Leith Wheeler
INVESTMENT COUNSEL LTD.

INvested

SUMMER 2011

INVESTMENT OUTLOOK

Timing Isn't Everything

The second quarter of 2011 provided a great deal of volatility in the equity markets. In Canada, the S&P/TSX Composite declined by 5.2% in the second quarter and ended just slightly in positive territory for the first half of 2011 (+0.2%). Continuing concerns about Greece and the financial stability of the European Union are at the top of investors' minds. The news media uses descriptive words such as "plummet" and "plunge" on a regular basis to describe the ongoing volatility in the equity markets. After the severe bear market of 2008, some investors are wondering if we are about to experience a repeat of the financial crisis and if so, what should they do to protect their portfolio?

Financial theory relies on the notion that the markets are efficient and immediately absorb and reflect all information as soon as it becomes publicly available. Traditional portfolio theory assumes investors make rational decisions and determine an optimal portfolio asset allocation based on their risk tolerance and return objectives. Behavioral finance is an area that is gaining more popularity as it incorporates investors' actual behavior when it comes to investing. One finding from behavioral finance studies is the notion that investors are more sensitive to feelings of regret and to the potential of loss of their portfolio value than they are to potential gains. Another concept is that investors are risk seekers when faced with the prospect of substantial loss.

Continued Next Page

On June 18th and 19th, 16 people made up a Leith Wheeler team that participated in the ***Ride to Conquer Cancer,*** a bike ride from Vancouver to Seattle.

The team raised over $48,000 to benefit the BC Cancer Foundation, in memory of Murray Leith and numerous other friends and family affected by cancer.

www.conquercancer.ca

Download previous newsletters, and read some of Our Ideas online at:

LeithWheeler.com

The reality is many investors allow their emotions to dictate their investment decisions – particularly during extreme market conditions. We often say that the markets are driven by two things: fear and greed. As value investors at Leith Wheeler, we often use the analogy of buying stocks "on sale" or buying stocks that have a cloud hanging over them providing a temporary price reduction – the theory of 'buying low and selling high'. In practice, however, many retail investors find following this strategy more difficult because of fear. In 2008, investors were concerned that their portfolios would drop to zero. Although portfolios did decline significantly – really there was nowhere to avoid negative returns if you held assets with any kind of perceived risk – we have seen a strong recovery in the equity markets since. Had investors remained invested, they would likely have recovered the paper losses experienced in their portfolio and in fact, have since seen some growth. During this difficult period clients wanted to know if Leith Wheeler was recommending large changes to their portfolio. Should they move to cash and preserve what capital they have left? The answer was always the same: use the volatility to rebalance to your long-term asset mix. Why not move to cash? Because historically, investors who take that approach often do more damage to their portfolio than they would have if they had remained fully invested. Few people have been able to prove they can successfully time the market consistently.

"I can't predict the short-term movements of the stock market. I haven't the faintest idea as to whether stocks will be higher or lower a month — or a year — from now. What is likely, however, is that the market will move higher, perhaps substantially so, well before either sentiment or the economy turns up."

Warren Buffett
October 2008

Due to the recent volatility in the market, some investors are again asking the same questions. Specifically, should they move some of their portfolio to cash in order to avoid potential declines? First, short term market movements are not predictable. Although there are areas of concern and markets will likely be volatile, we expect to see continued economic growth globally – albeit at a lower rate than previously assumed. We feel that stock selection will prove to be critical going forward. Second, you have to get the timing of both the sell and the subsequent buy decisions right in order to outperform a long term buy and hold strategy. If you are lucky, you may get one of those investment decisions right .

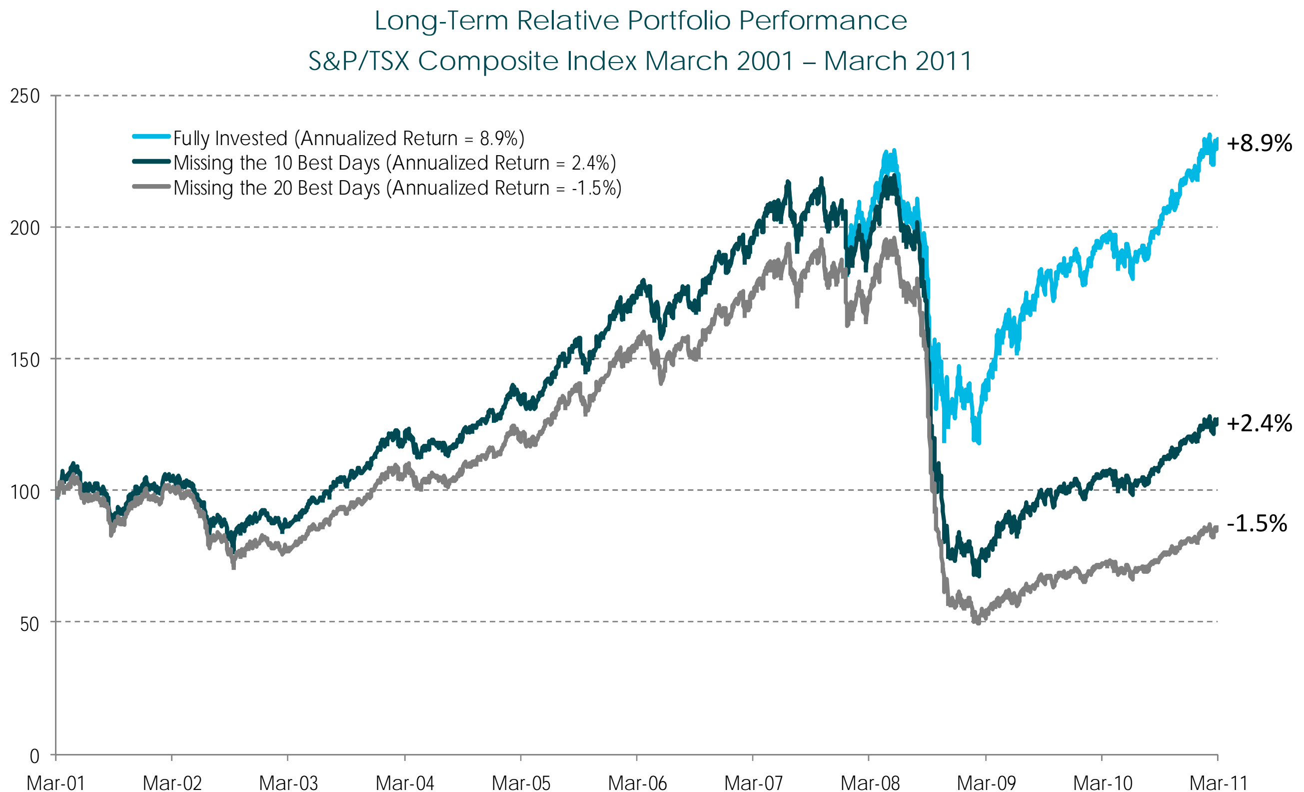
The more common scenario however, is investors wait until their portfolio declines significantly before deciding they can't tolerate market volatility and choose to abandon their strategy of long term investing in the midst of a bear market. This is an emotional decision made in an effort to preserve what capital they have left. Once on the sideline, they believe they will re-enter the market "when things get better". The most common outcome for these investors is markets have to recover substantially before they feel comfortable enough to buy back in and they end up buying in at a much higher price (sometimes higher than the levels they sold at). This is why the performance of

individual investors who try to time the market is significantly worse than the market's performance. A study by Morningstar in the U.S. showed that during the 10 year period ending December 31, 2009, the average return for investors was 1.68%. The average mutual fund returned 3.18% per year in that same ten year period*.

When markets recover, they recover very quickly and very strongly, so if you are not in the market, you will miss out. The following chart shows what happens if you miss the 10 and 20 best days of the market recovery versus staying invested throughout the entire period. If you miss the 10 or 20 best days, your portfolio grows by 2.4% per year or falls by 1.5% per year respectively versus 8.9% return per year if you had stayed invested.

Critics will counter with "what if you miss the 10 worst days?" Your portfolio would have performed well, but how do you pick those out in advance? Often the best days in the markets follow the darkest. Warren Buffet says "be fearful when others are greedy and be greedy when others are fearful". This embodies the buy low and sell high theory. Makes sense, but why can't we do it? It all comes back to fear and human nature.

Markets are not always rational and in fact, value investors depend on temporary mispricing in the markets in order to buy securities that will appreciate to their fundamental value. At Leith Wheeler we take a bottom-up approach to investing which means we don't try to outguess the market in the short term. We focus on finding high quality companies that have predictable earnings, a strong balance sheet and proven management and we try to buy them at discounted prices. We feel this is the only way to beat the market in the long term. We believe individuals should refer to their long term asset mix and investment policy during periods of challenging markets. If nothing has changed in their personal circumstances other than a temporary increase in market volatility, they should stick to their investment plan and rebalance their portfolio to their long-term asset mix.



*morningstar.com, Russel Kinnel, Bad Timing Eats Away at Investor Returns—02-15-10

One strategy that can help investors when faced with volatile markets is to ensure they have sufficient funds in short term, conservative assets to meet their income needs for the next year or so. This type of "mental accounting" (separating the overall portfolio into separate buckets to address specific needs) allows investors to feel confident that their income is protected and will give them time to allow their equities (the longer term assets) to recover from any short term loss. Related to this is a strategy used by many pension plans called "Asset-Liability Matching", where pension plans invest in fixed income securities that mature when their liabilities occur in the future. This allows them to be less concerned with short term market movements.

Markets will always move up or down and are not predictable in the short term. Investing in an asset mix that is appropriate for your objectives (in both good and bad markets) should not be abandoned. We are not suggesting we do nothing during volatile markets – quite the contrary. At Leith Wheeler, we believe holding a diversified portfolio with a good investment policy in place allows managers to adjust holdings within the portfolio based on valuation levels. Volatile markets provide managers opportunities to buy good companies at discounted prices. However, making big asset mix moves or trying to time the market is a risky strategy. Investors who try to do this historically have had much poorer portfolio performance than the markets in general.

Emotions should not drive your investment decisions. We feel that determining a suitable long-term asset mix and using market volatility to rebalance your portfolio at attractive valuation levels is the best way to manage your investment portfolio over the long term.

Leith Wheeler Investment Counsel Ltd. ("Leith Wheeler") is an employee owned firm providing portfolio management services for individuals, pensions and foundations.

INvested is not intended to provide advice, recommendations or offers to buy or sell any product or service. The information provided in this report is compiled from our own research and is based on assumptions that we believe to be reasonable and accurate at the time the report was written, but is subject to change without notice.

Leith Wheeler officers and employees may from time to time hold securities of issuers discussed in issues of INvested. If you are interested in our personal investing policy please contact us at 604-683-3391.

Contributor:
Karey Irwin, CFP
Portfolio Manager

Editor:
Michael Job
Portfolio Management Associate

1500 — 400 Burrard Street
Vancouver, BC V6C 3A6

Phone 604.683.3391
Toll-Free 1.888.292.1122

LeithWheeler.com