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GLOBAL STRATEGIST

Summer Reading

A plunge in global equity markets in July left investors with few places to hide other than the temporary safety of extremely high-priced government bonds. Recent economic data have been disappointing and geopolitical worries remain front and centre.

Unfortunately, U.S. politicians threaten to make a bad situation worse by scaring even honest CEOs out of their entrepreneurial wits with a frenzied witch-hunt for misdeeds or mistakes.

Our investment team is looking at this period of market distress as a time of opportunity. Relative to cash and fixed income, equity valuations are looking better than we have seen in decades and we have gradually been putting some of our fixed income and cash reserves to work in recent weeks. We believe that disciplined investing is not about trying to pick the bottom, but is simply a process of making continuous judgments on the relative value of competing securities.

We also believe that disciplined investing calls for a clear head and a long-term perspective, especially at times when emotions are running high. During stressful times like this, when the focus of the markets tends to be on short-term issues, I find it helpful to spend some time with books that focus on long-term issues that will ultimately be more important to investors.

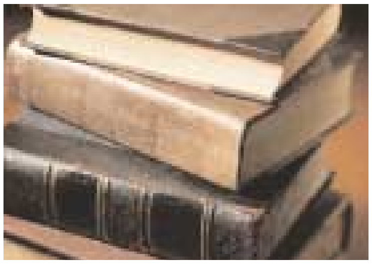
This summer, I have chosen a mix of books about the past and the future. One is a classic study of long-term stock returns in the United States. Another is a "new classic" on long-term stock returns globally. Finally, out of left field, is a book by a prominent research scientist about the future of robotics and artificial intelligence. Here are a few insights from my summer reading.

Stocks for the Long Run

This book is a classic study of long-term stock market returns in the U.S. It was first published in 1994 and has since been revised several times. Author Jeremy Siegel is a finance professor at the Wharton School and has devoted most of his career to developing and analyzing long-term statistics on the returns of stocks and other asset classes like cash, bonds and real estate.

Siegel's statistics go back to 1802 and show that stocks have been far less risky than bonds when held for long periods. According to his data, for example, during their worst 20-year period ever, stocks rose more than 20%. In contrast, the worst 20-year period for bonds saw a loss of 60%. Siegel is careful to warn readers of potential disappointments over shorter time periods and also warns firmly against other common mistakes such as lack of diversification or chasing hot stocks. An excellent addition in the latest edition is an entire chapter on lessons from the new field of behavioural finance. This chapter provides valuable insights into how emotions can cloud investment decisions and how investors can cultivate habits to avoid costly mistakes driven by emotion.

Siegel has been accused by some of being a Pied Piper who contributed to the stock market mania in the late 1990s by overselling the case for stocks. But even a cursory reading of his book makes it clear that the rewards to stock investing



Summer Reading *(cont'd)*

have historically gone mainly to patient, long-term investors. Although he does not recommend aggressive market timing, he also deserves credit for having issued a very emphatic warning in the Wall Street Journal about stock market valuations in early 2000.

Interestingly, toward the end of this July as the Dow Jones Industrial Average fell below the 8,000 level, Prof. Siegel made another appearance on the editorial page of the Wall Street Journal with a very clear analysis of stock market valuations in the midst of serious questions about the validity of corporate earnings data. His conclusion was straightforward: "By the toughest definitions of earnings, the prices of stocks are now more than reasonable. History is definitive that once investors have suffered this much pain, subsequent stock returns will be very rewarding. Amid all this gloom, the market looks very inviting to me indeed."

To be sure, this type of analysis by no means guarantees that the bear market has ended. But it does suggest that patient investors who stay the course will be well rewarded.

Triumph of the Optimists: 101 Years of Global Investment Returns

Triumph of the Optimists was co-authored by three finance experts at the London Business School: Elroy Dimson, Paul Marsh and Mike Staunton. The book is similar in content to Jeremy Siegel's *Stocks for the Long Run*, but is more ambitious in scope because it focuses on global stock markets, not just on the U.S. market.

The book's global and historical perspective results in a somewhat more cautious view of long-term stock market prospects. U.S. stock market performance was so exceptional for many decades that the authors believe that it may be unrepresentative. In other countries, history has not been as kind to investors in stocks, especially in countries like Japan or Germany whose markets were ravaged by world wars or other financial calamities.

Along with Jeremy Siegel, the authors conclude that "the risk takers who optimistically invested in equities were the group who triumphed over the long term." However, they are less convinced than Siegel that this will necessarily continue to the same degree we have seen in the past. Much of the book is therefore devoted toward making the case that we will see lower real returns in the future, a case that has now become virtual dogma among financial economists as well as other market experts like Warren Buffet.

That said, the book does not conclude that investors should shun stocks. Indeed, the authors suggest that there is now a compelling case for the traditional asset allocation of 60% equities, 40% fixed income. They take pains to emphasize that, despite the long-term triumph of stocks, there is also a compelling case for substantial exposure to fixed income and broad diversification across asset classes and securities.

I would definitely not recommend buying this book to read at the beach. That's because it is packaged as an expensive 340-page coffee-table book, complete with beautiful graphics and illustrations. This is clearly intended as a professional reference book, and a formidable one at that.

There is an old joke about Soviet agriculture being the result of "100 years of bad luck." In a sense, *Triumph of the Optimists* argues that the stellar long-term performance of the U.S. stock market is "100 years of good luck." One of the best correctives to that viewpoint is the final book on my summer reading list, one that foresees astonishing technological changes ahead.

Flesh and Machines: How Robots Will Change Us

This mind-bending peek into the future was written by Rodney Brooks, director of the artificial intelligence (AI) laboratory at the Massachusetts Institute of Technology and one of the world's leading researchers in the field of robotics.

Summer Reading *(cont'd)*

If you think that the stock market's "tech wreck" means the end of the technology revolution, it is worth reflecting on what Brooks has to say: "The battles and restructuring of our world brought on by the digital revolution is raging around us at its full fury today. It is shifting wealth and power, and restructuring our cities and lifestyles.

"We look forward to it running its course, and letting us catch our collective breaths. One wishes it were so simple. No, there is not another technological revolution brewing, about to inundate us with another tsunami that will toss our lives into disarray until we restructure them once again. There are two. They are about to hit us almost simultaneously."

Brooks is referring to the robotics and biotechnology revolutions, which are both continuing to gather massive force despite the recent gyrations in the stock market. His book, which focuses on robotics, anticipates stunning advances in intelligent robots that can operate in unstructured environments and do jobs that formerly could only be done by human workers. These advances are not decades away, but are in many cases just a few years away.

If he is even half right, the productivity-boosting consequences of the robotics revolution are likely to be profound and far eclipse the impact of the computer revolution. In his view, the "killer application" will be a rapid advance in remote-presence robots that will permit physical work to be done from any place in the world. Simple, relatively mindless robots already exist for purposes such as home security or flying surveillance aircraft over enemy positions. However, Brooks anticipates ever more nimble machines that will be able to undertake work ranging from household chores to industrial assembly. If necessary, their efforts will be overseen by human workers who may well control robots from remote locations with low labour costs.

Interestingly, he speculates that Japan may be at the leading edge of the robotics revolution because of its well-known demographic problems of an aging society, a dearth of young workers, and reluctance to permit large-scale immigration. Against this backdrop, the Japanese government is aggressively funding advance research in robotics. At the same time, major Japanese companies like Sony and Honda have devoted considerable resources to robotics research and development. Since many dismal long-term economic scenarios for Japan are based largely on the nation's unfavourable demographics, it would indeed be a surprise to most investors if sometime later in this decade Japan were able to confound the skeptics with a robotics-based productivity revolution.

More importantly, it will probably not just be Japan that benefits from a robotic-based productivity boost. Since productivity is ultimately the key driver of overall economic growth and market valuations, we part company with secular pessimists who believe that stock market gains of the past century were a fluke.

If Brooks is correct, another powerful wave of innovation and investment is not decades away, but just a few years away. That means that when the London Business School authors update their data on stock returns 10 years from now, they will still be hard at work analyzing why "the risk takers who optimistically invested in equities were the group who triumphed over the long term."

Have a great summer.

Optimistically yours,

William Sterling, Global Strategist
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