Market + 2	Low	Investment style
<b>InvestWELL Picks (Average)</b>	<b>1.44</b>	<b>-2.85</b>					
<b>Passive 60/40</b>	<b>0.34</b>						
<b>S&amp;P 500</b>	<b>0.63</b>						

Last week, our **InvestWELL Picks** outperformed the general market by a nice margin. Please keep in mind that InvestWELL Picks holds only two positions, which exposes InvestWELL Picks to greater volatility.

## Market Highlights

### May 28 – Jun 3, 2006

- In the last week, the US equities continued to rebound from a previously oversold area (Chart 2 & 3). The markets were supported by positive economic news (e.g. productivity) and benign data related to inflation (e.g. employment). We continue to believe that in the next few weeks the equity markets will be able to challenge the high level achieved in May 2006.

Charts 2 & 3 S&P 500: 5 Years and Last 10 Days



Charts courtesy of StockCharts.com

- The Canadian equities have gained ground on the strength of commodities and financials (Chart 4 & 5). The Canadian employment data will be released next Friday. The US and Canadian employment reports do not always come out at the same time.

Charts 4 & 5 TSX Canada: 5 Years and Last 10 Days



Charts courtesy of StockCharts.com

- The US home-price index was up 12.5% in the past year and up 2% from the fourth quarter to the first quarter. It was the slowest quarterly gain in prices since the first quarter of 2004. The report states that price growth is moderating, particularly in areas where prices have been rising the most.

- The proposed combination of the New York Stock Exchange and Euronext would mark the first trans-Atlantic securities market. The new entity is also contemplating opening for 12-hour trading sessions instead of the current 6.5 hours.
- Recently, the emerging markets have declined (e.g. in May 8.4% on average but still up 10.4% so far this year) more than the stock markets in developed countries. Analysts believe the prospects of rising interest rates and slower economic growth in the US will likely put additional downward pressure on the emerging markets.
- The Canadian dollar closed at 0.9083 against the US greenback. We believe Canadian currency will likely approach 0.95 this year given, the strength of the Canadian economy and weakness of the US dollar.

### **Worth Watching**

- The Ontario Teachers Pension Plan has found that the amount paid to Canada's top executives is not related to the companies' total shareholders' returns! The Pension Plan was so surprised by the results of the findings, it redid the study several times using a variety of statistical measures. The study also concluded that companies with the most mediocre performance seemed to have the highest pay level. The report points to the obvious need for better alignment between the CEOs' pay and shareholders' returns.
- ProFunds Advisors plans to launch the first of its kind leveraged ETF (Exchange Traded Fund). It would allow investors to double their gains / losses e.g. a holder of a bullish S&P 500 would gain 2% if the market advances by 1%. We believe that more innovative ETF products will be coming to the market in the next few years.

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### **Behavioral Finance Indicators** (see explanation)

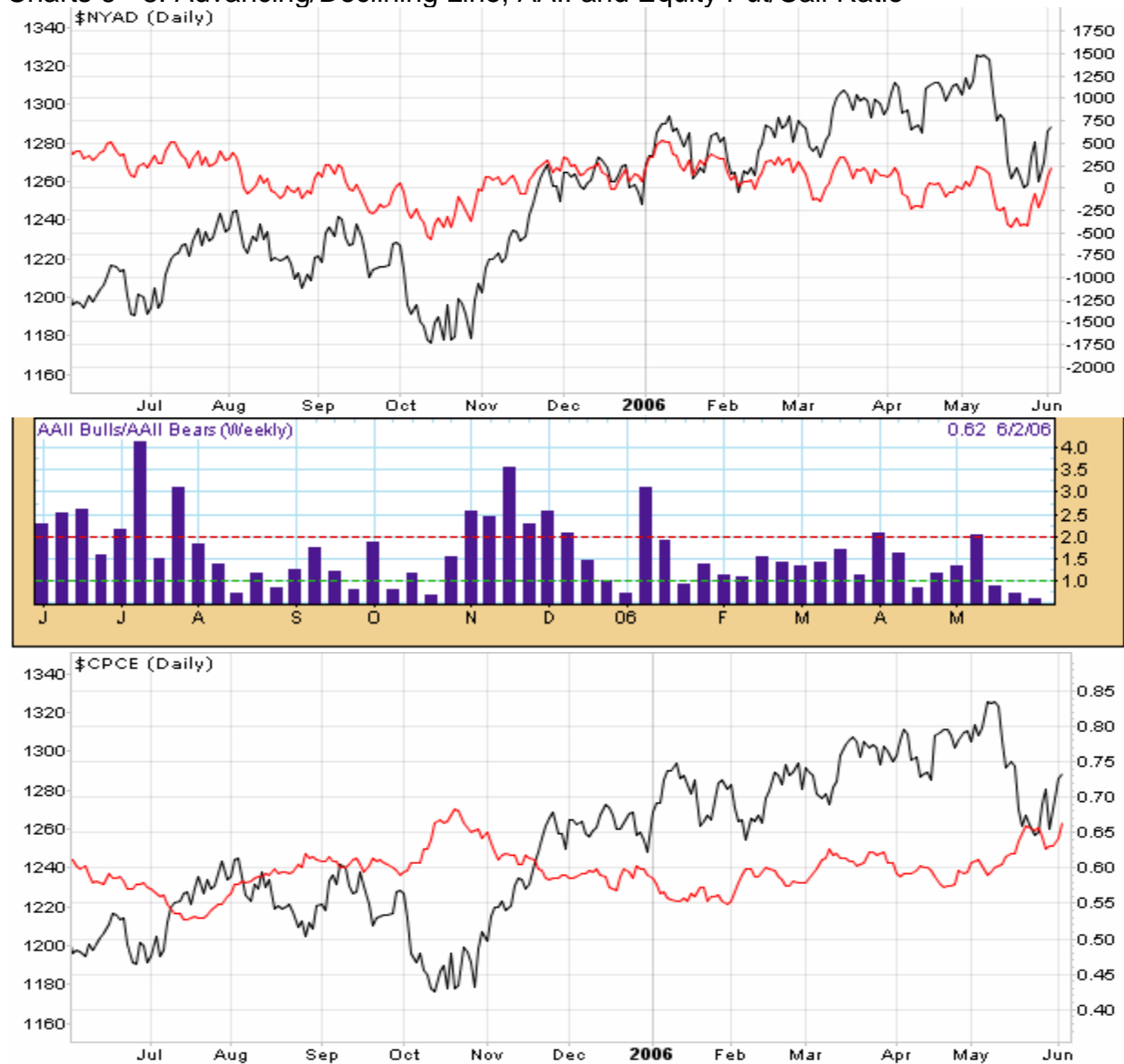
We are not buying into the recent strength of the equity markets. We believe there is an underlying weakness which will manifest itself in the next several weeks. We have a case for a short-term upward thrust but we do not have a case for an intermediate term (the next few months) bull market.

Given the readings of most of the behavioral finance indicators, we believe the stock markets will likely rebound in the upcoming weeks. On the surface, the numbers on the current indicators resemble October 2005, but there is a substantial difference. For example, the current situation is a result of an overextended bull market. By October last year the market was already falling for over two months (Charts 6 – 8).

Please consider the following factors:

- Chart 6 – the divergence between prices (black line) and the advancing/declining line (red line) is tightening but the two started to diverge in February this year.
- Chart 7 – a low confidence of small investors (as represented by AAll, i.e., the ratio of bulls/bears) points to a short-term rebound. Small investors are usually a contrary indicator.
- Chart 8 – the rising put/call equity ratio indicates that small investors are losing their confidence that the market will advance (red line). Again, an excellent contrary indicator pointing to a rebound in a short-term.

Charts 6 - 8: Advancing/Declining Line, AAll and Equity Put/Call Ratio



Charts courtesy of StockCharts.com and DecisionPoint.com

## Answer to the Quiz:

D is correct. Cash provides an effective hedge but it is very risky in the long-run (since it does not offer a good protection from inflation). “Junk bonds” and international stocks would have a high correlation with stocks. On the other hand, short positions offer a complete offset to a high correlation by taking the opposite position.

For instance, if two stocks have a correlation of 100%, then by shorting one of them, we would achieve a -100% correlation (a perfectly negative correlation). Please keep in mind that due to substantial risks, stock shorting should not be done by novice investors.

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