

Investment

Review & Update



Oct 19th 2007

Foresight, Hindsight, and Insight – The Investment Dilemma

The last three months have provided plenty of food for thought, particularly with regards to the stock market and investment portfolios. The “Bulls” are bellowing again as markets appear to shrug off the financial crisis that has seen a huge surge in liquidity being pumped into the markets by Central Banks to avert a further confidence crisis. What has taken place may be likened to a child “acquiring” candy from a store, and the parents walking back in and paying for it so that the family name is not compromised, but only consequence for the child is a warning. As an onlooker what can you say or do?

The continued commitment of the Central Banks to pump in cash has reduced concerns of traders, and market values reflect their new found confidence. Globally, resource demand remains high, oil prices are rising, gold and precious metals are finding new support and the mighty US Dollar is tarnishing. Fixed income remains a challenge as declining short term interest rates and increasing credit spreads keeps conventional bond funds underperforming expectations. Real

estate funds will face challenges. Ironically interest rates on investment savings accounts have gone up .25% to above 4%. While the waters are still murky, we are now of the opinion that it is not prudent to continue to wait for them to clear completely as the opportunity cost of not being invested appears to be greater than the immediate risks for downside. The key is risk management through diversification.

Foresight! We developed the PRISM program in 2002 when markets were still smarting from the declines which started in 2000, and as a result we incorporated into the investment process a “Stop Loss” function which would be triggered when an investment value dropped by a margin greater than its standard deviation. The goal was to protect clients from a run-away collapse in the market. Over the last 5 years we have triggered this Stop Loss mechanism three times reducing the volatility in client portfolios. While this has protected the downside for portfolios, these experiences have also raised some questions as we have witnessed that market corrections have been

followed by fairly quick bounce-back. Timing the re-entry to the market has become an issue, as our concerns related to the financial crisis have not fundamentally been addressed. As a result even a few days can make a difference of 3% or 4%.

Hindsight! Our ability to optimize the exit and entry for every client is hindered by our compliance requirement that each client authorizes and signs every trade request and MFDA short term trading rules. Those clients quickest to respond have had the greatest benefit, but in these volatile markets it is impossible for us to deliver and process every client’s trade tickets in the same day. Therefore in attempting to defend absolute return there is clearly an opportunity cost for actual return.

This has forced us to revisit our research. David Swenson, Chief Investment Officer for Yale University Endowment funds is arguably the most successful investment manager of the last 20 years, based upon his track record. In his book “Pioneering Portfolio

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Management – An unconventional approach to Institutional Investment” Swenson argues against timing entry and exit from market but rather recommends selecting a strategic asset allocation based upon the target risk level and being disciplined in rebalancing back to the selected allocation as required. Mark Mobius, the highly revered manager of the Templeton Emerging Market Fund say this, “It is impossible to predict how long the bull market will last. No one can predict the market direction and a bear or bull market could start or end at any time. However the good news is that bear markets are shorter in duration than bull markets, and bear markets go down a smaller degree than bull markets increase. That is why we must invest for the long term.”

Managing risk in individual portfolios is achieved in the same way Swenson has done it for Yale. First you establish the appetite, ability and need for risk, and then you customize the strategic asset allocation that meets that risk. Your allocation will consist of a diversified group of different asset classes which show low correlations with each other. Implicit in this is the reality that when some assets are going up in value, others may be going down. The goal should be that overall values go up, or at least are not subjected to violent swings often seen in the markets. Rarely, as we

have seen this year, when there is a financial crisis or major geo-political event, all investment classes move to the negative, and then there is a rush to cash or gold. While these principles are well understood, our human tendency is to focus on the negative short-term components and not see this in the context of the longer term portfolio performance. Part of our role as advisors is to help keep the bigger picture in mind and not compromise the long term market performance by over-reacting to short term market movements.

Insight! While it creates a sense of comfort to many clients that their advisors are taking action when the market is experiencing volatility, we are coming to the conclusion, that managing volatility through major portfolio reorganization away from the strategic asset allocation is actually compromising the risk-return rewards for the clients. Real risk management comes back to diversification not frequent action. We are further being convinced that the best value add to the portfolio is the selection of managers who are adding Alpha (beating their relative benchmarks) on a consistent basis, with superior risk adjusted return relative to their peers. As we go forward, we intend to continue to concentrate our recommendations for clients upon strategic asset allocation, rebalancing and manager

selection strategies limiting major readjustments to individual client objectives and priorities. A by-product of this strategy is that it will be more tax-efficient for corporate and non-registered accounts as we will most likely be initiating fewer trades.

Conclusion: We value every client relationship and take earnestly the responsibility to advise you in your investment and financial affairs. We believe that this review of our process and of our experience of working with the client investments over the last five years demonstrates our continued commitment to improve our service to you all. In this regard we will be contacting each of you as soon as is practical to review your personal and family objectives and redefine the target asset allocation for your portfolio. Thank you for your trust. If there are any questions please call Victor Whang at 604-331-2524 or Malcolm Ross at 604-331-2521.

Best regards,



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