



# Bulletin ■

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- **P.1 Comments on Financial and Economic Developments**
- **P.2 Fair Value Accounting**
- **P.3 Book Review: *A Perfect Mess***
- **P.3 What is the definition of... Survivorship Bias?**
- **P.4 Selection of Financial & Economic Indicators**

## Comments on Financial and Economic Developments

By Rolf Spielmann, CFA



In a recent research report, Dresdner Kleinwort examined the outlook for US productivity and concluded that the "New Year" productivity boom is coming to an end. If that is indeed the case, then it will have far-reaching consequences for investors, since

productivity growth and profit growth are linked.

It is not our habit in this publication to make economic forecasts, but we feel it is important for investors to keep an open mind at all times, and to anticipate the changes that will be thrust invariably upon us rather than be influenced by past or current events.

The resilience of the economy in recent years has been remarkable. As the Dresdner Kleinwort report states: "[while]...the late 1990s saw massive volume expansion and infrastructure spending in technology – more perspiration than inspiration – the productivity benefit came much later, after 2002. This high productivity growth gave the economy its *magic* – i.e. its resilience to adverse factors such as energy shocks and monetary tightening."

Productivity growth matters. As Paul Krugman described it in one of his books, **productivity isn't everything, but in the long run it is almost everything**. No wonder, then, that economists cheer for high productivity growth.

While US labor productivity varied between 4.1% in 2002 and 2.3% in 2005, the growth rate dropped to 1.4% in 2006, suggesting companies are finding it increasingly difficult to squeeze additional productivity gains from the present technology. As the Dresdner Kleinwort report points out, this is a common phenomenon with most technological revolutions of the last century – railroads, modern energy and aviation included: at some point after the introduction of the technology, its ability to increase productivity reaches a plateau.

To their credit, Dresdner Kleinwort has earlier written about declining productivity growth, as they were concerned that after years of high productivity growth (as in 2002 to 2004) growth would naturally have to slow down. That is exactly what happened in 2005 and 2006.

With no revolutionary technology on the horizon to jumpstart a strong new productivity growth cycle, the research report concludes that "we think that the US economy's uncanny resilience to energy shocks and monetary tightening – something we have gotten accustomed to over the past 5 years – could finally be put to a test. Our analysis also suggests that the boom in all-economy profit growth of the past three years could begin to subside – a point of crucial significance to investors."

## Fair Value Accounting

The November 2006 edition of the CPA Journal published an article by Robert G. Haldeman, Jr., CPA, questioning whether the move towards fair value accounting (the general name for economic valuations) is beneficial. In particular he looks at Enron and ways in which changes in accounting practices have led to a situation where at times it is difficult to differentiate between fact and fiction. For investors this has far-reaching consequences.

***"...its financial statements bore little resemblance to its actual financial condition or performance..."***

The final report on Enron's accounting stated that "its financial statements bore little resemblance to its actual financial condition or performance." And yet Mr. Lay and Mr. Skilling were prepared to argue that Enron's use of the entities (the author refers to the special-purpose entities used by Enron) met all necessary accounting and legal criteria."

As Mr. Haldeman writes, in January 1992 Skilling persuaded the SEC that Enron should be able to use mark-to-market accounting to value long-term gas contracts and derivatives.

***"...the SEC handed Enron the tools that enabled it to abandon traditional principles and introduce the bookkeeping equivalent of financial engineering..."***

Thus the SEC handed Enron the tools that enabled it to abandon traditional principles and introduce the bookkeeping equivalent of financial engineering into nonfinancial companies. Enron found itself in a position to record substantial profits.

The author states that knowingly or not, the FASB (Financial Accounting Standards Board) is pushing to change the role of the independent accountant from objective reviewer of financial information to subjective valuation specialist.

This brings up the question of who ultimately will be responsible for fair value accounting. He writes that "in the end, increasingly subjective financial statements, combined with insulation from liability, will make it nearly impossible to hold anyone accountable for the inevitable opportunistic bookkeeping."

***"...Enron had an investment grade credit rating right up to its collapse..."***

Enron had an investment grade credit rating right up to its collapse. The kind of rating it was assigned by the two major rating agencies has a historical default rate of between 0.166% and 0.20%. An investor therefore had few reasons to worry. This underlines the wide-ranging dilemma faced as a result of changing but not clearly defined accounting rules.

***"...issuers of corporate securities ask investors to trust them with their money..."***

Financial markets rely on accurate and trustworthy information. The quality of financial reports is hugely important. Mr. Haldeman delivers a wake-up call by stating that "Issuers of corporate securities ask investors to trust them with their money. Financial statements provide the vehicle through which companies communicate to investors what has been done with that money. This is not a theoretical exercise and should not be treated as one. I believe that until FASB can produce evidence of its value, the fair accounting project should be limited to footnote or schedule disclosures. Otherwise, investors must become even more skeptical of accounting information than they now are, and questions about the quality of earnings will possess greater urgency." Caveat emptor!

## Book Review



### **A Perfect Mess The Hidden Benefits of Disorder**

By Eric Abrahamson and  
David H Freedman  
Little Brown 2007

For a change, something on the lighter side, and yet a good read not only for the neatness freak but equally for somebody feeling guilty about not being a neatness freak. What the authors intend to prove in their rather delightful book is that it is costly to over-organize and that meticulously planning your day does not save you time, it costs you time instead.

***"...we have been trained to leave little up to chance, and maybe that is where we might be wrong..."***

Many of us have invested an inordinate amount of money and effort to acquire the most up-to-date organizers which allow us to make endless lists of things to do. We have been trained to leave little up to chance, and maybe that is where we might be wrong. Could it be that less is more when it comes to organizing?

Abrahamson and Freedman make a case that a certain level of disorder may bring unexpected benefits and their opinion is that a messy system can be more efficient than a neat one, referring not only to our messy closet, but to messiness in organizations, in leadership etc.

It is not uncommon to over prepare for an event only to find out that said preparation was ultimately useless because the environment or the priorities had changed at the last minute. This is the kind of organisational waste the authors would like us to avoid. To make their point they mention more than once that the US Marine Corps refrains from making details plans ahead of time. Their saying that "to plan to far ahead is to plan twice" has a certain ring of truth ring to it as most of us will have to admit.

Of course one should not get carried away, in certain matters tidiness has great advantages. It would be difficult to argue with the tax department that messiness can be good. Everything at the proper time, we presume. But this does not make reading this book any less enjoyable!

## What is the definition of... Survivorship Bias?

Investment manager universes and performance studies are often misleading because of what is known as survivorship bias. In many cases, the overall performance may indicate higher mean returns than is actually the case. The reason is that companies that fail (often because their performances do not measure up to the industry standards) are suddenly excluded from performance studies.

***"...the results are only those of successful companies that have managed to survive..."***

The result is that the summaries of some of the studies are skewed to the upside, since the results are only those of successful companies that have managed to survive.

Clearly this tends to skew the correct overall picture. This particular problem is more often than not seen in the study of hedge fund performances.

Since a great many hedge funds fail every year and thus stop reporting performances, the studies often represent only the results of flourishing firms. Surely this is why many investors look at their manager's performances and wonder why their numbers are not even close to the mean return!

## Selection of Financial & Economic Indicators

Index	DJ Ind	DJ Transp.	Nasdaq	S&P500	S&P/TSX
April 30	13062.91	5037.35	2525.09	1482.37	13416.68
Monthly var.	+ 5.74%	+ 4.71%	+ 4.27%	+ 4.33%	+ 1.91%
Year-to-date	+ 4.81%	+ 10.46%	+ 4.55%	+ 4.52%	+ 3.94%
Year-over-year	+ 14.92%	+ 8.04%	+ 8.72%	+ 13.11%	+ 9.88%

Index	FTSE	DAX	CAC40	SMI	Nikkei
April 30	6449.20	7408.87	5960.04	9428.27	17400.41
Monthly var.	+ 2.24%	+ 7.11%	+ 5.78%	+ 5.03%	+ 0.65%
Year-to-date	+ 3.67%	+ 12.31%	+ 7.55%	+ 7.31%	+ 1.01%
Year-over-year	+ 7.07%	+ 23.28%	+ 14.87%	+ 17.16%	+ 2.92%

Commodities	Gold	Copper	Crude Oil	Lumber	CRB
April 30	683.50	354.25	65.71	232.20	312.62
Monthly var.	+ 2.17%	+ 12.60%	- 0.24%	- 3.45 %	- 1.38%
Year-to-date	+ 7.05%	+ 24.30%	+ 7.63%	- 13.36%	+ 1.74%
Year-over-year	+ 4.48%	+ 10.19%	- 8.58%	- 32.64%	- 10.58%

Currencies	\$CAN	¥	€	£	\$AU
April 30	1.1095	119.50	1.3650	1.9995	0.8295
Monthly var.	+ 3.81%	- 1.40%	+ 2.21%	+ 1.57%	+ 2.60%
Year-to-date	+ 4.85%	- 0.38%	+ 3.37%	+ 2.12%	+ 5.07%
Year-over-year	+ 0.72%	- 4.96%	+ 8.25%	+ 9.71%	+ 9.29%

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### Notice to our readers

Starting June 1st 2007, our new address is:

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