CUMBERLAND

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Where are the "Black Swans" now?

Equity markets continued to rally through the month of October on the back of strong third quarter earnings reports and growing expectations for more quantitative easing from the Federal Reserve. The S&P 500 gained 3.7% last month and finished October up 6.1% year to date (both measured in U.S. dollars). The Canadian dollar continued to display relative strength to both the U.S. dollar and global currencies generally, rising a further 1% in October to just over US$0.98. The appreciation of the loonie this year has cut the 2010 gain in the S&P 500, when measured in Canadian dollars, by more than half to just 2.7%. In Canada, the TSX has continued to power higher, led by commodities and energy, rising 2.5% last month to bring its 2010 gain to almost 8%. The euro rallied again as well, climbing 2.3% to approach US$1.40 once again, although this recent strength could be decidedly short-lived given recent discussion of a possible bailout for Ireland.

Worries over longer run inflation caused by a fresh round of money printing by the Fed has continued to fuel further advances in gold, commodity and energy prices. The yellow metal climbed almost 4% last month (up 24% YTD) and crude oil prices advanced another 3%. The pending Fed action also drove yields on both U.S. and Canadian government bonds lower yet again, while spreads on Canadian corporate bonds managed to tighten (good news) as well. Both very good security selection and good asset mix decisions have allowed our client portfolios to benefit from the strong move in both equity and credit markets last month.

All of which brings us to the theme of this month's letter: lessons we were supposed to have learned from the great credit crisis of 2008. Back in the depths of that dark period, a few "prophets" were anointed by the popular media as having accurately predicted the events of 2008. Over time it has become apparent that many of these so-called prophets always held, and continue to hold, a very negative view of the future. So while they were right for a point in time, there is probably not much to be learned from them. Indeed, many appear to be at least beginning to lose some popularity as we move farther away from the depths of the crisis. There were others however, who had a more thoughtful approach to risk and reward, and in particular, how investor behaviour can shape the market response. One of the more interesting of these (at least in our view) is a lecturer, writer and investor named Nassim Taleb.

Taleb published a book back in 2007, titled "The Black Swan", whose main thesis was that humans by nature tend to underestimate the likelihood of potentially very high impact future events simply because we are not good at foreseeing things which we have never experienced. All swans were "known" to be white right up until black ones were discovered in Australia. House prices were "known" to never decline on a national basis right up until they did - to the tune of over 30%. Taleb holds that because of this tendency, investors tend to take much larger risks than they realize and in return, receive far less of a risk premium for doing so than they should. For example, AIG made "boatloads" of profits insuring mortgage derivatives against default because housing prices don't go down on a national basis. To their horror, once it was discovered that house prices CAN go down nationally, and in fact began to decline significantly, AIG experienced catastrophic losses and went bankrupt. Simply put, the premium AIG received for insuring against default turned out to be far, far too low for the actual risk they were taking.

Supposedly, we all learn from experience, don't we? So let me ask, where are the Black Swans now? Who is getting paid far too little, to take a risk which appears so remote as to be "impossible" but would suf-

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fer very large losses if that assumption was wrong? It doesn't even really matter whether the negative outcome happens or not. If you take a risk, you should get paid for it – this is perhaps the most important principle of investing. I submit, for your consideration, the large and rapidly growing group of investors holding government bonds. They own these instruments at all-time low yields because they believe that in a low growth (and in their view, most likely negative growth) deflationary world, the real yield and capital preservation of these bonds makes them the most attractive asset class. Perhaps. But, what is the Black Swan if you hold these instruments?

It appears (to us at least) that the worst case outcome would be if somehow, some way, the developed world economy started to increase its growth rate. Impossible you say? Well, if I was to do nothing but watch business news channels and read the paper, I would have to agree with you. When was the last time you saw an "expert" talking about the growth rate of the large developed economies even possibly returning to their potential? No, our choices are apparently limited to a second, more catastrophic collapse or, if we're lucky, muddling through in a "new normal" of sub par growth. But what if growth did get back to potential? What if business confidence improved because of emerging market demand, higher stock prices or balance sheets which are flush with cash? What if they started to invest in new technologies and business opportunities again? What if growth picked up? Unemployment would fall, tax revenues would rise, deficits would shrink, inflation would accelerate and, eventually monetary policy would begin to tighten. Inevitably, interest rates would need to increase, perhaps very quickly. If you happened to be holding a government bond, purchased at today's very low yields, then the market value of your investment would decline rapidly. Yes, if you hold them to maturity, you will get your money back, but selling before maturity will realize a painful (and potentially very large) capital loss and holding to maturity would realize a negative real return (after inflation).

Of course this might not happen. In fact, we would argue that the chance of developed economies returning to full potential growth any time soon isn't the most likely outcome. But we would also argue that it is a considerably more likely outcome than the market is discounting. Over the course of human history, our species has a habit of persistently assuming the future will be worse than the present and then somehow, some way finding a path to make it better than we expected. In our view, that makes the current paltry yields on government bonds look suspiciously like the premiums AIG was all too happy to get paid (until suddenly, they weren't).

Within our clients' capital appreciation portfolios, we have continued to grow our allocation to equities while trimming our longer term bond exposure. Within income portfolios, we continue to favour higher yielding equities and increasingly, high yield bonds. With future outcomes for the economy and markets both highly uncertain, we remain vigilant regarding risk and in particular, Black Swans.

John Wilson
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