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## Comments on Financial and Economic Developments



Every so often we read an article that has a profound impact on us. One such article, "Black Monday and Black Swans", by John C. Bogle, was published in the March/April 2008 edition of the Financial Analysts Journal. The article was written last

year at the very beginning of the subprime crisis, yet it talks about the elements that invariably led to the crisis. The author, who can look back on a long and distinguished career as an investment professional, states, "The application of the laws of probability to our financial markets is badly misguided because in the stock market anything can and does happen." He wonders why, despite the recent wild disturbances in both the stock and bond markets, most market participants seem confident that future returns will resemble those of the past.

His recommendation is that rather than slavishly looking to past market returns, we should seek out evidence that contradicts our assumption. This, of course, goes against human nature and so we casually talk about risk and forget about uncertainty. Mr. Bogle states that uncertainty is immeasurable and therefore not subject to probabilities. This is something to keep in mind as we busily examine the returns and volatility patterns of investment managers and investment instruments alike. For Mr. Bogle, these are fairly meaningless exercises since they do not tell us much about the future.

John Maynard Keynes described the market as a "...battle of the wits to anticipate the basis of conventional valuation a few months hence,

rather than the prospective yield of an investment over a long term of years." To this Mr. Bogle adds that over time speculation has proven to be virtually meaningless. He calculates that of the 9.6% average annual investment return over the past century 9.5% can be attributed to investment return and 0.1% to speculative return. Nevertheless, speculation remains rampant as everybody tries to outperform the market and returns are measured over shorter and shorter periods. This being the case, business executives are forced to worry more about quarterly profit numbers instead of planning for the long term.

Moreover, speculation requires that increasingly sophisticated instruments are developed. "Sophisticated" means that they become more and more complex and thus the actual risks are more and more effectively concealed. The size of these markets is staggering. Mr. Bogle cites outstanding credit default swaps that total \$45 trillion, or five times the size of the US national debt and three times the size of US GDP. Financial institutions generate great earnings peddling such products and if it means exposing themselves to incalculable risks, then this is considered acceptable. Oscar Wilde once quipped that the only thing banks could not resist was temptation. Recent events have proven him right.

Mr. Bogle's message is that we need to get away from designing ever more complicated financial instruments and that instead we need to accept the unpredictability of markets and the benefits of long-term investing.

*By Rolf Spielmann, CFA*

## Dramatic changes...

The world has changed dramatically over the past 20 years. Warsaw Pact members now belong to NATO. Chris Patten's prediction that China and India would return to be the great economic powers they once were is playing out in front of our eyes. Russia is threatening the West with its wealth and not with its tanks. Deflation is being replaced by inflation as both food and energy prices increase together.

***"...Deflation is being replaced by inflation as both food and energy prices increase together..."***

Yet history also has a habit of repeating itself. The Savings & Loan debacle of the early 90s is replayed in the form of the subprime mess. As Donald Coxe states with his usual eloquence in his April 2008 Basic Points, the only way for Wall Street to achieve robust earnings growth to justify robust earnings for its top management was to expand the supply of homebuyers to include the imprudent, the incautious, the over indebted, the bankrupt, the unemployed, the unsophisticated and the downright fraudulent. After creating the high-tech bubble, Wall Street created the housing bubble and the creators of those excesses paid themselves handsome bonuses for impoverishing savers everywhere.

Gone (for now..?) are the days when, regardless of its quality, financial paper could attract a triple-A rating. What took a little longer was for compensation consultants to conclude that not every bank CEO was way above average. There is a delayed realization amongst investors that buying financial products that only a Nobel Prize winner can partly understand is not a good idea. And there is much unhappiness that, as Martin Wolf stated in the Financial Times, the banking industry has been conspicuously successful in privatizing profits and socializing risk. Sadly, but not surprisingly, Americans find themselves without savings now that housing - that infamous ATM machine - no longer produces fictitious gains nor freely spits out money to be invested in swimming pools, vacations or SUVs.

Maybe the time has come for investors to rethink their investment policies and risk appraisal. Bank shares are still found in all too many portfolios, partly on the assumption that the stream of their dividend payments will never diminish. Ignored is the fact that dividend payments as a percentage of net profits are in many cases rising to unsustainable levels.

***"...What then prevents an investor from examining his portfolio in light of the future rather than the past?..."***

Should not a long-term investor, instead of holding on to outdated notions, instead concentrate on the new global demand/supply ratios that will remain in place for a long time to come unless China starts a new Cultural Revolution or India decides to check its economy by returning to socialism and a crushing bureaucracy? Chances are that these countries will not return to policies that in recent memory have failed them so spectacularly. What then prevents an investor from examining his portfolio in light of the future rather than the past?

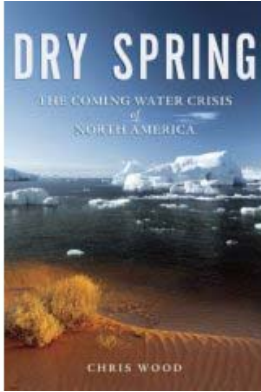
### ***European news***

*"I believe this idea does not correspond completely to the general inclination. But since I do not want to quash the debate, we will undoubtedly discuss the French proposals."*

That was Jean-Claude Juncker's recent reaction to a proposal by French President Nicolas Sarkozy to put a ceiling on value-added taxes (VAT) on fuels. However Mr. Juncker, Chairman of the Eurogroup, did acknowledge that there are *"obviously more vulnerable categories"* and *"sectors that are suffering more than others."* The finance ministers of the eurozone member countries will soon be meeting to discuss *"different proposals"* in an effort to mitigate the impact of skyrocketing fuel prices.

Source: lemonde.fr





### ***Dry Spring: The Coming Water Crisis of North America***

By Chris Wood  
Raincoast Books  
March 2008

For Canadians particularly it seems difficult to imagine that water could be in short supply one day. On a per capita basis we use twice as much water as Australians, three times as much as the French and ten times as much as the Chinese. We happily hose down our driveways with drinking water, in summer we let our sprinklers dispense huge amounts of drinking water on our immaculate lawns until the early morning hours, and fly over any city and count the swimming pools, all filled with drinking water as well. We are very much aware that on its way to our homes and offices and farms a good portion of our drinking water is lost through leaky pipes, but there is no political pressure to remedy this waste.

***"...it seems difficult to imagine that water could be in short supply one day..."***

The abundance of water and its extreme low cost (we either pay nothing or next to nothing) makes us easily forget that the supply of this life-sustaining resource is not guaranteed, not even to Canadians. We read about the city of Atlanta running dry, about the Colorado River Delta having turned into a desert, we are incensed about power plants using tremendous amounts of water (and blissfully forget that almost 100% of that water is returned, albeit slightly warmer than what might be good for the environment). And of course we enjoy our daily portion of vegetables and fruits and grains and forget that agriculture alone uses 70% of non-returned water. But do we give any thought about preserving this precious resource?

Wood has written an excellent book on the subject. He looks for answers to the problem we increasingly face and examines the impact of the ways we increase water supply, be it by desalination, deeper well drilling, cloud seeding, river diversions etc. He also looks at the problem in the context of the climate change we are witnessing. Wood is not trying to scare us into action, but he invites the reader to start thinking about an issue which will gain in urgency in coming years. If we are attempting to find ways to deal with carbon emissions, then as he suggests, why not also consider ways to deal with the coming water shortages?

Canadians have no reason to be proud to be the world's largest consumers of water. Education on the preciousness of water could go a long way. And education has to start early as everybody who has a teenage daughter knows. A shower needn't last until the paint lifts off the bathroom walls and the ceiling. Future generations of teenagers will hopefully acknowledge this because their parents will lead by example.

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## Selection of Financial & Economic Indicators

Index	DJ Ind	DJ Transp.	Nasdaq	S&P500	S&P/TSX
June 30	11350.01	4948.03	2292.98	1280.00	14467.44
Monthly var.	-10.19%	- 9.00%	- 9.10%	- 8.60%	- 1.68%
Year-to-date	-14.44%	+8.26%	-13.55%	-12.83%	+ 4.63%
Year-over-year	-15.35%	- 2.96%	-11.92%	-14.86%	+ 4.03%



Index	FTSE	DAX	CAC40	SMI	Nikkei
June 30	5625.90	6418.32	4434.85	6958.51	13481.38
Monthly var.	- 7.06%	- 9.56%	-11.56%	- 7.36%	- 5.98%
Year-to-date	-12.87%	-20.44%	-21.00%	-17.99%	-11.93%
Year-over-year	-14.86%	-19.84%	-26.76%	-24.44%	-25.67%

Commodities	Gold	Copper	Crude Oil	Lumber	CRB
June 30	928.30	388.25	140.34	242.00	462.99
Monthly var.	+ 4.13%	+ 7.67%	+10.20%	- 1.71%	+ 9.55%
Year-to-date	+11.01%	+28.20%	+47.37%	+ 3.42%	+29.50%
Year-over-year	+42.62%	+12.54%	+99.23%	-13.48%	+46.81%



Currencies	\$CAN	¥	€	£	\$AU
June 30	1.0194	106.23	1.5744	1.9916	0.9585
Monthly var.	- 2.61%	- 0.63%	+ 1.22%	+ 0.50%	+ 0.27%
Year-to-date	- 2.66%	+ 4.77%	+ 7.84%	+ 0.31%	+ 9.36%
Year-over-year	+4.28%	+13.78%	+16.36%	- 0.82%	+13.03%

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