REVIEW & COMMENTARY
3RD QUARTER 2008

Crime and Punishment

It is hard when innocent people get punished for the transgressions of others. It is even worse when the punishment doesn't seem to fit the crime. Over the past 5 weeks, the markets have turned from what might be loosely called a "normal" market into something totally irrational. While this happens periodically in the markets, it is rare that the selling continues when regulatory forces do so much to turn the tide of opinion. The US Fed and Congress, now joined by Global Central Banks, have promised to stand behind the capital markets and every major financial institution. Interest rates are being lowered around the world. And markets continue to sell off. This would defy our logical perspective of the world but the market can remain irrational much longer than any of us might ever predict.

We do not feel that the end of the world is near. With time, this claim will be either naïve, fortuitous or somewhere in between. In SIM's collective 100 years plus of experience in the investment business, we have never seen anything like this. We would have said the same thing, however, in the early 1980's when the Resolution Trust was set up, in October 1987 when the Dow Jones was down 22% in one day, during the Asian financial crisis in 1997, and when Long Term Capital failed in 1998. Each time the market undergoes a dramatic downturn, it is usually something rarely seen before. What has happened is a crisis of confidence and given all the undertakings by Central banks, it is hard to imagine that matters will get much worse.

Many factors have led to this. Improper supervision of short sellers, changes in accounting to "mark to market", excessive leverage by some professional investors, questionable real estate loans and many others. Regardless of what and when, these are among the areas to point at in order to locate the cause. Trying to find the perpetrators does little to fix the problem, and to look backwards, misses the point. We have to look at what actions are being taken now and what they will do in the future is far more important.

In the US, the Federal Reserve and the US Treasury have taken over Freddie Mac and Fannie Mae, extended an 85 billion dollar loan to guarantee AIG, injected hundreds of billions of dollars into the credit markets, guaranteed money market funds and will oversee 700 billion dollars swapped into banks for questionable loans that most likely are trading at, and accounted on many financial institution's books, at a fraction of their true value. They have pledged to stand behind every deposit of major financial institutions and do everything in their power to abate the financial crisis. Now other central banks are joining the party. One thing they can not do it seems, is to restore confidence.

It is almost impossible to redirect the mindset of the public through actions such as these. Investors are panicking. Crowd mentality is extremely fickle and often the most base level of intelligence prevails. It will take some time for investors to realize that the worst of the financial situation is behind us. Admittedly, the next focus will be on the economies of the world and how they will be affected by what has happened in the financial markets. It seems doubtful that China will stop building out their infrastructure because the Dow Jones or TSX is now down more than 25 %. Although China's growth will slow, many economists still feel that it will grow at a reduced 7-8% per year. The Middle East will continue to accrue cash through the sale of crude and oil by-products. The demand for resources and raw material will continue. Certainly, North America will be hurt but it wouldn't be difficult to argue that the market is already reflecting this. And given that the market is forward looking, when it decides that things are improving it will turn quickly and decidedly. The market is inexpensive. The price earnings ratio for the SP 500 using consensus forward earnings for the next 12 months is at an all time low. Admittedly, earnings are suspect and very difficult to predict at any time, even more so now, but earnings will be hurt. While it is likely that many economies will enter into a recession, it is the length of these recessions that will be in question. When the credit markets thaw and business returns to a more normal level, equities will react before the news turns positive.

While the threats to the long term viability of the global economy may be terribly underestimated by us, we do feel that those looking to liquidate their portfolios are far too short sighted. This sell off is more traumatic than we anticipated, however, it does suggest that the market is setting itself up to be healthier for the future. It would be equivalent to considering a cardiac patient in light of where he was, rather than where he will be, if he takes the appropriate steps towards recovery. Sadly, when it comes to the market, it is easy to cast blame but even if we were to identify the culprit, we all have been punished. It takes time to heal but the market looks forward not back and we remain confident that better times are ahead.

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