

Dark Clouds Can Have a Silver Lining

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When we were young, we would calculate just how far away an approaching storm was by counting out loud – one, one thousand, two, one thousand, three, one thousand – the time that elapsed between each bolt of lightening and the subsequent clap of thunder. If we counted to five, then the downpour was but five miles or so away. Needless to say, if we were caught some distance from shore on a canoe trip, such a warning would have us paddling furiously for a safe harbour. This simple system very seldom, if ever, failed us.

Unfortunately, many systems in the securities industry, which were generally accepted as being safe, have failed miserably in recent times. Examples can be found in the following litany of dark clouds that are overhanging the stock market and are having a negative impact on investor confidence. If they are not dealt with adroitly they might just nip the new born bull market in the bud. If they are, there may well be a silver lining!

THE NYSE MUST GET IN STEP WITH THE TIMES

The 211-year-old New York Stock Exchange has long been seen as an important pillar of the free enterprise system in North America and elsewhere about the globe. Every significant publicly traded corporation's common shares have come to be listed on the NYSE since the second World War. It is privately owned by its 1,366 members and to date has been self-regulated.

There have long been rumblings that the NYSE has not kept in step with the times in terms of overseeing its members and with respect to some of its time-honoured trading and governance practices. In addition, the recent disclosure about the massive amount of deferred compensation owed to its now former CEO and a number of other senior executives, and of their similarly over-generous retirement packages, caused a furor.

The first recommendation to come from its newly appointed interim chairman and CEO is to reduce the unwieldy twenty-seven-member board down to eight independent members, with securities-industry representatives sitting on a separate board, the much-criticized regulators reporting to the independent directors.

Though he is expected to crack down on trading floor abuses, there is little indication yet of any fundamental changes in the way business is to be done. Thorny issues surrounding the specialist system, which many have long contended is antiquated and unfair to large volume traders, are not yet under consideration. The excuse being given is that to do so might endanger the survival of the exchange and the well-being of its notoriously change-averse floor brokers and specialists.

In addition, many institutional investors are pushing for greater automation. They claim that a dealer-based system, well established at most other stock exchanges, would be far more effective. Some would like to see the NYSE opened to competition from ECNs or at least have it do away with the “trade-through” rule and allow a client’s order to be executed wherever the best price is available.

While they are at it, the common practice of money managers paying premium commissions, allegedly for research, and getting under-the-table rebates, known as soft dollars, to hide the costs that should be reported to investors as expenses, must be stopped dead in its tracks. As should the notion that the NYSE be trusted to continue to be a self-regulating entity. Those times are long gone as the recent turmoil demonstrates.

As to the distribution of new issues, a number of changes are needed. To begin with, every issuer and every underwriter should strive to maximize the number of institutional and retail accounts subscribing, as this will provide broadly based aftermarket support and thereby moderate stock price volatility. Obviously those investors who are the more active accounts of a syndicate member firm might continue to expect to get at least a partial fill, buying the balance on the open market. This is no different than having a favourite men’s or ladies’ store call its best customers and offer them a pre-sale buying opportunity.

What must be stopped, however, is the nasty practice of “spinning” IPOs, whereby institutional investors are given first crack at a hot new issue by promising to give the underwriter an even greater share of its day-to-day commission business. Not only does this practice result in underpricing of the new issue, it also discourages proper distribution and invariably results in a relatively volatile trading pattern, which ultimately discourages longer-term investors from ever buying the stock.

Putting internal and external politics aside for a moment, it would appear that it will be up to the next full-term CEO and the new board of directors to set the ultimate course of action. No matter what, the Big Board, as it is often referred to, must take a long, hard look at significant structural changes. When it does, investors may well find a silver lining in the dark cloud now hanging over its location at the corner of Broad and Wall streets. Who knows, it may one day decide to go public, as the TSX did. If that ever came to pass, we might all get a chance to own a small piece of one of the world’s greatest money-making machines!

MUTUAL FUND MANAGERS NEED TO SMARTEN UP

Believe it or not, illegal mutual fund trading is so widespread in the U.S. that fully a quarter of the brokerage firms have admitted to making questionable after-hour trades, to say nothing of the fact that 450 of these outfits have long been overcharging investors for mutual fund purchases. Worse still, a growing number of fund managers have also taken up the hocus-pocus practice of making money by taking advantage of their very own investor clients!

For the record, there are approximately 95 million Americans who have money socked away in 9,500 U.S. mutual funds. The total assets managed by the 800 or so fund companies amounts to U.S.\$7 trillion or thereabouts. The Canadian tally is more like \$409 billion. Needless to say, the uncovering of wrongdoing by the Wall Street and mutual fund companies has confirmed longstanding suspicions that the money game cards have been stacked against the average investor for quite some time.

It is also little wonder that investors are so fed up with the Securities and Exchange Commission (SEC) and the mutual fund industry associations for having failed to take the steps necessary to prevent such dastardly deeds from ever happening. Unfortunately, every other day seems to bring forward new and troubling allegations and avenues of investigation for regulators and prosecutors to pursue. Though the courts will likely be chock-a-block for years to come, it is anybody's guess as to when the dark clouds overhanging this important aspect of North American life will eventually dissipate.

When the sky does clear, however, the U.S.-managed funds will no longer be able to promote the interest of the managers at the expense of the investors. Late-trading and fund-timing abuses, plus other unfair practices, will be a thing of the past. Fortunately, we Canadians tend to match our buy and sell mutual fund orders through FundServ Inc. It guards us against the fly-by-nighters trying to take advantage of late breaking news. Such simply cannot be done in Canada.

In any event, maybe, just maybe, the 88 percent or more of the mutual funds that underperform the major Canadian and American indices, on a year-over-year basis, will do better in the future by sticking to tried and true longer-term money-making investment strategies, rather than always going for the quick buck gain. One possible piece of good news is that the portfolio turnover rate has declined in recent years, from 120.2 percent in 2001, to 82.7 percent in 2002 – the lowest level since 1996. Notwithstanding, given the record trading volumes in the U.S. and Canada of the past six months and a dramatic rebound in the earnings of Wall and Bay street firms, the gunslingers may well be back in the saddle, driving trading costs through the roof! Nevertheless, one would hope that a way will soon be found for economies of scale to work to the advantage of the mutual fund investor rather than just the investment manager.

It is time the regulators did what they are supposed to do and stopped giving the fund industry the appearance of propriety. Remove the regulatory prop and it would look much less legitimate. Take away the barriers to entry for hedge funds and it would quickly become a far more competitive marketplace. May I also suggest that a regulator that is incapable of doing its job is at least as guilty as the wrong-doers it is supposed to govern!

Hedge funds represent about 8 percent of total U.S. mutual funds or U.S.\$560 billion. They amount to but one percent or \$5 billion in Canada. Unlike the run-of-the-mill mutual funds, hedge funds are typically more aggressive investors. They can and do take on large short positions as part of the day-to-day investment strategy. Recent publicity suggests that they are fast becoming the preferred choice for some of North America's more sophisticated investors. However, a survey by the United States Trust Co. indicates that the confidence of approximately two-thirds of America's wealthiest investors has been badly shaken in recent times. Seventy-nine percent of those polled question the reliability of corporate financial statements and do not trust equity analysts; 67 percent do not trust corporate management; and 65 percent do not trust independent auditors. So many do not plan to get back into the game for some time to come.

While no such survey has come to light in Canada, do not for one moment think that our well-to-do investors have forgotten all about scandals like Bre-X, Philip Services, Livent, YBM, Cartaway, Cinar, VisuaLabs, and the very recent blows up at Atlas Cold Storage or Biovail Corporation. Nor the faded blue-chip stars like Nortel, JDS Uniphase, Celestica, Bombardier, CAE and Air Canada, to name but a few.

I cannot blame them for feeling that way. Obviously, these spooked investors have

missed the recent rebound in stock prices. Then again, they can well afford to do so! That said, if there is in fact a pot of gold at the end of the rainbow, we will never know for sure until the dark clouds swirling above the mutual fund industry move on and allow the silver lining to show through!

THERE IS A DEARTH OF REAL LEADERS

Anyone who has been an investor over the past three years will recall the euphoria going into the year 2000. Every investment benchmark was shooting straight up, propelled by never-say-die estimates of cash flow and earnings growth. Everyone, or so it seemed, was a raging bull.

Lo and behold the Dow Jones industrial average peaked that very January. The Nasdaq and the S&P 500 took it on the chin that March, as did the S&P/TSX in September. It was not until October 2002 that there was any sign of a rebound of substance. All the while CEOs took to hiding as their sins of omission began to surface. They are still a somewhat cowardly group to this very day. To investors there appears to be a dearth of real leaders in the business world willing to stand up and be counted and that, my friends, is a very sad state of affairs.

Having overstated earnings in the past, many companies are being called upon to redress financial statements. Disclosure standards are being tightened, as are insider trading and reporting rules. Institutional investors are screaming blue murder, threatening to use the form of proxy to behead any CEO who ever again dares to step out of line. Just ask the folks at Hollinger Inc.!

Meanwhile, capable and willing independent directors cannot be found for love nor money. Quarterly earning guidance, so willingly offered just a few years ago, is tougher and tougher to come by. The auditors, lawyers and investment bankers continue to say that everyone else is to blame for the melee and not them. The ratio of insider sales to purchases of stock recently hit a ten-year high at 59 to one, a bearish sign being anything greater than a 20 to one. Research analyst credibility has never been lower, at least not since the 1930s! That said, trading volumes on the NYSE, Nasdaq, the TSX and TSX Venture Exchange have recovered nicely. If you were clever enough to buy TSX shares back in November 2002 at \$20, about the price when they were first offered, you would be whistling Dixie at \$43 a share at year-end 2003, having cashed a special \$5 dividend cheque to boot!

BETTER DAYS ARE COMING

Despite the all too apparent lack of real leadership in many quarters, life goes on. The bandits are being dealt with. The regulators are slowly but surely getting on with what needs to be done. Investors are swallowing their pride and coming back into mutual funds and stocks, while maintaining a rather healthy commitment to royalty and income trusts. The world is apparently not coming to an end.

CEOs must also come to realize that the payment of dividends can be the very key to better stock prices. As a recent Canadian study of the S&P/TSX 60 corporations has confirmed, corporations that increased their dividends rapidly returned almost 17 percent

in the past five years, compared with just 4.3 percent for the index itself. Similar research published earlier this year revealed that U.S. companies paying out a larger proportion of their profits actually have higher growth rates. It is little wonder that the royalty and income trusts became so popular during the same time frame.

Fortunately, many of the dark clouds overhanging the stock market do have a silver lining. Though the road ahead may be somewhat bumpy for a while yet, if they ever want to be considered in a favorable light when the sun finally bursts through, CEOs must get about and build a creditable research analyst following. Until they do, investors will tend to stay away rather than embrace the new bull market.