

Mutual Success

Your Fund of Information



Oct 2008

Confused and Confounded

*“With ruin upon ruin, rout on rout,
Confusion worse confounded”*

– John Milton

How appropriate are the words of the famous poet John Milton for describing the collapse of the credit markets, the rout of the major players and the ruin of the very financial system in which they played. On Monday (Sept 29th) we saw the US Congress fail to pass the bailout provisions so heavily advocated by President Bush, and Treasury Secretary Paulson. It is evident that there is considerable confusion over how such a large plan can be implemented and controlled. In a further irony, the bailout was supported by a majority of House Democrats while the President and for that matter Senator John McCain were unable to muster the support of their Republican colleagues. The one day market swing was the largest points drop in the history of the US markets with a market capitalization drop estimated to exceed \$1.3 trillion, nearly twice the value of the bailout!

The ripple was felt throughout the globe with most markets shedding between 4.7% and 8.6% in one day, compounding the universal carnage we have seen on global markets as illustrated by the MSCI Barra Indexes for year to date as at September 29, 2008 from the table below:

Index	MTD	YTD
Europe	-14.43%	-31.93%
Far East	-8.52%	-22.36%
Nordic Countries	-20.70%	-36.69%
North America	-14.13%	-24.19%
G7	-13.30%	-25.72%

Uncertain as to what it all means, Investors (including Canadians) watched their currencies decline by as much as 3% as investors bought the US\$ T-Bills which are a traditional target in the flight to safety, even though yields are below 2%. It is confounding that there has not been a greater flight to Gold and Precious Metals, but this may yet happen as investors see that the “financial engineering” of the

United States, and its insatiable consumptive debt that belies the real substance of value in the currency.

It is sobering to watch the markets and the activity of the financial regulators around the world as they step in to attempt to prop up a global credit system which is in ruin. In addition to what we have observed in the US with Bear Sterns, Fannie Mae, Freddie Mac, and AIG, the failure of investment bank Lehman, and the merger of Merrill Lynch with Bank of America, we have also witnessed the largest bank failure in Washington Mutual, and narrowly missing the same fate Wachovia Bank merged with Citigroup. In UK Bradley and Bingley Bank, until recently one of the largest building societies and the largest “buy-to-lease” mortgage lender was taken over by the Financial Services Authority and the mortgage component was transferred to the already nationalized Northern Rock while the depository business was sold to a Spanish bank. In Europe Fortis and Dexxa have both been bailed out by the Dutch and Belgian

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Governments, and even Iceland has had to bail out its major bank. In an effort to address the liquidity issues, central banks around the globe have increased their lending to commercial banks. According to Dr Martin Weiss a highly respected economic research consultant from Florida in a submission to Congress, review of the data of the Federal Deposit Insurance Corporation in the US indicates that "based on a broader analysis of recent FDIC call report data, we find that institutions at risk of failure include 1,479 FDIC member banks and 158 thrifts with total assets of \$3.2 trillion, or 41 times the assets of banks on the FDIC's list."

The fundamental requirement for granting of credit is the confidence in the ability of the borrower to repay the debt. When banks refuse to lend to each other because of their concerns of repayment, it shakes the confidence of depositors, investors and institutional lenders alike. The result is that we are witnessing rising credit spreads, a reduction in available credit and much more rigorous lending conditions making it difficult for businesses to operate, and most importantly, more difficult for consumers to finance their purchases. This will result inevitably in an overdue contraction in consumer spending, placing more stress on businesses and profitability, with probable increase in unemployment.

With the bailout commitments that we are seeing throughout the world it is likely that when G8 leaders meet on October 10, 2008 we will see a concerted effort from them to collectively reduce interest rates. This is in the interest of everyone as it will reduce borrowing cost to Banks, and it will inject liquidity into

the markets. Importantly it will effectively reduce the interest carrying costs of the bailout to the governments and by extension to their taxpayers.

In the interim, investors remain focused upon the eye of the storm, and wait to see if the US Senate can pass an amended plan and then convince the Congress to follow. If the measures pass and there is a concerted approach to interest rates we will likely see a market rally which may last until the New Year. Failing that we will be experiencing a very uncertain market until the New Year and the change of the Presidency, and the reconvening of the Senate and Congress.

Canada of course is being affected by the fallout. Our bank and financial stocks have followed the declines globally, but due to tighter regulations and better management there is not the same exposure as in the US or UK. However, as portfolio values shrink so do the reserves of these institutions and we would be naïve to believe that we are immune from some repercussions. Credit spreads are rising, and there is a contracting of available credit. Combined with high fuel costs and increased food prices there are visible shifts in consumer spending patterns which will impact earnings and share values. Resource and commodity stock have been hard hit in anticipation of a global economic slowdown, and smaller mining companies including those we would expect to move in tandem with precious metals have seen their share prices drop more than the metals price due to expectations associated with credit availability. Acquisitions and consolidations are very likely in this market as investor emotion drives share below their

intrinsic or strategic values, and as corporations seek to rationalize costs and seek to secure strategic advantage.

When first learning business finance back in the Seventies (that would be the 1970's and not as my kids would like you to believe the 1870's!) corporate dividend yields were higher than those of guaranteed investments based upon the inherent risk associated with them. Based upon the current economic climate where we could see contracting rather than global growth, we may expect returns to be made up as much from their dividends as their capital gains. The drop in market values will represent opportunity for investors and fund managers to acquire quality assets at a discount. It was interesting to watch Warren Buffet step in to invest \$5B into 10% yielding Preferred Shares with Warrants in the troubled Goldman Sachs because of his underlying belief that they will survive and that his shareholders will benefit handsomely from the liquidity that the investment creates. We believe that this is the signal that there is a re-emergence of the risk premium in dividends. For this reason we do not believe that it is prudent to tie up large amounts of liquid cash into fixed rate GICs the income from which is fully taxable when in the New Year we believe there will be investments available with a better yield and preferred tax treatment.

In these volatile times we should reminded by the beginning of the famous Rudyard Kipling poem; "If you can keep your head when all about you are losing theirs..." Clearly the goal to manage risk has never been more important, and as your Investaflex Team at Sterling Mutuals

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we are taking this very seriously. We continue to look for ways to reduce risk while identifying the potential for future returns. However, if your current asset mix is causing you a loss of sleep, then please do not hesitate to call us.

Best Regards,



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