

My Annual Report Card for 2004

The best investors are like professional socialites. They always know where the next party is going to be held. They arrive early and make sure that they depart well before the end, leaving the mob to swill the last tasteless dregs. Good money managers understand that. Investment is all about change and anticipating it.



17th Century School

Jan Steen, one of Holland's famous painters depicts the chaotic interior of a 17th Century school. The teacher punishes a student for spoiling her home assignment.

Jan Steen was one of Holland's great painters during the 17th Century. Today his creations fetch large sums of money if they become available. In my young years I spent many a day visiting the Rijksmuseum in Amsterdam my city of birth where I was bewildered by the painter's intricate work. Jan Steen often depicted chaotic situations and one of his paintings entitled "The household of Jan Steen" shows the chaotic household of a Dutch family. Whenever one presently encounters a Dutch family, which seems to be less organized and family members living in a constant chaotic state i.e. a messy household, the Dutch call it "a household of Jan Steen." I have visited the Rijksmuseum many times during the past 40 years and I continue to stand in awe when viewing Jan Steen's paintings.

Like paintings excellent investments of the paper kind are far and few between. Some are terrible investments as many investors have found out during the collapse of the markets in 2000 and 2001 and remain mediocre, many an investor relying on hope that they will recover if only held a little longer. Having an eye for and understanding the underlying fundamentals which move the financial markets is similar to have an appreciation and understanding of what goes into a "objet d'art."

The key is to be able to identify the investment in its early stages of a long-term bull market, preferably much before the start of a long-term bull market. That's not all because then the investor and advisor must have the discipline to just sit and let it ride until it is time to take money off the table or when such an investment has come to its end of the long-term bull market cycle. One would think that this is an easy task to accomplish. Not so. Financial markets and sectors can humble many an investor and advisor and one has to be forever vigilant. Throwing darts at a board and hoping that several of the darts will stick is not good enough. Therefore the often-perpetuated mantra of "asset allocation" and "diversification" is a panacea and a simpleton method of investing.

HOPE

It's human nature to be optimistic. It's human nature to hope. Furthermore, hope is a component of a healthy state of mind. Hope is the opposite of negativity. Negativity in life can lead to anger, disappointment and depression. After all, if the world is a negative place, what's the point of living in it? To be negative is to be anti-life. Ironically, it doesn't work that way in the stock market. In the stock market hope is a hindrance, not a help. Once you take a position in a stock, you obviously want that stock to advance. But if the stock that you bought is a real value, and you bought it right -- you should be content to sit with that stock in the knowledge that over time its value will work out without your help, without your hoping. So in the case of this stock, you have value on your side -- and all you need is patience. In the end, your patience will pay off with a higher price for your stock. Hope shouldn't play any part in this process. You don't need hope, because you bought the stock when it was a great value, and you bought it at the right time.

Any time you find yourself hoping in this business, the odds are that you are on the wrong path -- or that you did something stupid that should be corrected.

Unfortunately hope is a money-loser in the investment business. This is counter-intuitive but true. Hope will keep you riding a stock that is headed down. Hope will keep you from taking a small loss and instead, allowing that small loss to develop into a large loss. In the stock market hope gets in the way of reality, hope gets in the way of common sense. One of the first rules in investing is "Don't take the big loss." In order to do that, you've got to be willing to take a small loss. If the stock market turns bearish, and you're staying put with your whole position and you're HOPING that what you see is not really happening -- then welcome to poverty city. In this situation, all your hoping isn't going to save you or make you a penny. In fact, in this situation hoping is the devil that bids you to sit -- while your portfolio of stocks or mutual fund goes down the drain. In the investing business my suggestion is that you avoid hope. Forget the siren, hope -- instead embrace cold, clear reality. **Courtesy Richard Russell, DOW THEORY LETTERS**

My philosophy and strategy past, present and future....

In the often-misleading vocabulary of the fund business, my strategy is not based on allocation in specialty funds defined as a 'growth fund' or a 'value fund' or an 'index fund'. Therefore my strategy does not have a fancy description. In reality, I have merely been aiming at the preservation of your capital which you entrusted to me in a manner not dissimilar to that of a wise man looking after his fortune - entirely uninterested in what anyone else is doing. Alas, capital preservation of your capital is far more difficult in practice than the words seem to suggest. In order to understand the quality of investment results, it is important to look beyond the unqualified presentation of its numerical performance. When someone tells you proudly of his returns, you must question him closely as to the risks he ran in achieving them. It is one thing to earn \$1 and quite another to earn \$100 by betting \$100 at the game of roulette. In each case, the outcome might be the same, but both the chances of success and the consequences of failure - i.e. the risks - could not have been more different.

In yet another way, compare the case of a gold jeweller working on a commission from a familiar and creditworthy customer, with that of a lone prospector, pick-axe in hand, leading his mule up a rocky trail into the bandit-ridden high country. Now ask yourself: who took more risk to make a profit from the possession of a few ounces of gold? Despite the obvious satisfaction, which would accrue to all in comparing our results to the general markets, I will not do so. Competition with others is not my game. Wall Street and Bay Street choose to measure returns (whether positive or negative) relative to one's peers rather than in absolute terms. In my view, the practice could not be any more dishonest than that of relying on luck. Where I stand: it would be inappropriate and disingenuous to make any forecasts. In short, I view the economic environment at best as anaemic and view risks to capital missing out in some 'imminent' stock market rally.

Although I do practice 'sector allocation' it is only put into practice when one or more sectors are in harmony with the underlying fundamentals. You will not hear me proudly talking of 'beating the index', while losing my clients' money, or intoning that I should 'dollar cost average', or 'buy and hold'. Regardless of trends or the noise that surrounds me, the only thing I seek is under-esteemed value and the only thing I will hold fast to are my principles, eschewing all fads and talk of new 'metrics' or 'paradigms'. My methodology, though difficult in execution, is simple to enunciate. It is as follows: Firstly I prefer to hold what is least risky - or, conversely, what seems to be the most safe - whatever form that holding takes and wherever in the world it may be found. Simple as it may sound, it isn't. It requires that I have a sound understanding of the macroeconomic forces that are shaping our world and the courage to do what is right rather than what sells or what the herd is following. Doing this I will best be able to preserve the sacred capital which I manage - the most important of all duties - while using it to support the needs of its owners where possible, and, perhaps, of returning more talents than those with which I was first entrusted. My aim is stewardship - not speculation.

Sector-Allocation

A financial planner or broker should have the courage to advise clients to be invested in sectors which are either friendly to the underlying fundamentals, or exit the market when it becomes obviously overpriced. An advisor's job is to temper the herd mentality, to move you into a safer sector-allocation model. Traditional asset allocation is a simplistic notion of handling the market. An investor should remain content to sit in cash or in fundamentals-friendly sectors.

Now that 2004 is behind us and the performance of all mutual funds is public knowledge let's have a look at the sectors, which have generated excellent returns for mutual fund investors. Although these returns are exemplary in a secular bear market these are only 2004 – One Year Returns and when spread over 3 years the majority of asset classes post either lack-luster or minus returns. On average I must assume that mutual fund investors have not recovered their losses, which were first inflicted upon their portfolios in March 2000. Average mutual fund sector returns were as follows;

Average Annual Returns

Asset Class	1 Year (2004)	3 Years
TSX Composite	14.48%	9.59%
Asia ex-Japan	2.0%	3.0%
Canadian Balanced	8.0%	4.5%
Canadian Bond	5.4%	5.7%
Canadian Dividend	13.4%	9.1%
Canadian Equity	12.1%	6.3%
Canadian Income Trusts	21.2%	17.2%
Canadian Small Cap	16.5%	15.1%
Emerging Markets	13.7%	9.7%
European Equity	10.6%	-1.6%
Financial Services	7.7%	2.2%
Global Equity	6.0%	-1.6%
International Equity	9.2%	-0.2%
Real Estate	15.8%	11.0%
Natural Resources	20.8%	22.8%
Japanese Equity	6.3%	3.1%
Precious Metals	-17.0%	27.8%
Science & Technology	-0.2%	-9.6%
U.S. Equity	2.0%	-5.6%

Because of our over-weighting in Canadian Natural Resources Funds, Energy Funds, Real Return Bond Funds and Canadian Income Trusts my clients' accounts on average increased last year by:

2004 Average Client Account Increased + 19%

November 1, 1999 to December 31, 2003 (50 months) Total Return: **+110%**

November 1, 1999 to December 31, 2004 (62 months) Total Return: **+129%**

***NOTE: Individual client returns may differ slightly according to age and risk-tolerance levels.**

Precious Metals Funds had a difficult year in 2004 but consider their 3 year performance (per annum):

AGF Precious Metals Funds + 45.59%; Dynamic Precious Metals Fund + 27.89%; Dynamic Global Precious Metals Fund + 32.06%; Mackenzie Universal Precious Metals Fund + 25.40% and Sprott Gold & Precious Minerals Fund + 24.61% per annum.

Comparative Index Performance

Relevant indices posted the following returns for 2004:

As at December 31st/2004

S&P/TSX Composite Index **+14.48%**
S&P/TSX Capped Gold Index **-9.00%**
S&P/TSX Capped Energy Index **+28.68%**
S&P 500 Index **+9.00%**
DJIA **+3.15%**
Nasdaq **+8.59%**

PLEASE always remember that past performance is no guarantee of future performance results.

2004 Annual Returns on Funds Held by my Clients

AGF Canadian Bond Fund	5.48%	Dynamic Global Precious Metals	-22.12%
AGF Canadian Large Cap Fund	15.11%	Guardian Monthly High Income	24.72%
AGF Canadian Resources Fund	19.51%	Mackenzie Growth Fund	17.73%
AGF Precious Metals Fund	-7.95%	Mackenzie Maxxum Dividend Growth	14.86%
AGF Canadian Stock Fund	12.17%	Mackenzie Sentinel Real Return Bond	11.24%
AIM Trimark Canadian Resources	16.08%	Mackenzie Univ. Cdn. Resources	21.10%
CI Global Energy	39.14%	Mackenzie Univ. Precious Metals	-21.08%
CI Signature Canadian Resources	19.33%	Renaissance Cdn Income Trust	22.97%
CI Signature High Income	19.30%	Sentry Canadian Income Fund	29.36%
Dynamic Canadian Precious Metals	-24.43%	Sprott Energy Fund (6 mos return)	41.78%
Dynamic Focus Plus Div. Inc. Trust	26.66%	Sprott Canadian Equity Fund	37.85%
Dynamic Focus Plus Resources	19.42%	Sprott Gold & Precious Minerals	-18.76%

Summary: I do not make bold predictions and neither do I compete with my peers. My track record speaks for itself. For 2005 I will continue on our disciplined path by being over-weighted in those sectors, which offer the greatest amount of defensive safety and best possible return prospects. And, I promise to continue to adhere to Warren Buffett's Two Cardinal Rules of Investing: **Rule No. 1 – Never lose money and Rule No.2 Never forget Rule No.1**

My most sincere thanks go to Ed Bugos of Vancouver for his excellent analytical work and brilliant essays. <http://www.goldenbar.com> His brilliant work has been pivotal to the strategies I have followed. See his 2005 Outlook below. There are several others who with their independent articles and essays have helped me in formulating a "safety first" investment strategy. Thank you: Alan Newman of SAMEX Advisors in New York, Doug Noland and Marshall Auerback of PrudentBear.com, Bill Fleckenstein of Fleckenstein Capital in Seattle, David Chapman of Union Securities in Toronto and Robert D. McHugh Jr. of Mainline Investors Inc. The biggest "thank you" goes to you, my clients for your continued confidence, trust and the privilege that you have extended to me to be your financial well-being advisor.



2005 Outlook

By Ed Bugos, editor of The GoldenBar report

The Elusive Climax

21-Jan-05: At the outset of 2004 we thought that it would be a tough year for gold shares as we felt they were too far out ahead of the gold price trend by the end of 2003; we thought that the bear market rally in the broader averages (S&P 500 and the Dow Industrials) was topping and would roll over in 2004; we expected gold prices to rally further but that the gold price advance was nearing the end of the first phase of a great bull market, pending a blow-off scenario; and we wrote that the US dollar (FX) would try and bounce, but fail.

As it happened, our gold share call (for the averages) was on the money. So was our currency forecast. Our gold price call was half right because the higher high in 2004 didn't happen quite like expected. Our emphasis on gasoline prices was clearly correct, and my US\$50 target for oil prices was achieved.

The stock market call was going right up until about half way through the year.

Our accounts were generally up for the year but my own account was up only marginally due to the small (15%) allocation to a bearish position against the S&P 500. I would also be critical that we did not participate in the derivative commodity-related sectors, like the energies, utilities, and real estate and income trusts – derivative because the economic and financial arguments driving the gold trend are typically the same ones driving those trends.

Had we not been so bearish on the stock market (generally) in 2004 we would have done better.

Naturally, investment plans aren't just made at the outset of the year. Our outlooks have changed (though not discontinuously) throughout the year. Our commodity targets have mostly been made except in gold.

And the only forecast I'm willing to make in the US dollar this year is that there will be more volatility, and that at the time of writing the low for 2005 has yet to be seen. But, this is related to our gold forecast.

The conventional view on Wall and Bay Street today, we get the sense, is that the government has engineered a text-book neo-Keynesian style soft landing; with the help of some deficit spending and inflationary stimuli, the economic bust following on the down turn in 2001 was not as bad as the gold folks and perma-bears thought it would be. People want to believe it so bad that, although they are more cognizant of the inflation than they were the same time last year, they are still willing to put faith in the "data" published by the same government that is resorting to untenable policies and modes of creative accounting in order to paint it. Moreover, although the inflation case is more apparent today, it has different competing ideas – the deflation case would be contrarian today indeed. But so is the inflation case. Its acceptance has grown begrudgingly – show me the data!

The more popular themes driving the markets today include: 1) China – in terms of its *increased* demand for resources, currency policy, and the controversy over jobs; 2) Global recovery (as the US recovery spreads) is causing other competing sources of growing demand for the scarce resources – oil and copper usually cited; and 3) Productivity is so strong in the US economy that despite it all, there is still no inflation and it's causing wide spread job losses. These premises, or competing stories, are fallacious at worst; dubious at best.

Nonetheless, they are consistent in inference given a year in which gold under performed most assets, most commodities, and even most foreign currencies – despite new 17-year highs against the US dollar making it four back to back years of steady advances... the best the market has seen since the last bull market.

It is undeniably a bull market move (what bear market rally has ever dragged out 4 years?!) but its progression was and still is stealth, perhaps if only because these other themes dominated the market's psychology – they distracted it, if you will. For, all those results that are celebrated by Wall Street today could be equally achieved by aggressive resort to a policy of inflation (easy money in the passive sense), and just as mistaken.

Moreover, some of them can only be explained by inflation, which is worrisome because that means they aren't real. The consequences of "artificial" stimulus are that it is temporary, usually works opposite to intent, and causes the market mechanism to misfire. But it is fun while it lasts; *an opium for the people* (Mises).

This is not the place to spend much time on revealing too many fallacies since it's only a summary view of our position. But it is important perhaps to mention that productivity is a force which generally creates new jobs and pressures prices. Moreover, economic growth only causes prices to rise to the extent that the growth itself is a monetary phenomenon; if money supplies were fixed for instance, the growth of the market economy to include new countries (like China and Russia) would result in an increased demand for both, commodities **AND** money – they would offset each other. But the way it is now, only commodities are scarce. Moreover, in general, more goods would be produced for which prices would fall because they would be more abundant than money.

Economic growth is productivity. By definition it causes the opposite effect on the "general price level" from that which monetary factors do. In other words, if the general price level was flat in a given period it would be a poor analysis to conclude that it meant there was no inflation. It could easily mean that the effects of inflation offset the effects of productivity, and instead of falling prices they were flat. Needless to say, this is precisely the mandate of the Federal Reserve Board when its members refer to the concept of "price stability."

Of course, there is no way to measure the "general price level." It is a conceptual tool and the attempts to quantify it as representing a loss in the purchasing power of money are misleading on theoretical grounds, and also directly in practice because of the extent to which they are played with by statisticians.

The same goes for productivity.

It isn't intelligible to quantify. And while most people are still likely to write those objections off – since why else is everyone using this data (GDP, CPI, PPI, Productivity, etc.) without a second thought – there are those that will not because their fundamental veracity cannot be denied... those that refuse to be fooled by it any longer.

This camp is growing, side by side with the gold bull. To it, the Keynesian model of government intervention for the benefit of the short term at the expense of the long term has been long ago discredited, and the fact that it is still practiced is the consequence of the program of certain interests and general public ignorance.

The truth of the matter is that this boom is obviously different from the one that it is designed to replicate (1995-1999). There is clearly more inflation than productivity (the Fed of 1994 has turned into the Fed of 1971); the US dollar is falling, rather than rising; the government can't even pretend to keep its books balanced; there are deep-seated structural problems in the labour market (caused by inflation, malinvestment, and what is called capital decumulation); and prices are more clearly rising instead of falling as in most REAL booms.

Something is clearly wrong in Denmark but the gold story has been delegated to the back page even though it is the only one that sheds light. The gold price advance is as stealth as ever. But that should change in 2005 as we expect the untenable nature of the boom to reveal itself. The premise is a pent-up increase in interest rates.

Since everyone expects rates to go up now, I'll only forecast that they will rise to the high end of current prognostications. In other words, we expect them to rise faster than most participants do. We believe that the bond markets have put in a long term top (last year) and that the first bear market leg of many to come will occur in 2005. All central banks are expected to lag those developments as they occur in the market first; if it were otherwise my gold outlook wouldn't still be so bullish for the short term. As we've said to clients over the year, we believe that the scope of the current gold price advance is to push the Fed into action – which is another way of saying that the Fed won't act as it should until the gold story gets the attention it deserves.

It's possible that even bond yields won't really start rising until gold prices begin behaving like oil had in 2004; but this is all the more reason to remain bullish on gold: the current position of interest rates is inflationary all along the curve. Until that changes, there is little scope for downside in gold.

However, this doesn't mean that gold is likely to fall if rates go up. The relationship is historically opposite – gold price moves precede interest rate swings (10 year bond yields) by up to 2 years. It is likely indeed that gold will continue to advance until the Fed itself (and/or other key central banks) actually targets it, or inflation. If the central bank is hiking rates gradually on account that the economy is back on track, yet at the same time is continuing to

provide the “stimulus” for an artificial boom, it is just more of the same; and no reason for gold not to continue to advance. In summary, we expect to see a stronger year for gold in 2005 than in 2004 – as it rallies in all currencies, against most of the commodities, and relative to most paper assets (stocks & bonds).

My current target is \$500 if it occurs in the first quarter. If it doesn't occur until the last half of the year as has been typical in the last two years of the advance then that target will probably be higher. Whenever it occurs, it is the nature of the move that will reveal to me whether and to what extent the form of the subsequent correction will take. We have been looking for signs of a primary correction (a correction to the trend that began in 2001 which would be greater than the 15% intermediate corrections experienced so far) for a year.

However, the character of the advance to date has continued to be bullish – this is said in relation to the level of sentiment, the quality of the market's structure (see COT's), and the technical chalk marks made to date.

What we're looking for in gold is for the slope of the main trend to pick up, in a parabolic climax, to mark the end of the first primary sequence as most all commodities tend to; and especially since the reason they have is the very same reason gold is trending up, but which seems so obscure due to the competing fallacies, perhaps.

Of course, such a forecast would explain our bearish bond market forecast, and in turn would also explain our bearish stock market outlook which is predicated on (besides rates going higher than most expect) a shortfall in profit growth (especially real) and a contraction in PE ratios due to 1) falling profit expectations, 2) higher inflation risks, and 3) higher rates. It is all appropriately intertwined. So much so at the moment that I'd say if our gold price forecast is off then all bets are off on those factors as well. In fact, I'd go as far as saying that they haven't been realized yet because our gold price forecasts continue to fall just short of the mark, which in turn has served to keep the bull market case for gold relatively obscure. The fundamentals for gold remain as good as they ever have, and the technical situation begs for clarity – if it's a bull 2005 will probably show.

That's our call.

The best opportunities in the year ahead in our opinion will thus involve:

- A long position in gold bullion (and gold shares), aggressive to our targets (\$500 for gold; 265 for HUI)
- A short position in equities (or perhaps some profit taking in the non-gold commodity related)
- A short position against most bond markets
- A temporary accumulation of T-bills, as cash

There are many ways to structure a strategy around such an outlook – ask your financial advisor.

In conclusion, some elaboration on the gold shares: our short term outlook is bullish but on a reduced level (relative to pre-2004) to account for the uncertain intermediate outlook. In other words, if gold prices blow past our targets in February we would expect the equities to participate; but at the same time that would in our current view mark the beginning of a primary sector correction because it would complete the first bull leg.

The entry point for a core (long term) gold stock position, on the other hand, is as good as it has been at any time since 2001 – a core position being that segment of the portfolio that is considered long term (i.e. 5 years plus). The long-term outlook for gold is very favourable,

and does not require the level of introspection that is necessary to determine its year-to-year prognosis.

This is not the year 2000 when we were pounding our proverbial fist on the table that the next \$200 points in gold is up and that the gold shares were the buy of the century. However, the gold story has been far from realized at the same time. The intermediate term (1-year) call is much tougher today but the long-term call is as easy as ever. Gold prices are going to make it to US\$2,000 plus or minus a few hundred points.

The current advance merely represents the awakening of a trend that will take us there; and so we perceive upside at least until the gold bull is no longer so stealth that it defies sun up.

Regards,
Ed Bugos

The Goldenbar Report

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