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Do We Feel Better Yet?

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The recent gains experienced by North American stock markets have been significant and swift. Over the past ten trading days the S&P/TSX Composite has risen 18% while in the U.S. the S&P 500 is up about 23%. This represents gains equivalent to what we should typically expect to see over a two year period. In fact, Bloomberg reports that this current rally in U.S. stocks is the steepest two week gain since 1938.

Should we have seen this rally coming? As is usually the case, the so-called experts' opinions on the market's future direction, when it was near its lows, ranged from extreme pessimism to extreme optimism, but generally speaking sentiment at that time was pretty gloomy. Just think back to how you were feeling on the evening of Friday March 6th. The market was coming off another losing week (the fourth in a row for U.S. markets) with the S&P 500 having lost 7% during the week and at that point it was down 24% year-to-date. In an article in the Saturday March 7th Financial Post an analyst stated

"Equity indexes continue to be weighed down by fears that some of the companies underpinning indexes may go bankrupt, be nationalized or need additional dilutive financing. As bankruptcy talk and pleas for bailouts continue, investors may remain cautious toward equities."

Also, in the same newspaper were the following headlines; "U.S. Employment Index Decline Fastest in 35 Years", "Economy Has Fallen Off A Cliff", "New Home Construction Plummets", "Loonie Hits 4 ½ Year Low (at 76.89)". It was pretty tough to be feeling positive. Who would have thought that just two weeks later, U.S. bank stocks would be up 87% (S&P 500 Bank Index), the Canadian Financials (S&P/TSX Financials Index) would be up 34%, oil up 14% and the Canadian dollar flirting with the 82 cent level?

On March 9th I had a meeting with a client who expressed his desire to increase his longer term allocation to equities, but only once "things feel better". My point to him was that once we *feel* that things are improving, we will likely have already had a significant rally. I state this not to suggest that I have tremendous intelligence or insight, but rather to highlight a point that history has taught us, which is that no one can accurately predict when a bear market will turn around and waiting for things to *feel better* often leaves a lot of profits on the table.

I recognize that the tremendous gains over the past two weeks only brings the markets back to where they were in mid-February, and we have a long way to go to regain the all-time highs, but the lesson is an important one. We have no idea whether this is simply a bear-market rally and new lows are yet to come or whether the markets have truly turned the corner. Certainly the detailed plans released by the U.S. Treasury today to deal with up to $1 Trillion dollars of troubled assets currently sitting on the books of U.S. banks was welcome news, however it remains to be seen how effective this plan will be and whether or not they will be able to attract the private investors they are seeking to partner with in this venture. Further, even if Public-Private Partnerships are created and they purchase vast amounts of troubled assets from the banks, will the banks in fact use this new-found liquidity to significantly increase their lending (keeping in mind that too much debt is one of the factors that got the global economy into its current state).

It is true that global stock markets remain well below the all-time highs reached approximately 16 months ago, but no matter how financially and emotionally painful that fact may be it is irrelevant. The price you paid for something should have little bearing on whether you hold it or sell it as the only thing that matters is what it is worth today and whether or not it remains a sound investment and is appropriate for you. Irrespective of the impression the pundits may try to display in the press, it is impossible to predict market movements with accuracy and consistency. While some may make the occasional prediction that comes true, one should not assume that it can be done consistently.

When we consider the volatility that has existed in the stock markets since last September, one could have made tremendous profits had they been able to accurately time their way into and out of the markets at opportune times. But let's think about the number of decisions that might have entailed. If you decided at the beginning of each of the past six months to either be in T-bills or in stocks for the ensuing month this would have resulted in 64 potential combinations of investment allocations throughout that six month period (while this seems like a large number the following two month example will highlight the number of different combinations: October in stocks, November in T-bills, or October in stocks and November in stocks, or October in T-bills and November in T-Bills,

or October in T-bills and November in stocks, etc.). Mathematically this can be calculated as two potential investment options over six months equals 2^{6} (which equals 64). If we felt that we could be even more active and make those allocation decisions every two weeks instead of monthly to take greater advantage of the volatility the potential combinations of investments over the entire six month period would be 2^{12} which equals 4,096! You can quickly get a sense of how challenging it can be to get the majority of these decisions and combinations correct.

While it is human nature to want to do things that feel comfortable, when it comes to investments this is seldom the most rewarding course of action. What truly matters for any investor is how their investments are aligned with their needs and goals and not how they (or their Advisors) are currently feeling about the markets. For example, when considering short term needs (three years or less) we would strongly recommend that equities play no role in this portion of the portfolio as no one can predict with any degree of accuracy whether stocks will be up or down over that period of time. For longer term goals we typically suggest that equities represent an increasing portion of that part of an investor's portfolio. If you currently have a financial goal that is 10 years in the future, are you more likely to achieve that goal with a 10 year Government bond (currently yielding about 2.75%) or with equities? While the past 10 years has been difficult for equity markets there is good reason to believe that a well managed equity portfolio should be able to generate a return over the coming 10 years that is significantly greater than 2.75% per annum. If we wait until we feel better about the economy and the markets we quite possibly will have missed out on some tremendous upside. Of course the key is to begin to reduce the equity exposure as time passes and we approach that goal that is currently 10 years out.

Prudent alignment of investments with needs and goals is far more advisable than trying to time your way into or out of the market based on emotion or perceived knowledge of what the market will do.