GOODMAN PRIVATE

Wealth Management

From Our Perspective

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A message from Ned Goodman and the
Goodman Private Wealth Team

Two thousand and two is over. Most investors will bid good riddance to a year that marked a rare occurrence – a third consecutive annual decline in most major stock market indices. As is customary, stock market strategists, who should know better from past experience, have turned their attention to the coming year as they make projections as to where the indices will sit 12 months from now. They will undoubtedly be wrong and as Barron's recently noted, they will build on a trend that suggests that no reasonable investor should lend any amount of credibility, nor commit a single dollar of capital, to such predictions.

	2002	2001	2000
S&P TSX Composite Index	-12.4%	-12.6%	7.4%
S&P 500 Index	-22.7%	-6.5%	-5.5%
Dow Jones Industrial Index	-17.4%	-1.4%	-2.5%
MSCI World Index	-21.9%	-12.7%	-11.0%

Returns measured in Canadian dollars

The Canadian market beat the trend in 2000, largely as a result of the strong price performance of bank shares and BCE.

A fourth consecutive down year would be unprecedented – but not impossible.

The fourth quarter of 2002, though not nearly enough to move the popular stock market indices into positive territory, showed a significant rebound in stock prices from the lows established in September. However, the positive investor sentiment that continued into the early stages of 2003 gave way to the worries of the world and stock prices once again retreated.

Improved investor sentiment produced a strong fourth quarter in 2002, but all too familiar uncertainty returned resulting in a volatile and negative start to the New Year.

	Q3 2002	Q4 2002	Jan-03
S&P TSX Composite Index	-5.0%	7.5%	-0.5%
S&P 500 Index	-4.0%	8.0%	-5.7%
Dow Jones Industrial Index	-5.5%	9.4%	-6.5%
MSCI World Index	-5.8%	7.3%	-6.1%

Returns measured in Canadian dollars

The worries of the world have impacted Main Street as evidenced by the constrained U.S. economy. Notwithstanding relatively low levels of business and consumer confidence, the moderate economic expansion south of the border should continue in 2003. The U.S. Federal Reserve is dedicated to support economic growth and although rising, inflation remains at levels comfortable to policy makers.

Canadian economic expansion is slowing but overall growth should exceed U.S. levels again this year as the Canadian consumer remains strong and business momentum positive. Inflationary risks are greater in Canada and it is possible that we will see Canadian interest rates rise modestly in the first half of 2003. In contrast to equity market indices, fixed-income markets have performed well, helping balanced portfolios to outperform those dedicated to equity investments for some time. We expect fixed-income markets to remain volatile during the coming year but the downside should be limited by uneven economic growth and the ongoing presence of worrisome world issues. Our conservative, fixed-income strategy, designed primarily to mitigate portfolio volatility and provide income when necessary, remains heavily weighted toward high-quality government bonds complemented by a select few corporate issues.

Trying to predict the future direction of the stock market – like trying to predict human emotion – is fruitless, but even more difficult during times of intense geo-political circumstances. The current environment is marked by potential war in Iraq, burgeoning nuclear capabilities in North Korea, threats to U.S. oil imports from a shut down in Venezuela, and the traditionally "friendly to markets" second half of the U.S. presidential cycle. However, the continuing short-term focus of U.S. businesses and investor impatience leads us to predict intense stock market volatility with the inevitable truth that the ownership of good businesses will prevail in the long term.

The last three years, and the experience of similar stock market cycles historically, have taught us a great deal about what we might expect going forward. Our focus is not on the level at which the stock market will trade but rather the more predictable psychological impact that brutal bear markets tend to have on the psyche of investors.

When compared to previous stock market downturns, the current period has proven to be as bad as most in terms of the depth of the decline, and may be the worst ever in terms of its duration. But it is the retention of the memory of this negative experience that is important. That memory will remain problematic for those who rely on the value of the stock indices as a measure of investment performance and success.

The sideways markets that followed the long bear markets of 1929-32 and 1973-74 illustrate how fear can pervade investors' psyches. Using my own personal experience, when in 1960 I told my parents of my decision to return to school to qualify as an investment professional, their response was to each carefully remind me of what happened to the stock market in the 1930s depression era – this some 30 years after the fact! What is clear is that although most investors appear to rapidly lose their senses at the height of stock market bubble, they regain them very slowly, one by one. While the cat that jumped on a hot stove is unlikely to do so again for fear of being burned, he is just as unlikely to ever jump on any stove that may present no danger whatsoever.

All evidence suggests that fearful investors have withdrawn from the stock market. Investors, like the cat, remain ever mindful of past experience and the harmful effects of insufficient knowledge as they retreat from what was the most popular place in town only a short time ago. But they may be doing so at a time of great opportunity. Most businesses have been repriced in the stock market, many with good reason. But others have seen their prices fall lower than investment fundamentals suggest they should. These businesses will be difficult to identify and investment professionals will be challenged in what is becoming an old time "stock pickers" market. Individual selection of real businesses will once again have a dramatic impact on investment performance.

Using my "demographic advantage" (which I acquired having lived through several stock market cycles), I revisited my days as a portfolio manager between 1972 and 1982 to see what lessons could be learned from the last time the stock market was in a major bear mode. In those days I was privileged to be partnered with Austin Beutel, Seymour Schulich and David Williams in a professional investment practice called Beutel Goodman & Company Ltd. We were one of the few investment counsel firms to deliver good performance in what was a 10-year bear market primarily because we understood, anticipated and correctly analyzed the leadership change that was occurring with the changing times.

The S&P 500 index fell dramatically from 1972 to 1974 and then moved sideways for about eight years before reaching new highs. From 1968 to 1973, fifty stocks affectionately called the "Nifty Fifty" were at the top of every investor's list. These stocks were akin to the leading technology names of the late 1990s – they were the darlings of the market, the "must owns". This group of businesses had performed well prior to 1972 and their share prices continued to move higher well into 1973, even as the overall market began to fall. However, when the bear came, they too were hit with dramatic declines and then drifted sideways with the general market. Because I was looking at a period in stock market history that I know very well, I was able to look at one more group of businesses – the fifty best performing stocks in the S&P 500 index over the same period. These businesses included precious metals, energy and real estate companies and, as a group, advanced about 500% over the next eight years.

Perhaps the most important lesson learned from this period was that it is possible to achieve acceptable investment performance even during periods when the stock market moves sideways. Because a capitalization weighted stock market index does not perform well is no reason to expect all businesses to do likewise. An equally important detail is as the Nifty Fifty experience suggests, yesterday's investment winners are not likely to be tomorrow's. While a handful may continue to prosper, most will prove disappointing to those who invest in them.

With the madness of a runaway bull market behind us, investing has indeed gotten hard again. When times are good and a rising tide lifts all boats, it is easy to forget that investing is a serious business unkind to mediocre analytical work. We are continuing to witness, what I have called in the past, a shift back to the basics of investing. Real fundamental analysis of real understandable businesses is required to earn the returns we expect from the stock market. Common sense, rational thinking and a keen business perspective continue to be the foundation of the Focus+ investment philosophy.

The stock prices of Canadian businesses, reflecting fluctuating investor attitudes, moved up strongly in the final three months of 2002 in stark contrast to the preceding quarter. However, the early stages of the current year suggest that investor expectations remain inconsistent. Overall, our equity selections performed well in 2002 and our Canadian portfolios preserved capital and finished the year well ahead of the popular indices. Our favourite holdings have changed very little and we have taken a shine to selective gold companies adding exposure to the sector in our client accounts.

We are continuing to see widespread acceptance of income trusts in the Canadian marketplace. Investors, recognizing the need for income producing investments, have embraced many businesses that have adopted the income trust structure. Likewise, large institutional investors, including some of Canada's leading pension funds, have recently been buying steady cash-generating assets that have the same characteristics as those housed in income trusts. In fact, many have recently announced a formal allocation of fiduciary assets to income trusts. These strategies are no different than those employed by Warren Buffett when he buys a business in its entirety and effectively controls the cash flow it generates. The pursuit of income has become a major leadership change of the current market cycle and we believe that it will continue to be a prominent theme moving forward.

As we had anticipated, heightened volatility accompanied a flood of new trust businesses to market in the fourth quarter of 2002. The rush, however, was met by an impressive display of professional investor discipline that resulted in many of the proposed new issues being re-priced, deferred and in some cases scrapped entirely. The message is clear – income trusts as an asset class will exist for years to come. But as is the case with all equities, inferior businesses – and overpriced issues – will be unacceptable in this cycle of basic investing.

The financial services sector remains the most prominent industry in Canada, and Canadian financial stocks continued to outperform the market in 2002. Having recently witnessed the majority of history's largest corporate bankruptcies, Canadian banks appear to be through the worst of their loan losses. The franchises and sustainable earnings power of our favourite banks – TD, CIBC and the Bank of Nova Scotia – remain very strong. Similarly, Canadian life insurance companies have demonstrated unique resilience relative to their European and U.S. counterparts who have been more negatively impacted with balance sheet impairments and annuity guarantees. We are currently gaining interest in investments in investment management companies whose earnings and share prices have been devastated by the severe bear market. These companies have been focused on improving efficiencies through cost reductions and are positioned for significant margin expansion when equity markets improve. Overall, financial businesses are poised for strong growth in free cash flow that will undoubtedly support dividend growth as the industry matures and dividend tax policies improve. We remain committed to the sector's growth prospects, reasonable valuations, consolidation trends and supporting demographics.

The U.S. stock market followed on two successive years of negative returns with a more than 20% decline as measured by broad market indices. Our U.S. businesses were unable to escape unscathed but, on average, their share prices declined by less than half that of the major indices. The crisis of investor confidence in the U.S. continues to influence institutional and retail investors and performance of the stock market remains disconnected from that of the stronger than expected U.S. economy. In the 1990s, stocks outperformed business fundamentals and it appears now that business fundamentals may outperform stock indices. We have not made many changes to our American holdings, preferring to patiently hold those businesses with which we are most comfortable. Internationally based companies will continue to face similar challenges as those faced by their Canadian and U.S. counterparts. Stimulative monetary policies will gradually revive the global economy which, in turn, will support improved earnings growth and, eventually, improved stock market valuations for best-in-class businesses around the world.

The current bear market is poised to become the longest in more than a hundred years, but the worst declines appear to be over. Investors must remain diligent to endure the prolonged but less painful final stage, which may last many years. The value of sensible financial advice is always most prevalent in a bear market and this cycle is no exception. Investors are once again recognizing the appeal of working with a professional financial advisor who has the ability to help them do what they should, rather than what they would if emotions were their guide. The Focus+ investment team continues to utilize these same sensible principles, combined with a time-tested investment philosophy that emphasizes three important tenets:

Stocks are parts of a *business.*

Stock market *mis-pricing* often represents opportunity.

Margin of safety should be a part of all investment decisions.

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