

## Andex Letter 2009

January 2009

Dear Client(s),

Each year, we send our clientele an “Andex Letter” and an “Andex Chart” which summarizes economic data such as stock market indices, interest and inflation rates.

This letter is divided into four sections as follows:

- Executive Summary
- A Review of the Andex Chart
- Financial Crises; Past & Present
- Portfolio Strategy Going Forward

### EXECUTIVE SUMMARY

As this letter is rather lengthy, we have provided this executive summary:

- Our clients’ portfolios “survived” the market crash of 2008 and losses were mitigated (i.e. we did “less worse” than markets as a whole).
- We have been growing increasingly concerned over the last few months over the severity of the current financial crisis and we believe (although we do not know for sure) that the financial crisis and economic outlook will continue to deteriorate, and may be much worse than consensus economic forecasts. As a result, we do not believe that stock and real estate markets will have a sustained recovery in 2009, and the risk of markets falling further (perhaps significantly) is increasing.
- We anticipate that the world of tomorrow may look very different than that of the past, and thus, investment strategies that we may have implemented for you may need to be altered (at least temporarily) to “weather the continuing storms”.
- Our investment mandate is, and has always been, to do our best to ensure our clients’ portfolios do not sustain a catastrophic loss and thus, we are recommending to clients who are either: a) retired, b) close to retiring, or c) feeling very nervous, to reduce some of their equity investments and hold “safer” investments (cash, bonds and/or GICs) until the future of the global

economy appears more certain. This change can either be permanent or temporary, depending on your unique financial position, objectives and risk tolerance.

Please contact us to arrange for either a telephone or face-to-face meeting if you would like to discuss this in greater detail.

## THE ANDEX CHART – THE PAST 58 YEARS

Andex charts are produced at the end of each calendar year (the enclosed 2008 chart is produced at the end of 2008); however, there is a time lag between economic data being summarized and the production of these charts. Therefore, the data reflected only runs to June 30<sup>th</sup>, 2008.

Coincidentally, this is just before stock markets plunged in September, October and November, and thus the Andex chart does not illustrate the precipitous drop in stock markets since June 30<sup>th</sup>, 2008. In fact, on June 30, the Canadian stock market (as measured by the “S&P/TSX Composite Total Return Index”- or the red line on the chart) was very close to its all-time high as oil was approaching \$140 per barrel. However, you can see that U.S. and World stock markets (as measured by the purple, blue and yellow lines) were already starting to decline since the emergence of the “sub-prime mortgage crisis” in August 2007.

### Short-Term Returns

So how did various asset classes fare in 2008?

Indices	Description	Return *
<b>DEX Universe Bond</b>	Canadian bond market	<b>6.4%</b>
<b>S&amp;P/TSX Index</b>	Canadian stock market	<b>-35.0%</b>
<b>S&amp;P/500 Index</b>	US stock market	<b>-38.5%</b>
<b>EAFE Index</b>	Europe, Australia & Far East stock markets	<b>-45.1%</b>
<b>Gold</b>	Change in price of Gold (in US\$)	<b>4.9%</b>

\* These one-year returns are as of December 31<sup>st</sup>, 2008 and are not reflected on the Andex Chart, which only illustrates returns to June 30<sup>th</sup>, 2008.

As you can see, the only “safe haven” in 2008 was in government bonds and gold bullion (and cash and Guaranteed Investment Certificates, which are widely held by our clients but are not illustrated in this table).

Stock markets suffered one of the worst price declines in history; in fact, the S&P/500 (i.e. the broad measure of the US stock market) had its second worst decline since inception in 1825 (183 yrs). Only 1931 had a larger loss of 43.3%.

While major stock markets fell 35% to 45% last year, our clients' portfolios fared much better due to prudent diversification (i.e. holding all major assets such as cash, GICs/bonds, precious metals and stocks) and our long-standing conservative investment approach.

We are generally pleased with how our "Model Portfolio" held up in the Great Crash of 2008, however, we remain very cautious about the near term future and want to ensure that our clients' portfolios remain defensive.

### **Long-Term Returns**

To give us some longer-term perspective, we have summarized a few of the key indices illustrated in the Andex Chart since 1950 (to June 30<sup>th</sup>, 2008) as follows:

<b>Index</b>	<b>Description</b>	<b>Return *</b>
<b>Consumer Prices</b>	Cost of living (inflation)	<b>3.9%</b>
<b>DEX Long Term Bond</b>	L.T. Canadian Government Bond Market	<b>7.5%</b>
<b>S&amp;P/TSX Composite</b>	Canadian stock market	<b>10.8%</b>
<b>S&amp;P/500 Total Return</b>	US stock market (in Cdn\$)	<b>11.4%</b>
<b>World Markets ex US</b>	Global stocks not including US (in Cdn\$)	<b>11.6%</b>

\*Compound annual returns from 1950 to June 30<sup>th</sup>, 2008 (market drop of late 2008 not reflected)

Over the last 58 years, both bonds and stock markets grew at a faster rate than inflation (thus providing a "real return" net of inflation), and stock markets performed better than bonds (as expected). Thus the more investment risk one took, the better off financially one would have been.

As we stated in our 2008 Andex Letter, if we knew for sure that the next 58 years would be exactly the same as the past 58 years, then we would recommend that our clients hold nothing but global stocks, as this asset class has outperformed any other (including real estate which, unfortunately, is not included in this chart).

However, we are not certain that the past will replicate itself; in fact, we believe (and have for many years) that the returns of bonds, stock markets and real estate will be considerably lower going forward, primarily as a result of the "unwinding of debt" (and derivatives) in the global financial system. It is our opinion that the returns on all asset classes over the last 50 years has been an aberration from historical norms, fuelled by developed nations (North America and Europe) living well beyond their means. Both governments and citizens have borrowed and spent too much, and earned and saved too little.

We believe this trend is coming to an end, which will likely prove to be very challenging for both the rich and poor alike over the next few years.

## FINANCIAL CRISES; PAST & PRESENT

One of the most pressing concerns that we have (and we're certain that you share) is whether the current financial situation will continue to deteriorate in a material way. If it does, then how do we protect our wealth to avoid a potentially catastrophic loss in the short-term? Conversely, if the worst is behind us, then perhaps markets have "bottomed" and we should take advantage of this historical buying opportunity.

One way to gain perspective of the future is to look at the past as a guide, as history appears to repeat itself, but never with exact outcomes. As Mark Twain noted, "*History doesn't repeat itself; at best it sometimes rhymes*".

When studying past financial crises in our recent history (i.e. over the last 80 years), *on average*, stock markets fell 60% from their peak, real estate declined 35%, unemployment rose by 7%, economic output (GDP) fell by 9%, and government debt soared by 86%.

We have yet to reach these "average" benchmarks during the current financial crisis, which may be an indicator that ***the worst is not behind us***. We are compelled to ask ourselves, is this just an "average financial crisis" that will result in average market losses and economic hardship? Based on the results of our studies and our professional judgement, we believe that this crisis will prove to be one of the most challenging in history.

Here are a few of our observations that lead us to this conclusion:

- The financial and real estate markets have experienced abnormal (and unsustainable) growth over the last 20 to 30 years, fueled by over-consumption in the industrialized world (in particular, the US and UK consumer and government).
- This over-consumption was facilitated by falling interest rates and easy credit, compliments of emerging markets such as China, India and the Middle East (and Japan) subsidizing the US dollar. Low cost labour in emerging markets also resulted in (artificial) low prices of consumer goods (TVs, cars etc.).
- The global financial system encouraged excessive borrowing by businesses, hedge funds and more significantly, consumers, through the historic issuance of credit cards, student loans and home equity lines of credit, which grew at exponential rates thanks to the "financial engineering" of complex derivatives (e.g. sub-prime mortgages).
- Politicians and governments have grown increasingly irresponsible in their fiscal and monetary policies; they have cut taxes too low and spent too much, an unsustainable and dangerous combination that is only accelerating at alarming rates during our current economic crisis. This combination eventually leads to

currency devaluation, which causes an increase in the rate of inflation (and in extreme cases, hyperinflation).

- Global investors, in particular “Sovereign Wealth Funds” (SWFs), will be increasingly cautious in lending money to the US and other developed nations, and the SWFs will likely diversify their holdings out of US dollars and into other investments, particularly hard assets (oil, gold, real estate, infrastructure etc.). These actions by SWFs, in addition to governments debasing their currencies through their irresponsible fiscal and monetary policies, will put downward pressure on the US dollar and many other major currencies, causing inflation and economic hardship in those countries (stagflation). However, emerging markets must be careful not to bankrupt their “best customers” (Americans and Europeans) prematurely, as their continued growth depends on these consumers until such time as domestic demand can replace foreign demand.
- We believe that there is a contraction of global wealth taking place. A certain amount of the world's wealth doesn't really exist (it exists only in the form of money printed by governments with no basis for doing so). This “artificial wealth” is starting to disappear. In addition, the wealth of the world is being redistributed. The “rich countries” of the world are becoming less so. This will likely lead to a long-term erosion of the standard of living of the western world (to the extent that we define standard of living in material terms).

On a positive note, governments around the world are working in an unprecedented and coordinated fashion to stabilize the financial system and credit markets, while trying to stimulate the economy through monetary policy (lowering interest rates) and fiscal policy (promising new tax cuts and spending programs). Also, Barack Obama may just be the catalyst to regaining the confidence the world so desperately needs.

However, the challenges facing policy makers today should not be underestimated, and the consequences of failing to stabilize the financial system and global economy could be severe.

For these reasons, among others, we are inclined to recommend that clients take an even more defensive position with their wealth, whether it be with one's real estate, investment portfolio, level of debt or income (preferably all of the above).

## **PORTFOLIO STRATEGY GOING FORWARD**

We are now recommending to clients who are either a) retired, b) close to retiring (say within 5 to 10 years), or c) feeling very nervous, that they consider reducing the overall risk of their portfolio.

We recommend that these clients hold a considerable portion of their retirement assets (at least 50%) in “safer” investments (cash and/or bonds) until the future of the global economy appears more certain. This change can either be permanent or temporary, depending on your unique financial position, objectives and risk tolerance. Note that in analyzing a client’s portfolio, we consider their total financial assets and the capitalized value of their pension plans.

One may ask why we are suggesting such a change in investment strategy, especially after markets have already fallen so significantly. Is this not the time to be taking advantage of depressed stock markets and consequently increasing the level of risk in our portfolios?

For those clients who are no longer building their savings (and are in fact drawing on their portfolios to generate their retirement income), we believe that the financial risks that now lie before us are significant enough to warrant us to “err on the side of conservatism”.

For those clients who have more than 10 years until retirement (and therefore are still active savers), and/or clients who are comfortable with the level of risk in their existing investment portfolios, we are not suggesting any significant changes in investment strategy. The next few years may prove (in hindsight) to be some of the best buying opportunities in stock and real estate markets.

We have always taken a very conservative approach to managing the wealth of our clients. For example, we have ensured that a reasonable component of our clients’ portfolio be in Fixed Income Investments (GICs, Bonds and/or pension plan entitlements), 10% be in Precious Metals (gold, silver and platinum bullion) and have diversified the Equity (stock) investments into “many baskets”. For retired clients, we have allocated approximately 5 - 10 years worth of income in cash, GICs and/or Bonds so that we would not be forced to sell an equity investment after stock markets had fallen in order to create the required retirement income.

We have encouraged our clients to pay down their debt as soon as possible and to avoid borrowing to invest (excessive “leverage” is one of the root causes of the financial crisis we are living through today).

As a result of this planning, we feel that most of our clients are in a strong financial position and have weathered the current financial crisis much better than most investors, and we want to do everything in our power to ensure they maintain their financial independence.

It is our opinion that stock markets have not yet hit their bottom point. There may be a short-term rally due to massive government stimulus initiatives, but we believe that there will be unanticipated bad news that will further shake the confidence of investors and thus push markets to new lows before there is a sustained recovery.

If we knew that we were right (aside from being very popular and very rich), we would recommend that our clients sell all equity positions.

However, our analysis might be wrong, so we continue to recommend a balanced approach albeit a very defensive balanced approach.

Investors are in a precarious position today. Perhaps we are experiencing a once-in-a-lifetime “buying opportunity” where one can build wealth by being aggressive. Perhaps we are at a very dangerous juncture where one should be conservative and defensive. It is our professional judgement that this is a time for caution.

So we ask you, our clients, what you are most fearful of: experiencing further portfolio losses or missing out on above-average investment gains? Your answer will help guide us in devising an appropriate investment strategy.

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Thank you for our ongoing relationship and trust.

Please do not hesitate to call us or any member of our support teams if we can provide any additional information. Our past economic commentaries are available on our website ([www.rogersgroup.com](http://www.rogersgroup.com)); please contact us if you want assistance in navigating our website or if you would like us to mail or email information to you.

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