OPINION

Why the stock markets will recover

Despite the amount of fear today, the global crisis won't last long

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The last year, and especially the past three months, have been a difficult time for Canadian and global investors, who have been hurt financially and emotionally by the market meltdown and the global economic credit crisis.

There is clearly a tremendous amount of fear and uncertainty among investors.

Can the stock markets get any worse?

Maybe for a while, but not for long.

Here's why the markets will recover:

■ **Capital markets work**

The world's stock exchanges facilitate a free market system that is the cornerstone of capitalism. The markets are the meeting of suppliers of capital (investors buying and selling — you can't have one without the other) and demanders of capital (companies). These capital markets simultaneously price the cost of capital and the expected return from the risk of capitalism. Free markets perform this highly important task in the most effective and efficient manner because the knowledge of all investors exceeds the knowledge of any individual. Due to the millions of intelligent and highly competitive investors, it is unlikely that any individual investor will consistently profit at the expense of all other investors. Markets are relatively efficient and higher returns cannot be achieved without higher risk.

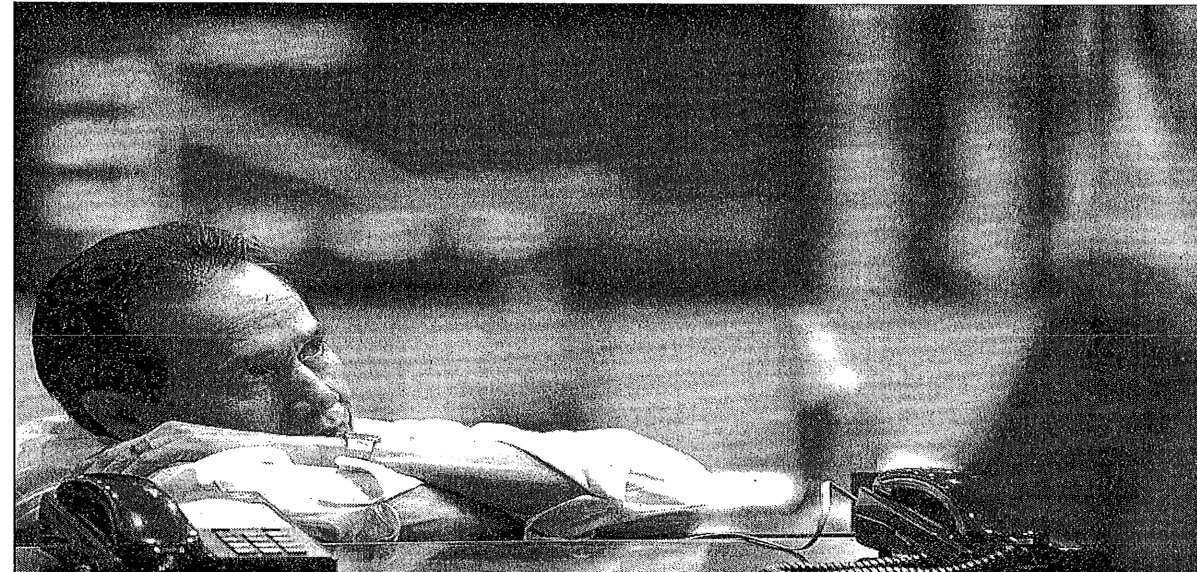
■ **The markets are just buckets of risk and return**

Capital markets work on the math of equity returns for equity risk. I tell my students and clients to think of equity markets (broad asset classes) as buckets of risk and return. Assume that a given equity asset class will generally produce a 10 per cent compounded average return over a given 10 year period. During decade the asset class may experience three or four negative return years. The annual returns of this asset class can range from plus-50 per cent to minus-35 per cent. Investors get compensation (return) in exchange for asset class risk (Canada, U.S., International, Real Estate, Small Cap, Value and the like)

Without risk, there is no expected positive return beyond the risk less rate of interest. But if risk means the return runs the chance of turning out to be negative, risk also means the return could exceed the investor's expectations. Real life cuts both ways.

■ **Markets don't die — just many stocks and some fund managers**

The markets are evolving all the time. Last year's winning stocks are falling from grace and different stocks are seeing their share price rise. A stock market is like a cylinder of oil and water that constantly changes. Markets are moved by news. News is unpredictable and random by definition. Therefore, the markets movements are unpredictable and random. However, this market randomness does have a positive average of about 10 per cent per year because capitalism works. As markets evolve there are many stock market casualties (Nortel, Enron, Lehman Brothers, etc.) and fund manager casualities (AIM Blue Chip America Growth fell 80 per cent between 2001 and 2003). The best way for a diversified portfolio to capture the brilliance of capitalism is with a portfolio of low-cost asset class funds.



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■ **Risk at the worst price (market tops)**

There are points in history when the equity markets offer equity risk (reward) at a less attractive price. When markets get expensive and price bubbles occur the valuations are less attractive. Expensive equity risk has a low probability to compensate investors with higher returns. Some examples of these events include the stock market bubble in the summer of 1987, the technology bubble and the most recent commodity bubble.

As they evolve, markets will adjust prices relative to risk and returns will normalize.

■ **Risk at the better price (market bottoms)**

Like market bubbles, market bottoms can only be spotted when they are in the history books. Whether they know it or not, all investors are seeking equity risk at the better price. Today, based on many historical valuation models (price to book, price to earnings, price to sales, dividend yield, etc.), the markets are relatively cheap indicating equity risk is at an excellent price.

Markets have been and always will be about price relative to risk. At this price we have accepted and experienced most of the risk. In the next few years the market will experience the return.

■ **Markets are a constant voting mechanism — volatility is a natural occurrence**

Markets are really just a giant voting machine. We can buy what we like and sell what we don't like and ignore the rest. When markets experience unusual price increases it is because investment buyers become price takers rather than price seekers. When markets experience unusual price declines it is because investment sellers become price takers rather than price seekers. Markets constantly move from price seeking (patient investors) to price taking (impatient investors). Market buyers and sellers are driven by the emotion of the markets perceived risk and return. Currently, the market is experiencing enormous uncertainty (risk) that drives investors to become sellers at almost any price, rational or not. Volatility, a natural occurrence, is the emotional side of the capital markets.

■ **Believe in the capital markets**

Markets are a lot like daily traffic. Each day thousands of cars enter and exit the city of Victoria and the Trans-Canada Highway slows to a crawl. There are days when the drive seems effortless and there are days the fender benders and road construction drives some to mini road rage.

However, everyone in traffic is motivated to get somewhere and amazingly they all do. The markets, like traffic, are just millions of intelligent and highly competitive investors, seeking the best return relative to risk. They invest in highly competitive companies seeking to grow their business with the lowest cost of capital. The capital markets, in Darwinist fashion, weed out the poorly run companies, the bad investment decisions and the less informed investors. The markets will continue with this cycle, albeit with the occasional price bubbles and price corrections, well into the distant future.

Capitalism is human nature. I wouldn't bet against capitalism and capital markets.

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