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Taking Stock—

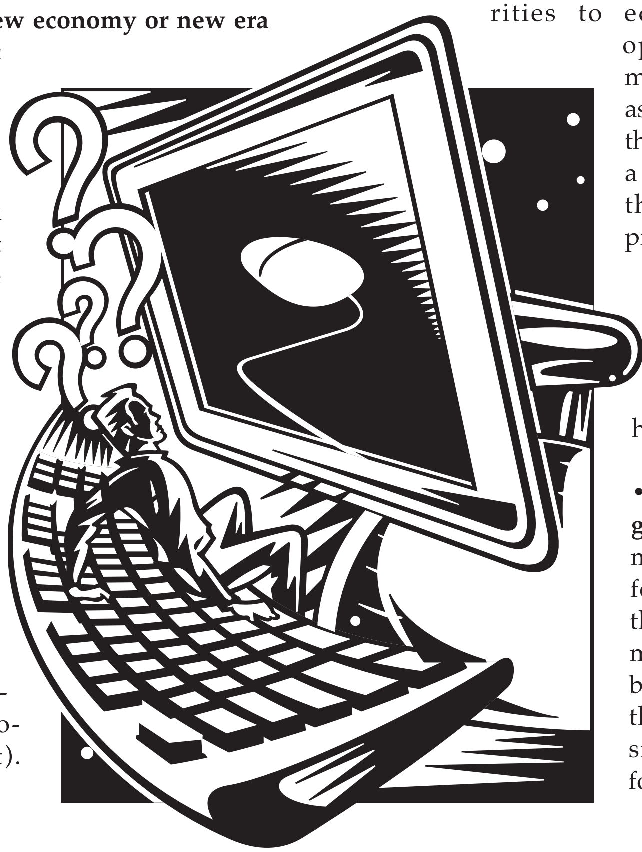
What Really Has Changed In The Past Two Years

by Nino A. Boezio

Even though many of our readers are aware of what has changed in both the economic environment and in the world during the past two years, it still may be useful to summarize what we have seen. These underlying themes have made important contributions to our volatile equity markets and will continue to dominate for some time to come:

- **Investment management is still an art, not a science.** With the proliferation of models, new behavioral research, risk management techniques, analytics and the elevated discussions addressing corporate governance, one may have gotten the impression that investment losses would have been mitigated in the current market decline—instead we may now be thinking that, after all the fuss, we simply just learned to lose money in a more disciplined manner (perhaps losses were indeed some what mitigated, we just do not know how market performance would have looked like if such tools and approaches were absent). We still have a long way to go in understanding investment activity.

- **The new paradigm, new economy or new era was probably just wishful thinking—again.** The technological advances, economic and societal changes that took place in the past decade did improve financial performance and productivity, but their relative impact was too overblown; especially in equity valuations. We were also told that the stock market would be strong to the end of this decade because baby boomers were still saving for retirement (the demographic argument). We were hoping that the incredible advances in technology and the use of the Internet would transform our economy and way of life to something simpler, more profitable and much more productive, and this would continue to filter through the economy and the markets for a very long time. Similar thoughts dominated the strong market advances of prior generations, only to disappoint later. These arguments induced people to buy more equities than they otherwise would have been comfortable with.



- **The equity markets cannot solve all our financial problems.** The stock market was being seen as the opportunity of the lifetime and the best and safest place to park one's money. Anyone who stayed out of the market was being too conservative. Perhaps the most graphic illustration of this thinking was in the area of public Social security programs where the markets could even promise to grow assets so fast that deficits could be eliminated. For example, some proposed successfully that the Canada/Quebec Pension Plan move part of its assets from low-yielding fixed income government securities to equity investments, using opportunity cost-type arguments, only now to see such assets falling far short of where they would have been had such a push never been adopted in the first place. Those voices promoting more equity investments have now become silent (now it is probably the time when they should really become audible—contrarian thinking does have its place).

- **We were not market geniuses after all.** Rising markets made many people feel like they were on top of the world and that they were market mavens. We all probably know someone who quit their job to become a professional day-trader. Now such former day-traders change the subject when you bring up that stage in their life, for it is somewhat embarrassing to discuss.

- **Perhaps our jobs are not so bad after all.** The goal of many was to retire as soon as possible with as much wealth as possible. Now with several years of bad equity returns and hence smaller personal portfolios, people may feel that their job is actually not so bad (and happy to have a job), that another five years or so of working may not be so painful (it may actually be fun) and all that free time after retirement could be over-rated (we will be bored). Therefore, many now look for more ways to enjoy our work.

- **Surpluses have changed to deficits.** Even though this is not a new phenomenon, we were, however, getting accustomed to seeing regular surpluses in government and public programs, including public and private pension plans. For example, once a surplus arose in pension plans, it would often continue to grow in excess of actuarial assumptions. There was a temptation to employers (even if pressure was not coming from employees) to improve plan benefits or use the surplus for down sizing via early retirement windows; especially since such surplus was not easily accessible to corporate operations due to regulation and legislation, and since the surplus was perceived to be a permanent gift from the markets (and/or arose from expert investment management). Insurance companies also got lured by the strong equity markets of the past 20 years into giving various floor guarantees on fund investments. Now every one running an financial program will be looking over their shoulder for the next 10-20 years before they spend a surplus, realizing that it can disappear quickly.

- **Technological advances have outpaced our current needs.** Do we really need a 2.4-gigahertz CPU, 60-gigabyte hard drive, 256mb RAM CD R/W notebook computer to run our Microsoft Office, when our machine of three years ago can still do the trick? And if we wait a year, we can get a 3.2-gigahertz CPU, 100 gigabyte hard drive, 512mb RAM DVD R/W notebook (plus some more add-on gadgets) for about the same money than we would spend today. Also, how small does our cellphone really have to be, and how clearly do we want to hear that pin drop as we see on commercials? The phrase 'significant improvement' is not so significant right now. There is this continued - mental struggle to buy that advanced technology now, versus the dread of it becoming slightly out-of-date in as little as six months time (patience is a virtue). We see the rapid changes in technology now also affecting cameras, hand-held devices and media players.

- **The world is probably not buying the American dream.** Even though the United States has been the dominant economy of the past 10 years, people and nations perhaps admired the United States because that was where the action was, not because that was where they wanted to be, or what they wanted to be. All this talk about terrorism has raised national concerns because the rest of the world does not seem to think the way we do in North America, even though we thought (or hoped) they did. The rest of the world perhaps wanted to enjoy part of our prosperity without becoming like us.

- **The United States now has undertaken the tough job of keeping the world from falling apart.** Can a nation of 300 million people prevent chaos in a world of six billion? Can the United States physically and financially afford it? Will such 'service' be appreciated? (The world is often unwilling to admit that the United States and the United Kingdom often accounted for much of the global stability in the 20th century). There are many forces of disruption in the world that are more interested in destroying rather than building, or picking up the pieces afterwards. If such forces are successful, then the whole world suffers. It makes one worry more today about holding the S&P 500 futures long overnight. Also the United States has a tough task of promoting its political, social and economic values to the rest of the world, when other countries may argue that the United States is not a moral example nation either.

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- **The Internet is still a fuzzy tool.** There were times when people had a clear vision of what the Internet would add to our life and our economy, and this helped fuel the dot-com rage. Now the whole subject has an element of confusion to it. The Internet is excellent for getting information and viewing products online, but I do not get the sense that too manyknow what its ultimate role or economic value will be in our society.

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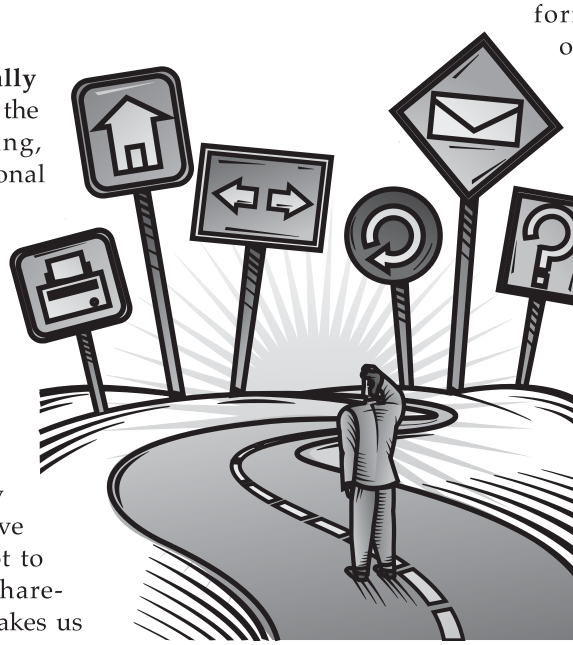
- **Non-economic factors cannot be ignored.** Investments have tended to be made primarily based on financial attributes, since other factors were difficult to determine and hence, incorporate into the decision making process. Behavioral research has noted that investors tend to think of factors that impact an investment decision in compartments, and are not often assimilating such factors together correctly to make a proper decision. Hence we may have invested based on economic and financial factors, ignoring or down playing major political problems that would have made our decision somewhat different or have inadvertently allowed our biases to improperly weight various attributes. Based on the uncertainty in today's world, we have to do a better job of putting all of these attributes together.

- **We learned that we often could not tell the difference between good corporate marketing, optimistic projections, a good story or simply, bold-faced lying.** We put a great deal of trust in the nobility of our corporate leaders, advisors, analysts and our institutions; since the financial world is very large, very complex and we simply do not have the ability, the time nor the expertise to monitor everything. We often took what we heard about a company, its prospects and its activities as being very close to the facts. The confidence that we always hear the truth has now been undermined and shaken. We are now finding that we cannot delegate the entire investment function, especially on the personal level, to others with complete assurance that everything will work out alright.

- **Are professionals really professional?** With all the professional training, emphasis on professional standards, regulation, government watchdog organizations and emphasis on ethics and honesty, we have found professionals who are willing to wiggle through loopholes to satisfy clients, satisfy themselves or to achieve certain objectives—not to serve the public or shareholders. It certainly makes us worry about where things could have gone wrong, since we, in North America, have prided ourselves as being far advanced when compared to the rest of the world on how our companies and people do things, and we have prided ourselves as nations of good law and behavior.

- **The Middle East continues to be a focal point.** Ever since the fall of the Ottoman Empire after World War I, when the nations of the Middle East became 'free' from Turkish rule, there has been escalating unrest in that region. As long as oil and gasoline are dominant factors in the world economy, the Middle East will always be a source of concern for much of the world, and always poses a danger if the wrong people come into power. The late-1990s gave us the impression that peace was finally blossoming forth when we saw various former enemies shaking hands, only to see it all unravel two years ago. Unfortunately, we hate to mix religion with economics, but it is a reality we always have to keep in mind when planning investments, as we only like to consider factors that have a numeric value and not intangible impact. Peace can be an illusion as history shows. Unlike other economic factors, countries such as the United States simply cannot control that part of the world, and yet, it is so vital to world stability and prosperity.

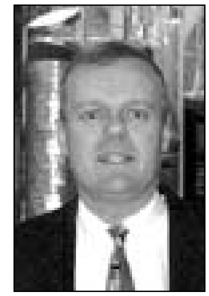
- **Things can either change very quickly or very slowly.** I wrote an article in *Risks & Rewards* in 1995 where I had a slight negative bias towards the equity markets, since equities broke most former (fundamental) measures of overvaluation. I felt the market was going to be in trouble within the next couple of years. I was wrong. Overvaluation only became a major focus in early 2001. On the other hand, we saw equity crashes within a few months of the market making a major top, which bothers those academics that argue that the market is rational. We simply cannot do straight-line-type projections on how the markets will perform; reactions are very slow or very swift, even though signs may or may not be evident in advance.



- **What is truly important in life?** Change makes us reflect on the past. The economic downturn has caused us to re-evaluate our lives in the prior economic boom—whether our lifestyle was wise, whether we got carried away with the mood of the times either in what we bought or did not buy and how we balanced our work versus family. People relationships are now being seen as being more important than physical possessions and status.

- **Information overload.** Recently my computer crashed which initially made me depressed. I managed to save my client files, but lost much of what I had accumulated over the past three years onvarious subjects (which I thought might be useful someday). Ironically, I am very happy now that I lost those other files. I had so much junk stored on my computer that I probably could not find any saved information easily even if my life depended on it. Much of it was out-of-date and I also get so much new stuff daily, that I would never re-read that old stuff again anyway. If I need to look for something, I can simply search the Internet and get current, up-to-date and more useful information that I had before. I have come to realize that sometimes we accumulate information because we think knowledge is power; yet if we accumulate too much, we can no longer see straight. Too much information can confuse us, waste our time and slow us down in making decisions. Also saving things that 'might' be useful someday is often just not worth it. We live in an age where so much information is available and is ever increasing that we have to set priorities on what we will bother with. Time is becoming a more valuable commodity than information is, and a valuable skill is not knowing something in advance, but knowing where to find that something when we need it and knowing how to apply it. I would often get troubled when I heard portfolio managers boast about all the information they had at their finger tips, but when I would ask how they use such information, their eyes would glaze over and they would begin fumbling for an answer.

Overall, the world is not difficult to understand, but it is hard to weigh all the factors in order to make an investment decision. Unfortunately right now, this uncertainty is something that cannot be wrung out of the system that easily, it is expected to hold back equity performance somewhat and keep yields on fixed income securities lower than what otherwise would have been expected. But uncertainty and confidence have traded places often in history, and we must always be prepared to handle these shifts.



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Looking Back...Investment Section Council Photos

Members of the 2002-2003 Investment Section Council biding farewell to outgoing chairperson, Max Rudolph.at the SOA Annual Meeting in Boston
Left to right—*Larry Rubin, Craig Fowler, Steve Easson, Mike O'Connor, Max Rudolph, Doug George, Joe Koltisko, Mark Bursinger*

Missing Council Members – Charles Gilbert, Bryan Boudreau

Doug George (right), incoming Investment Section chairperson, presenting the "Bull and Bear" statue to Max Rudolph, retiring section chairperson, in appreciation of a job well done.