NEWSLETTER #10
NOVEMBER 2009

PERENNIAL
ASSET MANAGEMENT

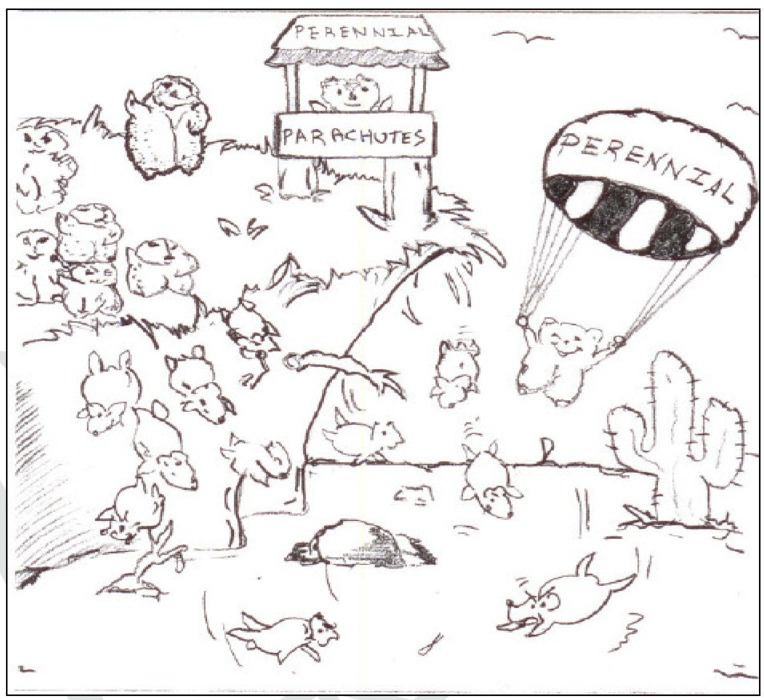
Perennial Perspective

ADAPTING TO CHANGE

"Change is the law of life. And those who look only to the past or the present are certain to miss the future." - John F. Kennedy

In the investment world it is clear that "the times they are a changing". Investment strategies that have worked for decades have now let investors down. The old standbys such as buy and hold, buying on dips, stock picking versus market timing all proved successful in the twenty year bull market from 1981 to 2001 but they have hurt investors since.

Equity indices are where they were ten years ago. Savings accounts often pay no interest. Americans are now re-evaluating whether they should continue to expect their house price to rise in value. What is an investor to do?



Managing To Perform In All Market Environments
225A MacPherson Avenue, Suite 200 Toronto. Ontario M4V 1A1
t. 416-966-2552 f. 416-966-5005 www.perennialasset.com

Investors should be questioning their investment strategy. The evidence suggests that the expected benefits of traditional strategies have not materialized. However most still find themselves at a loss as today's successful strategies are what they have previously been counselled to avoid. Therefore the common solution appears to be leaving the statements unopened and ignoring the problem, hoping it will fix itself. This is not the answer.

Research showed that buying good quality companies and holding them was a great strategy from 1981 to 2001. According to research conducted by Charles Schwab in 2006, between 1926 and 2005, a 20-year holding period never produced a negative result. Is that all we expect? Investors we know are not prepared to wait 20 years for their portfolios to be profitable. What happens after inflation? How are they going to achieve their financial goals if this continues?

IT IS NOT WHAT YOU THINK

Let's look at a couple of investment tenets that have been around for as long as I know.

1. If you are willing to put up with volatility you will earn more in stocks than in bonds.
2. Don't try to time the market. The price you paid will not matter in 20 years.

The following chart tells a different story.

Oct. 20, 2009	**Performance**	
	Bonds*	**Stocks****
5-yr	34%	10%
10-yr	119%	1%
15-yr	249%	208%
20-yr	410%	380%
25-yr	970%	1081%

Long-Term Treasury Bond Total Return Index** * S&P 500 Total Return Index**

As per the table above, investors would have earned more in long bonds than in stocks over the last 5, 10, 15 and 20 years. Not until one goes out 25 years would an investor have been better off by investing in stocks. A New York Times writer produced a different study but came to a similar conclusion. If you care to look at their analysis please follow the link at the end of the newsletter titled '10 Year Returns'.

Why have we not heard this message in the media? Why are they trotting out the same old information that has not been true for a long time? Should we conclude that stocks are not a good investment and fill our portfolios with bonds?

To be a successful investor, one must understand that in the face of significant change, the past is not always a reliable indicator of the future. Do not expect that bonds will always outperform stocks since they have over the past twenty years. In 1981 US long term bonds were yielding 15.2%; today they are yielding 4.3%. Coming to the conclusion that bonds will outperform over the next 20 years from this starting point would bring us back to the lemmings cartoon.

WHAT DO THE INVESTMENT ICONS DO

Advocates of a buy and hold strategy will point to icons such as Warren Buffett, to prove that a long-term strategy works. But does this mean that the CEO of Berkshire Hathaway does not wait to buy companies when they are cheap? Proponents of the buy and hold strategy use Buffet as an example of a value investor who does not time the market. However a closer look at his style shows that he is happy to wait for stock prices to fall to levels where he believes he can make money. For example in 2006 Berkshire Hathaway held a 46.5% position in cash - $40 billion cash, compared to $46 billion invested in securities.[i]

In an October 2008 New York Times interview Buffett referred to how he was managing his personal account:

> *“So ... I’ve been buying American stocks. This is my personal account I’m talking about, in which I previously owned nothing but United States government bonds. (This description leaves aside my Berkshire Hathaway holdings, which are all committed to philanthropy.) If prices keep looking attractive, my non-Berkshire net worth will soon be 100 percent in United States equities.*
>
> *Why?*
>
> *A simple rule dictates my buying: Be fearful when others are greedy, and be greedy when others are fearful.”*[ii]

Does this sound like a person who does not time the market? He was moving from 100% bonds to 100% stocks. Why did he own no stocks personally in 2007? Why was he planning to own nothing but stocks at the end of 2008?

Buffett obviously cares what he pays. He sat on billions of dollars for years until prices reached the level where he believed he could earn his required rate of return. Buffett's "fat pitch" analogy nicely illustrates this. He states, "All day you wait for the pitch you like; then when the fielders are asleep, you step up and hit it". Buffett finds investing easier than baseball because you cannot get called out for not swinging and he sat on his cash horde for a long time before swinging.

Market timing is a strategy that acquired a bad reputation because it proved inferior during the steadily rising markets of the 1980s and 1990s. The market environment since 2000 has been much more conducive to market timing. Even long-term investor Jeremy Siegel, often referred to as the "father of holding stocks" publicly stated recently that economic conditions had resulted in cheap stocks, presenting an opportunity for investors. Advising investors to buy now due to low stock prices is a clear form of adapting one's investment strategy based on changing economic times and investment prices.

Peter Tingling, a professor at Simon Fraser University, proposes a theory regarding adaptive investment strategies in an article entitled 'Avoid Change at your Peril'[iii]. He talks about Peter Drucker's Theory of Business. It says all businesses operate under a core series of assumptions that managers make about their environment, market, customers, competitors and technology. Using GM as an example, Tingling argues that when managers remain static in their strategy, refusing to account for the changing world around them, the result is declining market share. In a similar manner, investors must recognize the change in the economic climate and position their portfolios to take advantage of these changes. Therefore one must consider ways to adjust their strategy in order to obtain the best possible returns. As Mr. Tingling wrote, "When you are thinking about the theory of your business it is wise to think about the underlying assumptions and the extent to which these assumptions are still valid."

The past two years have been devastating for those that were not continually re-evaluating their investment hypothesis and position. At the same time those that were able to adjust their portfolios to reflect the changing environment were able to profit handsomely.

Final Thoughts:

You may remember from our previous newsletters that we have written about “Growth” and “Value” investment strategies. Today we write about “Market Timing” and “Buy and Hold” investment strategies. We do not have a preference for any of these strategies as we believe they will all outperform at some point. However, unlike lemmings, we only want to follow the one in front of us if it makes sense. Sometimes one needs to step back to try and understand what is really happening.

We encourage investors to challenge their investment stance and positioning on a regular basis. Investment strategies work for extended periods of time and then they don’t. Adaptability and flexibility are always required.

The recent market rally provides a perfect opportunity to shape your strategy for the future.

10 Year Returns - http://www.nytimes.com/2009/10/25/business/economy/25mark.html?scp=1&sq=stock%20and%20bond%20returns&st=cse

[i] http://www.advfn.com/column3/berkshire-hathaway-holding-cash.html

[ii] http://www.nytimes.com/2008/10/17/opinion/17buffett.html

[iii] http://www.nationalpost.com/related/topics/story.html?id=2017850