Bulletin

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Comments on Financial and Economic Developments

By Rolf Spielmann, CFA

In many different respects, our planet is undergoing tremendous changes. Who will easily forget this winter's strange weather patterns? Regardless of the seeming inability of scientists to agree on whether such occurrences are caused by human intervention or natural phenomena, air conditioners may be in short supply in a few months and it may not be a good idea to speculate on lower natural gas prices.

Since 2000, the number of people living in market economies has increased by about 2.5 billion. It goes without saying that the global population today consumes far more than it did 10 years ago, and steadily growing income levels have led to a tremendous boom in infrastructure spending, which is putting a huge strain on the sharing of such resources as air, land, commodities, fish and fresh water.

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This is a reason for the major advance in commodity prices in recent years. Supply and demand are no longer balanced, and will remain difficult to balance in the short run.

Unfortunately, the demand for increasingly scarce resources will also invariably lead to political tensions.

Growing wealth also translates into a decline in the old-age insurance policy of the very poor: children. The aging of the world's population will therefore continue, and the pace may even accelerate as it reaches beyond the Western world. The aging trend, together with a lengthening of life – and working life – expectancy not only has political repercussions, but will surely change the nature of financial markets.

An older population has increased savings requirements and it will be more risk-averse in its investments. In addition, as governments strive to meet the ever-rising costs of elderly care with a declining (and less willing?) tax base, rising taxation levels in coming years must be anticipated.

Risk aversion will translate into an increasing demand for debt instruments. This, in turn, will likely mean that interest rates will remain relatively low in years to come. It will also mean that the risk aversion of the older generation will spur a younger generation of investors to actively seek and manage investment risk. Risk can already be considered an asset class for "modern" investors. And that is only the beginning!

In defence of hedge funds

Foreign Affairs, in its January/February 2007 edition, published an interesting view on hedge funds. Are they really the evil monsters some make them out to be, or do they actually serve a worthwhile purpose? The essay is clear in its conclusion: Misconceptions abound and hedge funds not so much create risk as they help to manage it.
Hedge funds did not have great returns in 2006, and the $6 billion loss at Amaranth Advisors made terrible headlines for the industry. However, the very limited fallout from Amaranth (from a market perspective) proved an important point, namely that hedge funds have a function to reduce risk.

There are two sides to any trade. If somebody is betting on higher prices, then somebody else must be betting on lower ones. Overall this is a zero-sum game.

As the essay states, what causes worry is the belief that one side of some risky bet is concentrated in a particular corner of the financial system that could collapse without the other parts of the system coming to the rescue.

But as the example of Amaranth shows, what was negative for Amaranth, which had to liquidate positions fast and regardless of price, was balanced by the positive for healthier hedge funds, since it allowed them to pick up contracts at unusually cheap prices.

"…one feature of many hedge funds is that they oblige their clients to agree to so-called lock-up periods…"

One feature of many hedge funds is that they oblige their clients to agree to so-called lock-up periods, i.e. an investor cannot withdraw his funds on short notice. This guarantees hedge funds the necessary resources to buy assets during a crisis and it is one of the reasons for their overall success. This also means, of course, that hedge funds are not for the faint of heart who prefer their money to be invested in AAA government bonds.

Hedge funds have a lot of freedom to exploit mis-pricings, mis-management and errors of judgement. As the economist Melvyn Krauss and the former hedge fund manager Michael Simoff have written (quoted in the essay): "Hedge funds may be a disruptive force – but they disrupt what needs disrupting."

This largely explains the success of hedge funds. In having the courage and the resources to challenge what needs to be challenged, profits can be generated and even larger imbalances can be avoided.

"…since the end of the Bretton Woods agreement, the investment world has become full of risks but also full of rewards for those willing to assume those risks…"

This overall positive function makes it questionable whether regulators should impose restrictive rules on hedge funds. Since the end of the Bretton Woods agreement, the investment world has become full of risks but also full of rewards for those willing to assume those risks. Hedge funds are a manifestation of this.

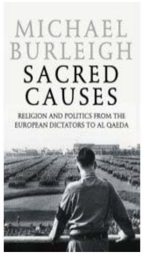
Successful hedge fund managers are handsomely paid; most would say rather overpaid. But their pay depends largely on the returns they generate for their clients, which is quite different from mutual fund managers, who are paid on the size of their funds rather than on the gains they generate.

A giant fund cannot be as nimble as a small one, something that many mutual fund buyers fail to understand. We believe there is nothing wrong in paying a manager for his good work; everybody benefits from it.

"…where the hedge fund industry fails is in getting out the message that while individual funds may take larger-than-average risks, they thereby offset other risks…"

According to the authors, where the hedge fund industry fails is in getting out the message that while individual funds may take larger-than-average risks, they thereby offset other risks. By looking at both sides of a trade instead of focusing only on the losses of one party, a less distorted image of hedge funds will emerge.

Book Review



Sacred Causes:
The Clash of Religion and Politics

By Michael Burleigh
Harper Collins
2006

This is not a comfortable book to read, but one that is very well written and that helps us better understand the unsettled world in which we are living. Perhaps a good deal more thought should have been given to this particular subject a lot earlier.

Indeed, Michael Burleigh challenges us to consider why the religious implications of the massive Third World immigration have only been studied after the fact.

"…Burleigh examines the influence religion has had on 20th century Europe, from World War I to today's War on Terror…"

We meet in this book many of the infamous icons of the last century: Stalin, Hitler, Mussolini, Franco. Partly through them, Burleigh examines the influence religion has had on 20th century Europe, from World War I to today's War on Terror.

He shows how religion has (always) been either attacked by politicians and/or misused by them for their benefit. He also looks at the churches' response to such attacks and misuse. Over time, many of the churches have faced agonizing choices, as for example in their response to the Holocaust.

The War on Terror is daily in the headlines and in that particular problematic, religions cannot be ignored. Most shocking, perhaps, is how even today the interplay between politics and religion is little understood. It is for this reason that we are recommending this book to our readers.

"…neither politics nor religion can be looked at in isolation…"

It is important for all of us to understand that neither politics nor religion can be looked at in isolation. It sounds somewhat obvious, but we only have to look around to see how little thought has been given to this!

The New Dividend Taxation Rules

By Martin Raymond, De Grandpré Chait, LLP

Despite what climatologists may be saying, the late arrival of snow this winter is most probably due to a particularly warm trend this fall resulting from the flurry of new taxation provisions. The measure that appeared in the news most often was undoubtedly the government's decision to tax distributions by income trusts. However, the reams of paper devoted to the discussion of income trusts reduced our focus on the new dividend taxation rules which will apply as of January 1, 2006 and will have a direct impact on a number of Canadian taxpayers…

If you would like to read the whole article, you may visit our website www.bluebridge.ca under the section « in the news ».

Selection of Financial & Economic Indicators

Index	DJ Ind	DJ Transp.	Nasdaq	S&P500	S&P/TSX
February 28	12268.63	4863.52	2416.13	1406.82	13045.02
Monthly var.	- 2.80%	- 1.08%	- 1.94%	- 2.18%	+ 0.08%
Year-to-date	- 1.56%	+ 6.65%	+ 0.03%	- 0.81%	+ 1.06%
Year-over-year	+ 11.60%	+ 9.63%	+ 5.91%	+ 9.85%	+ 11.62%

Index	FTSE	DAX	CAC40	SMI	Nikkei
February 28	6171.50	6715.44	5516.32	8789.70	17604.12
Monthly var.	- 0.51%	- 1.09%	- 1.64%	- 3.78%	+ 1.27%
Year-to-date	- 0.79%	+ 1.80%	- 0.46%	+ 0.05%	+ 2.20%
Year-over-year	+ 6.56%	+ 15.86%	+ 10.32%	+ 11.37%	+ 8.63%

Commodities	Gold	Copper	Crude Oil	Lumber	CRB
February 28	673.30	273.50	61.74	253.20	312.37
Monthly var.	+ 2.25%	+ 5.80%	+ 6.34%	+ 0.60%	+ 3.72%
Year-to-date	+ 5.45%	- 4.04%	+ 1.13%	- 5.52%	+ 1.66%
Year-over-year	+ 19.40%	+ 25.69%	+ 0.47%	- 23.39%	- 3.75%

Currencies	$CAN	¥	€	£	$AU
February 28	1.1695	118.45	1.3235	1.9640	0.7880
Monthly var.	+ 0.59%	+ 1.86%	+ 1.53%	- 0.05%	+ 1.42%
Year-to-date	- 0.30%	+ 0.50%	+ 0.23%	+ 0.31%	- 0.19%
Year-over-year	- 2.90%	- 2.33%	+ 10.99%	+ 12.00%	+ 6.13%

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Blue Bridge is an independent wealth management consulting firm that provides investment advice to high net worth individuals.