The QAM update that highlights recent developments that we think either affect the markets or are important to understanding them.

Our dilemma is that we hate change and love it at the same time; what we really want is for things to remain the same but get better. - Sydney J. Harris

One of the challenges of investing is what behavioral economists call hindsight bias, which tends to occur in situations where a person believes (after the fact) that the onset of some past event was predictable and obvious, whereas in fact, the event could not have been reasonably predicted.

Many events seem evident in hindsight. Psychologists attribute hindsight bias to our natural need to find order in the world by creating explanations that allow us to believe that events are predictable. While this sense of curiosity is useful in many cases (science, for example), finding erroneous links between the cause and effect of an event may result in incorrect oversimplifications.

Events commencing in 2008 with the collapse of Lehman Brothers are still unfolding; of course, many investors believe the sharp downturn had clear signals (overheated U.S. housing market, easy credit and low interest rates, over-valued capital markets and so on) that were so obvious. Why did so many investors miss them?

The result of the 2008 fallout in the capital markets was that many investors panicked and exited the market to the safety of the sidelines. Many of these investors stayed on the sidelines after March 2009 (the "bottom") after which the capital markets rebounded significantly. Why did so many investors miss this recovery?

The answer to both these questions lies in hindsight bias. What appears so clear now was only unfolding reality then.

As we begin 2011 and read reports from economists, investment managers, analysts and the media explaining all that happened in 2010 (the PIGS, sluggish U.S. economy, China slowing down) it is easy to get the feeling that we are still victims of this phenomenon.

But let's look at what really happened. In 2010 the S&P/TSX returned 14.4% (17.6% if we factor in dividends) and the S&P 500 returned 12.8% (17.6% factoring in dividends). Furthermore the S&P 500 Index has soared 90 percent from its March 2009 low. The stars of 2010 were Canadian Small Caps represented by the BMO Small Cap Index (heavily weighted with resource companies) which returned 38.5%. International developed markets didn't do as well as evidenced by the MSCI EAFE Index return of 2.1% (Net in Canadian Dollars). Emerging markets, represented by the MSCI Emerging Markets index, returned 13.3% in Canadian Dollars. In the fixed-income world, the DEX Universe Bond Index returned 6.74%.

These are all pretty good numbers.

The markets have been driven by macro events more than ever. Fears of sovereign debt crises, collapse of the Euro, the end of an era for the US dollar, inflation in China, screams of currency wars and, of course, the mother of all fears: a double-dip recession in the United States. Markets reacted (and in most instances overreacted, as they usually do) to the fear in/fear out switch. To add to this we now have political unrest (or crises as the media terms it) in Tunisia, Egypt and possibly other countries.

What has Quadrant learned from hindsight bias? We cannot ignore it since it affects all investors, our clients included. But we continue to look at value: that's why we have been more positive on equities than bonds (see our January 2010 Newsletter). However, the experience has emphasized that asset mixes need to be reviewed in light of high market valuations and not only rebalanced but also possibly revised based upon client risk tolerances.

Market perspectives and portfolio positioning

We think inflation is a tangible threat as the economy starts to get traction and the massive amounts of money that Central Banks injected into the system begins to make its comeback. We are not panicking nor criticizing. We liked the metaphor that circulated during the 2008 crisis of the fire in the building and firefighters tearing doors down and throwing water and making things messy. The fire was the danger of a financial collapse and an economic depression; the firefighters, the Central Banks.

But we think a thoughtful investor should be ready for this threat. To put into perspective what inflation could do to the purchasing power of a portfolio we decided to see what a "basket" of goods and services that cost $100.00 in 1972 would cost in 2010. The number is $524.55. That’s the same as saying that a dollar in 1972 would be worth 19 cents in 2010.

In case you wonder, the average annual rate of inflation (decline in the value of money) was 4.46%.

In the international scene a big issue is the debilitating Euro and the fiscal weakness of some members of the European Union. The Euro has had its big detractors since its creation. The main criticism was that a group of countries with different cultures, histories and economies couldn’t share a common currency and monetary policy while keeping fiscal and political autonomy. The theory was there. Politicians, from the left and from the right, made their magic and managed to make the Euro a fact for many years. Economic forces are coming now with all their might. More and more analysts suggest that time is running out. For the Euro to survive, some sort of confederation is needed. Fiscal and political decisions will have to be unified. The mettle of the Eurozone will be severely tested. Investors have to be confident that the European Banks (backed by the European Central Bank) will throw life preservers to maintain the solvency in the banking industry. So far the Federal Reserve’s policies for stimulating the U.S. economy are allowing European banks to sell a record amount of dollar-denominated bonds to refinance about $1 trillion of debt maturing this year.

In the meantime the Euro is going to get weaker and weaker and devalue versus other currencies.

What to do? Given inflation and deficits in our future, Quadrant prefers active bond management to ferret out countries that are in better financial shape but we are more comfortable with the corporate bond market as balance sheets have improved, providing higher yields and even more stability (in the short term) than some of the sovereign borrowers. Furthermore, we think that lower duration provides protection for clients’ portfolios should interest rates continue to rise.

On the equity side we continue to favor value-oriented managers that approach investments based upon detailed, fundamental research and whose objective is to own good quality companies purchased at reasonable valuations based on profit margins, return on equity, balance sheet strength and cash flows.