In our last quarterly mailing we sent out a list of ten investment questions for you to consider. Below we answer those questions along with additional commentary to draw out the issues we wish to highlight. The objective of the exercise is to help you to better understand the process of creating and preserving wealth with the least amount of risk and maximum amount of personal comfort.

1) **What offers a better return; a portfolio that earned six per cent for four consecutive years or a portfolio that earned fifteen per cent for three years in a row and then lost twenty per cent in the fourth year?**

   The mathematics of investment can easily fool the casual observer. On the surface consecutive years of high returns look very appealing and makes one feel very comfortable. However, just one year of losses reduces the cumulative long term return relative to a portfolio earning consistent but somewhat lower returns.

   In our example a $500,000 portfolio that earned a steady six per cent per annum for four years would be worth $631,238.48 while a portfolio that earned fifteen per cent for three years and then lost twenty per cent would be worth $608,350.00. <u>While the three years of high returns of the latter portfolio sound more exciting it was actually worth less than the first portfolio at the end of four years.</u>

   In portfolio management, as in most aspects of life, slow and steady usually prevails; the tortoise does win the race.

2) **Which has the worst performance; the TSX dropping from 14,000 to 13,600 or a stock that fell from $8.00 to $7.50?**

   After a large numerical drop (i.e. 400 points) in major equity indexes newspaper headlines scream and radio announcers blare that there was a "huge plunge" in the market. Indeed the actual decline does sound large, however what is relevant is the percentage change in value. A four hundred point fall in the TSX from its current level of approximately 14,000 represents a loss in value of 2.86%.

   On the other hand, rarely does one hear any comments about a share price that fell from $8.00 to $7.50. After all fifty cents doesn't seem all that much; it's less than the cost of a cup of coffee. Not true! The percentage drop in this example is 6.25%.

   <u>This seemingly small drop of fifty cents is actually more than twice the loss in value of the "400 point plunge".</u>

3) Do stock splits make an investment any more valuable?

Often times as a company's share price rises above a certain point, say $50.00 per share, management announces a stock split. They often increase the number of shares outstanding by a factor of two and the stock price should then trade at $25.00 per share. The shareholder who originally owned 100 shares for a total value of $5,000 (100 x $50.00) then owns 200 shares for the same total value of $5,000 (200 x $25.00).

However, when management announces a share split investors typically bid the price up in the short term even though nothing has fundamentally changed. The company's business prospects have not changed and its intrinsic value has not changed. It is similar to purchasing a whole pizza for ten dollars, cutting it into two equal pieces and claiming that it is suddenly worth eleven dollars.

Share price increases due to stock splits make no economic sense. <u>The only way to generate true and sustainable wealth is through the purchase of securities below their intrinsic value and/or through the growth in the underlying value of a business.</u>

4) If a stock falls fifty per cent in price does it mean that it is a good investment?

Investigating a stock that has fallen fifty per cent from its peak is a good exercise. However, it does not necessarily follow that it is a good investment or that the underlying business is fundamentally sound.

Simply purchasing shares that have dropped substantially is tantamount to speculation. As always a thorough analysis and valuation must be carried out. The shares may have fallen dramatically because the business is fundamentally unsound and bound for serious problems. Or the shares may have fallen because they were trading substantially above the intrinsic value of the business.

<u>The percentage decline in the price of a security is in and of itself irrelevant.</u> The share price must always be compared to the true worth of the underlying business to determine if it offers the potential for acceptable returns.

5) Which asset class has performed better since PCM's inception in March of 2000; T-Bills or the S & P 500?

T-Bills have outperformed the S & P 500 during the March 31, 2000 to September 30, 2007 period. The S&P 500 has generated a compound annual rate of return of only 1.92% compared to an average yield of 3.18% for T-Bills over the same period.

This fact may be a surprise to many because of the strongly ingrained belief that equities always outperform fixed income instruments. If you recall, equity valuations

were near record highs in March of 2000; fuelled by the tech boom. The S&P 500 subsequently declined and then recovered; however the compound annual rate of return has been very low over the past seven and one half years.

<u>The returns of an asset class or individual security depend on the price and valuation at the time of purchase.</u> High valuations (i.e. high P/E ratios and low dividend yields) such as those that existed in March of 2000 invariably lead to low future rates of return. Conversely, low P/E ratios and high dividend yields offer high rates of return.

6) How many investments does a portfolio need to be truly diversified?

Academic studies show that equity portfolios only need seven to twelve different securities to be fully diversified. However, most professional money managers hold well over fifty investments in their portfolios with many having more than one hundred different companies in their funds.

In our view this over diversification leads to a less than optimal portfolio management process. The amount of knowledge and analysis for each security is by definition less comprehensive, turnover is much higher and the aggregate portfolio statistics are likely to be very close to the index. <u>As a result, highly diversified portfolios tend to closely follow index returns but at a higher cost to the investor than an index fund.</u>

7) What are an investor's best friend and worst enemy?

<u>An investor's best friend is time coupled with patience.</u> Time allows the compounding effect to work its magic. The passage of time allows for the growth in the underlying business to occur and for the share price to appreciate to its true value. History shows that the purchase of undervalued securities held for the long term produce the highest returns with the least amount of risk.

<u>An investor's worst enemy is transaction costs.</u> Typically high transaction costs are the result of a large amount of trading in a portfolio driven by a very short time horizon. Academic studies indicate that excessive trading reduce a portfolio's return by several percentage points. In addition, frequent trading leads to very inefficient after tax returns due to capital gains that must be paid.

8) What is the most important rule of investing?

<u>The first and most important rule of investing is to never lose money.</u> As Warren Buffett has stated the second and third most important rules are never to forget the first rule.

Capital is lost in two ways. The first is to purchase securities of high quality companies at very high valuations. For example, those who purchased the shares of Microsoft at its peak price of approximately $60.00 USD and sporting a P/E Ratio of nearly 70 are not likely to recover their original investment any time soon.

The second way that capital is destroyed is to purchase shares in companies that are fundamentally unsound and eventually go out of business; Enron is an example of one such investment.

The loss of capital is devastating to the process of creating wealth. Not only is the original capital lost but the opportunity to compound that capital is permanently lost. This long term "opportunity cost" is far greater than the beginning sum that was lost. For example, assuming a seven per cent return over twenty years, $100,000 invested today would be worth approximately $397,000. If that $100,000 were lost then the additional $297,000 dollars that would have been earned is also lost. Thus a $100,000 loss could legitimately be viewed as a loss of nearly $400,000!

9) According to legendary investor, John Templeton, what are the most dangerous words in the investment business?

John Templeton has famously stated that the most dangerous words in the investment business are <u>"it's different this time".</u>

These are the words that are usually used during very bullish times to justify strong short term returns and very high valuations. From the "Nifty Fifty" in the seventies to the Japanese equity bubble in the eighties and onto the tech mania in the nineties, history shows us again and again that it never is different; excessive bullish sentiment and unsustainably high valuations inevitably lead to losses.

10) How did one of Europe's wealthiest families, the Rothschilds, claim to have made their fortune?

When asked how the Rothschild family became so wealthy a member of the clan is reported to have answered, "We have earned three per cent per year for the last three hundred years. "

<u>This statement captures the true essence of wealth creation; a long time frame, patience and prudence.</u>

Vito Maida
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