

Notes

Nexus Investment Management Inc.
Portfolio Management & Financial Counsel

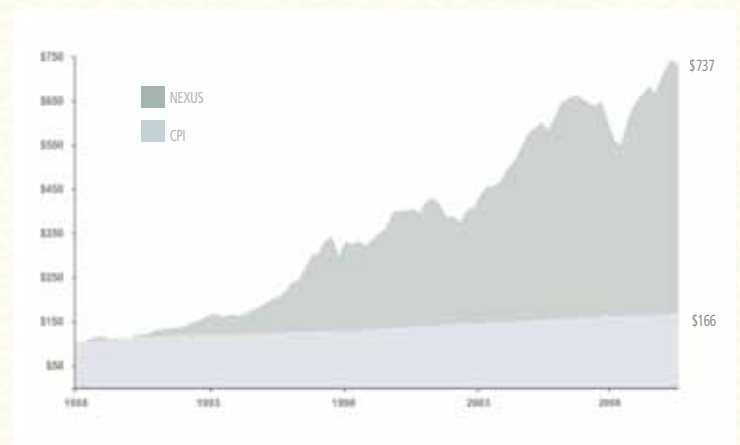
Inside Articles

THE INVESTOR'S CONUNDRUM
THIS IS NOT A ROLLER COASTER
BUILDING THE BUSINESS
PEARLS OF WISDOM

Building Value for Clients

Since its establishment in 1988, Nexus has pursued an investment approach which concentrates on real growth in client wealth over the long term. The chart illustrates the impact of this long-term investment thinking – a \$100 investment in a balanced portfolio in 1989 has grown to \$737 at June 30, 2011.

\$100 Investment with Nexus in 1989



The Investor's Conundrum

The relaxing days of summer are but a distant memory. However, the stock markets' performance of the past few months is not. Market volatility continues to be the norm and with good reason.

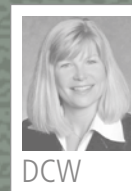
The precarious state of the U.S economy, European debt concerns and general economic malaise continue to be in the headlines. Many investors worry that a recession is upon us. The dilemma for investors is that while turning your back on the stock market and running for the hills may be satisfying in the short-term, this will likely leave you further behind in the long-term investment "marathon".

In order to tolerate short-term market volatility when investing for the long term, it is important to determine a sensible investment program that is most likely to achieve your own realistic long-term objectives. In order to do this, you need to develop an objective understanding of yourself and your situation. This means understanding your investment knowledge and skills, your tolerance for risk and uncertainty, your psychological needs and aspirations for the short and long term. It also means you must understand your own financial situation. This includes such things as assets, liabilities, income, spending obligations and expectations and investment time horizon.

A recent article in the Financial Analysts Journal reinforced this approach. The article stated that while investors are similar in many ways, they are very different in many more ways and it is their differences that matter most when it comes to individual investment success. All investors want to do well and avoid harm to their portfolio. However, investors must acknowledge and understand their own financial

situation in order to regularly achieve their own realistic, long-term objectives instead of the lemming-like pattern of following the crowd or getting in and out of the market at precisely the wrong time.

Helping clients create a sensible, long-term investment strategy is an important objective for us at Nexus. This is achieved through the creation of a tailored, long-term financial plan for clients which is a key component of the counselling services we offer. Understanding our clients and their circumstances helps us develop the proper asset allocation and diversification that is appropriate for each client's specific risk tolerance and time horizon. As market volatility is a hot topic these days, in this issue of Nexus Notes there is an article on how to deal with the short-term market fluctuations that we are currently experiencing. In addition, you will find a few exciting announcements that we would like to share with you.



This is Not a Rollercoaster¹ Surviving Equity Market Volatility

In early August, the equity market turned nasty. Whilst many of you were basking at the beach or snoozing on the dock, the trading range for the TSX Composite and S&P 500 was around 4% to 6% daily for six days in a row.

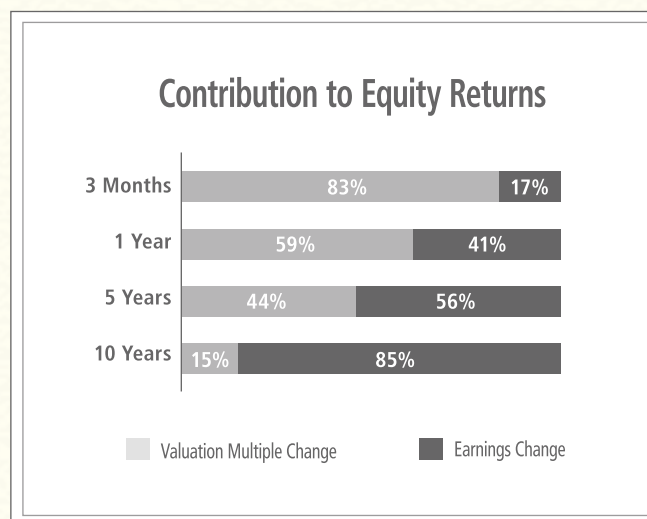
For volatility extremes, October 19, 1987 still takes the cake, with a one-day decline of 20% for the S&P 500. But history shows that these volatile days tend to cluster into periods that can last for weeks, months or even years.

For some, this may conjure up thoughts of being an unwilling captive on a rollercoaster. A quiet summer's day – interrupted – gut-wrenching drops, tight turns, and screaming. Well, the equity market sure feels like a rollercoaster right now – especially the part about starting up high and ending down low, along with many unpleasant moments in between – but it's not a rollercoaster, at least over longer time periods, as I'll explain.

OUR ANIMAL SPIRITS

Equity prices swing far more widely than changes in the underlying fundamentals for equities. Indeed, the drivers of equity prices can be derived by mathematics. If the market value for the market as a whole is determined by total actual corporate earnings multiplied by the valuation multiple, or $P = E \times P/E$, it follows that the stock market's return (change in market value) can be determined by changes in earnings and the valuation multiple.

Thanks to a study by RBC Capital Markets², what we find is that whilst change in total corporate earnings is the dominant driver over longer periods of time, for shorter periods, changes in earnings contribute very little to stock



Note: Based on U.S. equity price returns since 1956; source: RBC Capital Markets

market returns. Instead, change in the valuation multiple is driving the stock market, as can be seen in the exhibit above.

So why does the valuation multiple change so much in the short term? There are some solid fundamental factors that determine the valuation multiple. These include interest rates, regulation, liquidity and so on. But none of these varies much over short periods of time. Simply put, the valuation multiple also embodies investor's hopes and fears for the future. And this is what is ever changing – at times oscillating wildly and clearly way beyond any real change in the outlook. This is what John Maynard Keynes dubbed

¹ Inspiration for the title comes from a painting by the Belgian artist, René Magritte (painted 1928–29). The painting of a pipe – and a pretty good one at that – has written below it, “Ceci n'est pas une pipe”. In English, “This is not a pipe”. Philosophers, it seems, liked it.

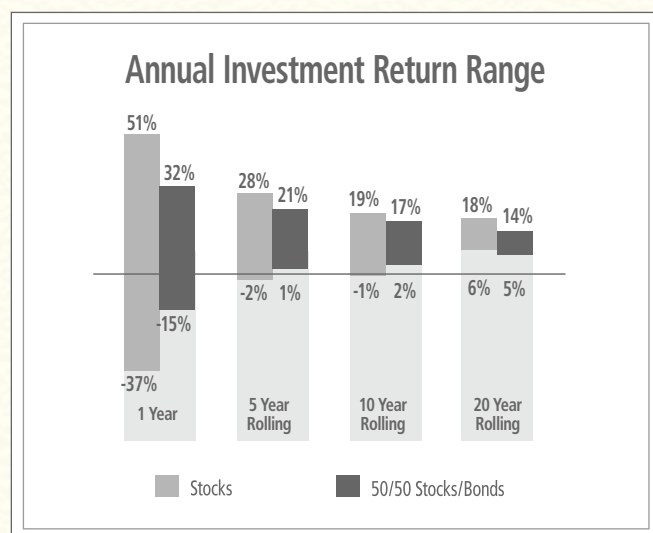
² U.S. Equity Strategy Weekly, Myles Zybblock, RBC Capital Markets, August 17, 2011.

This is Not a Rollercoaster cont.'d

the 'animal spirits' of the market. It follows that predicting equity prices over shorter periods has very little to do with fundamentals. Rather, it is about trying to divine how *other peoples'* moods and fears will change tomorrow, next week and next month.

TAMING THE BEAST

The standard approach to taming the equity markets is simple. Diversify across a range of equities. This much goes without saying. Invest in multiple asset classes, with bonds and cash being the principal ingredients that get added to the mix. Finally, let time heal all. The results of this are dramatic.



Note: Based on U.S. equity price returns since 1950; source: JPMorgan Asset Management.

Based on actual data for the U.S. from 1950 until today³, one-year equity returns from "the beast", as I'll now refer to the equity market, have ranged from minus 37% to plus 51%. Now, using a 50/50 equity/bond portfolio and looking at any rolling five year period within the 60-year span of the data, the beast is tamed. The annual return range for a 50/50 portfolio was from low of +1% up to a maximum of

+21%. Pause for a second. Yes, the lower end of the return is *positive* 1% annually for the full 5 years. In other words, at no time in the last 60 years has a 50/50 investor in the U.S. market indices ever lost money over any five year time horizon. Over longer time periods, the beast transmogrifies itself even further into whatever – let's say your favorite warm wooly sweater. Over any 20-year period, the range of returns for the 50/50 investor narrows down to +5% to +14%. Again, that is *per year*. With the power of compounding, that is a total 20 year return of at least 165% and ranging as high as 1,274%. Hardly a rollercoaster.

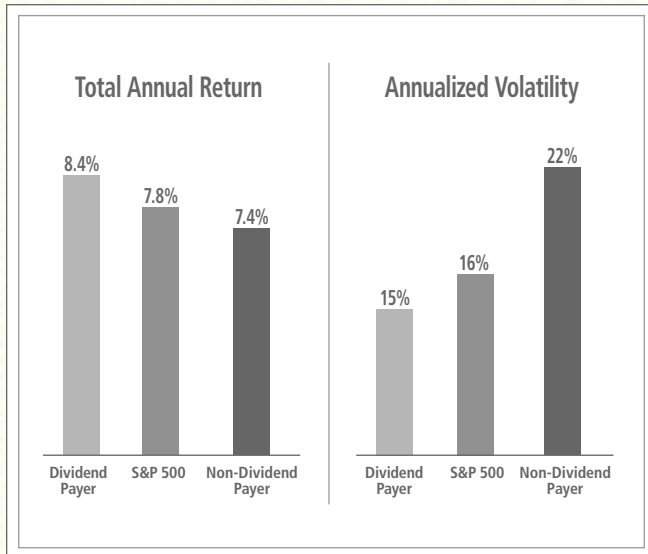
There are two caveats. First, the range of returns indicated at left is for an investor who received the same return as the overall equity and bond markets. Unfortunately, most investors don't do as well as the markets, even when controlling for the issues of active or passive management and fees. The key reason for this? Again, it's investors' emotions, those animal spirits (cue the asset bubble book by Charles Mackay, *'Extraordinary Popular Delusions and the Madness of Crowds'*, first published in 1841, but suited to every bubble and hot stock ever since). It turns out that, while the approach for taming the beast may be simple, it's not easy. In fact, it's very hard for investors to resist buying what has done well (looks tame) and selling whatever has done poorly (looks wild). This is otherwise known as 'buy high and sell low' and is a sure way to consistently lag the market indices.

The second caveat relates to the investor's choice of investment strategy – something more specific than just holding the indices, as has been assumed above. Again, a fairly simple (but not necessarily easy!) active management approach of owning quality equities, can further tame the beast. Using dividend paying stocks as a surrogate for quality equities, and based on

³ *Fear vs. Valuations*, Dr. David Kelly, J.P. Morgan Asset Management, August 2011.

This is Not a Rollercoaster cont.'d

U.S. data for the last 17 years, a portfolio of dividend paying equities had better returns and lower volatility than the S&P 500 overall or non-dividend payers, as illustrated in the exhibit below⁴.



Note: Based on U.S. equity total returns since 1995; source: RBC Capital Markets

So, volatility in the markets may well continue. Rather than getting queasy, a disciplined investor can successfully navigate through. Ensure that you have the right mix of equities and bonds for your circumstances. Accept the animal spirits in the market for what they are and control yours by focusing on longer periods of time – don't get caught up by the scary day-to-day news. Finally, not all stocks are created equally. A portfolio of quality stocks may well achieve investors' nirvana – better than markets returns *and* with less volatility.



FWG

Nexus Annual Client Event Mark your Calendars!

It's that time of year again – the fall! This means in November, we will be hosting our annual client evening at the National Club.

You will get a chance to hear the Nexus principals, as they take you through a thought provoking presentation. Afterwards, you are invited to a wine tasting and light supper reception. There will be two evenings so please mark your calendars for one of the two dates, Tuesday, November 22nd or Wednesday, November 23rd. We hope to see you there!

BACKBENCH



⁴ Numerous studies have demonstrated this, but this data come from the *U.S. Equity Strategy Weekly*, Myles Zyblock, RBC Capital Markets, August 17, 2011.

Building the Business

We are pleased to welcome Jim Houston to Nexus. He is assuming a new role leading our business development efforts. Jim comes to us most recently from the President's role at another investment counsel firm.



While there, he was responsible for a range of activities including client development and the investment research process. Previously, Jim worked on the dealer side of the street as an institutional equity salesman at RBC Capital Markets and then Credit Suisse. He began his career as a research analyst with Midland Doherty.

Interestingly, Jim has been a client of long-standing with Nexus and we know he thoroughly understands our investment approach. In tumultuous times, he has the experience and expertise to tell the Nexus story to a broader audience than we have previously been reaching – leaving the rest of us more time for investment research and speaking with clients. Apart from speaking directly with potential clients of the Firm, Jim will also be reaching out to accountants, lawyers and other centres of influence who deal with individuals who might also benefit from the Nexus approach to investing.

Away from the office, Jim is married (Lisa) and has two sons. On week-ends, especially in winter-time, they can often be found in Creemore. Perhaps more importantly, Jim would be the odds-on favourite in a Nexus golf tournament, were we to have one.

If you are in the practice of coming into the office from time to time, please take a moment and say hello to Jim. Also, if the challenging conditions in markets are making you uneasy, or if you know of someone who could benefit from Nexus' approach of integrating financial planning and investment management, don't hesitate to contact any of us or Jim.



Pearls of Wisdom

Reading is one of the principal occupations in our profession. As the group of us digest a wide range of material, interesting ideas and surprising facts – some serious and some light-hearted – rise to the surface. We attempt to share a few of those with you in each of our issues of Nexus Notes.



- How the mighty have fallen. Along the lines of Bernard Baruch's famous statement that the main purpose of the stock market is to make fools of as many men as possible, comes the tale of several erstwhile stock market superstars. The year 2011 has not been kind to many managers who previously were the toast of the town. Bruce Berkowitz, manager of the Fairholme Fund, recently was named U.S. Equity Mutual Fund Manager of the Decade (of the 2000s) by Morningstar. This year, his fund is down 26% and ranks last out of 311 funds in its category. Bill Gross is the world's most famous bond manager and runs the world's largest bond fund (\$244 billion). He is Morningstar's Fixed Income Manager of the Decade. His fund ranks 501st out of 584 bond managers in 2011. The legendary Bill Miller, Morningstar's U.S. Equity Manager of the Decade in the 1990s, ranks last of 840 similar funds over the last five years. His fund has lost 9% per year for five years. Last but not least, Fidelity's Magellan Fund, once the largest and most famous equity mutual fund in the U.S., has lost more than 80% of its assets since 2000 through a combination of bad performance and client redemptions. (*Financial Times*, August 30, 2011.)

- We were recently reminded by a correspondent of comments made by Cicero in 55 B.C. at the time of Julius Caesar's rise to power in Roman politics. "The budget should be balanced, the Treasury should be refilled, public debt should be reduced, the arrogance of officialdom should be tempered and controlled, and the assistance to foreign lands should be curtailed lest Rome become bankrupt. People must again learn to work, instead of living on public assistance." It is amazing to consider how little civilization has changed in 2,066 years.

- Notwithstanding the simple investment axiom of "buy low and sell high," human beings are emotionally wired in a way that often leads to the opposite behaviour. David Swenson, the legendary chief investment officer of the Yale endowment, takes another crack at explaining this phenomenon in a recent *New York Times* commentary. Aided and abetted by mutual fund company marketing pitches, Swenson demonstrates how investors repeatedly chase "hot" funds to their great disadvantage. Morningstar, the independent mutual fund ranking company, awards specific funds with one (the worst) to five (the best) stars based on historic investment performance. In 2010, for example, investors redeemed \$152 billion from one-, two- and three-star funds and added \$304 billion to four- and five-star funds. Of course, the funds awarded four and five stars change from year to year, but the flow of dollars to the hottest funds is unrelenting. A fact that we have pointed out previously is that investors, on average, actually earn a lower return than the funds they are invested in because of ill-timed buying and selling. Analysis shows that if investors as a group had simply held onto the fund they owned in 2000 for 10 years, they would have earned 1.6% per year more than they actually earned – with the difference being due to ill-timed buying and selling. Unsurprisingly, the more volatile a fund is the more likely it is to generate ill-timed buying and selling decisions from investors. In fact, investors in conservative low-volatility funds only underperformed the returns generated by their funds by 0.5%. In contrast, investors in highly volatile technology funds earned a whopping 13.4% per year worse than the returns of the underlying funds. Clearly, there was a lot of buying going on at the peak of the technology bubble. (*The New York Times*, August 14, 2011.)



NEXUS

Portfolio Management & Financial Counsel

Nexus Investment Management Inc. provides discretionary investment management and financial counselling services to private clients, trusts, estates and foundations.

- Exceptional client service and objective advice:** tailored to the client's individual needs.
- Superior investment performance¹:** long-term record of superior after-tax returns and capital preservation.
- Disciplined investment approach:** "Growth at a Reasonable Price" philosophy, using research and patience.
- Alignment with clients' interests:** as the Firm is wholly owned by its principals, we are committed to your financial success.
- Cost-effective management:** our services are accessible directly, without the costs of branding and distribution.

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¹ A composite of Nexus accounts, managed to a balanced mandate, has earned 6.4% per annum, pre-fees for 10 years. A composite of notional returns from a weighted average of the following indices: T-Bill (5%), Bonds (35%), TSX (35%) and S&P 500 (25%) earned a return of 5.0% over the same period.

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