

## ALSO IN THIS ISSUE:

- 2008 -- A Year of Emotion and Upheaval ..... 2
- Evaluating Investment Managers ..... 3
- Black Swans and Improbable Events..... 4

# THE NORTHWOOD STEPHENS PERSPECTIVE

WINTER 2009

## President's Message



The most frequent comment in Christmas cards and New Year's greetings I received over the past few weeks was – "Let's hope 2009 is better than 2008." I couldn't agree more. Here are a few thoughts from my perspective.

1. I expect that the economic news will continue to get worse, especially in the United States. Consumer sentiment and spending is down, job losses are on the rise, and there is still a lot of leverage to wring out of the system. But remember that the stock market is a leading indicator, and despite being in the jaws of a deep recession, the market drop in 2008 has already reflected a very severe slowdown. Unless we are going into a depression (which I do not believe), there is a good chance that stocks will be up in 2009.

2. As you will see in the articles in this issue (and as you will know if you have met us even once!), we believe in prudence, in conservatism and in planning ahead. And that approach has served us and our clients well in the current environment. I can't tell you the number of conversations I have had with other people who regret not being better prepared for this meltdown and not having a clear, sensible plan in place from which to make decisions. Often the conversation ends with "What should I do now?" At those moments, an old Chinese proverb often comes to mind. "The best time to plant a tree (– or build a resilient plan for your family) is 20 years ago. The second best time is today." Maybe it is time to engage a family office?

3. I have also had a lot of conversations with people about how Canada has fared in this global meltdown. While our stock prices are also down, Canada is becoming recognized as a relative bastion of safety and security in a world of instability and uncertainty. We have the soundest banking system in the world, according to the World Economic Forum, we didn't venture into sub-prime lending in any significant way and we have quite a lot of regulation, which was once seen as an annoyance and now boosts our reputation of conservatism. I think our characteristic Canadian moderation has actually benefitted us all, and I believe our future is very bright. In fact, the February edition of Toronto Life magazine features an interesting cover story entitled "The New Economy: Why Toronto will be the next global financial capital." Interesting.

**Tom McCullough**  
President and CEO

*Photograph courtesy of Frances Juriansz Photography*

## Swimming Naked

*Tom McCullough, MBA, CIM, Ch.P.*  
*President and Chief Executive Officer*

As Warren Buffett once said, in reference to major insurers' inadequate protection from catastrophes after Hurricane Andrew:

**'When the tide goes out, you can tell who has been swimming naked!'**



The first time Buffett used this now-famous line was in 1992, but it is just as applicable to the current economic and market catastrophe 16 years later. The big story has been the demise or diminution of the titans of finance – Bear Stearns, Lehman, AIG, Merrill, Fannie and Freddie – who found themselves 'swimming naked' when the tide went out.

How about investors? Let's start by reminding ourselves what the environment was like at 'high tide' when things were still looking good – as recently as 12-18 months ago.

- Stock markets had been strong for several years and commodity markets in particular were surging

- Interest rates were relatively low and it was easy to borrow
- Bonds seemed boring and a 'drag' on portfolio returns
- Corporate profits were running above trend
- Hedge and specialty managers were the talk of the town
- And everyone was a (successful) real estate speculator!

In that heady environment, *lukewarm* managers were traded in for *hot* managers in a quest for the best possible return and bigger market outperformance. The financial press and the investment industry told us to ask ourselves these questions:

- Are you beating the market? Is your portfolio up as much as your neighbour's?
- Are you in the top performing investments/ funds?
- Shouldn't you be 'making hay while the sun shines' and taking advantage of great returns? Are you taking enough risk to get the returns you need?
- Why are you bothering with bonds? There's hardly any yield at all.

When the tide finally went out (as it always, inevitably does) in the Fall of 2008, formerly hot managers went cold, and many equity portfolios dropped 50-70%. The nude bathers – the ones without a plan and proper understanding of their risk allocation – were exposed!

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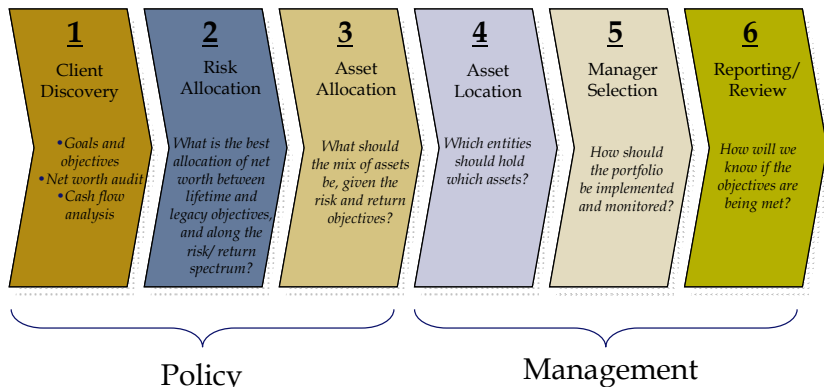
**NORTHWOOD STEPHENS PRIVATE COUNSEL INC. IS A MULTI-FAMILY OFFICE PROVIDING COMPREHENSIVE NET WORTH MANAGEMENT™ TO WEALTHY FAMILIES AND FOUNDATIONS.**

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So how do private clients get the perspective and clarity they need to make good decisions? It starts with a **very different set of questions**, which investors should always ask themselves, in good markets or bad:

- How much money/ return do I need -- to fund my current and future objectives?
- When will I need that money?
- How certain do I have to be that the money will be there when I need it?
- What is the highest probability way to achieve these objectives?

The proper risk allocation, asset allocation and ultimately investment selection flows out of the answers to those questions. We like to think about it in six steps for our clients.



**Step 1 – Client Discovery**

We start by helping clients identify and quantify the goals they have for their family, then we do a net worth audit to review all the components of their family wealth, and we forecast cash flows for the family based on this information, for their lifetime and often for future generations.

**Step 2 – Risk Allocation**

Next, we allocate a family’s existing net worth to the appropriate ‘risk bucket’. While each family is unique, typically, their *lifetime* needs should be virtually guaranteed with very conservative assets. Their *legacy* objectives (estates, bequests, etc.) can afford a higher risk/return character.

**2008 – A Year of Emotion and Upheaval**

*Bryan O’Neill, CA  
Northwood Stephens Private Counsel Inc.*

Whether as part of our jobs or out of personal interest, many of us have followed the U.S. credit crisis and can recite the events in great detail. However, others have only recently taken an interest. Either way, it can be helpful to reflect on the roots of this calamity that is widely accepted as Wall Street’s biggest crisis since the Great Depression.

**Roots:**

The history of the current crisis dates back to the late-1990s, when the tech bubble burst. This saw many of the once-mighty technology stocks plummet, eventually taking the U.S. into a recession. As a reaction, the U.S. Federal Reserve substantially lowered interest rates in an attempt to limit the damage, caused by the declining stock values.

The lower U.S. interest rates meant ‘borrowing was cheap’, so people used this opportunity to jump on the property ladder or refinance their existing home. This low-interest rate environment resulted in escalating home prices.

**Step 3 – Asset Allocation**

Only at this stage is it appropriate to make asset allocation decisions – in other words, which asset classes should be employed, in what amounts and what the proposed combination is most likely to increase the probability of the client family achieving their objectives. We capture all of this in an Investment Policy Statement (IPS).

**Step 4 – Asset Location**

We then look at the components of the family and their related corporate and trust structures to ensure that all planning opportunities are taken advantage of. The critical decision from an investment standpoint is which entities should hold which assets

**Step 5 – Manager Selection**

At this point, we are ready to look at specific investments and managers to fulfill the objectives as laid out in the IPS. We select managers based on a number of factors including quality of people, a sensible investment approach, degree of correlation with other managers, and consistent investment performance. Once the managers are selected, they are monitored on an ongoing basis to ensure they continue to deliver what they promised.

**Step 6 – Reporting and Review**

We review and report to our clients’ on their investments and overall net worth every quarter, at a minimum. We want to ensure that we are still on track to meet their long-term objectives. We also want to understand what, if any, changes have occurred with the family and how it may influence their objectives or financial situation and what changes if any, need to be made.

You can see that the goal is meeting the family’s objectives. It puts the client at the centre of the process, not the market.

To be sure, no investor is immune from loss, particularly in a market meltdown like we have seen in the past six months. But, in ‘low tide’ periods like this one, they are much more likely to have comfort and confidence in plan they have in place -- and not be caught swimming naked



During this period, institutions increased the availability of mortgages to those borrowers deemed ‘subprime’.

Subprime borrowers are those individuals that have an increased perceived risk of default, such as those who have a history of loan delinquency or those with limited debt experience. The interest charged on subprime mortgages are initially set very low, often to reset at a much higher rate at a later date, substantially increasing the monthly mortgage payment.

Banks and other institutions then began to devise a number of financial instruments whereby they would dissect, bundle and resell the mortgage- backed securities. Investors often bought these bundled mortgage instruments as a yield enhancement alternative to cash or to high quality fixed income vehicles.

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As interest rates eventually began to creep back up, previously - affordable subprime mortgages, became burdensome to many across America, particularly when the mortgage interest rate reset substantially increasing monthly mortgage payments. However, even as default and delinquency rates rose in 2006, the willingness to leverage oneself increased as the belief that home prices would continue to rise remained. Eventually as interest rates made new mortgages unattractive and existing ones unaffordable, the demand for homes dropped and default and delinquency rates rose sharply.

A numbers of events then unfolded that brought us to where we are today, with U.S. and Canadian companies seeking to shore up their respective economic systems.

**Some of the Key Events:**

June 2007 – U.S investment bank Bear Stearns announces collapse of two of its hedge funds that invested heavily in subprime mortgage market. As time passes more and more banks in the U.S., Canada and abroad find that a large number of securities are backed by what becomes known as ‘toxic mortgages’.

- **September 2007** – One of Britain’s largest mortgage lenders, Northern Rock, lobbies for emergency financial support from the Bank of England. In February 2008, Northern Rock is nationalized.
- **November 2007** – The Fed injects over \$47 billion in temporary reserves into the banking system.
- **December 2007** – Canadian Imperial Bank of Commerce (CIBC) discloses \$9.8 billion exposure to U.S. subprime mortgage market.
- **March 2008** – The Fed assumes \$30 billion in Bear Stearns’ liabilities and quarterback a sale to JP Morgan Chase, preventing a Bear Stearns bankruptcy.
- **September 2008** – As their stock prices plunge, the U.S. Treasury Department announces that it is taking over Freddie Mac and Fannie Mae, key players in the U.S. mortgage markets.
- **September 2008** – U.S. government refuses to step in and save U.S. investment bank Lehman Brothers from bankruptcy like it did for Bear Stearns.
- **September 2008** – Merrill Lynch, previously thought to still be on strong footing, is sold to Bank of America.
- **September 2008** – America International Group (AIG), a U.S. insurance powerhouse, is bailed out by the Fed in a \$85 billion deal.
- **October 2008** – The U.S. passes a \$700 billion bailout plan, aimed at limiting the damage and shoring up the U.S. economy. The tactics of the plan continue to shift.

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*“Now we just have to sit back and wait for the Fed to bail us out.”*

**Summary:**

This has brought us to where we are today, with world governments trying to get a grip on to how best deal with the economic fallout from the above. To complicate things even further (in North America), in the last year we have also had a U.S. election, a Canadian election, an attempt to topple the ruling party in Canada (ongoing), U.S. auto companies in crisis...

As we look forward into 2009, we hope to see world economies stabilize and begin to recover from the unprecedented events of 2008.

**Evaluating Investment Managers**

*Eric Weir, CFA, CFP  
Northwood Stephens Private Counsel Inc.*



The past year has been one of the biggest tests most investment management firms have ever faced. At Northwood, we monitor the performance of numerous investment managers in both Canada and around the world, and the range of performance through the year has been extremely wide. Given the challenges over the past year and the performance struggle most investment managers faced, many families and institutions will be taking time in the New Year to evaluate their managers.

Although the managers Northwood has chosen for our clients experienced declines in 2008, on a relative basis to their peers and market benchmarks they **performed very well**. We are never happy with losses, but in a year as challenging as 2008, the measurement of success is measured in how deep those losses are, and we are happy to find that are losses were not as deep as most. And when combined with a prudent asset mix, the overall result was gratifying.

At Northwood, we follow a very detailed quantitative and qualitative process to review investment managers, and we thought we’d give you a glimpse into how we evaluate potential investment managers.

At a high level, we categorize our review into four key segments (the four P’s) of an investment management firm. Each firm is evaluated in these four areas and must perform well in all of them. Below, you will find a brief summary and some examples of the four criteria:

**People**

- Do the people running the firm and managing the portfolio have integrity?
- Do they do a good job?
- Are the people who are responsible for past performance still there?
- Have there been any organizational changes that may affect the key decision makers?

**Philosophy**

- Does the philosophy make sense?
- Do current market conditions support the philosophy?
- Has the manager stuck with the style through difficult years?

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**Process**

- Is their process proven?
- Is it sensible, disciplined and repeatable?
- Is it unchanged?
- Have they experienced significant changes in assets which would change process?

**Performance**

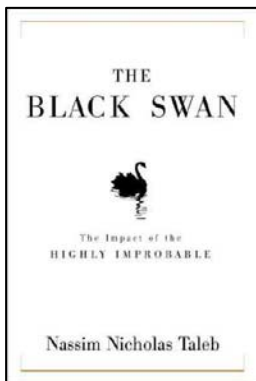
- Is the performance reasonably consistent or do their long term numbers reflect one or two good years?
- Did they have similar performance in previous difficult markets?
- How much risk do they take to achieve their results?

Although it is tempting to concentrate on only at the last P – performance – it is very important for investors to look beyond the numbers and into the organization that has produced those results. When funds are allocated to an investment management firm, past performance becomes irrelevant since you don't get to enjoy previous success.

When an allocation is made to an investment manager, what you are really investing in is the 'People, Philosophy and Process' which produced those previous results and the belief that they can be reproduced in the future. If you're satisfied with the people, philosophy and process behind the investments, you can look forward to 2009 into what we all hope is one of the best investment opportunities we have seen in recent history.

**Black Swans and Improbable Events**

Tom McCullough, MBA, CIM, Ch.P.  
President and Chief Executive Officer



This past summer, I read Nassim Nicholas Taleb's now-famous book called The Black Swan: The Impact of the Highly Improbable. It was published in mid-2007. If you haven't had a chance, it is an interesting read, particularly given the events of the past year.

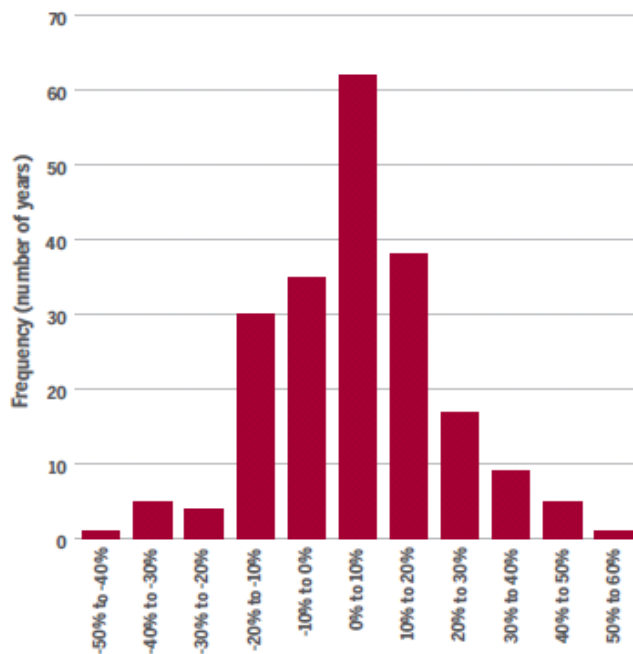
Essentially he argues that we have all been fooled (by pretty much everyone, including finance professors, hedge funds managers and investment advisors) into thinking that significant negative events (or 'black swans') are statistically so unlikely that we can pretty much ignore them.

The bar chart (courtesy of Citicorp) explains his point. Citicorp's equity strategist took 207 years of stock market returns and grouped them by returns. As you can see, the most common outcome over all those years (the tallest bar) is a return of 0% to +10%. In fact, that occurred about 30% of the time. If you add together the five bars in the middle, you can see that the market produced annual returns in the range of -20% to +30% about 88% of the time.

So if you were forecasting what would happen in 2008 before-the-fact, using traditional probability theory and the normal distribution curve (which Taleb's hates!), you would have assigned a very low (1% or once every 100 years) probability to the almost 40% meltdown that actually occurred.

Taleb argues that black swans aren't actually rare at all. Each individual one may have a low probability of occurring, but there are many different black swans (eg. 9-11). And unfortunately each can have a significant negative impact.

Annual Returns of S&P 500 or Functional Equivalent



Data Source: Citi Investment Research as of 21 November 2008

While the book is a bit of a 'rant', we actually subscribe to many of his views. It fits right in with our approach of segmenting client risk into buckets based on specific client goals vs. a probability-based balanced portfolio trying to beat a random index.



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