WARATAH

Brad's Musings
It's Only Money

I am sure you recall having heard the expression, "It's only money". From my experience, this is usually uttered by someone who has not recently experienced a financial loss to someone who just did. From the perspective of the person who experienced the financial loss, these words are only slightly less infuriating than "I told you so". All kidding aside, there is a beautiful truth contained within the expression "It's only money". It indirectly points to the existence of something larger and more important than money. That larger something for me is life and my experience of love. My family and friends, my children, my health and whatever time I have left to live is infinitely more valuable to me than money. I think most people would agree with that statement.

Although I appreciate the implied wisdom of the expression, there's something I really dislike about it as well: it doesn't give money the respect it deserves. If it is "only money", why do we care so much about it? Why do we feel so much emotion when we lose it? What loss are we actually experiencing? I have dedicated my professional career to growing and protecting money so I think about questions like these. Money is important and valued for some obvious reasons. It takes effort and time to earn it, we can derive a sense of security from having it and we can use it to feed, clothe, shelter and educate ourselves and those we love. We can enjoy the things and activities that money can buy. And as I have come to appreciate, money can be used to make more time available for doing what we love to do (I no longer cut my own lawn as an example). However, I believe there is a deeper and more meaningful value to money. If we choose, we can use money as an expression of our life's purpose and we can express our love with it. Viewed in this context, money is completely consistent and complementary to what I value most. One does not need money to live with purpose or to express love but it can be used in ways that are consistent with both. Money, like energy, represents stored potential. Potential to get things done. Potential to build and create. Potential to help and potential to harm. As the creator and owner of money, you have the ability to determine when, how, into what form and for what purpose that potential is realized.

Now that I've established why I work to protect my money and yours, I'd like to discuss how I view risk. *The Oxford English Dictionary* defines risk as "a situation involving exposure to danger". I like the verb definition: to risk is to "expose (someone or something valued) to danger, harm, or loss". From the moment we are conceived we are exposed to risk. It is an essential consequence of life. Although we cannot escape uncertainty, we can take actions and behave in ways that limit or reduce the likelihood of harmful outcomes. We wear seatbelts, we have our airplanes and elevators inspected and we follow rules. We have the ability to consider the effects of our actions and how we can mitigate circumstances that pose danger. We have that same ability when it comes to protecting our money if we choose to use it.

Mitigating risks starts with identifying them. Many risks related to equity investing are obvious. Others take hard work and creative minds to uncover patterns and hidden relationships. We are very good at this at Waratah. The greatest risks of all are the risks we don't know we are exposed to. Donald Rumsfeld, the former US Secretary of Defense, famously referred to these risks as the unknown unknowns. Even though we can never know the unknown unknowns, mitigation is possible. The first and most important step is accepting that undesirable events that pose a risk to your money exist. Some people refer to these as "tail risks" in reference to the extreme right and left sides of the normal distribution curve. The collapse of Lehman Brothers in 2008 and its effect on global capital markets is commonly cited as an example of a low probability, tail risk event. The best book I've read on this subject is *The Black Swan* by Nassim Nicholas Taleb. In his book he expands on a story about a turkey, first told by Bertrand Russell, to demonstrate how humans place too much reliance on past observations to estimate probabilities and draw conclusions. Taleb asks his readers to consider the life of a turkey. Every day, the turkey wakes up and is fed by the farmer. The animal leads a peaceful and contented life for a thousand days. All the turkey knows is his cumulative experience. Every day of his life forms a recurring pattern which he uses to make predictions of what will happen the next day. This is of course until the fateful day when the farmer shows up with an axe and the turkey himself becomes a meal. From the turkey's perspective this is an unpredictable 'tail' event. In the turkey's defense, at least he was relying on historical data when concluding that he would live forever. Humans, and in particular those of us who invest in the stock market, have a strange habit of ignoring the historical evidence. Metaphorically speaking, the farmer takes an axe to the stock market on a fairly regular basis.

I've been working in this industry for 16 years. In that short time I have witnessed the following "tail events":

Event	Facts Most People Have Forgotten
Bre-X Scam 1997	TSX Gold Index fell 56.5%[1] TSX Index fell 10.1%[2]
Asian Crisis 1997	S&P 500 fell 10.8%[3] TSX Index fell 13.1%[4] NYSE "circuit breakers" breached leading to early close[5] Hong Kong Hang Seng Index fell 18.7% over 2 days[6]
Long-Term Capital 1998	S&P 500 fell 19.2%[7] TSX Index fell 29.0%[8]
Bricks & Mortar vs. the Internet 1997 - 2000	TSX Real Estate Index fell 41.4%[9] DJ US Real Estate Index fell 34.1%[10] Riocan's dividend yield was 13.6% on the day NASDAQ peaked[11]
Dot.Com Crash 2000 - 2002	S&P 500 fell 47.4%[12] S&P 500 fell 5.8% in a single day[13] NASDAQ fell 77.9%[14] NASDAQ fell 9.7% in a single day[15]

9/11 Terrorist Attack	S&P 500 fell 11.6% over 5 trading days[16] TSX Index fell 11.2% over 7 trading days[17] US stock markets were closed for 4 days[18]
Income Trusts are Outlawed 2006	TSX Income Trust Index fell 24.1%[19] TSX Income Trust Index fell 12.4% in a single day[20]
Quant Quake August 2007	S&P 500 fell 9.3%[21] TSX Index fell 12.0%[22]
Lehman Collapse/ Global Financial Crisis 2007-2009	S&P 500 fell 55.3%[23] S&P 500 fell 16.8% in a single month[24] S&P 500 fell 9.0% in a single day[25] TSX Index fell 48.5%[26] TSX Index fell 16.7% in a single month[27] TSX Index fell 9.3% in a single day[28]
Flash Crash May 6, 2010	S&P 500 fell 8.6% intraday[29]
European Sovereign Debt Crisis 2011-2012	S&P 500 fell 18.6%[30] S&P 500 fell 6.6% in a single day[31] TSX Index fell 20.6%[32] TSX Index fell 4.0% in a single day[33]

My Grandma is a wonderful person whom I love dearly. Can you imagine what her list looks like? In her lifetime, she has lived through all the events I just listed plus the crash of 1929, the Great Depression, World War II, the Korean War, the Cuban Missile Crisis, the Vietnam War, the oil crisis and stagflation of the 1970s, 20%[34] mortgage rates, the Black Monday crash of 1987 when the markets fell 22.6%[35] in a single day and many others. She has an amazing list of great things that happened too, just as the markets have had some great runs, but no one needs protection from that. I really hope I am fortunate to live a long life. I do not know what 'tail events' are awaiting us in the years to come but I know the list exists and I know it will get longer.

My reality is that I live my life one day at a time. I feel stress, fear, and anxiety when I live through 'tail events'. I feel the pain of losses and I do everything I can to mitigate them even though they are destined to become blips on a chart in the fullness of time. This is a huge contradiction that I find fascinating. On one hand, the historical evidence supports the conclusion that bad things are going to happen to you and your money. The longer your investment horizon, the more certain you can be that you will experience 'tail events'. Fortunately, the historical evidence also supports the conclusion that everything will work out well and the longer your investment horizon is the more certain you can be of this. Is it possible for everything to work out well without having to experience any loss along the way? I believe the answer is no. One must lose occasionally to truly appreciate what one has gained. Loss is a necessary part of life but that is no justification for not trying to mitigate risk. Life's experiences have a lot to teach us but I'd rather learn my lessons inexpensively.

Brad Dunkley
21 November 2013

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Notes to risk and return data:

A. Source of all data is Bloomberg, Bank of Canada website and NYSE website
B. Index information is determined as follows determined in local currencies:
    a. TSX Gold Index refers to S&P/ TSX Gold Index
    b. TSX Index refers to S&P/ TSX Composite Total Return Index
    c. S&P 500 refers to S&P 500 Total Return Index
    d. TSX Real Estate Index Refers to S&P/TSX Composite Real Estate Industry Group Index
    e. DJ US Real Estate Index refers to Dow Jones Real Estate Total Return Index
    f. NASDAQ refers to NASDAQ Composite Index
    g. TSX Income Trust Index refers to S&P/TSX Income Trust Index

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[1] S&P/TSX Gold Index fell 56.5% from 2/28/1997 to 12/9/1997
[2] S&P/TSX Composite Index fell 10.1% from 3/10/1997 to 4/14/1997
[3] S&P 500 fell 10.8% from 10/7/1997 to 10/27/1997
[4] S&P/TSX Composite Index fell 13.1% 10/7/1997 to 1/12/1998
[5] NYSE circuit breakers triggered for first time on 10/27/1997, source: NYSE website
[6] Hong Kong Hang Seng Index fell 18.7% from 10/27/ 1997 to 10/28/1997
[7] S&P 500 fell 19.2% from 7/17/1998 to 8/31/1998
[8] S&P/TSX Composite Index fell 29.0% from 6/8/1998 to 10/5/1998
[9] S&P/TSX Real Estate Index fell 41.4% from 10/6/1997 to 2/24/2000
[10] DJ US Real Estate fell 34.1% from 10/7/1997 to 12/14/1999
[11] NASDAQ Composite (CCMP INDEX) Peaked 3/10/2000 at 5048.62, Price of REI-U on that day: $7.90, Total of Dividends in REI-U in 2000: $1.07125 ($1.065 regular, $0.0625 special), Yield: 13.56%
[12] S&P 500 fell 47.4% from 9/1/2000 to 10/9/2002
[13] S&P 500 fell 5.8% in a single day: 4/14/2000
[14] NASDAQ Composite fell 77.9% from 3/10/2000 to 10/9/2002
[15] NASDAQ Composite fell 9.7% in a single day: 4/14/2000
[16] S&P 500 fell 11.6% from 9/10/2001 to 9/21/2001
[17] S&P/TSX Composite Index fell 11.2% from 9/10/2001 to 9/21/2001
[18] US markets were closed 9/11/2001 to 9/14/2001
[19] S&P/TSX Income Trust Index fell 24.1% from 4/21/2006 to 11/14/2006
[20] S&P/TSX Income Trust Index fell 12.4% in a single day: 11/1/2006
[21] S&P 500 fell 9.3% from 7/19/2007 to 8/15/2007
[22] S&P/TSX Composite Index fell 12.0% from 7/19/2007 to 8/16/2007
[23] S&P 500 fell 55.3% from 10/9/2007 to 3/9/2009
[24] S&P 500 fell 16.8% in a single month: October, 2008
[25] S&P 500 fell 9.0% in a single day: 10/15/2008
[26] S&P/TSX Composite Index fell 48.5% from 6/18/2008 to 3/9/2009
[27] S&P/TSX Composite Index fell 16.7% in a single month: October, 2008
[28] S&P/TSX Composite Index fell 9.3% in a single day: 12/1/2008
[29] S&P 500 fell 8.6% intraday and closed down 3.2% for the day
[30] S&P 500 fell 18.6% from 4/29/2011 to 10/3/2011
[31] S&P 500 fell 6.6% on a single day: 8/8/2011
[32] S&P/TSX Composite fell 20.6% from 4/5/2011 to 10/4/2011
[33] S&P/TSX Composite fell 4.0% on a single day: 8/8/2011
[34] The Canada Mortgage and Housing Corporation reported that the average residential 5-year mortgage lending rate exceeded 20% from August to October of 1981, source: Bank of Canada website
[35] Dow Jones Industrial Average dropped by 22.6% on 10/19/1987