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Comments on Financial and Economic Developments



What a difference a year makes. Less than twelve months ago, the appetite for risk was tremendous. Risk was good, risk was great, risk was positively risk-less. Only the faint-hearted were incapable of seeing the advantages of

extracting a few extra basis points through lending money to those who had no hope of ever paying interest — let alone principal — on their debt. What did it matter as long as house prices appreciated at double-digit rates ad infinitum and investors sensed their right to expect never-ending positive returns.

Besides, did not the credit agencies confirm the worth of their investment instruments by assigning them AA, even AAA ratings? What could possibly go wrong? The time-honored strategy whereby the haves would get richer on the backs of the have-nots was once again bearing fruit. And in the unlikely case of something going wrong, the Federal Reserve would once again ride to the rescue; Mr. Greenspan had written the book on that.

Few dared to think, and even fewer express, that the flimsy house of cards would one day collapse. Those who did, however, came out the winners. John Carswell wrote in the October 2007 Canso Market Observer, "*We called for continued economic growth in our June newsletter, albeit at a slower pace, with stubborn inflation. We also believed that the risk of a financial accident was high due to the very speculative behavior in the credit markets which might move the Fed into rate reductions*

mode. Our prime candidate for impending financial trauma was the institutionalized stupidity of collateralized debt obligations and the US mortgage market."

John Carswell, of course, saw it right. He protected his clients and he had a right to be frustrated. The house of cards did collapse, and the dust will not settle for some time. Financial institutions could have avoided their tremendous write-offs had they observed sane lending practices. Instead, we saw an astounding appetite for risk that surely would have been rewarded at year-end with super bonuses. Alas, **the computer models overlooked the crucial factor that market liquidity can and does occasionally dry up.** The shortsightedness — indeed sheer blindness — engendered by greed is a constant source of amazement, as is the power of the herd instinct.

While today's headlines center around the ongoing saga of the subprime collapse and the attempts by the Fed to manage the fallout, scant space is allocated to the weak state of US fiscal policy. Observe the themes discussed in the presidential debates: Iraq, Iran, terrorists and terrorism, illegal immigrants, and yes, health care. But has any candidate expended as much rhetoric on the budget? Not so far; it is too hot a potato. Thus the problem will grow and one day, just like the subprime market and the high tech bubble before it, the weaknesses will be exposed, and once again the market will be caught unawares.

By Rolf Spielmann, CFA

Active portfolio management and the right answer to the wrong question

W.V Harlow and Keith C. Brown, CFA, examined this issue in a recent edition of the Journal of Investment Management. They argue that **rather than asking if the average investment manager can earn excess returns, a would-be investor should instead ask whether it is possible to identify managers who are delivering excess returns on a consistent basis.**

In our work, we are inundated by calls from managers who have had excellent returns over the past 12 months and wish to cash in on their recent success by expanding their client base. In contrast, investment managers who consistently outperform the indexes, i.e. the real long-term alpha producers, rarely call. Our challenge, therefore, is to find the truly exceptional managers, which begs the question of whether it is possible to determine in advance which managers will outperform.

This is also the question Harlow and Brown addressed. To find the answer, they point out that one needs to examine a manager's expense ratio, portfolio diversification, portfolio turnover and return volatility. Studies show that the average manager does not add value net of fees, i.e. investors would be equally well served by passive management as by the average active investment management. Indeed, only 1 out of 3 managers is able to fulfill and exceed expectations.

In addition, the authors argue that when past alpha generation is used to forecast future alpha generation, one has only a slightly better chance of finding a well performing manager, but the chances of success remain below 50%. How then does one find such an exceptional manager? The key is to select a manager who ranks amongst the very best in every one of the above-mentioned categories: return volatility, expense ratio, diversification and turnover.

This sounds logical but it is not easily achieved. The analytical complexity of dissecting huge volumes of data requires a high degree of specialization and relatively few investors have either the time or the knowledge to perform the

due diligence. Most investors content themselves with a superficial review of a manager's recent performances and easily forget that higher-than-average returns are often achieved at the expense of higher-than-necessary risks.

Harlow and Brown show in their study that superior investment managers do indeed exist and that there are ways to find them...for those who are willing to plough through the necessary analysis. Alas, human nature being what it is, investors as a group have no particular loyalty to either fear or greed, which is why the pattern and repetitive nature of bubbles is so striking. Investor sentiment can switch from fear to greed very rapidly, and when that happens a lot of empty investment manager talk and promises are accepted at face value. All too often the result is disappointment, which could, with a little more effort, have been avoided!

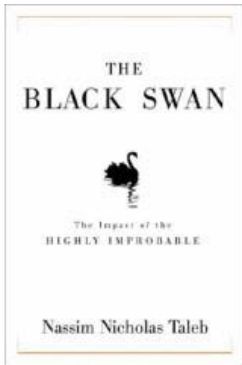
European news

Since the end of the summer, consumer confidence has been shaken by a sudden fear of inflation, in reaction to the sometimes drastic increases in the cost of food products as well as high energy costs

This is the announcement that the GfK Institute issued recently regarding confidence levels within German households. The increase in the cost of food or electricity (10% in some cases) in Germany is beginning to have an impact on consumer confidence. Inflation could rise to 3% by the end of 2007. The GfK barometer, the main consumption measurement tool in Germany, dropped to 4.9 points from 6.7 at the end of September. One particular figure came at the wrong time: the government revised its growth outlook downward (2% in 2008 and 2.4% in 2007) and was counting on household consumption.

Source: lemonde.fr

Book Review



The Black Swan: The Impact of the Highly Improbable

By Nassim Nicholas
Taleb

Random House, 2007

A black swan is a highly improbable event with three principal characteristics: It is unpredictable; it carries a massive impact; and, after the fact, we concoct an explanation that makes it appear less random, and more predictable, than it was. The astonishing success of Google was a black swan; so was 9/11. For Nassim Nicholas Taleb, black swans underlie almost everything about our world, from the rise of religions to events in our own personal lives.

Why do we not acknowledge the phenomenon of black swans until after they occur? Part of the answer, according to Taleb, is that humans are hardwired to learn specifics when they should be focused on generalities. We concentrate on things we already know and time and time again fail to take into consideration what we don't know. We are, therefore, unable to truly estimate opportunities, too vulnerable to the impulse to simplify, narrate, and categorize, and not open enough to rewarding those who can imagine the "impossible."

For years, Taleb has studied how we fool ourselves into thinking we know more than we actually do. We restrict our thinking to the irrelevant and inconsequential, while large events continue to surprise us and shape our world. Now, in this revelatory book, Taleb explains everything we know about what we don't know. He offers surprisingly simple tricks for dealing with black swans and benefiting from them.

Elegant, startling, and universal in its applications *The Black Swan* will change the way you look at the world. Taleb is a vastly entertaining writer, with wit, irreverence, and unusual stories to tell. He has a polymathic

command of subjects ranging from cognitive science to business to probability theory. *The Black Swan* is a landmark book—itsself a black swan.!

How did your manager perform ?

The survey of Canadian Institutional Pooled Funds as published by Mercer reveals the following results for the 3rd quarter 2007:

- 0.20 % for Canadian balanced accounts
- +1.90 % for Canadian equity
- +1.64 % for Canadian fixed income
- 4.90 % for US equity
- 4.60 % for international equity, and
- 4.80 % for global equity.

The results for the first nine months are as follows:

- +2.60 % for Canadian balanced accounts
- +11.90 % for Canadian equity
- +0.85 % for Canadian fixed income
- 7.3 % for US equity
- 2.70 % for international equity, and
- 5.10 % for global equity.



Andrea Juan & the Antarctica project

BLUE BRIDGE is offering you the opportunity to view photographs on display in its offices taken by Argentine artist **Andrea Juan** during a trip to the Antarctic Peninsula. The exhibition provides a very clear picture of the effects of climate change and the possible impact that humankind has on these phenomena.

Andrea Juan has a master's degree in visual arts and is a professor at the National University of *Tres de Febrero*. A recipient of many awards, she was granted a fellowship by the Guggenheim Foundation in 2005.

Selection of Financial & Economic Indicators

Index	DJ Ind	DJ Transp.	Nasdaq	S&P500	S&P/TSX
November 30	13371.72	4661.29	2660.96	1481.10	13720.73
Monthly var.	- 4.01%	- 5.03%	- 6.93%	- 4.41%	- 6.18%
Year-to-date	+ 7.29%	+ 2.22%	+ 10.17%	+ 4.43%	+ 6.29%
Year-over-year	+ 9.41%	- 1.40%	+ 9.42%	+ 5.75%	+ 7.59%



Index	FTSE	DAX	CAC40	SMI	Nikkei
November 30	6432.50	7870.52	5670.57	8828.36	15680.67
Monthly var.	- 4.30%	- 1.85%	- 3.03%	- 2.12%	- 6.31%
Year-to-date	+ 3.40%	+ 19.31%	+ 2.32%	+ 0.49%	- 8.97%
Year-over-year	+ 6.34%	+ 24.75%	+ 6.44%	+ 4.05%	- 3.65%

Commodities	Gold	Copper	Crude Oil	Lumber	CRB
November 30	789.10	318.45	88.61	254.40	339.86
Monthly var.	- 0.78%	- 8.31%	- 6.26%	+ 11.33%	- 3.18%
Year-to-date	+ 23.59%	+ 11.74%	+45.14%	- 5.07%	+ 10.61%
Year-over-year	+ 20.77%	- 0.45%	+40.78%	- 4.58%	+ 5.70%



Currencies	\$CAN	¥	€	£	\$AU
November 30	1.0000	111.15	1.4630	2.0565	0.8830
Monthly var.	- 6.10%	+ 3.22%	+ 1.00%	- 1.07%	- 5.31%
Year-to-date	+ 14.24%	+ 6.64%	+ 10.79%	+ 5.03%	+ 11.84%
Year-over-year	+ 12.43%	+ 3.97%	+ 10.46%	+ 4.60%	+ 11.98%

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