SHAUNESSY INVESTMENT COUNSEL INC.

Why holding bonds is getting risky.

WEEKLY INVESTMENT PRE/ REVIEW ------ May 4 th, 2009

- **The price of fear: RBC Canadian Money Market** is a top dog among money market funds says Rob Carrick of the **Globe & Mail**. Deposit $5,000, say in your new **Tax Free Savings Account** (at least $50 in set up fees) and you will earn, over the course of the next twelve months, all of $35.50. Most Canadian money market funds provide much less. If the investment isn't tax sheltered, and with inflation, such a return is negative. Guaranteed Investment Certificates or **GICs** are a little more generous alternative (though the holder is *locked* in for the term): currently a one year GIC pays 1.25% to 1.60% or, at best, the equivalent of $80 (before taxes and fees) on a $5,000 investment. On a year to date basis, the volatile TSX Composite is leading global markets and is up 5.7% or a return of $285 before taxes or fees.

- **No risk, no reward: The Investment Fund Institute** of Canada reports that Canadians have socked away over C$75 billion in money market funds as of the end of March 2009, compared with C$66 billion and C$47 billion in the 2 previous years. This trend is amplified by the relative decline in the value of stocks that investors held on to. Many portfolios will now have too little risk to generate significant returns to recover losses sustained in 2008/09 or to provide the desired ongoing 8% year over year return that investors generally seek.

- **Quantitative easing**: The **US Federal Reserve** is still seeking to prop up the US economy but with interest rates near zero it has run out of options on that front. The central bank is therefore looking to drive rates below zero by intervening in debt markets through something known as **'quantitative easing'** which is the buying back of its own debt as it did earlier this year. The Administration is already authorized to buy-back US$300 billion of government bonds, over US$1 trillion of mortgage-backed securities and US$200 billion of other debt issued by government backed agencies **Fannie May** and **Freddie Mac** and to date has moped up about US$500 billion of various debt. Something known as the **'Taylor Rule'** posits that the key interest rate should be *-5%* in order to properly revive a sagging economy. The **Taylor Rule** has been discussed by the **US Federal Reserve**. The **Bank of Canada** has suggested that its thinking is in line with US monetary policy and recently announced that Canadian rates will remain at 0.25% for at least a year (an unheard of pronouncement) and that it too would deploy 'unconventional' measures to prop up the economy if necessary.

- **Conclusion:** investors with too little exposure to stocks are taking significant ***opportunity risk***. All signs point to a recovery in stock prices (and it matters little how big) as economic and financial conditions improve and because bond holders simply must return to stocks given that their previous investment theory --- that the world economy as we know it will implode --- has not come to pass. Recent investments in long term bonds entail ***interest rate risk*** as current returns offered are historically low and are bound to rise, perhaps accelerated by inflation triggered by government profligacy. A bond rally causing the value of pre-existing bonds issued at low interest rates to fall is every bit as painful as a decline in stock market prices.

- **Risk and uncertainty**: often these two terms may be used interchangeably yet there is a material difference that goes some way to explaining why investors shifted and still hold on to bonds. Risk is a situation where the range and likelihood of possible outcomes is largely known whereas uncertainty is a situation where it is not clear what may happen and risks are unknown causing fear. In a recession or some other economic or financial crisis (such as the one experienced in Q4 2008) the initial watershed event creates a level of uncertainty that is so intolerable that investors bail out of stocks without discrimination. It seems that a return to stocks (and a balanced portfolio) is slower than the exit until such a time when the remaining investors reach a common pain threshold where they can no longer stand being out of stocks. At that point investors may return like a herd.

- **Cars, planes and hotels:** If we can avoid it, we *never* invest in those sectors as, sooner or later, those investments return nothing but dust. The **Chrysler LLC** saga (soon to be followed by the **GM** sequel), which is getting far too much media coverage and government attention, is a case in point: this is a perpetually struggling, relatively small company in a declining industry (for North America) that doesn't have a single model among the top ten passenger cars sold in Canada; a company that is now joining another weak player (**FIAT**) after having been ditched by a very capable partner (**Daimler AG**) and which, without repeated government assistance, has not been viable for some time. Chrysler in Canada in this decade alone has received over C$872 million in grants and loans and has $1billion in tax liabilities. In this case we prefer to take under-performing bonds, and not because of uncertainty.

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