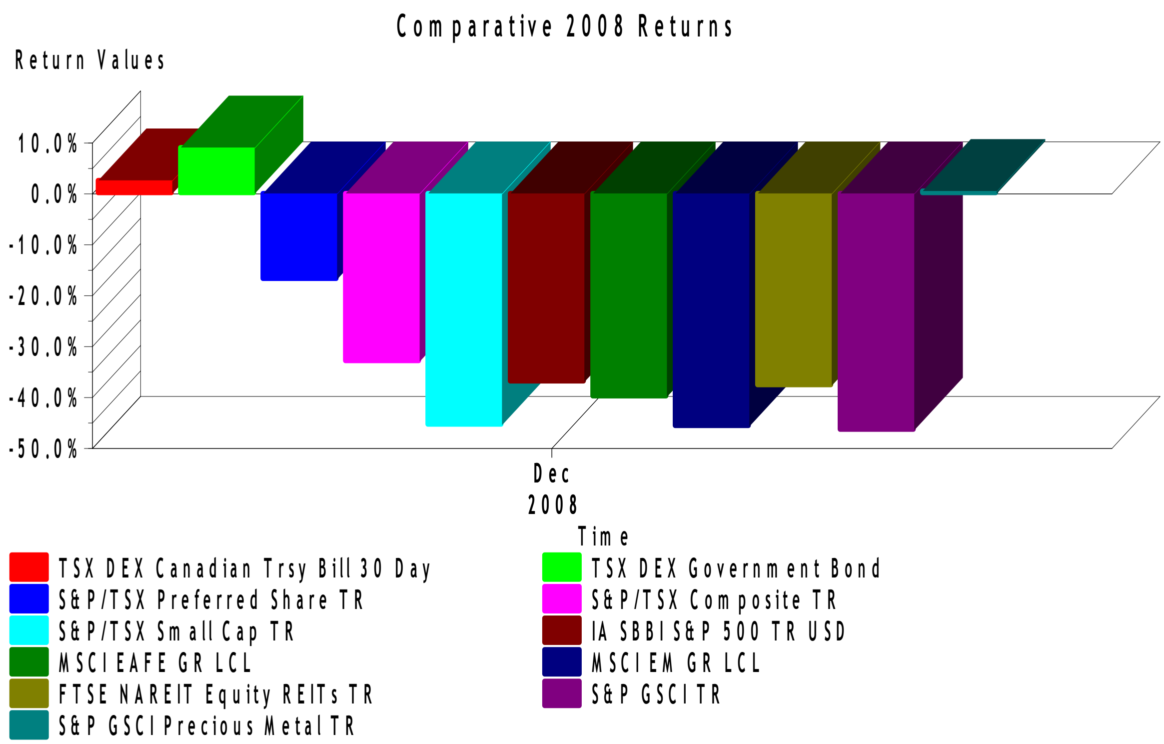
TACITA CAPITAL

You Are Not as Poor as You Think

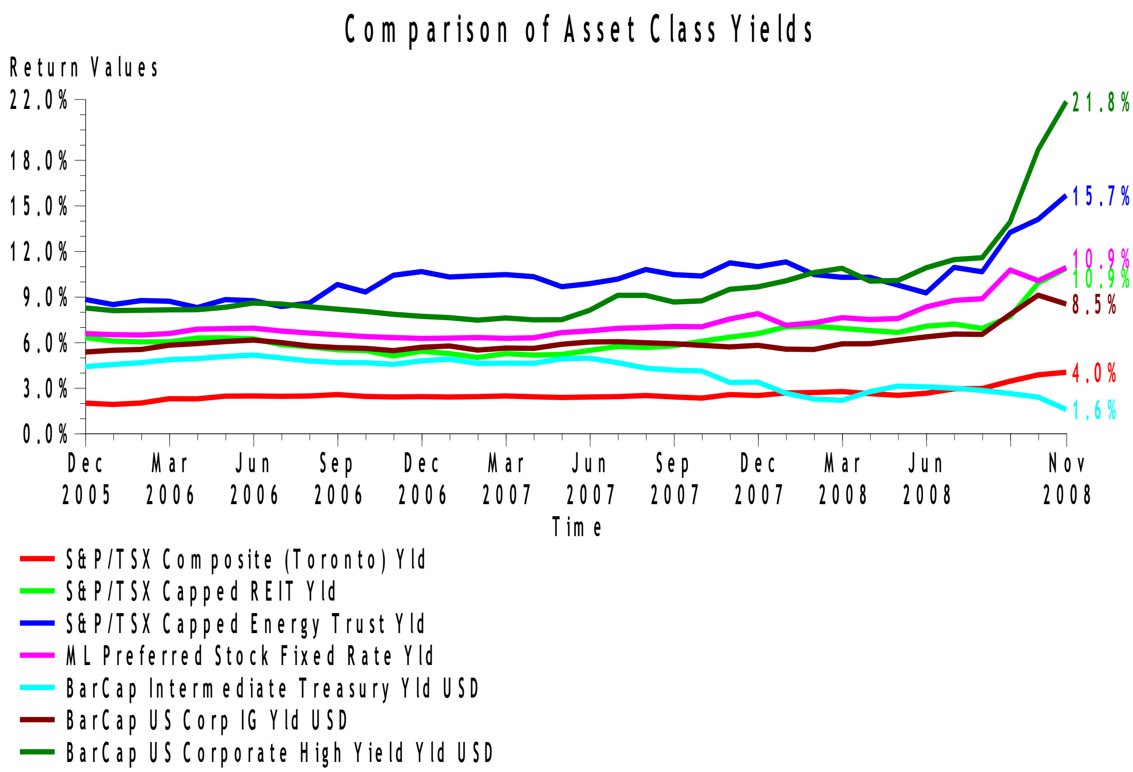
2008 was a year for the record books. Nearly every major asset class suffered record calendar year losses with several approaching 50 percent.



There were only a few assets in positive territory – cash, government bonds, and precious metals, and among hedge fund strategies, managed futures and dedicated short bias funds. Globally diversified, non-currency hedged investors experienced reduced declines as a plummeting Canadian dollar ameliorated losses in non-Canadian securities (see Table I in the Appendix). Nevertheless, even balanced investors with a reasonable exposure to both bonds and equities endured losses of fifteen to twenty percent.

The current sea of red ink has two interrelated causes. One is self-evident – a deep global recession is substantially reducing corporate profits and increasing the incidence of bond defaults as bankruptcies, such as Nortel's, rise. More important, however, is the fact that fearful investors are demanding much higher premiums for putting their capital at risk.

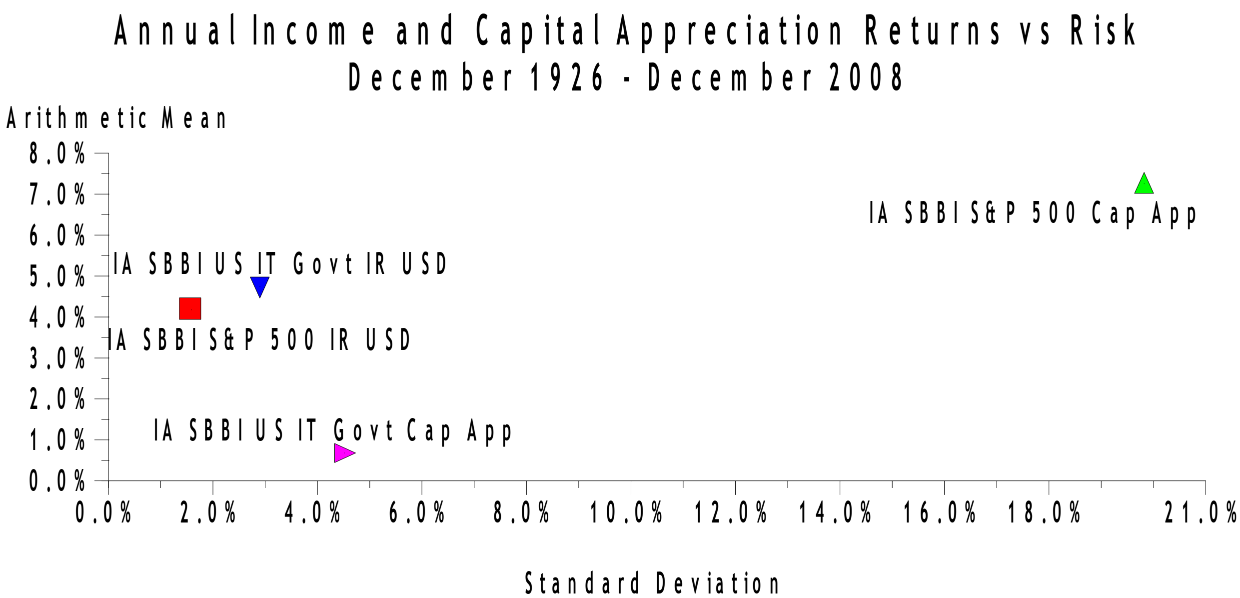
It is the higher future returns now demanded by investors that have driven prices lower. Yields in every asset class except government T-Bills and bonds skyrocketed at the end of 2008 as dividend and interest payments continued virtually unabated in the face of deeply discounted prices.



Of course, dividends will be cut in 2009. But even in the U.S., where low to mid-teen percent reductions have been forecast by analysts (the worst since the 1930's), dividend yields on the S&P 500 at current prices will be in the three percent range, in excess of current Treasury bond yields.

Balanced investors are likely to find that the income generated from their portfolios will be down moderately in 2009, somewhere in the five to ten percent range. This expected reduction in portfolio cash flows in 2009 is much less than the percentage decline in portfolio values in 2008.

Historically, the same pattern exists – income returns are far more stable than returns from capital appreciation. This is illustrated in the following graph which compares the income returns from U.S. large cap stocks (in red) and intermediate term Treasury bonds (in blue) to capital appreciation from these classes (stocks in green and bonds in pink) as well as the associated volatility or risk (as measured by standard deviation) from 1926 to 2008.



Income returns from stocks have only one-twelfth the volatility of returns from capital appreciation. Companies with a view to long-term performance are reticent to reduce dividends unless it becomes imperative; in contrast, stock prices reflect the daily emotions of the investing public. In fact, dividends have declined only a handful of times since the 1930's (see Table II in the Appendix). Even in the Great Depression, the percentage decline in real dividends was one-half the decline in real stock prices. Investors with their eyes glued to their portfolio values – which are determined by the opinions of other investors, and not cash flows – which are determined by the economic performance of the assets – miss this vital difference.

In fact, there are several academic studies* which suggest that today's higher dividend and earnings yields are somewhat predictive of higher expected long-run returns than would have been the case a year ago. Intuitively, this makes sense. The growth in real stock prices, however volatile, is ultimately tied to real earnings growth, which is fundamentally driven by population growth and productivity improvement. Unless one believes that global population growth and productivity improvement are forever gone, renewed corporate profit growth should occur at some point.

Certainly, that is what has happened over the twenty-eight business cycles since 1870. And since prices are much, much lower today than a year ago, this translates into higher expected long-term returns.

GMO, a global institutional investment manager, recently updated its seven-year return forecasts for major asset classes. GMO has an excellent track record in forecasting. In 2001, they forecast that U.S. large cap stocks would lose 3.2 percent annually over the next seven years – the actual number was a loss of 2.9 percent. The following table sets out their recent major asset class forecasts compared to their 2007 year-end counterparts:

Asset Class	Forecast 7 Year Annual Return December 31, 2007	Forecast 7 Year Annual Return November 30, 2008
Large Cap U.S. Stocks	**1.4%**	**9.6%**
Large Cap International Stocks	**2.7%**	**11.3%**
Emerging Market Stocks	**2.5%**	**12.4%**

Source: GMO website library at http://www.gmo.com/America/Library/Forecasts/. Inflation assumptions have been added to real return forecasts to calculate a nominal return forecast.

While rising expected returns are not a guarantee of future performance, they do suggest that the potential for future growth has improved markedly from the bull market levels of 2007.

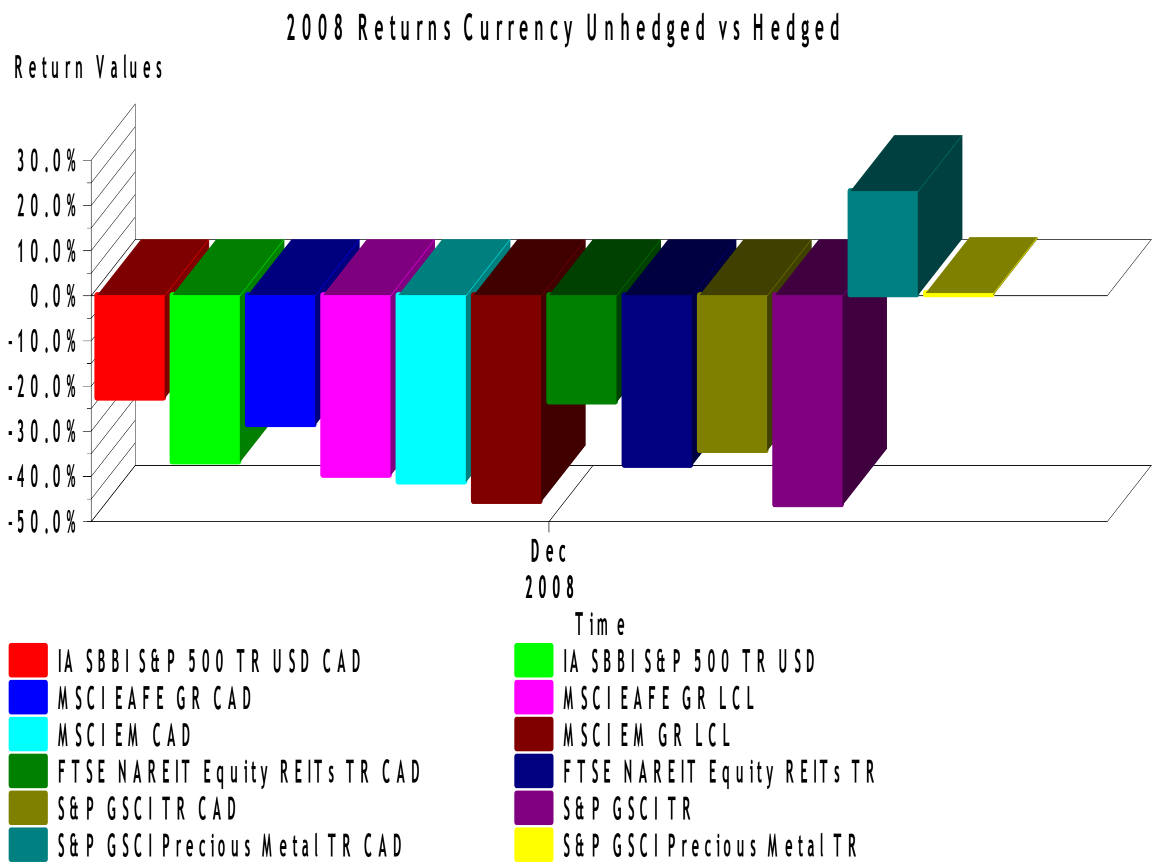
Most investors are poorer today than a year ago. However, today's depleted market values don't tell the whole story. Viewed through the prisms of future cash flows and potential returns, investors are not as poor as they think.

January 22, 2009

*- Interested readers can contact Tacita Capital for the academic sources to which we refer.

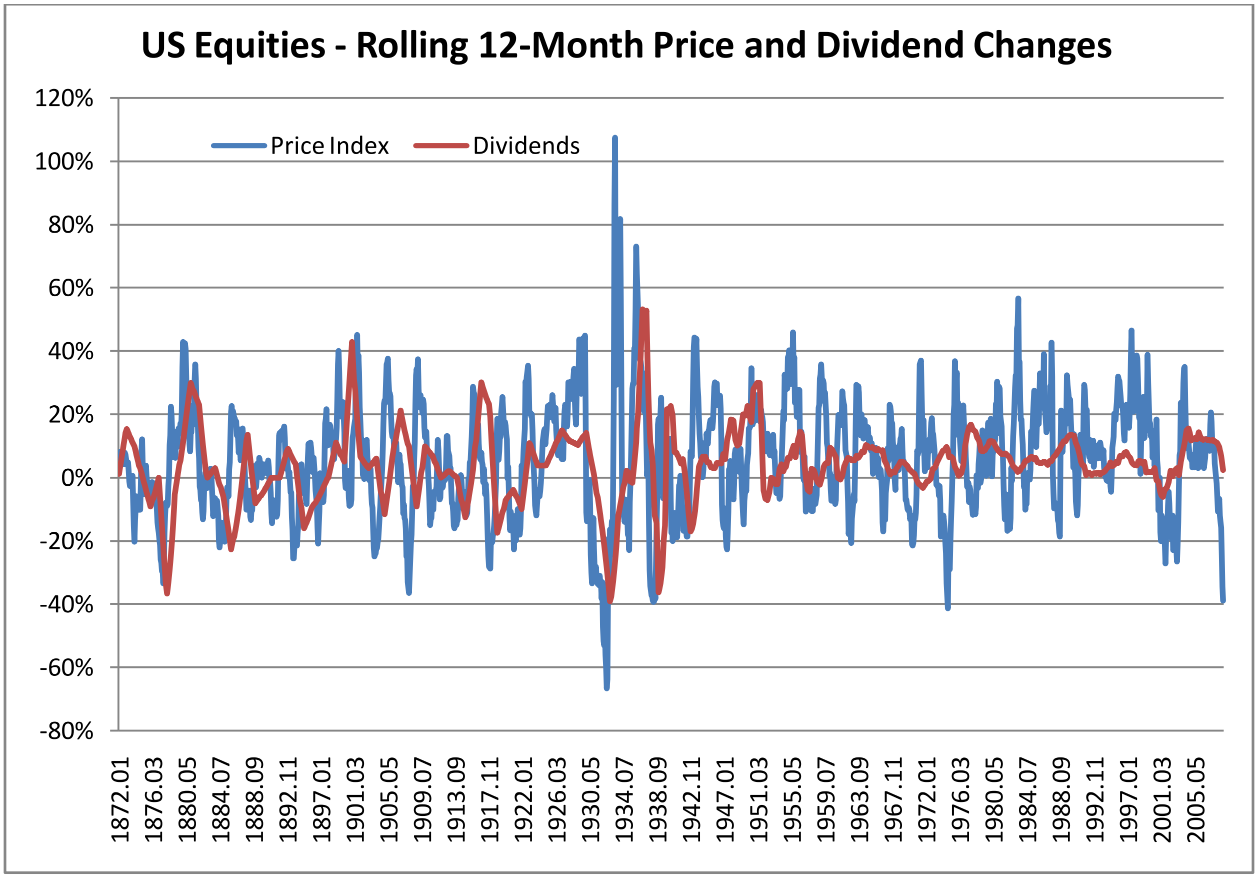
Appendix

Table I



Note: Unhedged return descriptions are followed by CAD reflecting the conversion into Canadian dollar returns.

Table II



Source: Robert J. Shiller's website - http://www.irrationalexuberance.com/index.htm

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