April 2008

A Time for Rational Thinking

Research and analysis compiled for Canadian investors by Renaissance Investments

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Foreword

In June 2004, the U.S. Federal Reserve initiated a cycle of 17 interest rate increases that went from just 1%—the lowest level since the 1950s—all the way to 5.25%. By August 2005, the U.S. housing boom was starting to unwind under the burden of higher borrowing costs. Building rates dropped to decade lows and prices fell. Borrowers with high-risk sub-prime mortgages began to default. By March 2007, rumours spread that one of America's biggest sub-prime lenders was about to declare bankruptcy.

As 2007 went on, the trickle of bad news became a river. Record numbers of Americans found themselves in danger of losing their homes. Major lenders and financial institutions reported multi-billion dollar losses or went out of business as a result of sub-prime debt holdings. Finally, in the first few weeks of 2008, global stock market indices reacted with double-digit losses, washing away most of the gains from the previous year.

So where do we go from here? Often, the best way to see the road ahead is to take a look back.

Reviewing the events of the past few years, there were certainly clues that U.S. home prices and mortgage lending practices were unsustainable. It also seems likely that the practice of bundling and reselling U.S. sub-prime mortgages in the world market made it difficult for investors to fully understand the risks they were taking.

But looking back over the past century, a bigger picture emerges: markets have always been cyclical in nature. Further, even though these cycles periodically reach extreme levels—think the crash of Black Monday in 1987, or the technology stock boom more than a decade later—the market tends to be very resilient over time.

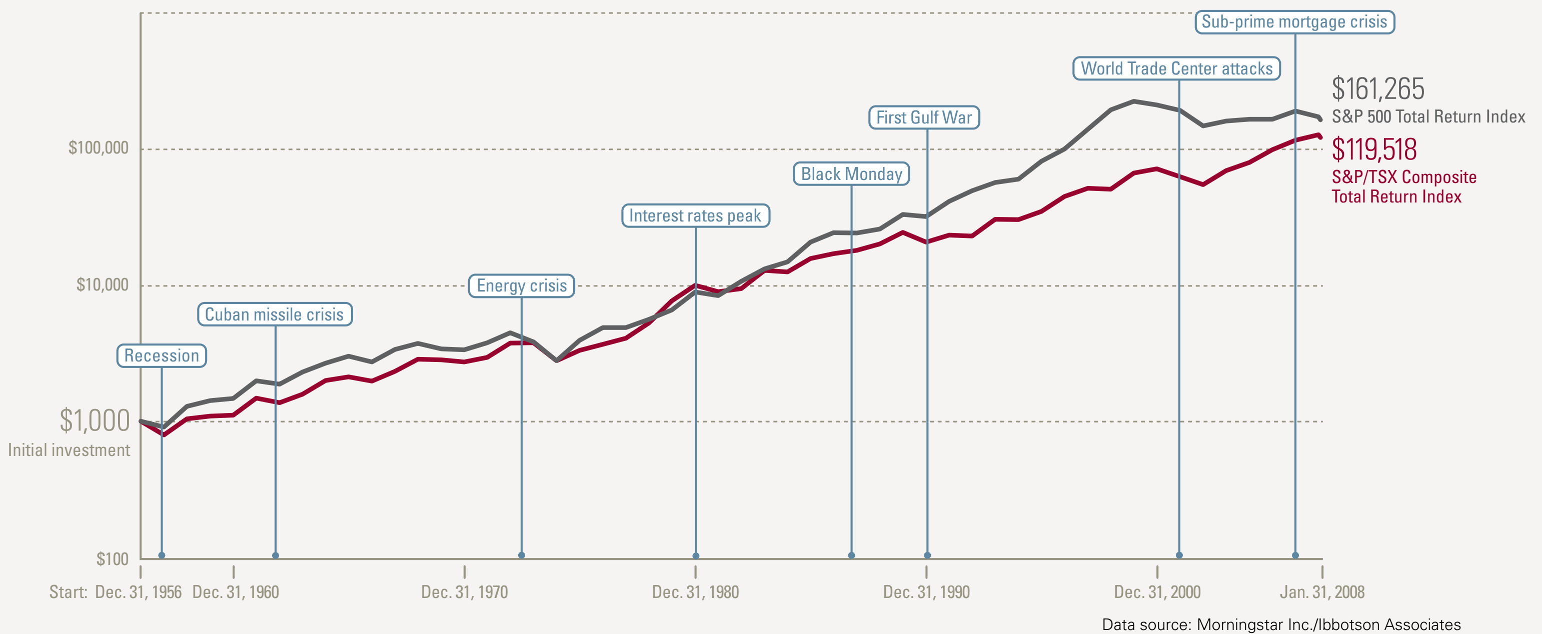
Short-term extremes typically occur when economic realities can be exaggerated by the human emotions of greed and fear. In fact, these emotions influence even the most seasoned and sophisticated investors. Yet, in the long-run, steady economic progress has always prevailed and the market's trend has remained positive throughout multiple generations and a wide range of crises.

The following pages provide graphical evidence of how stock markets perform in times of political and financial uncertainty, the impact of emotion on investor behaviour and how today's investors can apply rational thinking to make wise decisions.

I. Stock Market Performance

Growth of a $1000 investment 1956 – 2008

S&P 500 Total Return Index and S&P/TSX Composite Total Return Index



Data source: Morningstar Inc./Ibbotson Associates

This chart clearly illustrates the market's long-term resilience throughout numerous short-term crises. Given its long history of peaks and valleys, no one should be surprised when a market downturn occurs, even though it is nearly impossible to predict exactly when a downturn will occur.

The most important piece of knowledge to hold on to is the fact that investing in the market can be highly rewarding as long as investors have the patience and discipline to withstand the bumps in the road.

Unfortunately, many people do not. They react emotionally when a downturn comes along. They see short-term declines in their portfolio and make a critical error—selling their investments and crystallizing their losses.

Even worse, they sit nervously on the sidelines as the market reaches its bottom and begins a new upswing, causing them to miss out on the opportunity to recover their losses and earn new gains.

Of course, in a severe market decline, some stocks will suffer serious and perhaps irreparable consequences. But even this risk can be greatly reduced by holding a diversified portfolio that's managed by professionals that select companies with the ability to endure and grow in spite of fluctuations in the markets or in the overall economy.

> No matter how bad things may look, one fact remains: markets will go up again as surely as they came down.

II. Market Reaction in Time of Crisis

To further illustrate the resilience of the markets, this table highlights the dramatic declines and equally powerful rebounds of the market during and following some of the most significant political and economic crises in recent history.

Crisis events, Dow declines and subsequent performance

Event	Reaction dates	% Gain/loss	22 days later	63 days later	126 days later
Stock Exchange Closed (World War I)	07/22/14-12/24/14	-10.2%	10.0%	6.6%	21.2%
Stock Market Crash of 1929	10/11/29-11/13/29	-43.7	27.3	34.1	46.0
Germany invades France	05/09/40-06/22/40	-17.1	-0.5	8.4	7.0
Pearl Harbor	12/06/41-12/10/41	-6.5	3.8	-2.9	-9.6
Korean War	06/23/50-07/13/50	-12.0	9.1	15.3	19.2
Suez Canal Crisis	10/30/56-10/31/56	-1.4	0.3	-0.6	3.4
Sputnik	10/03/57-10/22/57	-9.9	5.5	6.7	7.2
Cuban Missile Crisis	10/19/62-10/27/62	1.1	12.1	17.1	24.2
JFK Assassination	11/21/63-11/22/63	-2.9	7.2	12.4	15.1
Martin Luther King Assassination	04/03/68-04/05/68	-0.4	5.3	6.4	9.3
United States Bombs Cambodia	04/29/70-05/14/70	-7.1	0.4	3.8	13.5
Arab Oil Embargo	10/16/73-12/05/73	-18.5	9.3	10.2	7.2
Nixon Resigns	08/07/74-08/29/74	-17.6	-7.9	-5.7	12.5
Iranian Hostage Crisis	11/02/79-11/07/79	-2.7	4.7	11.1	2.3
U.S.S.R. in Afghanistan	12/24/79-01/03/80	-2.2	6.7	-4.0	6.8
Falkland Islands War	04/01/82-05/07/82	4.3	-8.5	-9.8	20.8
Beirut Bombing	10/21/83-10/23/83	0.0	2.1	-0.5	-6.9
Stock Market Crash of 1987	10/02/87-10/19/87	-34.2	11.5	11.4	15.0
Invasion of Panama	12/15/89-12/20/89	-1.9	-2.7	0.3	8.0
Iraq Invades Kuwait	08/02/90-08/23/90	-13.3	0.1	2.3	16.3
Gulf War	01/16/91-01/17/91	4.6	11.8	14.3	15.0
Gorbachev Coup	08/16/91-08/19/91	-2.4	4.4	1.6	11.3
ERM U.K. Currency Crisis	09/15/92-10/16/92	-4.6	0.6	3.2	9.2
World Trade Center Bombing	02/25/93-02/27/93	-0.3	2.4	5.1	8.5
Oklahoma City Bombing	04/18/95-04/20/95	1.2	3.9	9.7	12.9
Asian Stock Market Crisis	10/07/97-10/27/97	-12.4	8.8	10.5	25.0
Sept. 11 Terrorist Attacks	09/10/01-09/21/01	-14.3	13.4	21.2	24.8
Bali Nightclub Bombing	10/11/02-10/13/02	0.3	6.6	12.3	6.7
Iraq War	03/19/03-05/01/03	2.3	5.5	9.2	15.6
Madrid Terrorist Attacks	03/10/04-03/24/04	-2.4	3.9	3.9	-0.1
London Train Bombing	07/06/05-07/07/05	0.3	2.3	0.1	5.6
India, Israel and Lebanon Bombings	07/11/06-07/18/06	-3.0	5.0	10.9	16.4

Source: Ned Davis Research, Inc. (NDR)

The 22, 63, 126 and 253 day rate-of-change is calculated from the last day in the reaction dates column. The first date in the reaction dates column indicates the start of the market reaction or the trading day prior to the event.

1914 data - In 1916 a new list of 20 stocks for the DJIA was adopted and computed back to the reopening of the exchange on 12/12/1914. NDR analysis for this study adjusted the DJIA index level prior to 12/12/1914 to reflect an accurate and consistent data set. Source: The Dow Jones Averages 1885-1990, Edited by Phyllis S. Pierce.

Days = Market Days

While dramatic events can have a short-term negative impact on the market, history indicates that the long-term impact is limited.

III. How Do Investors React to Market Fluctuations?

Because of the range of emotions investors go through, they tend to sell stocks at the "point of maximum financial opportunity" and buy them at the "point of maximum financial risk." This is precisely opposite to their best interests.

The emotional roller coaster of investing

Source: Westcore Funds/Denver Investment Advisers LLC

1. The cycle starts with Optimism, as investors see stock prices rising and conclude that the market is a "safe" place to invest.
2. At the top of the market, investors become Euphoric and many take additional risks.
3. As the market heads downwards, investors reach a point of Panic and sell their investments at a loss.
4. At the bottom of the market, investors are Depressed and too frightened to make new investments.
5. As the market regains its losses, investors once again become Optimistic that the market is a "safe" place to invest.

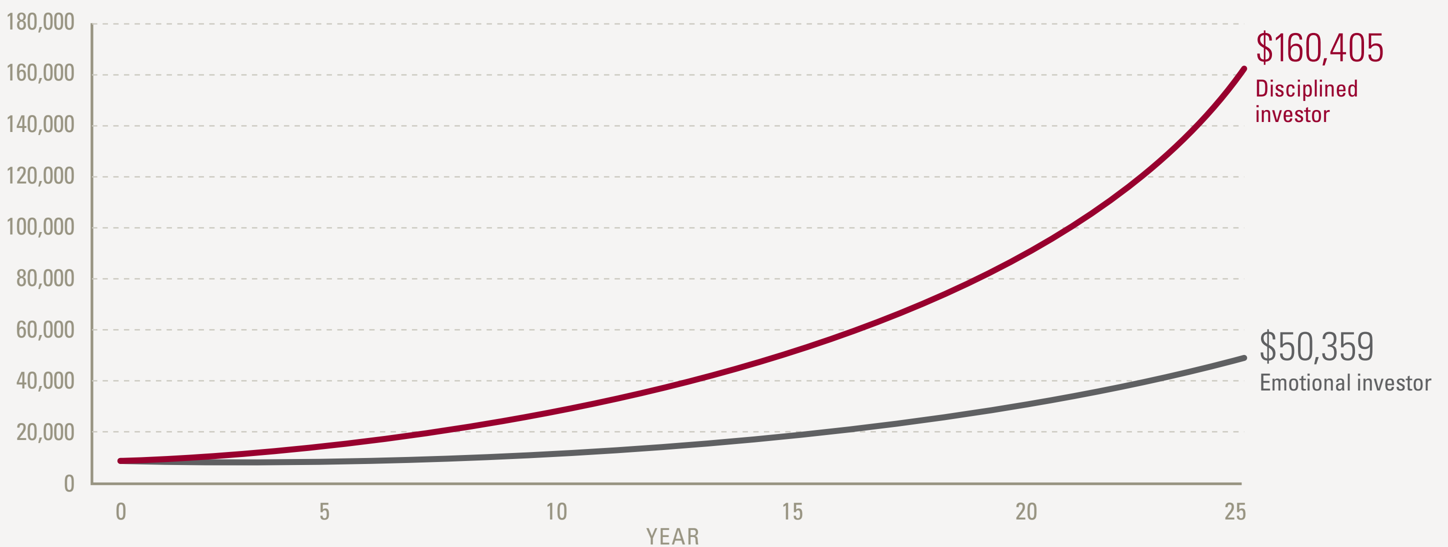
Unfortunately, emotionally-driven investors end up buying stocks at high prices and selling at low prices. Instead of benefiting from the market's long-term upward trend, they end up losing precious capital during periods of short-term volatility.

> Rational investors stick to a long-term investment strategy, as short-term market timing rarely proves effective.

III. How Do Investors React to Market Fluctuations? (cont'd)

The cost of letting emotions drive investment decisions – in bull or bear markets – is higher than many people think. By analyzing mutual fund trading patterns in the U.S. over the past decade, Financial Research Corporation has determined that there is a significant gap in returns between those who adhere to disciplined portfolio management over those who make emotionally-driven investment decisions.

The opportunity cost of emotional investing



Source: Financial Research Corporation

In this chart, the "Disciplined investor" is represented by the Average Un-weighted Morningstar Category Return in the U.S. while the "Emotional investor" is represented by the Average Flow-Weighted Morningstar Category Return in the U.S. for one-year returns over the past 25 years.

This approach to analyzing data shows the difference in the returns of equity mutual funds based on their pure performance, versus the returns of equity mutual funds when their performance is adjusted to account for investors' decisions to enter and exit the funds based on their reactions to market fluctuations.

Emotionally-driven investors ended up missing $110,000 in market gains over a 25-year period, and sacrificed 69% of the returns they could have enjoyed had they simply remained invested.

Over a 25-year period, emotional investing can diminish an investor's equity market returns by 69%.

IV. When Will Markets Go Up Again?

Nobody can be certain how deep the impact of sub-prime lending will be on the world's stock markets, nor how long a potential bear market might last.

However, as this table illustrates, bull markets have consistently outrun bear markets in terms of frequency, magnitude of returns and overall duration:

			Current situation
	Bear market	**Bull market**	**As at Jan. 31, 2008**
Average duration (years)	1.4	5.2	0.3
Average % return	-31.40%	185.00%	-12.50%

Data source: Yahoo! Finance

The economic uncertainty caused by recent events will undoubtedly have an effect on investor emotions and economic performance—particularly in the U.S.—for some time to come. But history tells us that, apart from the Great Depression of the 1930s, economic recovery occurs more quickly and lasts for a longer time than recession.

The historic dominance of positive market conditions is the strongest argument in favour of remaining invested throughout periods of short-term volatility. There's no reason for long-term investors to worry. The market will go up again.

Rising markets occur more frequently, provide returns of greater magnitude and last longer than falling markets.

V. How Should Investors Be Planning Today?

Experienced investors generally agree on three things.

One, equity investing pays off in the long run. Taking a gamble on a hot stock tip may work once in a while, but it's risky business, and not the way to build long-term wealth. In contrast, a steady and disciplined approach to investing throughout all types of market conditions is virtually guaranteed to produce positive results over an extended time frame.

Two, any investment portfolio—large or small—should contain a diversified mix of investments. That means exposure to stocks, but also some exposure to bonds or other fixed income securities that can increase stability during rough patches in the market. In addition, stock market investments should be spread among various global markets and specialized investment managers.

Three, professional advice is almost always necessary to determine the best investment strategy for each individual investor, to implement an appropriate mix of assets, to engage qualified portfolio managers and—perhaps most importantly—to help temper emotional urges and provide a rational viewpoint as the market goes through its inevitable cycles.

With the benefits of continuous equity market exposure, broad portfolio diversification and ongoing professional advice, investors can look back at the market's long and prosperous history, and feel confident that the future continues to hold promise.

For more information, visit www.renaissanceinvestments.ca, call 1.888.888.FUND (3863) or contact your Investment Advisor

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