

Mutual Success

Your Fund of Information



September 2009

Perspective on the Market: Then, Now and What Next?

It has been a most eventful year for the stock and financial market.

Last September, we witnessed events that shook the foundation of Wall Street firms and the global financial system. Merrill Lynch, the famed 158-year-old investment bank vanished overnight, and the US government bailed out insurance giant AIG. A series of events began that threatened to collapse the banking sector in the US and around the world. It has been said those events marked the official beginning of the financial crisis, although there were many signs of trouble brewing in the background months before.

In light of that, we'd like to offer our perspective on where we have been, where we are today, and what to expect for the period ahead. And perhaps most importantly, what lessons can we learn from last year's financial collapse?

WHAT HAPPENED?

Following the threat of a total collapse in the world financial system, the US Government, Regulators and

Central bank (FED) were quick to react by setting up a \$700 billion rescue program now known as TARP (Trouble Asset Relief Program). TARP was succeeded by other similar programs (TALF, etc) to rescue troubled banks. To date the US banks rescue effort has cost taxpayers roughly US\$ 1.4 trillion.

In our opinion, the US had no other choice but to prop up the banks, who had overextended themselves by lending into an inflated real estate sector. Mortgages were bundled together, packaged and sold as low risk diversified investments. However when real estate values dropped the losses were real. This affected both banks' and investors' balance sheets and credit-worthiness.

Globally, rescue efforts taken by other central banks and governments sought to tackle the threat of an impending "Great Depression". Understandably, fear was rampant. Stock markets responded by hitting 5 year lows in March 2009. Investors reacted with a flight to the security of Government Guaranteed investments despite their low returns.

WHERE ARE WE TODAY?

From that apparent market bottom, signs of market and economic improvements are evident. These include:

1) An Asian-led stock market recovery of about 50% from the low (see Chart 1) and about 40% in other parts of the world.



Chart 1 –Improving Stock Market –S&P 500 (Source Bloomberg)

2) The Volatility Index (VIX), indicators of risk has returned to pre-crisis level, signaling a normalization of risk (Chart 2).

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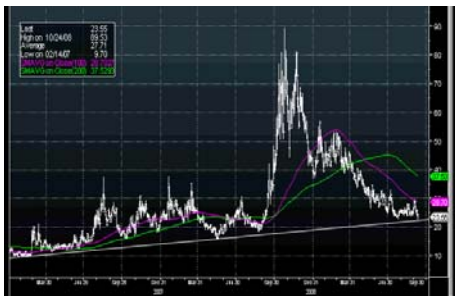


Chart 2-Volatility Index - Signaling a normalization of risk (source :Bloomberg)

3) The yield on corporate debt has returned to normal, implying reduced risk of corporate failures (Chart 3).

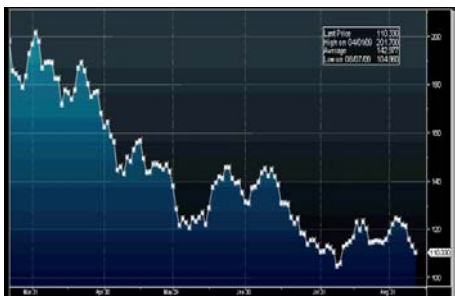


Chart 3-Diminishing US Corporate yield Spread (Source : Bloomberg)

4) The commodity index is on a gradual uptrend, rising from the bottom, signaling global recovery (Chart 4).



Chart 4-CRB Commodity Index is on a uptrend (Source ; Bloomberg)

In Canada, we swung from complete optimism pre-Sept 2008 to absolute pessimism in March 2009. Today the market hovers between these two extremes and many investors feel too bruised and battered to act.

But, healthy caution aside, more people are willing to take risks as market sentiments continue to improve. In parts of Canada, anecdotal signs of an improving economy are evident in the bidding wars on prized Vancouver real estate and condominiums in Toronto. Some previously stalled construction projects are resuming after the delay of last year's credit problems. The Canadian Dollar has benefited from stronger commodity demand and general weakness in the US Dollar.

The improvements in sentiment are independent of economic numbers, which at best show marginal improvement: i.e. less negative on a monthly or quarterly basis, but not yet positive. Analysts are divided on whether it will be a slow and gradual "U" shape or a more vigorous "V" shape recovery. A few are expecting a no growth "L" shape or even a "W" shape recovery. Whatever shape it may take, recovery it is! The good news is that there are always opportunities and buying on dips seems to be the strategy for the short and medium term.

WHAT HAVE WE LEARNED?

Five Lessons from the last Twelve Months

1) We are reminded that stock markets can be risky and the traditional concept of asset diversification may not protect one from a big and drastic downturn. In fact, diversification of assets has become more difficult with increasing globalization, as the world is more connected than ever. The downturn highlights the big difference between high and

lesser risk asset classes, and the advisability of moving aside to a lower risk class in financially stormy times.

- 2) Active risk management is now more popular now than in the past. Over the last 10 years we have witnessed two major bear markets that have suffered more than 50% drops in value, thereby shaking the core concept of buy-and- hold investing. It takes a strong risk appetite to sit through a 50% loss and a great deal of patience to wait for a 100% recovery in order to break even.
- 3) Short term sentiment is just as important as long term economic fundamentals for portfolio performance. The quick turnaround is driven more by sentiments than by solid economic fundamentals. The reality is that the banking sector is still under repair, consumers are over their heads with bad debts, labor markets are still depressed and the governments are drowning in red ink. One can go on and on about the poor fundamentals but sentiments have a way of driving investor confidence that feed a rising long term fundamental picture.

4) Traditional valuation using price to earning ratio (P/E) to gauge over-valuation (above 20) or under-valuation (below 10) become meaningless when current valuation is at 137. This indicator is showing stocks as extremely overvalued. One could stay out of the market for years waiting for valuation to approach 10 again. What we have noticed is that there is a "disconnect" between short term price fluctuations and long term traditional valuation.

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5) Stock markets are highly unpredictable and many investors discovered they can tolerate less risk in their portfolio than they had initially believed. A prudent approach is to exercise control over the areas one can control, such as cash flow planning and risk management.

Thank you for your continued trust in our team.



Victor Whang
604.331.2524

Malcolm Ross
604.331.2521

Violet Smith
604.331.4465

Rob Radloff
604.331.2508

WHERE DO WE GO FROM HERE?

Our view is that market sentiment will continue to drive both stock price and market recovery. This will have an impact on economic recovery and reflation of hard hit asset classes such as real estate. If this happens, inflation will again become a concern and equities will remain in demand, at the expense of bonds.

We believe it is prudent risk management to progressively increase our equity exposure to take advantage of market sentiment and as a defense against future inflation. (We do not want to be fully exposed in the market yet because of residual concerns over fundamentals and valuations.)

CONCLUSION

We hope we have provided a good discussion on the risks and opportunities for the months ahead and have been proactive in communicating our thought processes throughout this period.

Our carefully thought-out investment process has remained relatively unchanged over the years as we actively deal with the uncertainty of the stock market. We continue to review all client portfolios on an active basis and invite your calls on any questions or concerns.

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