



***Be fearful when others are greedy and be greedy  
when others are fearful  
- Warren Buffett***

On March 29, 1999, my wife and I flew into New York City. It was a Friday and my wife had the whole weekend planned: sight seeing, a Broadway show, 5th Avenue and a Rangers game on Friday night. Because this was Friday, my first priority was to visit the New York Stock Exchange because when I left the office that day, the Dow Jones Industrial Average was flirting 10,000 and I wanted to be there. Unfortunately, we got downtown after the market closed but I can always say that I was in New York City the day the Dow closed above 10,000 for the first time.

Now, if I had bumped into you that day and you told me that in 2008 Bear Stearns and Lehman Brothers would be bankrupt, Fannie Mae and Freddie Mac would be taken over by the US government, AIG would require an \$85 billion bail out loan by the US government, of \$700 billion rescue bill would be passed by Congress, Merrill Lynch would be forced to sell itself to Bank of America, Morgan Stanley and Goldman Sachs would become bank holding companies and banks around the world would require financial injections from their governments, I would have told you you were crazy. But here we are and this has all happened in a matter of months.

Needless to say, this has been a rough start to the fourth quarter and especially for everyone's portfolio. For the past 2 months, I have tried to put something down to paper for the *Rocca Report* to explain to you what was going on and how this was affecting you. The problem was that it seemed like everyday, something new came up and I had to start over. In the interest of time, I'm sending this e-mail instead.

This is a very complex issue so I'm not going to attach a glossary that defines terms you're probably hearing and reading about such as LIBOR and Credit Default Swaps. We have an extremely interconnected global economy now so what happens in Vegas doesn't necessarily stay in Vegas, if you catch my drift.

Imagine you just bought a duplex for \$200,000 and the rent you are receiving covers your costs like maintenance and mortgage payments so you're pretty happy. But three months later, the real estate market crashes and your duplex is now worth \$100,000. No problem, you say to yourself. I'm still getting my rent, my expenses are covered and at some point, the real estate market will recover. Not so fast, say your banker and accountant – we have to record this as a loss and by the way, you owe the bank \$100,000. But I don't have \$100,000, you say. And besides, this is a long term investment and I have no intention of selling anytime soon. Too bad, they say and unless you can find some way to raise \$100,000, you're basically out of business.

This is basically what has happened to financial institutions around the world. They had a large amount of bad mortgages on their books and were forced to book losses. This affected their capital ratios (the amount of assets they are required to have on their books by regulators) which is why you've seen some very large and venerable financial institutions go under. This has had a terrible cascading effect which is causing the entire

system to deleverage. This means that many market players such as hedge funds are selling everything and at almost any cost. In many cases, they're selling because they have no choice. The CEO of Chesapeake Energy, as an example, recently sold 33 million shares of his own company because he had to meet a margin call. It's the last thing he wanted to do but he had no choice. This is going on everywhere right now.

It has also caused an almost unprecedented flight to safety. Despite their problems, the US Treasury Bill is still considered the safest investment in the world. On September 17, 3 months US T-Bills were trading at a *negative* yield. That means those investors were paying the US government to lend them money. That makes no financial sense whatsoever but this is what happens when people panic.

It does not help that we live in a 24/7 news world and every second word on the news is either "crisis" or "depression". This feeds the negative emotion and fears of investors and that's why we tend to overshoot either on the downside or on the upside.

*OK – thanks for the doom and gloom – is there any good news?*

I'm glad you asked. Yes – there is lots of good news. The first thing we all have to accept is there are things we can control and things we cannot. We cannot control the markets but we can control how we react to them. In my case (knock on wood), no clients have called me to liquidate their holdings. Historically, it has always been a horrible mistake to sell during times like these and the chart below illustrates why.

**Table 1: US Bear Markets**

Bear Market Began	% Decline	Duration (Months)	3 Month Return from End of Bear Market	6 Month Return from End of Bear Market	12 Month Return from End of Bear Market	2 Year Return from End of Bear Market
1-Jul-56	-19.0%	17	5.3%	13.1%	38.1%	49.8%
12-Dec-61	-24.6%	6	2.8%	15.3%	26.7%	5.9%
18-Jan-66	-22.1%	9	4.9%	17.8%	26.3%	34.1%
14-Nov-68	-36.1%	19	15.8%	26.7%	37.1%	47.3%
11-Jan-73	-48.2%	21	7.9%	31.2%	32.0%	65.6%
21-Sep-76	-19.4%	18	11.7%	18.7%	10.6%	31.0%
13-Feb-80	-17.1%	1	11.9%	22.9%	33.2%	40.7%
28-Nov-80	-27.1%	21	11.2%	35.7%	51.8%	50.2%
25-Aug-87	-33.5%	3	16.3%	13.8%	18.8%	37.7%
16-Jul-90	-19.9%	3	13.1%	23.5%	29.1%	58.5%
17-Jul-98	-19.3%	2	21.5%	29.3%	37.9%	36.7%
24-Mar-00	-49.1%	31	7.9%	4.0%	22.2%	17.7%
<b>Average</b>	<b>-28.0%</b>	<b>13</b>	<b>10.9%</b>	<b>21.0%</b>	<b>30.3%</b>	<b>39.6%</b>
<b>Median</b>	<b>-23.4%</b>	<b>13</b>	<b>11.5%</b>	<b>20.8%</b>	<b>30.6%</b>	<b>39.2%</b>
9-Oct-07	-26.1%	11				

**Note:** Bear Market defined as Peak-Trough correction exceeding 15.0%  
**Data based on daily close prices**  
**Source: RBC Asset Management**

You'll note that the average US bear market lasts about 13 months and has an average drop of -28%. We're almost a year into this bear market and the drop is close to 40%. We will never know where the bottom is but the *average* return 2 years after a bear market has been 39.6%. We see many signs that the market has bottomed or is close to it.

Central banks and governments around the world have taken unprecedented steps to reliquify the system including cutting interest rates, buying distressed mortgage assets,

investing in financial institutions and many other measures. It will take time for these measures to kick in but we're already seeing the credit markets begin to loosen up. We are not going into a depression but the stock market is now priced as if we are. Based on market valuations now, investors are anticipating a 40% drop in earnings for the average company. This would be Armageddon and as bad as things feel right now, a depression is a highly unlikely scenario. But this is what happens when investors panic and rational thinking goes out the window.

Typically, the trough in equities will precede the trough in indicators of manufacturing activity by three months, the trough in unemployment by seven months, the trough in earnings by six to nine months, and the trough in consumer sentiment by four months. Thus, even while the economy continues to exhibit deteriorating signals, the equity market often looks into the future and begins pricing in a recovery well in advance, which conforms to our experience following the launch of the Resolution Trust Corp after the US Savings and Loan crisis of the early 1990's. *Put another way, by the time the average investor begins to feel confident that the bear market has begun to fade, much of the post-trough upside in equity prices may already have passed.* So if the estimates that this recession will be 6 – 9 months are correct, we may already be at the bottom.

Finally, I believe Warren Buffett is the greatest investor ever. If you asked him the secret of his success, I believe he would tell you that he never makes emotional decisions. Some might say that he doesn't have to be emotional – he's worth \$50 billion! I say that's how he got to \$50 billion. He makes mistakes but getting emotional about his investments is not one of them. He knows that patience is required to be successful long term in stocks. And, as usual, Mr. Buffett is putting his money where his mouth is this year by buying between \$25 – 30 billion in distressed securities through his holding company Berkshire Hathaway. Buffett recently wrote an op-ed for the New York Times and the link is below. I strongly encourage you to read it.

[http://www.nytimes.com/2008/10/17/opinion/17buffett.html?\\_r=2&scp=2&sq=buffett&st=cse&oref=slogin&oref=slogin](http://www.nytimes.com/2008/10/17/opinion/17buffett.html?_r=2&scp=2&sq=buffett&st=cse&oref=slogin&oref=slogin)


The Bottom Line:


Unfortunately, we can never know when the market has bottomed until after it has happened. I am looking for opportunities everyday and taking advantage. Just remember Warren Buffett's mantra: Be fearful when others are greedy and be greedy when others are fearful. Let's be like Buffett and let's not look back in 2 or 3 years and wish we had taken advantage of the some of the great bargains in the market today.

Take care and please call or e-mail me if you have any questions.

Regards,

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