SHAUNESSY INVESTMENT COUNSEL INC.

When everyone's thinking the same, no one's thinking.

WEEKLY INVESTMENT PRE/ REVIEW ------*February 20th, 2009.*

In volatile times, one of the most difficult things to do, is to not follow the herd over the cliff. For most investors, to abandon a 40/60 or similar asset allocation in favour of a cash only position (as many investors have done), is to do just that. Here's some information the herd isn't considering:

- stock prices are going down, not because they are inherently worth less today than yesterday, but because the are few buyers. Both the S&P 500 and TSX Composite have been stuck in a deep rut since December. For now, the absence of good news means no traction, so stocks remain stuck at bargain prices.
- Canada is an ocean of stability and value: our economy, financial and banking systems are not burdened with the excessive leverage, greed, flawed financial innovation, regulatory failure and fraud to be found in the US. Even if our financial sector faces reduced earnings in 2009, the financial index (representing about a third of the TSX) should not be down 50% year/ year. The Royal Bank, which perhaps was priced to perfection at $60 in May 2007, is now trading for just over $26! Similarly, Canada has an export-driven economy and so, a global recession will cause a contraction, but not a wholesale collapse of the economy. Demand for Canadian exports will resume. Energy companies for example, will return to profitability, yet the energy index (representing another third of the TSX) is down 60%. The Canadian materials sub-index (representing the remaining third of the TSX), even though it is buoyed by gold, is down 40%. With all of the Canadian market at a deep discount, it is hard to know why an investor should not hold a liquid and diversified index instrument like XIU (TSX 60) or XIC (TSX Composite).
- The 2009 recession is the first synchronized global downturn since the 1930s. The recession is intricately linked to a decline in credit markets, banking, and regionally, housing and consumer confidence. Booms and busts, like this one, occur with depressing regularity; yet in each instance order has been restored. Although the trillions of dollars in fiscal stimulus and support is disconcerting, and its method of allocation seems clumsy, there is an unprecedented level of global political will to fix things. It is now not a matter of "if" but a matter of "when" the fix will take affect.
- Everyone can see that defaults over the next 12 months will run relatively high. There are sectors that may be more vulnerable than others (automotive and financial in the US). However, that doesn't mean that *every* car company and bank is facing bankruptcy! In a properly diversified portfolio, especially a blue chip or investment grade portfolio, the risk of default is mitigated by having many (at least +50) holdings.
- By abandoning the asset allocation discipline, investors are betting against the stock market; they are foregoing dividend income; and, are betting that they can pick the just right moment to shed their fear and buy stocks back. Also implicitly, investors who have loaded up on bonds, are now part of a bond bubble and have added inflation risk.
- Price information is the mechanism by which markets begin to restore balance. The National Bank reported recently that "the tide is turning" as the US median price of existing homes in January fell back to a long term-equilibrium in line with median income. "What's more", reported NBF, "home and condo inventories have decreased by about 1 million units since peaking". The real point is that while the US economy has been mired in recession for about 15 months, home price deflation has been going on twice as long. If current affordability trends continue, it will only take 5% of existing renters to buy up that inventory and return the market to balance. Stability in the US housing market is one leg of the recovery; the other two are stability in credit and financial markets and a return in consumer confidence.
- Other esoteric indicators (i.e LIBOR, the Baltic Freight Index, VIX, TED spread) are positive but that is not to say all is well: the CDR Counterparty Risk Index, which averages credit default swap spreads of the largest derivatives dealers, is up on fears that Treasury Secretary Tim Geithner's plan to fix US banking may not work. Credit default swaps insuring the debt of Citigroup and Bank of America are trading at wider spreads than last October. This concern has made this past week truly miserable as speculation is rampant that the US Administration may, in one form or another, nationalize these banks. The long term implications are unclear but with markets so fragile, pessimism abounds. Unless we all want to become day traders or remain in cash, these setbacks are hugely uncomfortable but simply must be endured. The temptation is to do something -- *anything!* -- is huge. We constantly re-visit our clients' portfolios to ensure the asset mix is right and that we hold only the most liquid and diversified instruments. After that all anyone can do, is turn the TV off.

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