



**WEALTHWORKS**  
F I N A N C I A L



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## **ANNUAL CLIENT REPORT DECEMBER 2008**

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*- Franklin D. Roosevelt*

Investors... should be fearful when others are greedy and greedy when others are fearful.  
*- Warren Buffett, 2004*

The odds of a depression [are] almost nil.  
*- Dr. Martin Murenbeeld, Chief Economist, Dynamic Funds*

The time to buy is when there is blood in the streets.  
*- Baron Rothschild*

It is during crises like this that the wealthy separate the middle class from their assets.  
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Pessimistic visions about almost anything always strike the public as more erudite than optimistic ones.  
*- Joseph Schumpeter*

I've always found that when the market's going down and you buy stocks wisely, at some point in the future you will be happy. You won't get there by reading 'Now is the time to buy.'  
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## *EXECUTIVE SUMMARY*

### *January 5, 2009*

*This has been – and continues to be – a very turbulent time on the financial front. While we can gain some comfort from the fact that the world has been through many financial crises in the past and survived, it is understandably worrisome to hear or read the negative reports that issue practically on an hourly basis from the media.*

*This report attempts to explain many of the factors that devalued or otherwise influenced the financial markets in 2008, while also pointing out positive aspects that the media sometimes overlook.*

*We hope you and your loved ones had a terrific Holiday Season. May the Year 2009 bring happiness, good health and renewed prosperity to you and your loved ones.*

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#### **1. The Panic of 2008**

The market turmoil of the past couple of months can only be called a “panic” rather than a “crash” or a “correction.” It has been, in order of magnitude, unlike anything most people alive today have experienced in the post-war era. But it is not unprecedented. “Panic” is a traditional economics term used to describe similar periods in history. (For example, in the early 1840s, and following a decade of rising prices and wild speculation, U.S. real estate values plunged so drastically that the U.S. government technically went bankrupt.)

So what happened this time? Globally, most major investment markets fell off a cliff in early September following the bankruptcy of Lehman Brothers and the rescue of AIG from a similar fate. The result was a cumulative drop in market values of some 50% in major markets and up to 70% in markets such as China, Russia, and Ukraine.

There was nowhere to hide, as even diversification failed to protect investors from portfolio losses. Every asset class except cash was affected – homes, bonds, pension funds, oil, gold, commodities and so on. The speed of the market drop was breathtaking. Up until the end of August most major markets had been correcting since mid-June with drops in the 25% range. Then, in early September, they dropped another 15% or so within days. The selling was emotional, illogical and devoid of any relationship to underlying economic values. The selling climaxed in the first 10 days of October. The markets have since traded in a sideways range.

Calls were made to clients throughout this period and special email alerts were sent out with commentary about the situation as it evolved. The basic message was that, despite what the media was claiming, this was not a precursor to another 1930s-style Great Depression. The other point was that it was too late to sell as the bulk of the damage was already done. As with the situation following 9/11, there is little to be gained from selling during the middle of a storm that is purely driven by fear and panic.

To appreciate why this happened, it helps to remember that investment markets are, in essence, auction markets, just like those auctions you may have attended selling off artwork, livestock, or estate effects. They are a price-setting mechanism which establishes what someone is willing to pay for a specific asset at a specific point in time, which may or may not be representative of that asset's true underlying value.

There are two aspects to the events that unfolded in September. The first is the forced and panicked selling and liquidation of investment holdings at any price by certain parties. The second is the functioning of the auction market process and the impact this can have on “price” as distinct from “value” of an asset.

The U.S. government pumped additional capital injections into mortgage companies such as Fannie Mae and Freddie Mac to repair damaged balance sheets, as well as taking steps over the summer to bolster the value of financial stocks as part of the ongoing efforts to deal with the fallout from the sub-prime and credit crisis. This included a temporary ban on the short selling of financial stocks. (See

box below for a brief explanation of short selling.) The hope – ultimately a failed one, as it turned out – was that this would bolster the value of U.S. bank stocks to make them more attractive as investments for sovereign wealth funds, among other large investors. One side effect of these moves was to trigger a 19% uptick in the U.S. dollar over the summer, one of the strongest rallies by the U.S. dollar ever over such a short period of time.

*“Typically [in the process of short selling], the short-seller will ‘borrow’ or ‘rent’ the securities to be sold, and later repurchase identical securities for return to the lender. If the security price falls, the short-seller profits from having sold the borrowed securities for more than he later pays for them. However, if the security price rises, the short seller loses by having paid more for them than the price at which he later sells them. The practice is risky in that prices may rise without bound, even beyond the net worth of the short seller. The act of repurchasing a shorted security is known as ‘closing’ a position.”*

- Wikipedia

What happened next can be best understood as follows. Imagine you own a shoe store. There is another shoe store down the street in the same town that goes bankrupt and liquidates its entire inventory. Seeing this, and despite the fact you are in good financial shape, you voluntarily decide to also liquidate your entire inventory at fire-sale prices in order to be competitive.

Pretty soon every shoe store in town is forced to follow suit and voluntarily put themselves out of business at fire-sale prices. Consumers, overwhelmed by the volume of cheap shoes they can choose from, either buy all they need or decide to wait for even cheaper prices, forcing shoe prices even lower.

(You can also see this on a smaller scale every Christmas, when consumers hold off buying major purchases until the Boxing Day sales – which started even before Christmas in 2008!)

This is pretty much what happened in September, when hedge funds and other large institutional investors were forced to close out leveraged positions in commodities and repay their loans in U.S. dollars. This selling had nothing to do with economic value and everything to do with the attempted survival of a relatively small number of sophisticated players.

*An extreme example of short selling was the coordinated and legal attack on hedge funds in Germany via that ever-so-humble auto company, Volkswagen. This was kicked off when Porsche made the surprise takeover announcement of VW in early October.*

*This came as a complete shock to those hedge fund managers who had heavily shorted the smaller company to the equivalent of about 12% of the total number of existing VW shares. However, at the time of the Porsche announcement, only about 4% of the shares were actually available to be bought back in the public markets to close out their short positions. The gap between 4% and 12% caused a classic “short squeeze,” generating a desperate panic among hedge fund managers who were forced to pay any price for scarce VW stock. Hedge fund managers were reportedly literally crying on the phone in their efforts to buy VW stock, with the prospect of financial ruin and possibly jail time before them. Shares skyrocketed 400% within minutes; for a brief moment in time, VW became the most valuable company on the planet. The financial losses were unprecedented for hedge funds and were in the order of many billions of dollars.*

The second aspect to understand is that of “value” versus “price” as a driver of the events in September. Imagine that a home in your neighbourhood is sold at distress prices due to circumstances unique to that homeowner. For argument’s sake, let’s imagine that the house was sold for \$50,000. The “normal” value for homes in your neighbourhood is in the \$500,000 range, and given that this was an unusual sale it made no difference to your situation and the enjoyment that you derived from the ownership of the home.

The next day you get an unexpected job promotion and need to move to Europe to take up your new duties. The real estate agent says: “Well, Mrs. Jones, the market is slow right now with few buyers, and, based on recent sales activity, your home is worth \$50-\$60,000 dollars.” You naturally believe the value is much higher and you would likely resist selling for such a ridiculous price. You might decide to keep the home and wait until market prices are more reflective of the “true value” of your home.

And that is exactly what happened in September, due to the forced selling by numerous players in the early days of the month. By month-end, the panic selling had spread to average investors and then even to some advisors; crowd psychology took over. Imagine 300 people all rushing to get through the same doorway at the same time.

Individual stocks got crushed, with some major stocks dropping 60% or more, and junior resource stocks dropping to almost zero. There are numerous instances of junior stocks that previously traded at \$4-\$5 per share dropping to pennies per share within days.

It was – and is – so drastic that there are numerous instances today where the stock price values the company at less than the amount of money it holds in the bank. For example, a company with \$30 million dollars sitting in its bank account may be assigned a stock price value more appropriate to \$20 million dollars in cash, effectively rating the company and all its operations at zero value.

Could you make money buying a company like this? Several of our investment managers are doing just that. The reality is that there are hundreds of companies like this in Canada and around the world in almost any investment sector you can imagine.

## **2. When Will It End?**

The best way to understand the impact of the events in September is to think of someone dropping a large boulder into a small pond. The first effect is a large splash, followed by ripples spreading out over the pond. The size of the ripples, the distance they travel and the length of time they can be seen will last long after the original splash has disappeared.

Most people are still feeling the emotional shock from the Panic of 2008. They are not yet ready to believe that the worst of the crisis has likely passed. Many are unable to accept that this crisis shall too pass and take its place among the annals of history.

“How can it be over when people are losing their jobs and GM is on the verge of bankruptcy?” they ask.

The answer is that the economic ripples from the market splash will be felt for some time to come, perhaps months and maybe for another year. The exact timing is hard to predict. The U.S. recession – defined as a lack of economic growth – officially started in December, 2007, according to a U.S. National Bureau of Economic Research press release in late 2008. The average length of a U.S. recession is 16 months. That means that this U.S. recession could end as early as the spring of 2009

or sometime later in the year, according to Merrill Lynch economist David Rosenberg.

But the media headlines will continue to trumpet gloomy headlines about the economic situation. The same thing happened following the “tech wreck” of 2000–2001. You can expect ongoing “ain’t it awful” news reports detailing layoffs, bankruptcies, cries for justice, showy trials of Wall Street bankers who caused this mess, and calls for jail time. You will also read endless charges and hand-wringing about the failures of capitalism and the need for more reform, more regulation and new rules to prevent this in future.

You can probably anticipate and write your own headlines and you can expect this to go on for some time, even after the worst of the recession has ended and a recovery has begun. As they say, history doesn’t repeat itself but it sure does rhyme.

The financial credit crisis that started in the spring of 2007 is likely over or in its late stages. Some commentators have suggested it has now become a credit workout, much like a bankrupt company, which is salvaged from the wreckage.

The effects will likely be felt for years to come, especially by consumers. The days of buying a \$400 TV with no money down and a payment of \$23 per month for three years may be gone, and the auto leasing industry in Canada has reportedly disappeared since last summer. It is back to the “good old days” when you paid cash for most consumer purchases. Credit in general will become harder to get going forward for both consumers and businesses.

The other casualty of the events of last September was the utter and absolute destruction of the American investment banking industry. Few, if any, major investment banks remain as independent entities. They have either all gone bankrupt or been absorbed by commercial banks or applied to become commercial banks. (Simply stated, a commercial bank gets its capital from deposits while investment banks raise capital in the bond or other investment markets.) The power of the SEC will also be greatly diminished since a large chunk of their clientele quite simply no longer exists.

The other aspect of the great global de-leveraging process is the U.S. housing crisis. It is still unwinding and appears to be far from ending any time soon. President-elect Barack Obama needs to

address this as one of his first priorities early in 2009.

Co-ordinated global central bank action and interventions have put a floor under the credit crisis since early October. These actions, including interest rate cuts, cash infusions into private companies, nationalizing various companies such as AIG and Fanny Mae and Freddie Mac, were taken to restore confidence in the commercial credit markets and to unfreeze credit for consumers and businesses.

The global economy was literally on the edge of a total system meltdown in mid-September as normal commercial credit facilities and conventions froze, bringing normal commerce and trade to a halt. Media reports documented the goods piling up on the docks in Vancouver, as one example, because Letters of Credit from buyers in countries such as China were no longer acceptable, and cash was demanded before goods would be shipped. There was absolutely no trust that the banks behind the Letters of Credit would be able to make good on those IOUs to Canadian companies.

Global shipping literally stopped for a period of time, as reflected in the Baltic Freight Index, as shipping rates dropped dramatically. For several seconds, the heart of commerce stopped beating as governments around the world held their collective breaths before swinging into action.

But the U.S. housing crisis continues to deteriorate and the economic recovery cannot occur until this crisis hits bottom. But first the unique nature of this Made-In-The-U.S.A housing situation should be clarified.

The U.S. is one of the few countries that use “non-recourse” mortgages as the main instrument for funding home purchases. This type of mortgage means that a bank or other mortgage lender can only legally use the value of the home to back the mortgage money loaned to the consumer. If the consumer decides to walk away from the home then the bank is legally unable to go after any other assets in order to recoup any capital losses that may occur between the value of the mortgage outstanding and the subsequent sale of the foreclosed property.

So there is very little incentive for consumers to keep homes when facing negative equity, where the value of the home is less than the value of the mortgage. And they are walking away in droves,

putting ever-increasing price pressure on the remaining homes in a neighbourhood.

The U.S. government is continuing to find ways of putting a floor under the housing market to stop this downward spiral. In July, a new housing bill (HR 3221) was passed into law mandating that mortgage companies modify loans for homeowners to help them avoid foreclosure. The autumn featured announcements from companies such as the Bank of America, Citigroup, and ING, stating that they were suspending foreclosures pending further government action.

Several remedies have been proposed in the halls of power, with the latest being a Treasury Department-mandated mortgage rate of 4.5%, all with a view to keeping homeowners in their homes and continuing to make mortgage payments in some form or another. Another proposal being floated is to limit mortgage payments for qualifying homeowners to 38% of their monthly income. Finally, there is talk of the government providing partial guarantees for bank losses on certain types of mortgages.

“We need to stop this downward spiral [in falling housing prices],” says James Lockhart, head of the U.S. Federal Housing Finance Agency.

Economist Martin Feldstein, President of the National Bureau of Economic Research since 1977, advocates a government solution similar to the Resolution Trust bailout used to resolve the 1990 Savings and Loan crisis. The U.S. has no choice and must do something to put a floor under the U.S. housing market in order to avoid a housing meltdown that could drag the country into an economic depression.

Feldstein estimates that 20% of current homes have negative equity, and that this number could climb to 40% next year.

In late November, in another effort to shore up the housing market, the U.S. government announced a plan to purchase up to \$500 billion in mortgage-backed securities. They have also committed a further \$200 billion for new lending to consumer-backed securities in an effort to stabilize the securitized housing and consumer loan markets.

So far, the damage to the U.S. economy from the twin structural housing and credit problems has equalled the damage to the economy from the Savings and Loan crisis, or about 7% of U.S. Gross Domestic Product. Therefore the situation is not

unlike previous crises and the U.S. will likely survive this one as well and recover to new levels of economic prosperity.

For a special nine-page background report on how this crisis developed, please go to:

[www.strategicimperatives.ca/blog/wp-content/themes/richards/files/TheSubprimeCrisisExplained.pdf](http://www.strategicimperatives.ca/blog/wp-content/themes/richards/files/TheSubprimeCrisisExplained.pdf)

### **3. What is the Financial Planning Lesson?**

Discussions with clients often centred on how many dollars their portfolios were down as a result of the Panic of 2008. Rarely was the matter couched in terms of percentage changes, or how much of this was a loss of investment profits versus originally invested capital. It is often assumed by clients that profits, or peak portfolio values, are permanently earned and that any fall from the heights is a loss.

However, it is unlikely that clients were going to take whatever the value of that portfolio drop was and spend it tomorrow on a vacation or a new car. The real effect has been on the income earned from that drop in portfolio values rather than the actual capital itself that is a concern. This is a point that most clients readily agreed with.

For example, if you took a draw on capital of 5% annually while retired (somewhat higher than the recommended draw of 4%), then a \$20,000 drop in a portfolio equals an income shortfall of \$1,000, or just under \$85 per month. A \$100,000 drop would equal an income shortfall of around \$425 per month. These types of impacts may or may not be significant depending upon each individual's personal situation and strategy.

Another way to look at the impact of recent events is to go back to a time when retail investors were making a lot of money investing in Nortel stock. One such investor was overheard at a social event waxing eloquently about a recent 30% return on the stock, which he continued to own. The assembled throng murmured their admiration and congratulations on this success. While basking in the social status and reflected glory of such a brilliant move, an observer asked if a 30% return was enough.

As the MasterCard commercials say, the look of confusion on his face was "priceless." He had no idea how to answer the question because he had no financial strategy or game plan against which to compare his progress. And without such a financial

plan and wealth building strategy, he was at the mercy of external events over which he has no control.

The concept of "what income do you need in retirement?" versus the current value of your portfolio is difficult for even the savviest individuals to keep straight. Our culture is so ingrained on focussing on the "price" performance of the markets and how one is doing versus your neighbour's investment returns, that what is often forgotten is the whole point of the financial planning exercise.

And that point is the need to convert human life potential at the start of one's career into assets. The job of these assets is to replace earned career income with passive unearned investment or pension income. There are other financial planning goals that matter, such as estate planning and wealth preservation, but the job of building assets is the one that most clients are focussed on. Other goals, such as funding educational costs or paying off debts, are often tactical in nature and are often a subset of the overall financial plan.

Your personal vision for your life, including the type of lifestyle you want, is the most important tool in assisting you to deal with the raw emotions that the events of 2008 have evoked. A good financial planner's job is to keep you focussed on this vision. Challenging times call for you to review your strategy and, while still feeling the rising levels of fear, refrain from acting upon that fear. The moment you act based on fear is the moment you have abandoned any rational wealth creation strategy and plan.

This is not to minimize the fear. The fear, or rather the panic, has been so great that one colleague reported a GIC client ordered him to cash in his \$1,000,000 in GICs in October because he was convinced all Canadian banks were going bankrupt. The money was put into government treasury bills. No amount of discussion or logic, such as the fact that Canadian banks are among the strongest in the world, could change this client's mind, despite the severe financial penalties for redeeming the GICs before their maturity.

While this fear is real and palpable, one's need to build a bag of money or assets remains. This task occurs along a continuum that we all operate on. At the far left is the savings model and at the extreme right end of the line is the investing model. Most people fall somewhere along this continuum or line.

The savings model is referred to as the “farmer’s savings plan.” This is where the farmer stuffs surplus cash under his mattress and spends it during retirement until it is all gone. Since studies show that most Canadians have a saving rate of almost zero, then counting on a 100% savings approach is not a model that you should be relying upon for your retirement income strategy.

The other end of the spectrum is where an investor takes a sum of money, say \$10,000, and spends his/her days trading in the stock markets and is able to build a significant asset base of, say, several million dollars, from which to fund his/her retirement. This strategy requires skill, emotional fortitude and luck to build sufficient retirement assets. Not many people have succeeded using this approach exclusively.

So, the reality for most people is they will likely build assets through some combination of savings and investment returns. And that is where a solid financial plan and wealth building strategy come into play.

Please call us to review, update or create your life vision and the financial strategy needed to fulfill that vision.

#### **4. The Year In Review**

Yes, even with the market crash in September overwhelming the news, there are other things to review about this past year. The year can be broken into two halves, with the first half – to about July – marked by rising oil, food and commodity prices, and sluggish economic growth. Riots broke out in many emerging markets when food inflation approached 25% and inflation was over 10% in some 50 emerging market economies. The riots are understandable considering that many families spend almost half their incomes on food alone in these emerging economies.

The growing inflation threat led to increasing pressure on central banks around the world to increase interest rates. Several countries did in fact raise interest rates going into June. The policy conundrum was that raising U.S. interest rates would create havoc in an already stressed housing market.

In May, Federal Reserve member Thomas Hoenig stated that “serious inflation pressures may compel the central bank to raise interest rates. The

combination of slowing growth and inflation is troublesome.”

Adding to the pressure were rising oil prices which peaked at \$147 U.S. per barrel in early July and saw U.S. consumers paying \$4 a gallon for gasoline. Demand destruction increased as the year progressed, with motorists cutting their motor vehicle use and miles driven as oil prices soared. The effect was an old-fashioned energy shock to the global economy.

The price of oil had effectively doubled over the year ending in June, and had increased some 160% in the previous 18 months. U.S. oil demand dropped some 800,000 barrels per day in the first half of the year, the largest decline in 26 years. China, following its preparations for the Olympics, saw oil consumption drop some 7.1% in July, which was their steepest demand decline in some three and half years.

Oil usage in the OECD had also been declining for two years. The emerging markets moved by mid-year to reduce the impact of soaring oil prices on their overheating economies. China and India took steps to reduce government oil price subsidies to consumers in an effort to reduce demand and have consumers pay the true cost of energy consumption.

A red flag for oil prices was that oil company stock prices failed to keep pace with the oil price increases in the nine months leading up to June. The investment markets were still valuing oil company stocks based on about \$80 per barrel, despite record company profits. Clearly, the investment markets did not believe that such profits were sustainable in the long run, and it appears that this assessment was correct.

The other theme was increasing speculation that stagflation would emerge due to rising inflation and sluggish growth caused by the twin implosions of the credit markets and the U.S. housing market. There are still some who believe that the expected economic recovery sometime in late 2009 will be a stagflationary recovery.

Canada’s inflation rate also spiked higher, hitting a five-year high by August. Pressure was building in Canada to raise interest rates. The Conference Board of Canada issued a report in July blaming rising world food prices on increasing emerging markets demand for protein-based diets, stagnating agricultural productivity, demand from bio-fuel producers, and government controls that

limit output and trading. It was not, they concluded, the result of speculators, as some scapegoating governments wanted people to believe.

By August, the U.S. S&P 500 market had effectively returned 0% over the previous decade, dropping into the negative on an inflation-adjusted basis. This compares to stock market returns over the previous 100 years of 9.6% compounded, with about half of this return coming from dividends and the rest from earnings growth.

Fund manager Larry Sarbit observes that S&P 500 returns from 1950-2000 compounded at a 13.3% rate: "one of the greatest periods of compounding in the history of the markets." These returns saw contributions of 4% from dividends, 6% from earnings growth, and the balance from an expansion in the price/earnings (P/E) ratio. The P/E ratio expansion means that investors were willing to pay more for each dollar of earnings over that 50-year period. He notes that the P/E ratio was 7 in 1950 versus the high double digits reached in 2000 before the stock market correction of 2000-2002.

During this period U.S. stocks grew to represent some 40% of global stock market value, while its economy represented only 25% of the global economy.

Cash reserves continued to build to mid-year as some \$3.4 trillion U.S. was stashed in money market funds. A similar trend occurred in Canada, where a record \$45 billion was parked in similar cash vehicles, and where 100% of all new mutual fund purchases went into cash over the previous year.

The U.S. auto sector revealed that it has real structural problems that even government bailout programs may not solve. In 2007 the U.S. auto sector had sales of about 17 million new cars, a level that had been sustained for many, many years. Auto sales for 2008 are expected to be about 10.5 million cars, the lowest number of cars sold since 1983.

There is now one car in the U.S. for every person of driving age. Given that newer models are better built and last longer, the decrease in new auto sales is likely to be a reality for years to come.

The credit crisis and reduced loan facilities means that a new GMAC scoring system allows only 58% of Americans to qualify for auto loans, with cheap auto financing now a thing of the past. Auto companies have abandoned most leasing programs since they can't package the loans and

sell them as securitized instruments. U.S. consumers now need a minimum 12% down payment on a new car purchase to qualify for a loan.

A February report on the future of oil by Canadian statistical research company Trendlines foreshadowed the July fall in oil prices. The report pointed to a measure called Ultimate Recoverable Reserves (URR) to make its case, pointing out that the world's URR was increasing at twice or thrice its historical pace, and from 2000 had grown at a 6% pace.

Trendlines noted that, "Peak oil prophet Mr. [Colin J.] Campbell has underestimated the actual rise in URR by tenfold," due mostly to improved oil extraction technologies and methods. This could be enough to put a dagger in the heart of the "peak oil" thesis. Stay tuned to see how this unfolds in the future.

In early July oil prices began to tumble from their lofty levels, flirting with the \$40 level in early December, which represented a decline of more than two-thirds from the peak of \$147. Commodity prices followed suited, with one commodity index dropping 53% from its July 3<sup>rd</sup> peak.

The trigger for the second half of 2008 appeared to be a move by the U.S. government to engineer a recovery in financial stocks in mid-July. The initial step in this policy shift occurred with U.S. Treasury Secretary Henry Paulson's temporary ban on the short selling of U.S. financial stocks – a wholly unexpected move amongst hedge fund managers.

Structurally, U.S. officials faced a difficult and deteriorating situation. Mortgage giants Freddie Mac and Fannie Mae (F&F) had been in financial intensive care for some months. While these were private companies and not government agencies, there was an implicit understanding in the world's capital markets that the securities and debt instruments issued by these two companies had the full and good faith backing of the U.S. government.

Many central banks, such as those of China and Japan, held about \$950 billion of this government agency debt issued by F&F, which was almost equal to the \$1.4 trillion in U.S. treasuries owned by foreign central banks. Allowing these companies to fail, and defaulting on the F&F debt, would have put the U.S. in a precarious position with their largest creditors, resulting in a wholesale dumping of U.S. assets by these countries and causing the U.S. economy grievous and unimaginable harm.

A final factor was the upcoming U.S. Presidential election and the need to provide the Republican Party with a shot at getting re-elected. Rising inflation, rising interest rates, out-of-control food, oil and commodity prices, and a rising gold bullion price did not provide the necessary economic conditions to enable the Republicans to maintain power.

The other factor was that many hedge funds had been shorting U.S. financial stocks, and in effect the U.S. dollar, throughout the year, while taking long positions in commodities using borrowed money.

In early September, the U.S. government effectively nationalized F&F by assuming and making good all of their debts (and wiping out shareholders' equity in the process), and concurrently allowed Lehman Brothers to go bankrupt. This triggered a panic liquidation of the hedge fund trade, short financials and long commodities, causing a collapse in global stock markets.

U.S. stocks fell some 53% from peak to trough over the year ending in October, making it the worst correction since 1929. By comparison, the 1974-75 market correction, also severe, was in the 45% range. The impact of this correction was felt globally, discrediting the "decoupling thesis."

Ironically, U.S. economic growth was still positive through to June, and corporate profits had not yet started to decline, noted PIMCO's Bill Gross in *Barron's*. Canada also had positive growth numbers as late as September.

With the U.S. still accounting for 75% of Canadian exports, and about 25% of its GDP, Canada failed to "decouple" from the U.S. economy and slipped into a recession late in the year, closing 2008 with aggressive interest rate cuts.

Meanwhile, China and India continue to post positive economic growth, albeit with the rate of growth slowing to levels not seen in some time. Both countries are somewhat insulated from the U.S. slowdown – China's exports account for 8% of GDP, with this being evenly split between Europe and the U.S., while India, largely economically self-sufficient, has only about 4% of its GDP allocated to U.S. exports.

There were several important milestones that arose out of the autumn market crash. The first is that this recession likely ends a 25-year period of disinflation and falling interest rates, says BMO Financial Group's Global Portfolio Strategist Donald

Coxe. The focus and fear today – vs the time of Federal Reserve Chairman Paul Volcker in the early 1980s – is no longer on inflation but rather on deflation.

Coxe points out that modern bear markets have been inflationary induced, with one as inflation was soaring and another as inflation was peaking. This was also the first recession that was not induced by the Federal Reserve.

The greater concern today is with a deflationary bear market similar to the last one in 1929. The twin threats of the U.S. housing and credit busts meant the U.S. Federal Reserve and other central banks had no choice but to throw inflationary fears to the wind in order to avoid a deflationary collapse.

This was in fact the first truly global asset bubble and it led to bubbles in all asset classes, observed investment manager Jeremy Grantham. There was too much money floating around the global economy and too-low interest rates that provided the fuel for these global bubbles. Investment risk was effectively priced at close to zero in mid-2007 versus safe-haven U.S. treasuries. This also coincided with the peak in the private equity market boom, as evidenced by the proposed takeover of BCE.

Dynamic's Chief Economist Dr. Martin Murenbeeld noted that global foreign exchange reserves rose some \$5 trillion since 2001. This money had to be recycled somewhere in the global economy, and he believes that much of it was allocated to global housing. He also noted that some 70% of global foreign exchange reserves are held in U.S. dollars.

U.S. domestic debt rose to record levels of 220% of GDP, which effectively absorbed much of the rise in foreign exchange reserves. The U.S. doesn't want the housing market to collapse and cause a depression, so they are buying time to allow consumers to pay down their debts in an orderly fashion by transferring the debt to the government.

The U.S. has moved quickly to provide unprecedented levels of fiscal and monetary stimulus as well as several bailout programs to head off a deflationary collapse. Other central banks followed suit and co-operated in a co-ordinated interest rate cut in mid-October. The U.S. alone quadrupled its monetary reserves in just eight weeks in a bid to re-inflate its economy.

The result of this government intervention was that by late October, some 70% of the entire U.S. banking system liabilities were now to all intents and purposes backed by the government through a combination of the Federal Reserve, FDIC, and U.S. Treasury guarantees, noted Bank of America's Jeffrey Rosenberg.

The second milestone was the effect this had on the U.S. dollar and Japanese yen carry trades. Global hedge funds had borrowed massive amounts of money in these currencies at historically low interest rates, and had then invested the money shorting U.S. bank stocks and going long global commodities. At the peak, July short interest in U.S. financial stocks was at 19.6% of the stock float.

Paulson's announcement banning short selling of U.S. bank stocks caused a classic short squeeze as hedge funds rushed to close out these leveraged trades. Demand for the yen and the American dollar soared, causing them to rise quickly versus other currencies.

The result was that, almost overnight, the Federal Reserve was no longer under pressure to raise interest rates with the June CPI number hitting 5%. Instead, deflation became the new concern. The genius of the strategy, according to Coxe, was to attack over-leveraged hedge funds.

The fallout included a complete wipe-out of Wall Street investment banks and a major power shift from the SEC to the Treasury Department in Washington, with the Federal Reserve being the other big winner in this new power structure, according to former OSC Chairman Ed Waitzer.

U.S. interest rates fell dramatically as global investors sought a safe haven at any price for their money. The prime rate continued to fall to below 1% as compared to 5.25% in September 2007. Yields on 2-year Treasuries dropped below 1% for the first time in history. And in some cases yields on treasuries were actually negative for a time, as investors paid the U.S. government for the privilege of protecting their money. Low-grade corporate bonds meanwhile soared to record interest rates of 20%!

Investor margin debt peaked in the summer at some 37% above the previous record high set in September 2000 during the technology bubble. Forced liquidation of these leveraged stock holdings in late September and early October exacerbated the market sell-off as retail investors

joined hedge funds in selling securities into a market with few buyers.

"It feels like 1974, a bleak period when people were just throwing stocks out the window," noted 43-year Wall Street veteran and investment manager John Clark.

"There has been an unprecedented, often indiscriminate liquidation of stocks, and naturally investors everywhere are frustrated, mad and nervously giving up and selling out," notes Fred Sturm, Chief Investment Officer for Mackenzie Financial. Sturm noted that by late September stock valuations had become just plain "silly."

"Never in the last 35 years has the breadth and magnitude of the S&P/TSX composite index rout been so severe than at the October lows," remarked Dundee Securities strategist Martin Roberge.

As the year winds down, stocks remain undervalued on any number of statistical measurements, as discussed later in this report.

The final milestone was an "Era of Fear" engendered by the media and reflected in a panicking public. The media took an almost ghoulish delight in reporting on the stock market carnage with frequent visual flashbacks to the Dirty Thirties. It got so bad that news anchors such as Lloyd Robertson were practically gleeful as they reported on the stock market tumble in September. In early November, Global News actually apologized on air to its viewers for over-sensationalizing their reporting and contributing to a sense of panic.

Several clients called to ask about the impending depression. Advisors were also panicking in late September, along with their clients, adding to the selling pressures. People were looking for relief from the emotional angst all around them and a herd mentality took over.

So how close were we or are we to another depression? In November *Barron's* reported that business loan delinquencies were at near record lows, and that credit card delinquencies were no higher than in the previous three years – a situation that they concluded hardly supported "a depressionary debt collapse."

There are also structural differences in society today versus the Great Depression. The reason it was called "Great" as opposed to previous normal depressions is the U.S. economy shrank 50% and unemployment rose to 25%. A normal depression is

defined as a 10% drop in the economy as compared to a recession, which is defined as an absence of economic growth or a mild contraction of a couple of percentage points.

But the main structural difference today is that governments moved to implement numerous social programs and safety nets following WW II. The main purpose of these programs was to provide income transfers to citizens during economic downturns, which in turn provided income stability by allowing governments to run deficits. Economic research shows that this goal of relative income stability has been realized.

Another difference is the Great Depression killed hundreds of banks. As BMO's Donald Coxe notes, these banks went broke honestly because their basic business of providing mortgage and business loans couldn't survive the U.S. GDP collapse.

Today, the U.S. has some 8,000 banks, of which the largest five control 45% of the assets. The U.S. banking sector is still healthy and largely unscathed by the sub-prime crisis, according to a former bank inspector. He noted that 75% of the banks are unaffected by the turmoil on Wall Street. Nonetheless, several observers expect this sector to consolidate in an orderly fashion in the coming years as credit demand and growth slows in North America.

Unlike the 1930s, U.S. household credit continues to grow, albeit at the lowest levels since 1970, according to RDQ Economics. Fidelity's Peter Drake also noted that consumer credit was growing modestly on a year-over-year basis as recently as early November.

Credit also continues to grow in much of Asia, specifically China, where the government is providing incentives to stimulate home purchases, among other strategies.

Corporate and personal balance sheets are much stronger here than in Europe and North America, and are much stronger than during the Asian crisis of 1997-1998.

Another point to consider is that the U.S. can afford its massive economic interventions. The IMF reports that the U.S. current account deficit peaked in 2006 at \$US 790 billion and has been shrinking since then. The IMF expects it to fall to \$485 billion in 2008.

U.S. government interventions are expected to reach some \$7 trillion, which is about 7% of GDP in contrast to the S & L crisis, which equalled about

6% of GDP. The NASDAQ collapse in 2000-2002 saw economic losses of some \$4 trillion, and again the U.S. economy came through that period just fine.

Consumers may also play a role in getting the U.S. through this crisis. The price of gasoline has dropped in half since the summer. This stimulus to consumers is equivalent to a \$150 billion tax cut which may then be spent during the holidays.

Finally, the current situation is, well, rather ordinary. Financial crises and defaults are a regular part of modern financial markets. A recent IMF study has documented more than 60 currency and/or banking crises around the world since 1970, and concluded that crises are a normal feature of the capital markets.

The world is not ending; this too shall pass, and the "Era of Fear" is dissipating.

## **5. Investment Outlook: What Can You Expect?**

Much of what was covered and discussed in last year's report remains valid. Please review that report for complete details – it is available at [www.wealthworks.com](http://www.wealthworks.com) or contact us to have it mailed to you.

The future investment landscape still includes the continued growth of the emerging markets and their demand for raw resources such as oil, steel etc. In fact, Capital Group Chairman David Fisher expects 70% of the world's growth over the next two decades to come from the emerging markets. Savings rates in these countries approach 35% of income versus 2% for the U.S.

Thus the global growth/demographics/urbanization thesis remains intact, with positive investment implications for areas such as infrastructure, agriculture, and ultimately commodities. This growth, combined with renewed economic growth in the U.S. and Europe sometime over the next year or two, will reinstate the price pressures on these in-demand and in short supply commodities.

Yet, the real question for most people amid the doom and gloom continues to be the near-term investing and the economic picture. Given that investment markets are as much about sentiment (read "fear" and "greed") as they are about corporate profits, let us look at some views of current reality.

One item that stands out from the raft of data is that U.S. money market assets, or cash, stood at

\$3.4 trillion on September 30<sup>th</sup> as opposed to the \$13.3 trillion total market valuation. This is a near-record 25% ratio, according to Ned Davis Research, which went on to observe that since 1980 the U.S. stock market always rises at least 12% whenever money market balances reach around 11% of market value. If and when this massive amount of cash moves back into the markets, you could see a “melt up” in stock prices in a relatively short timeframe.

As stock prices sank in October, corporate insiders such as senior executives and other highly placed key personnel went on a buying spree that saw their purchases of shares trump corporate insider selling of shares by a 3:1 ratio. This trend continues with news reports of buying up by well-known individuals such as Warren Buffett and Bill Gates. Insider buying is always a bullish sign for stock values.

Other indicators of value in today's investment markets include the fact that spreads on yields in favour of stocks vs bonds is the largest it has been in over 50 years. This likely means buying stocks at today's levels will see investors do very well over the next 3-5 years.

The S&P market capitalization today is smaller as a percentage of GDP than it was in the 2002 bear market, indicating that current markets have overshot on the downside. In fact, all U.S. market index gains from 2002-2007 have been wiped out.

In Canada, a useful contrary indicator is the movement of money into and out of money markets by retail investors. The “Investor Experience” chart opposite shows how money comes into the market after the market rises and leaves the market after it declines, continuing to leave the market even as the markets recover.

Retail investors redeemed a record \$4.56 billion in mutual funds in September. The previous record was \$1.7 billion in April, 2003 – right at the start of a five-year bull market run. The Investment Funds Institute of Canada reports another \$8.2 billion was redeemed from mutual funds, which means that net assets for the funds industry, including the market decline, fell 10% in about two months.

The Q Factor is another economic measure of the relative value of stocks compared to nominal U.S. GDP. At the height of the tech stock bubble, this ratio was twice the size of the economy, which, as events transpired, proved unsustainable. Today the Q Factor in the U.S. is at 59% stock valuation

versus the size of the economy, which is well below the long-term average ratio of 79% stock market value versus the size of the economy. In simple terms, it is cheaper to buy a company than to build one from scratch. For Warren Buffet, this is a signal to buy all day long, as quoted in media reports.

In fact, many and various assets such as stocks, commercial paper and junk bonds are priced for a depression. It takes courage to be a contrarian investor in this climate, but now is the time to buy.

Manager Frank Holmes of U.S. Global Investors notes the S&P is extremely oversold at current levels, and is even more oversold than during the Russian Crisis of 1998 and the 9/11 selloff. He further notes that the early December move by the Federal Reserve to buy \$600 billion in mortgage debt should have a positive effect on the markets in the next six to nine months. This massive liquidity injection could be just the catalyst needed to move the markets higher, he opines.

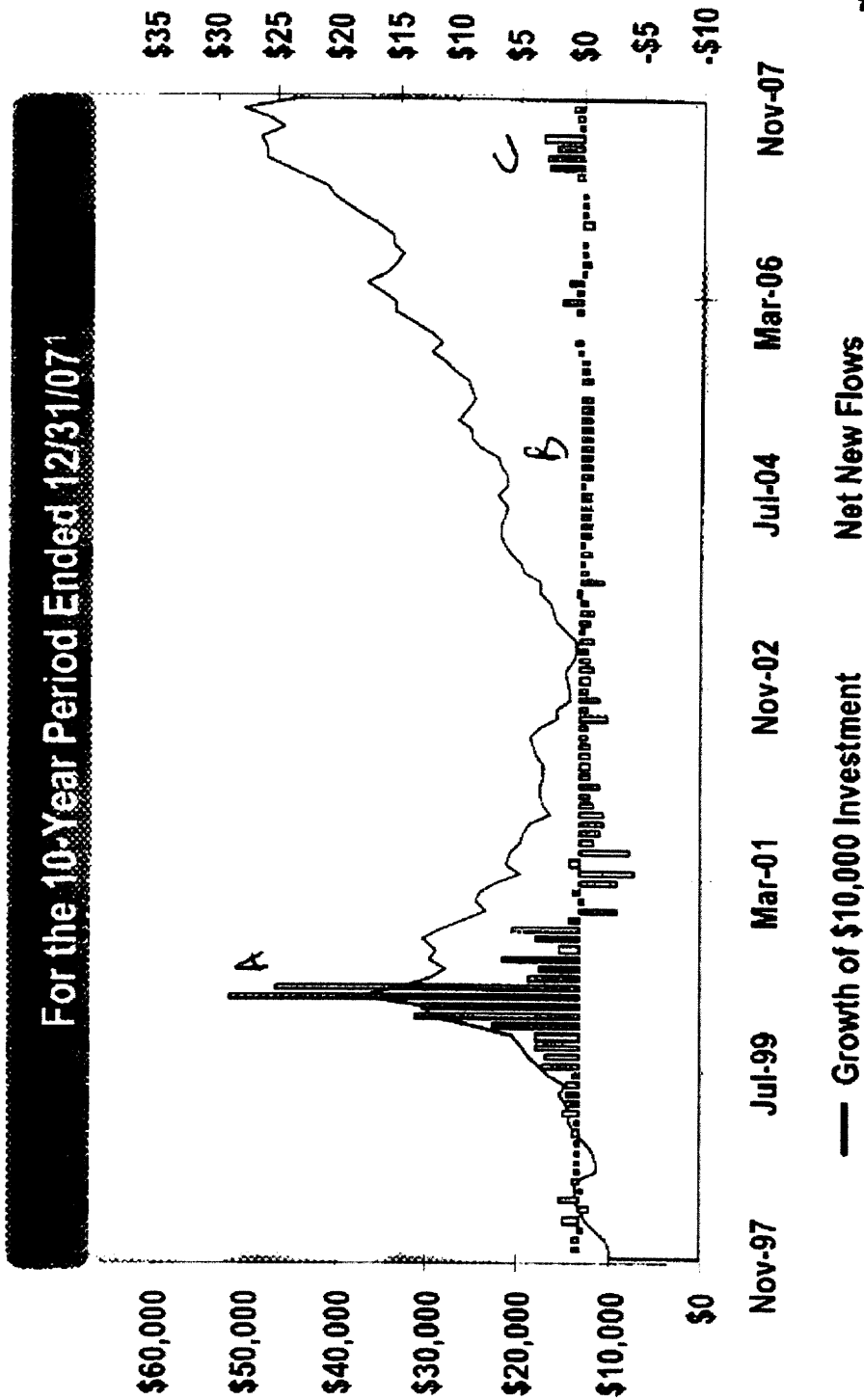
China's stock market is down some 70% from its 2007 peak. The P/E ratio for Hong Kong H shares is now around 7.4, versus 38 at the recent peak compared to a historical average of 15. The Shanghai exchange now trades at a 14.4 P/E vs 74 at the peak, according to Credit Suisse. In the meantime, China's August retail sales numbers rose 23% while inflation was falling. This data lends support to the thesis that the Chinese consumer may be able to pick up the slack from declining export sales.

Finally, Russia and the Ukraine are the cheapest of the emerging markets, with stocks trading at a very low 6 P/E and metals stocks trading at about 3.5-4 P/E, with very little debt and good cash positions, according to Cundill manager James Morton. In fact, he notes, share prices are so attractive at these levels that many companies have begun share buyback programs, and the Russian government has introduced a stabilization plan to buy stocks from foreigners who are abandoning this market through indiscriminate stock sales by parties such as hedge funds.

*Eminent Wharton School Professor of Finance and author Jeremy Siegel notes: “We had a bad 10 years [in the US markets], so now are we going to have another bad 10 years? I'm overwhelmed by the emptiness of that idea. The history of the market is precisely the opposite. If you have a bad 10 years, you're likely to have a good next 10 years.”*

# The Investor Experience

Growth of a \$10,000 Investment vs. Net Flows (\$Millions)



1. Source: Strategic Insight Lipper, Inc., as of 12/31/07.



The above chart shows how investors poured money into the stock market at the peak of the technology bubble (Point A). Then, as the markets started to drop, they took money out of stocks. But the sad reality is that they continued to take money out of the markets for another four years (Point B), even as the markets recovered and started to rise. Then, at Point C, investors piled back into the stock markets just as they were peaking.

In summary, it is almost universally agreed by investment professionals that the markets today represent the best buying opportunity of their careers. For a final comment we turn to Dynamic's economist Dr. Martin Murenbeeld, who stated in late November that the TSX was seriously undervalued by about 60% at the end of October.

He believes the crisis will end through these policy moves, some of which have already been taken. First, there is a need for Keynesian-style government deficits. Secondly, they need to keep the money supply up and keep monetary policy loose amongst other fiscal initiatives. Finally, there is a need to engage in currency devaluation to help fight the risk of domestic deflation.

You should avoid using economic news to time your entry into the stock market. If you are going to wait for the economic news to improve before buying stocks, you will be very late. That is because the markets typically bottom just after the midpoint of a recession.

For example, the U.S. markets following the 1973-74-market correction were up 70% in the following 18 months, even though the U.S. economy was still in recession during most of that period.

Another point to consider is that some 25% of the global economy, as represented by the Brazil, China, Russia, India, Mexico and Korea, is still growing today at rates of 6-7%. China alone will need an estimated 40,000 skyscrapers over the next 15 years, as an example of the wealth building opportunities that lie ahead.

This may be the best wealth-building opportunity in most people's lives! There are many exciting investment opportunities now open to investors, including private investment pools offering bond-like safety and stock market type returns.

Please call us for more information and to review your current investment programs.

## **6. News Briefs and Other Items**

### Client Portfolios

Most client portfolios will be down for 2008. A Desjardins Securities study on pension funds returns to mid-November reported drops in the range of 15-20%, which is similar to the results experienced by most of our RRSP accounts **for the year**. RRIF clients had drops of 10+% since they

are typically more conservatively invested; conversely, growth-oriented investors had losses in the 30% range. Client portfolios overall were holding up well, down about 8-10% through August, while the market indexes had corrected some 25% before the unexpected September market panic took indexes down another 25% through to early October, for total declines in the 50% range. The markets have been in a trading range since then.

A new analytical tool called Frontex Reporter is now being used to analyze client returns on a compound basis taking into account all new deposits and any changes to the investments. Samples in early July showed client returns in the 11-13% range since 2002. A review of some client accounts in mid-December found that those returns had since dropped to the 5% - 6% range. This means that even with the September market crash, many clients have had returns that surpassed GICs and bonds since 2002.

### IFRS Accounting Rules

Canada is quickly moving towards the new International Financial Reporting Standards (IFRS) for accounting and audit functions. These new standards are a move away from GAAP accounting and will make it more difficult for investors to compare financial data between companies and across sectors with no discernable benefit and plenty of risk of corporate fraud. "This is a colossal scam that will savage investors," declares CA and forensic auditor Al Rosen. "It's Nortel all over with faked numbers, and eventual collapse and probably bankruptcy of many corporations that publish audited rubbish." The rules have not yet been adopted and we urge you to write to Finance Minister Jim Flaherty at: [Flaherty.J@parl.gc.ca](mailto:Flaherty.J@parl.gc.ca) to express your concerns in order to stop these new rules from being implemented.

### TFASAs

The new Tax-Free Savings Accounts can be opened as of January 1<sup>st</sup>. This is possibly the most exciting and important financial planning development since the introduction of RRSPs. It can benefit almost everyone, with the only quibble being that the initial limits are too low. TFASAs are similar to RRSPs in that they can hold a variety of investments such as mutual funds, GICs, bonds

etc. (Please refer to the enclosed brochure for more details; more information is available at [www.wealthworks.com](http://www.wealthworks.com)). Call us to set one up.

### The Federal Budget 2008

The Registered Disability Savings Plan is closer to being launched as the administrative complexities of managing these accounts are sorted out. Expect to see these introduced sometime next year. The Budget also saw changes to the Dividend Tax Credit; new unlocking provisions for Federal pensions; the Medical Expense Tax Credit; and an increase in the Guaranteed Income Supplement threshold at which this is clawed back to \$3,500 of earned income from \$500. Please call for details of how these changes may affect your personal situation.

### Toronto Real Estate

People often view real estate as a rock solid, never-can-miss type of investment. As one commercial real estate broker said recently, he was confident the real estate market would recover while noting the recent stock market woes. He did concede that if real estate recovers there is no reason to believe stocks wouldn't also recover. A Goldman Sachs study of the Toronto property crash noted it was the fourth largest correction of 24 housing busts in the OECD since the 1970s. Prices declined from December, 1989, to September, 1998 – a 34-quarter marathon that took housing valuations down 50% in some areas. The causes included rising interest rates, overbuilding, a recession, and the introduction of the GST. The current housing correction is expected to be much milder in Canada this time around.

### On The Growth of Government

Early in the 19<sup>th</sup> century, political scientist Alexis de Touqueville, while reflecting on the future of the U.S., wrote:

*Modern despotism will cover the surface of society with a network of small complicated rules, minute and uniform.... until each nation is reduced to nothing better than a flock of timid and industrious animals of which the government is the shepherd.*

Politicians are already laying the blame for the current economic meltdown at the feet of free enterprise. They will likely succeed, since few people have an unshakable belief in totally free and unregulated markets. They will call for more controls and regulations, which will further encumber Canadians with new rules that steal their time and energy, as, for example, the new garbage regulations in the City of Toronto. The reality is that there are no totally free markets since everything in our modern society is regulated to some degree or other.

The U.S. authorities stood by and watched the tech and housing bubbles form and did nothing to mitigate these until after they erupted. Beware of the rush to judgement and the virtually inevitable power grab by bureaucracies everywhere that follows. The fact is that central planning type economies have been tried before in places like the U.S.S.R. and have failed. Be an informed and involved citizen and defend your freedoms.

### U.S. Economic Power in Decline

Recent data shows that 20% of U.S. taxpayers pay 80% of all personal income taxes. The health of the U.S. economy and its power as an empire is increasingly borne by a shrinking tax base, which is not a good omen. The U.S. is turning its back on free enterprise as the percentage of Americans of voting age who pay income taxes has fallen to just over 50%. According to BMO's Donald Coxe, history shows that as societies move to where most adults pay no taxes, "soak the rich" politics takes over and the downward spiral of economic weakness leading to collapse becomes entrenched. This "bread and circuses" phase of an empire in decline goes way back to the days of the Roman Empire.

### The Financial Sector's Golden Age Ends

The subprime crisis is the final chapter in the financial sector's golden age of the past 25 years, according to Bank Credit Analyst. From the early 1980s its share of corporate profits rose from 10% to 40%, and its share of market capitalization rose from 6% to 19%, well above historical norms. The financial sector's share of corporate profits and market capitalization is set to shrink significantly in the coming years, BCA concludes.

## The Harper Government

The recent attempted *coup d'état* by the opposition parties could not have come at a worse time. It is likely that the shenanigans in Ottawa are only serving to make a bad situation in Canada worse, and, more importantly, is rattling the confidence of consumers. Let us hope this crisis can be resolved quickly without further damage to our economy and our reputation in the global community.

## Climate Change

The climate debate continues with a new insight that the debate is mostly over whether global warming will be catastrophic for mankind versus an event that can be adapted to. Some pundits have pointed out that 30 years ago media reports were calling for a new Ice Age. Recently, climatologists have noted a decline in sunspot activity with no activity reported at all during the past summer. This is highly unusual; low sunspot activity correlates with cool and wet weather. This, combined with declining bee populations in the U.S., which are needed to pollinate the food supply, could lead to reduced crop yields and even tighter food supplies going forward. Call us to discuss how these events will impact your financial well-being.

## **7. Conclusion**

This has been the most difficult annual report to write of my career. On one hand it is important to

acknowledge and be sensitive to the genuine fear and concern that many people are feeling and will continue to feel as economic events unfold over the next year, while on the other hand it is equally important to keep them focussed on the exciting new opportunities that are now available to build wealth in the coming years.

All normal business was set aside and the focus was on the developing market situation. This involved much reading and listening to conference calls of various experts and economists as to what was unfolding and why. Hopefully, the information provided above will help you to answer the “why” of what has been happening.

While I am optimistic that the panic stage of the market correction is likely behind us, there may yet remain some surprises ahead. Merrill Lynch economist David Rosenberg believes that deflation will be with us for about a year, likely followed by re-inflation as government efforts to kick-start the economy, including an effectively zero percent prime rate, start to take effect.

Rosenberg also warns that trade protectionism, competitive currency devaluations and military conflicts are the major risks for 2009 since this is the most broadly based global recession, according to the IMF, in the post-WW II era.

On a positive note, Barry Ritholtz, with boutique investment management firm FusionIQ, noted in early December that most of corporate America, outside of the financial sector, has healthy balance sheets, lots of cash and is running very lean.

One last word...

The role of an advisor isn't to be in the fortune-telling business but to assess risks and probabilities and the most suitable balance of both in consultation with clients. Successful wealth building takes time, patience, flexibility and each investor's wholehearted participation.

Please call us at any time if you have any questions or concerns about your own wealth building strategies.

In closing, I'd like to thank all of you for allowing me the privilege of sharing the journey to reach your life's goals, even though that road can get somewhat bumpy at times.

And, finally, remember to take the time to count the blessings in your life.

Sincerely yours,

Jack Di Nardo, CFP, CLU, CH.F.C.  
Strategic Planner

E. & O.E.

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