

THE BRANDES PERSPECTIVE

Market Volatility—Friend or Foe?

“One of the main reasons everyone is fixated on volatility as a proxy for risk is that it’s easily measured. But being easy to measure doesn’t make it useful. In my opinion, most investors would be much better off if they simply ignored short-term market fluctuations and stayed with their investment plan.”

– Oliver Murray, CEO Brandes Investment Partners & Co

THE RIDING IT OUT

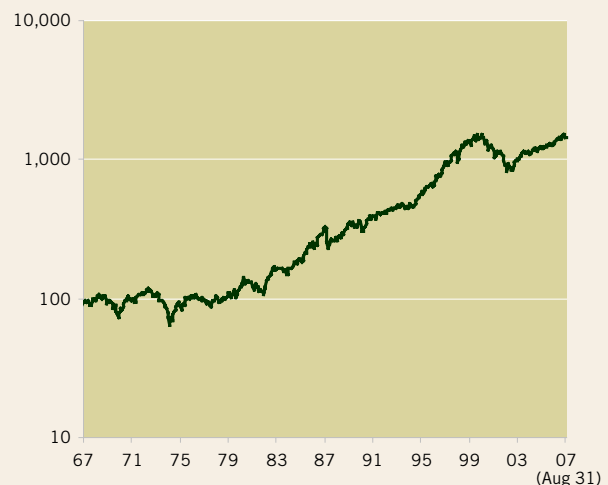
In recent months, the markets have taken investors on an emotional rollercoaster ride, not just in Canada but around the world. There are key differences between this roller-coaster and the one at your local amusement park. At the amusement park you usually sit looking forward, and you can see what’s coming next. However, as an investor, you sit facing backwards on your ride through the markets, and all you can see is what has happened recently.

Now, some may consider riding a rollercoaster backwards to be a rush. What they know, of course, is that the ride is designed to get you to the end safely. The same confidence does not exist with the stock market. When markets are going down, and all you can see is the recent past, there is no way to tell when decline will end, or if it will end at all. This is where human nature can be an investor’s worst enemy, as it can make him or her doubt their own sound decisions. It can lead to extrapolating current market trends and assuming the worst. Ultimately, the investor may get off the emotional roller-coaster ride altogether. That is, abandon their investments.

CONSTANT VOLATILITY

The graph (right) plots the forty year performance of the S&P 500 Index using a logarithmic scale. While the overall trend is upward, the line is by no means smooth—it’s punctuated by ups and downs—which translates into volatility. Notably, any other major stock market index measured over the same timeframe exhibits these same characteristics.

40 YEARS OF THE S&P 500
LOGARITHMIC SCALE



*Source: Bloomberg, Yahoo Finance; Index values exclude reinvested dividends

Ben Graham famously attributed this to the behaviour of “Mister Market,” which was his representation of the collective conscious of investors who participate in the market. Mr. Market regularly reacts to information—or misinformation as the case may be—with a mix of panic and euphoria, rather than reacting to the actual valuation of businesses. When the markets pare back as we’ve seen around the globe lately, Mr. Market can only think of three words: sell, sell, and sell. And as Ben Graham points out, Mr. Market rarely gets it right.

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SHOULD INVESTORS ALTER SOUND INVESTMENT PORTFOLIOS IN THE FACE OF VOLATILITY?

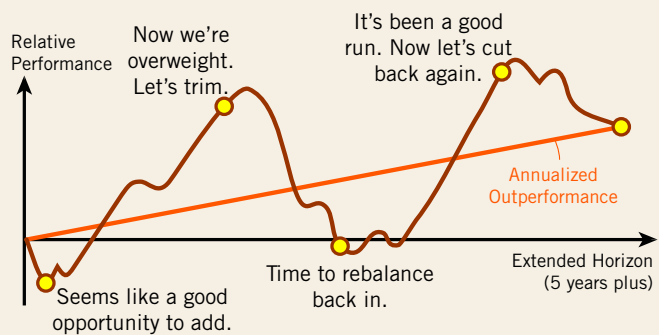
In a message to Canadian investors recorded in 2005, Charles Brandes recalled witnessing many markets like the current one, during his career, which spans five decades. He cited the “go-go” era of the late sixties when some stocks and funds posted gains of over 100%, and how that era came to a sudden end in 1974 amidst the OPEC embargo and Nixon’s resignation. He recalled that, in the eighties, investors enjoyed great gains early on, only to be jolted by the famous 29.2% drop in the world’s largest stock market index on October 19, 1987. The U.S. market recovered in the late 80’s and 90’s peaking with the tech bubble of 2000, which ultimately burst, kicking off a period of negative returns that lasted until early 2003.

While Charles indicated that he would never try to predict what the stock market will do next, he did assert that this up and down pattern has repeated itself in the past, and it’s reasonable to assume that it will continue to do so.

SO WHAT’S AN INFORMED INVESTOR TO DO?

When riding a rollercoaster, anxious as we might get during the ride, we’re strapped in and can’t get off until we reach our destination safe and sound. However, when investing, we can get off the proverbial ride at any time, and during short-term periods of market volatility many of us do—to our own detriment. Studies have shown that missing the best few days of the market—which often follow significant drops—can substantially decrease your long-term returns. At Brandes, we believe that the most important thing investors can do is stay the course.

The illustration above shows how a prudent investor views the market’s ups and downs over time—selling or paring back investments that have run-up in price, in favour of areas with lower valuations. At Brandes, we believe this is a sensible way to stay diversified and remain true to your long-term target asset mix.



THE BRANDES APPROACH

At Brandes, we view short-term market volatility the way Ben Graham advised—as a reflection of the emotional changes of the investors who participate in the market, and not representative of the value of the businesses it includes.

Therefore, rather than shying away from investing during volatile periods, we look forward to the increased ensuing opportunities to find value-priced companies. Our process, with its three-to-five-year investment horizon and strict adherence to value investing, remains unchanged—we continue to value companies based on their financial fundamentals, and apply the “margin of safety” concept.

In the same way, we believe investors should develop a plan through thoughtful consultation with a financial advisor who understands their long-term goals—and then stick to it. The benefits may not show up tomorrow or next week, but over the long term we believe they will.

VALUE SPECIALISTS

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