

My Annual Report Card for 2009

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.



Frans Hals. *Gypsy Girl*. 1628-30. Oil on wood, 58 x 52 cm. [Musée du Louvre](#), Paris.

Frans Hals (c. 1580 – 26 August 1666) was a [Dutch Golden Age painter](#) especially famous for [portraiture](#). He is notable for his loose [painterly](#) brushwork, and helped introduce this lively style of painting into Dutch art. Hals was also instrumental in the evolution of 17th century group portraiture.

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, 2001 and 2008 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 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 2009 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

Annual Returns 2009

Asset Class	1 year (2007)	3 years	5 years	10 years
TSX Composite	35.05%			
Asia Pacific Equity	-38.12%	-0.92%	-8.95%	0.88%
Canadian Neutral Balanced	16.88%	-0.52%	3.75%	4.07%
Canadian Fixed Income	6.22%	3.52%	3.60%	5.05%
Cdn Div & Equity Income	27.03%	-2.33%	3.69%	7.12%
Canadian Equity	32.12%	-2.43%	5.41%	5.14%
Canadian Income Trusts	37.07%	3.76%	5.58%	12.92%
Canadian Small Cap	52.01%	-3.09%	4.17%	7.42%
Emerging Markets Equity	58.03%	0.31%	10.78%	3.83%
European Equity	12.90%	-10.37%	0.59%	-2.44%
Financial Services	31.15%	-15.01%	-2.48%	0.55%
Global Equity	17.89%	-8.35%	-0.90%	-2.12%
International Equity	16.05%	-10.80%	-0.91%	-2.79%
Real Estate Equity	21.23%	-13.24%	-2.07%	7.93%
Natural Resources	61.36%	-0.96%	9.95%	14.33%
Japanese Equity	-6.05%	-16.30%	-6.30%	-8.32%
Precious Metals	71.47%	1.51%	14.99%	18.84%
Science & Technology	36.50%	-3.28%	0.05%	-10.28%
U.S. Equity	12.51%	-10.54%	-4.20%	-5.01%

Natural Human Reactions to Events

Since sentiment drives most short-term price moves, we all need to be students of psychology. Humans can react to the same event in different ways depending on their state of mind when it arrives. Consider the example of a flat tire. Imagine your life is going fantastically well. Your family is healthy and happy, your job is great, and you feel fulfilled. Then you get a flat tire on the way to work. It's unfortunate but you realize that it is not a big deal. You fix it and forget about it. But if the same thing happens when you feel terrible, like the world is conspiring against you, a flat tire would likely be viewed very differently. You'd stew over it for a long time as you wondered why nothing can ever go right in your life.

An identical event is interpreted differently depending on how we feel when it arrives, how our sentiment is. This is a major influence on the markets. If a stock misses earnings estimates by a couple pennies in a bull market when everyone feels great, no one cares very much. But if the same stock misses by the same amount in a bear market when everyone is worried, it gets slaughtered. Sentiment governs our reactions.

Even worse, we are generally oblivious to our own sentimental slant at any time. We assume what we think has to be perfectly fundamentally justified. This leads to a hazardous selection bias. We naturally gravitate towards information that justifies our feelings. We put greater weight on our interpretation of data that aligns with our worldview, while ignoring any that doesn't.

This leads to seeing everything through a hyper-bullish lens at the end of a bull market. Near the end of a bear market, everything naturally looks hyper-bearish.

The financial media greatly exacerbates this selection bias. As an advertising-based business, the media wants to get the largest viewership/readership possible. To do this it has to appeal to the biggest-possible market. The best to accomplish this goal is to tell investors *exactly what they want to hear*. The media's own selection bias reinforces the personal selection biases of investors. It reports on only bullish stories near major tops and bearish ones near bottoms.

On top of all this, there is great inertia in sentiment. We humans tend to assume that current conditions are the new norm that will persist into perpetuity. Regardless of how the financial markets are doing information that seems to support the status quo continuing is viewed favourably. But any data suggesting change is ignored or treated hostilely.

So wherever the markets are, whatever they are doing, it is natural for investors to assume this will persist. If a price has been rising in a bull market for some time, investors start to think it will continue higher indefinitely. If a price has been falling in a bear market, investors assume it will continue for the foreseeable future. We all naturally do this, and the media exploits this.

To be successful, investors must transcend all of this and step outside of our own emotions. But at the same time we have to grow very sensitive to the emotions of other investors so we can invest *contrary* to their prevailing sentiment bias. Courtesy of Adam Hamilton www.ZealLc.com

Exit 2009 - Enter 2010

"The True North, Strong and Free"

"Patience and fortitude conquer all things"

Emerson

Now that we are into February (where does the time go?) it's time for an update on our investments and revisit our strategy which during the past 10 years has been so successful. The question therefore is "Should we change our strategy and move to other sectors?" As Jim Rogers the former partner of George Soros says "We are in a long-term bull market in energy, base metals, precious metals and other resources. The down-turn in the markets in September 2008 and March 2009 worldwide has hurt performance of Canadians' retirement and investment accounts. The TSX Composite Index lost 41% in 2008 and gained 35% in 2009. The majority of Canadian mutual fund investors did not recover their paper losses. I am pleased to say that my clients did.

A similar situation occurred in 1973 and 1974. The stock markets worldwide lost some 50% of their value during these two years (the TSE300 was down some 45%). Inflation started to increase exponentially and topped out at 21% in the year 1980. Gold went from \$ 120/ounce to \$ 850/ounce. Remember the people lining up for blocks at the Bank of Nova Scotia in Vancouver to buy gold wafers and coins? It took investors who had been invested in plain-vanilla stocks/funds some 8 years to regain their losses.

In the meantime if one would have been invested in precious metals and resources stocks/funds they would have done remarkably well for a total of 7 years (1973-1980). After that we all know what happened. Paul Volcker became Federal Reserve Chairman and wrestled inflation to the ground and over the past 40 years interest rates were reduced to the lowest rate ever. That game is about to end and as inflation starts accelerating those same sectors which did so well in the Seventies will start to outperform again the precious metals sector likely being the leader of the pack.

In my humble opinion and understanding the underlying fundamentals which have not changed at all we had a great 2009 recovering from our paper losses. I might add the word *discipline* to Emerson's quote to underline my thoughts. February 2010

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

2007 Medium Risk Client Account Increased + 12%

2008 Medium Risk Client Account Decreased -37%

2009 Medium Risk Client Account Increased +70%

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

January 1, 1999 to December 31, 2008 (9 years) Total Return: 168%

January 1, 1999 to December 31, 2009(10 years) Total Return: 238%

Average Annual Return: 23.8% per year)

Mutual Fund Assets under Management: \$ 85 million

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

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 2010 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.

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 and Captain Hook of www.treasurechests.info, Jim Willie of 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.

Hans Merkelbach

Member: Dundee's President's Club

E-mail Address(es):

hansmerkelbach@shaw.ca

Personal Information:

Home Office Address:

520 Smugglers Cove Road

RR # 1-L-43

Bowen Island, B.C. VON 1G0

CANADA

Phone: 604-947-9623

Fax: 604-947-9624

Toll Free in British Columbia: 1-866-241-6068

Title: Financial Advisor

Company: Dundee Private Investors Inc.

Web Page: <http://www.strategicsector.com>