



Wealth Management Consultants Inc.



BULLETIN  
Sept. 2009

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### **Constructive paranoia**

The magnitude of the financial crisis which we started to experience in 2007 is beyond most investors' comprehension. Very few people grasped the full extent of the unfolding collapse and it took a long time before the

new reality was widely accepted, and this not only because of its frightening consequences. As a result of this the financial industry will undergo profound changes. From risk management to asset allocation, the whole process needs to be rethought.

The assumption that over time one always makes money in equity markets will fall by the wayside. Maybe healthy skepticism had been lost in recent years and surely caution was thrown in the wind. The fact that real estate appreciation exceeded all norms was questioned by few, too few as it turned out. As we chuckled about the silliness of the tulip mania which peaked in 1637, we failed to realize that already unaffordable houses could not appreciate by 15 or 20% year after year.

We will now surely move away from investing blindly. We will also no longer be able to rely on traditional asset allocation models. Emphasis will be on controlling risk, i.e. the verification of the soundness of an investment. A lot of investment managers will find it difficult to compete, for their clients will ask many more questions and will expect much higher standards of professionalism from their managers. The selection of an investment manager will therefore be even more important in tomorrow's world. New "stars" will surely emerge, but the shine of many older stars will as no doubt fade. The successful managers will know how to operate within assets classes,

for as the recent experience has shown, one can select the right asset class and still end up with a nasty surprise.

The process we are going through is nothing short of a redefinition of the entire financial system. This we must assume will be a fairly long and at times painful process, and occasional setbacks must be expected. Ultimately a more stable world will emerge but it remains to be seen for how long stability will hold. After the junk bond disaster we thought that we would be much more enlightened, yet shortly afterwards the savings and loan scandal erupted. Then LTCM brought the system to the brink, this was followed by the dot-com bubble, the Enrons and World-Coms, and ultimately the bubble of all bubbles (well so far at least...), housing. Every time regulators found themselves a solid step behind, every time a lack of control and supervision led to excesses.

In a recent article in the CFA Conference Proceedings Quarterly, Mohamed A. El-Erin of PIMCO writes that *you need to be something I call "constructively paranoid", meaning that you must always be concerned, in a constructive manner, that something may be going on that you do not understand. Unless you are constructively paranoid, you will be caught by surprise*". Timely advice indeed!

**By Rolf Spielmann, CFA**  
**Senior Vice-President of BLUE BRIDGE™**





## The Federal Reserve's Steady Hand

The re-nomination of Ben Bernanke to Chair the U.S. Federal Reserve represents a stabilization of the economic policy-making *body*, but also augers for stabilizing monetary *policy*. The U.S., indeed, the global economy has more or less bottomed. Many indicators suggest a turn-around is in progress, for example: two or three months of increasing U.S. home prices; a marked slowdown in the rate of increase in unemployment; and noticeably lower levels of initial claims for unemployment insurance. Second quarter U.S. GDP declined, to be sure, but at a slower rate than in prior quarters.

Two major concerns are the U.S. federal deficit and inflation. The White House only yesterday released new forecasts for the budget, *adding* US\$1 trillion to already gargantuan deficit projections for the next decade, and forecasting greater than US\$1 trillion deficits in each of the next two years alone. Meanwhile, the Federal Reserve has added trillions of dollars to its own balance sheet through debt-financed (that is, printed-money) purchases of mortgage-backed and other securities from stressed financial corporations. In total, the amount of debt and money that the U.S. Treasury and the Fed together have injected into the economy measures more than US\$10 trillion. If financial investors, in particular non-U.S. investors, limit the amount of U.S. debt they are willing to digest, the United States will suffer from three related problems: a weaker dollar, higher interest rates, and rapid price inflation.

But the Fed is quite aware of the problem. And they are already dealing with it. The Fed injected huge amounts of money into the banking system during the fall and winter, more than tripling the monetary base – currency and reserves that commercial banks hold with the Fed. Since then, however, they have added very little money to the system. The base actually shrank 6.5% (annual rate) between January and July, although

through mid-August it has grown 4% (annual rate). A broader measure of the money supply, M2, has grown by only 2% at an annual rate since mid-February.

What is the significance of recent low rates of monetary growth? Sustainable money supply growth would be in line with real economic growth plus inflation. For example, if long-term economic growth normally 2.5% and long-term inflation is expected also to be 2.5%, then money supply grow consistent with and supportive of the economy would be the sum of these two rates, or 5%. Thus, while the huge monetary impetus of last winter has helped the economy to turn around, but is also a danger for future inflation, if the Fed continues to grow the money supply from here at current modest rates, they very well could contain inflation below 2%. Success is not automatic, and may be less likely than failure, but the Fed already appears to be working very hard at the problem.



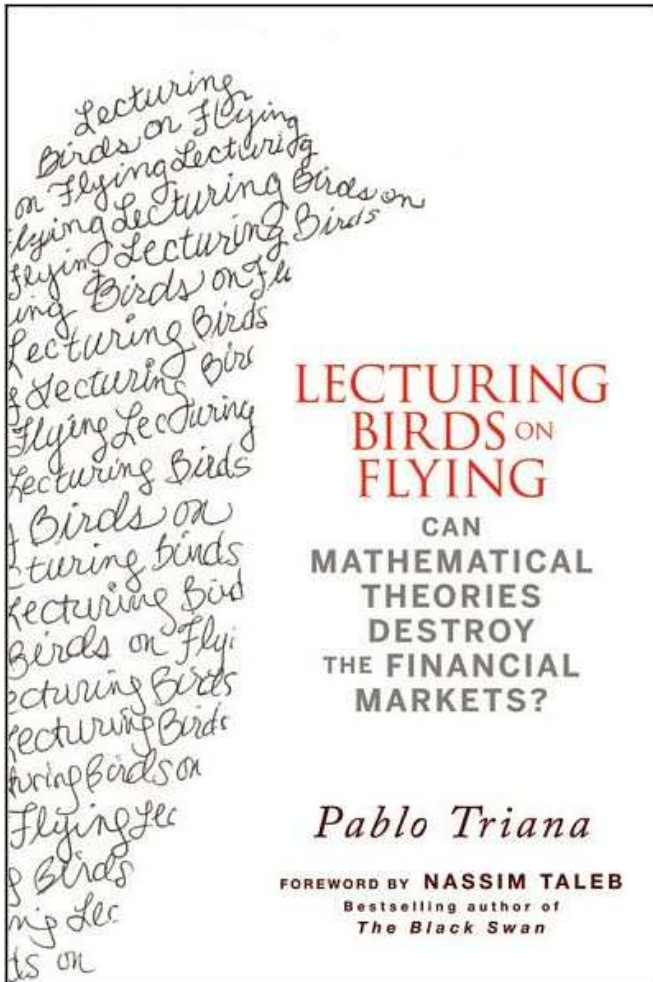
**By Matthew Gelfand, Ph.D., CFA, CFP®**  
**Managing Director**  
**Lynx Investment Advisory, LLC**  
**Washington**



## Lecturing Birds on Flying

Can Mathematical Theories Destroy the Financial Markets?

by **Pablo Triana**  
Wilet, 2009



Not too long ago we came close to the destruction of financial markets. And sadly, it was not the first time in recent memory. The cause of the credit crisis of 2008 was not that surprising for those of us who remember the portfolio insurance programs which were at the core of the stock market crash of 1987. And

them came LTCM in 1998 when the best and the brightest had calculated the future to the last fraction of a basis point, alas forgot to look outside the window. No, what was surprising was that after those devastating previous experiences, scientists and analysts happily continued to feed flawed assumptions into equally flawed models and uncritically accepted the results. Scientists became the darlings of Wall Street, for what they produced made a lot of people very rich...for a while...until the bubble burst...

A book written by somebody who knows the derivative markets as a trader, as a consultant, as a lecturer and as an author should bring insight to the table, and Pablo Triana does in this book. His writing is entertaining but merciless when it comes to attacking the weaknesses of quantitative finance. In easy to understand language he explains the problems besetting the models which have caused so much havoc, and he never fails to question why bankers put blind faith into models they could not possibly have understood.

There is a certain charm, and also laziness, to feeding numbers into a model and being told what the future will bring. What cannot possibly be captured by such models however is the unexpected which happens all too often. The unexpected can only be captured by common sense, for without an open mind and the willingness to accept and to adapt to ever changing conditions, one invariably is doomed.

Mr. Tirana's book is a wake-up call and an appeal to use common sense instead of believing that the future can be foretold by complex equations. The foreword is written by Nassim Taleb who has left his mark with books such as *The Black Swan* and *Fooled by Randomness*. The belief that the model is right and the market is wrong has, over and over again, led to devastating results. The market, it ultimately turns out, is always right!



## Selection of Financial & Economic Indicators

Index	DJ Ind	DJ Transp.	Nasdaq	S&P500	S&P/TSX	MSCI World
August 31	9496.28	3667.16	2009.06	1020.62	10868.21	1085.60
Monthly var.	3.54%	2.43%	1.54%	3.36%	0.75%	4.51%
Year-to-date	8.20%	3.68%	27.40%	12.99%	20.92%	17.97%
Year-over-year	-17.74%	-28.14%	-15.14%	-20.44%	-21.08%	-19.28%
Index	FTSE	DAX.	CAC40	SMI	NIKKEI	EURO50
August 31	4908.90	5464.61	3653.54	6217.12	10492.53	2775.17
Monthly var.	6.52%	2.48%	6.63%	4.48%	1.31%	5.19%
Year-to-date	10.71%	13.60%	13.54%	12.33%	18.43%	13.20%
Year-over-year	-12.91%	-14.91%	-18.50%	-14.11%	-19.74%	-17.54%
Commodities	GOLD	COPPER	CRUDE OIL	WHEAT	LUMBER	CRB
August 31	952.40	283.75	69.67	498.75	177.80	253.68
Monthly var.	-0.22%	8.26%	0.80%	-13.41%	-10.20%	-1.46%
Year-to-date	8.10%	102.75%	62.02%	-18.77%	4.71%	14.90%
Year-over-year	13.80%	-15.99%	-39.97%	-37.75%	-29.44%	-35.50%
Currencies	\$CA	¥	€	£	\$AU	
August 31	1.0945	93.1500	1.4340	1.6287	0.8450	
Monthly var.	-1.48%	1.64%	0.60%	-2.56%	1.08%	
Year-to-date	10.21%	-2.53%	2.72%	11.71%	19.86%	
Year-over-year	-2.96%	14.38%	-2.25%	-10.58%	-1.52%	

### Alain E. Roch, MBA

President | [alain.roch@bluebridge.ca](mailto:alain.roch@bluebridge.ca)

### Rolf Spielmann, CFA

Senior Vice President | [rolf.spielmann@bluebridge.ca](mailto:rolf.spielmann@bluebridge.ca)



Blue Bridge Wealth Management Consultants Inc. | [www.bluebridge.ca](http://www.bluebridge.ca)

1800 McGill College Avenue, Suite 2108, Montreal (Qc) H3A 3J6 Canada  
Tel. +1 514 845 9165

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