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1, Prof. Krugman, who warned about the serious problems of the Asian miracle economies earlier than perhaps anybody else, made interesting comments in the Fortune magazine recently (May 25, 98).

After making reference to evolutionary psychology, according to which our brains are designed for an environment that doesn't exist any more, he warns that our instincts aren't appropriate at all to operate in modern finance. Instinct guides us to follow behaviours that were successful yesterday, but 'rational investors .. should treat bygones as bygones.' Efficient-markets theory suggests that any future movement of a stock is inherently unpredictable. The long bull market conditions have even reinforced those inappropriate instincts, and people who take a long term view are almost extinct. Markets are overheated, mainly 'because of fresh purchases by people desperate to get in on the action. But sooner or later the supply of such people will run out: then what? … explanations we now hear of why current prices make sense are rationalizations rather than serious theories. … The whole situation gives me the chills. … if you ask me. there is an Ice Age just over the horizon.'

In his article four weeks later, Krugman pondered on the new big debate among economic pundits about the possible new stage of the U.S. economy where a faster than before long term economic growth rate is sustainable. He pinpoints that recent data provide arguments to both the believers in the New Economy and the old timers who forecast economic problems for the next few years. At the same time, he claims that while the 'new paradigmers' have simply no answer to the question of how the growth will remain sustainable if unemployment decreases further, the old timers have some real answers to the question of why there is no inflation, - that would normally be a basic part of their picture of an economy heading for trouble. The explanations are temporary, and Krugman thinks that 'even though the latest headline numbers are all rosy at first glance, they actually foreshadow a day of reckoning for the U.S. economy - and for the new paradigmers'.

2, In another Fortune article (June 8, 98), a Harvard prof. admits that the he finds the occasional question by friends and relatives about the future of the stock market quite easy, because he can at least say that he has no idea. What he finds more embarrassing is that he cannot give proper explanation even in hindsight. 'Even after the fact, stock prices are often a puzzle.'

He interviewed some top economists about their own portfolios, and he found quite different approaches. Some 'noted (correctly) that stocks have historically outperformed cash and bonds by a large margin …', but at least they agreed that timing the market 'is a fool's errand.' Other profs had almost nothing in equities. 'They noted (correctly) that historically, when stock prices have been high relative to fundamentals such as earnings or dividends, subsequent returns have tended to be low.'

He himself keeps a constant 60% exposure to equities. 'I buy a bit when prices fall and sell a bit when prices rise, which makes me feel as if I'm doing something, but not too much. I can't gloat like my more aggressive colleagues, but I've avoided most of the regrets of the market-timers.'

3, By the time you read this newsletter the really bad news might have arrived. The headlines will be about crisis, recession, meltdown, market collapse. Do we have to panic, cash existing investments, and postpone new ones at such times? It is important to keep perspective, and remember the lessons from history. It is these turbulent periods when big fortunes are made, though usually not by the gambler, and definitely not by the faint-hearted.

During the last 50 years, there were twelve bull (up) markets and eleven bear (down) markets on the stock exchange. On average, bull markets lasted 3 ¾ years and resulted in 100% gain, while the bear markets averaged nine months and brought about a decline of 25% to 30%. One year later after the market's low points, the stock appreciation averaged 24.2%, and two years later it averaged 35.6%.

If historic evidence is of any use, it suggests that bear markets should be seen as a buying opportunity. But it needs guts, long term commitment, and systematic approach.

During the 30 years from 1963 to 1993, stock markets were open for business 7,802 days. If you had invested one dollar in the market average at the beginning, it would have grown to $24.30

after the 30 years.

If you had missed the best 10 days in that period, your dollar would have grown to just $15.40. If it was 40 days that you missed, your money would have grown to only $6.50. An if you had been out of the market for only 2 days each year (60 days), your dollar would have grown to just $4.10. Finally, by missing the best 90 days (easy to do if you are a nervous investor reacting to press reports), your dollar would be only $2.10.

By comparison, one dollar invested in T-Bills at 6% would, in 30 years, have grown to $5.73, ignoring the effects of taxation.

4, The articles and facts reported above suggest what is well known but perhaps not always carefully / sensibly acted upon: namely, that investment is about risks, time-horizon, and timing.

There is simply no way of reliably forecasting what will happen tomorrow on various markets, with various types of securities, or with any particular company's stock. However, timing those very few decisive days referred above is not only impossible, it is not as important either as it might seem, provided someone invests regularly and for the long term. Calculations made with a fund with a most remarkable track record demonstrate this. If someone had invested $5000 in Templeton Growth Fund, Ltd. For each of the past 25 years on the day the market reached its highest point of the year, the average annual rate of return on the investment would have been 16.02%. If, however, the same $5000 investments had been made on the day when the market reached its lowest point of the year, the average annual rate of return would have been %17.81, not dramatically different from the other ('worst timing') scenario. Slogans like 'The best time to invest is when you have money!' might sound hollow, but such calculations with actual historic data give strong support to them.

Another basic way of managing those inherent risks is systematically diversifying our investments. If we accept that past experience on financial markets can give some guidance, even if not detailed prescription, for investors, 'systematically' is a key word here. According to historical evidence, ups and downs happen at different times to various asset classes (such as bonds, domestic stocks, stocks in various other countries, money markets, etc.) or in various industries. The less correlation the movement of the value of various securities have, the stronger the effect of 'smoothing out' wild fluctuations in the value of any one of them can be achieved by combining them into investment portfolios. This principle is staple food for even moderately savvy investors, and one of the reasons why mutual funds exist.

The more dimension a portfolio is diversified on, the more effective the balancing can be. In addition to the above mentioned dimensions, it is good to have some diversity in the portfolio according to the size of the companies, e.g., in which one has direct or indirect ownership. A next dimension with mutual funds can be the style of fund manager/s/, since under certain market conditions one management style performs better than the other, while at other times it can be just the opposite. Up until recently, one had to rely almost exclusively on the declarations of management style by the mutual fund company, or immeasurable impression from monitoring the activities of the fund manager, at most. Recently, someone elaborated an exact system of measuring to what degree and how consequently a particular fund is managed according to a declared style. A powerful software from The Globe and Mail's mutual fund information branch, beside other strengths, makes it quite easy to select and compare all the 1700 or so Canadian funds according to actual management style as well. This improves the opportunity to create better balanced portfolios.

Creating and maintaining well-balanced, diversified, portfolios is the purpose of asset allocation funds, balanced funds, or asset allocation services by more and more mutual fund and insurance companies. Based on modern portfolio theory, Mackenzie Financial's Star Program was the first such service, three years ago, and others followed suit since. The various examples of such software all measure where a particular investor strikes the balance between riskier but faster growing investments on the one side, and less risky but also probably more slowly growing investments, on the other. Measuring this individual risk-profile, together with the long term characteristics of all the available funds is the raw material to the program that churns out tailor-made suggestions for a portfolio. If you have not had experience with such program, it's well worth a try. It can help you to better understand your own underlying approach to investments, thereby to create strategies with which you will sleep well, but not at the price of securing meager performance that cannot help your dreams come true.

Another type of basic software in the arsenal of financial planners today is mostly about the impacts of time in investments. There is no magic in these, still they are very useful, since these powerful and specialized calculators can combine all those various elements of income, savings, major expenditures, timing, compounding, taxation, historic and expected investment returns, and the like, into a coherent picture that we just cannot comprehend in its totality, and with nearly comparable accuracy, without such computing tools. The users of these programs can try various scenarios that help to formalize realistic financial strategies according to their own circumstances, needs and wishes. Similarly to the asset allocation programs, if you feel like trying this, I can work with you on such software, without any obligation on your part to buy

anything from me.

5, Dealing with investments successfully is in a large part about being conscious of certain natural psychological weaknesses, and about controlling them. It is very natural, e.g., that we overreact recent events, we are biased for short term thinking, and we have a hindsight bias as well (meaning that in retrospect things that happened seem much more likely, and everything much more predetermined than they actually were). There are many scientific studies supporting such a statement, and these studies have very practical value.

One example for the importance of being aware of such psychological factors is the well known tendency that most people pay close attention to 'last year's returns' when selecting the mutual fund/s/ they invest in. There was an interesting analysis of Canadian funds made in this regard. In it, the movement of each fund's relative performance was monitored from 1986 to 1997. Every year, each fund was ranked according to performance, and 1st, 2nd, 3rd, and 4th quartiles were established. (The best 25% of all the funds were grouped in Quartile 1, the next 25% in Q2, etc.) These quartile ranks were established in every year. The interesting thing is how the funds moved from one quartile to the other, that is the pattern of such changes. The usual 'follow last year's winners' type of wisdom is obviously based on the (perhaps unconscious) assumption that funds in the top performing 1st quartile group usually remain in the 1st quartile in the next year as well. Far from truth! What actually happened is this: only 25% of those in the 1st quartile remained 1st quartile in the next year; 25% went to Q2, 20% went into Q3, and 30% went into Q4.

Ironically enough, basing the decision purely on 'last year's result' would have been worse than just basing it on the quartile ranking of funds grouped according to their names, e.g. If one had selected randomly from the first quarter of the alphabetical order of all the funds, the chance of selecting winners would have been higher than when the common sense wisdom had guided the decision. (Actually, 27% from the first quarter of the alphabetical list got into the 1st quartile next year, 22% got into the 2nd quartile, 20% into the 3rd, and 31% got into Q4, meaning better correlation than what was found between quartile rankings according to performance in consecutive years.) There was only one performance quartile, the last one, where funds showed somewhat more consistent behaviour, meaning that they really tended to stay where they had been. Arguably, the explanation for this latter thing is that funds in Q4 usually had very high MERs (management expense ratios) and that systematically eroded their results, year in, year out.

6, Average annual rate of inflation and returns in various asset classes in the last few decades (1950s, 1960s, 1970s, 1980s, and 1990-96, respectively):