

## My Annual Report Card for 2007

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*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.*



### 17<sup>th</sup> Century School – Paulus Potter

#### “De Stier” (The Bull) , Mauritshuis, The Hague

**Paulus Potter** (bapt. [Nov 20, 1625, Enkhuizen](#) - bur. [Jan 17, 1654, Amsterdam](#)) was a [Dutch](#) painter specializing in animals in landscapes. Potter studied painting with his father Pieter Potter in Enkhuizen. His father was for some time a manufacturer of gilded leather hangings in Amsterdam, but stopped after a few years. Paulus lived at that time in [The Hague](#) where he met his wife. He was introduced by her in the Dutch elite. After disagreements with fellow painters and [Amalia of Solms-Braunfels](#), a member of the [stadholder's](#) family, he left for [Amsterdam](#). Potter was invited by [Nicolaes Tulp](#), who was impressed by his civilized behavior and politeness. Potter painted his son [Dirck Tulp](#). Potter died in 1654, 28 years old, of [tuberculosis](#). In a short time he succeeded in producing about a hundred paintings, working continuously. His most famous painting is The Bull, in [Mauritshuis, The Hague](#). The bull is composed from drawings he made in nature: the front and rear are in a different angle, than the middle part. During the 19th century ([Romanticism](#)) it was a highly appreciated painting. [www.wikipedia.com](http://www.wikipedia.com)

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 that 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.

## Opening Pandora's Box

Markets tend to follow Newton's third law that "For every action, there is an equal and opposite reaction". Suppression by Central Bankers can be repeated and repeated, but at some point, the internal fundamentals become so coiled that an explosion occurs. This explosion can be similarly viewed to opening up Pandora's Box.

In Greek mythology, Pandora was the first woman of mankind. Each Greek god took part in creating her by giving her unique gifts. Zeus ordered her creation as a form of punishment to mankind, in retaliation for Prometheus stealing "fire" and giving it to humans for use. She carried a box wherever she went, which contained all of the world's evils. One day Pandora decides to open the box releasing the evil entities, with attempts to close it to no avail. With these evils came hope, which represents humanities only salvation.

It is so fitting to metaphorically replace the entire world's evil in Pandora's box with the packaged derivatives and generated fiat currency present in the world. Everything was fine until it was opened, but now is spreading to all the corners of the globe to unleash their wrath. Also within the box was hope, which can be replaced with gold and silver bullion. The evils of the world are going to cause a wave of inflation in 2008 not witnessed since the 1970's. Gold is going to be the only hope for those wishing to have any sort of net worth by 2012.

I am sure anyone reading our site is familiar with the concept of the Kondratiev Waves. In a nutshell, Nikolai Dmitriyevich Kondratiev proposed that capitalist economies have long-term economic cycles that ultimately end with a depression. His initial work was primarily based upon agriculture economics and the problems of food supply. His research suggested that democracy was favourable to socialist policies, which ultimately lead to his arrest and later execution.

Around the same period of time John Maynard Keynes was walking the face of the earth whom is credited with modern day government economic and political theory, coined "Keynesian Economics". Keynesian Economics involves a loose monetary policy (removal of gold backed currencies) to allow government intervention of economic booms, recessions and depressions. Creation of inflation with the application of rising interest rates in booms and removal during recessions with the appropriate level of financial stimulus to prevent any form of deflation. In this sort of environment, there is a long-term trend in rising prices which is due in part to increases in the amount circulating fiat currency.

When the gold standard was implemented in England between the 1500's to 1800's, the average inflation rate was 0.25% per year. During times of war, many countries chose to abandon gold standards and burn their currency by allowing rapid currency expansion to fund their efforts. Every time, this resulted in worthless currency often seeing re-implementation of the gold standard.

This sort of "economic behaviour" was present at the time of Rome. When Rome was first established, coinage had high purity levels of gold and silver. As the Roman Empire expanded, it required expansion of their currency well above the amounts of available gold and silver. Near the end of their reign, most of the currency was reduced to tin and copper. The only difference between modern and ancient times is the ancients diluted their currency with base metals instead of fiat paper. This is not totally true, as modern day pennies and nickels now contain anything but these metals. Ten-cent pieces used to contain silver, with silver dollars being 10x heavier. Oh how things have changed. Inflation is so rampant now that it actually cost far more to produce a penny than it is worth (4 cents Canadian to produce a penny (1-cent)).

David Petch, December 30th 2007 [www.treasurechests.info](http://www.treasurechests.info)

### Annual Returns 2007

Asset Class	1 year (2007)	3 years	5 years	10 years
TSX Composite	6.60%			
Asia Pacific Equity	2.13%	11.63%	12.12%	4.04%
Canadian Neutral Balanced	0.94%	6.98%	8.36%	6.01%
Canadian Fixed Income	1.82%	3.12%	4.04%	4.71%
Cdn Div & Equity Income	2.39%	10.83%	13.20%	8.62%
<b>Canadian Equity</b>	<b>7.25%</b>	<b>14.14%</b>	<b>15.60%</b>	<b>8.13%</b>
<b>Canadian Income Trusts</b>	<b>8.32%</b>	<b>9.35%</b>	<b>16.74%</b>	<b>11.88%</b>
Canadian Small Cap	6.92%	12.42%	16.88%	9.87%
Emerging Markets Equity	20.72%	25.72%	24.21%	9.30%
European Equity	0.640%	12.40%	12.52%	5.33%
Financial Services	-14.85%	5.16%	7.90%	6.80%
Global Equity	-4.50%	5.84%	7.21%	3.85%
International Equity	-5.07%	8.09%	9.40%	4.20%
Real Estate Equity	-17.08%	9.78%	13.48%	8.18%
<b>Natural Resources</b>	<b>13.22%</b>	<b>22.85%</b>	<b>24.93%</b>	<b>14.18%</b>
Japanese Equity	-0.90%	9.00%	6.00%	1.90%
<b>Precious Metals</b>	<b>4.06%</b>	<b>24.45%</b>	<b>18.60%</b>	<b>16.22%</b>
Science & Technology	2.09%	4.59%	7.83%	0.70%
U.S. Equity	-7.58%	1.10%	3.19%	0.95%

Canadian pensions returned just 1.5% in 2007 according to a report from Royal Bank's RBC Dexia Investor Services .

## **Exit 2007 - Enter 2008 "The True North, Strong and Free"**

The markets did not treat us as well as compared to the past seven years but we have still been able to deliver a gain by December 31<sup>st</sup>. Of course that does not mean that 2008 will be dismal as well. When we started out back in 2000 I must assume that my clients never expected to make the profit they have made to date. The average advisor if there is such an animal has barely averaged 9% per year and I expect that many will be "dead men walking" in 2008. The general make-up of the equity and bond markets has changed and if you have been keeping an eye on the various pieces of info I have been sending out I expect a banner year in 2008. The primary purpose of our portfolio make-up has not changed and will likely not change for the next two years or so. Precious metals including Canadian resources and energy are the key sectors to accomplish what I set out to do in 2000. Perhaps the returns are going to be a little less than the 25% average that I attained but I expect that the precious metals will lift all our boats. I expect the precious metals sector to go berserk (because of inflation/hyper-inflation). This should be well apparent by May/08 potentially sending precious metals values into orbit as over the next two years they will become the bubble de jour. It will take the Canadian resources sector along for the ride.

Hans Merkelbach, February 2008.

### **2007 Medium Risk Client Account Increased + 12%**

**January 1, 1999 to December 31, 2007 (8 years) Total Return: +205%**

**Average Annual Return: 25.60% per year (Medium Risk)**

**Mutual Fund Assets under Management: \$ 100 million**

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

**PLEASE always remember that past performance is not a guarantee of future performance results.**

**DISCLOSURE:** The rate of return or mathematical table shown is used only to illustrate the effects of the compound growth rate and is not intended to reflect future values of the mutual fund.

**Summary:** I do not make bold predictions and neither do I compete with my peers. My track record speaks for itself. For 2008 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 the following wise men who with their independent articles and essays have helped me in formulating a "safety first" investment strategy. Thank you: David Petch of [www.treasurechests.info](http://www.treasurechests.info) Doug Noland of [www.prudentbear.com](http://www.prudentbear.com) Bill Fleckenstein of Fleckenstein Capital in Seattle, Jim Willie of [www.goldenjackass.com](http://www.goldenjackass.com) 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.

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