

## 2007/2008 – The Market in Review

The investment markets during the 2007/8 plan year can best be described as a period of turmoil. In general, equity and bond markets around the world had extremely poor returns for the twelve month period. For the Canadian investor, this has been made even worse by strengthening of the Canadian dollar against most major currencies, a trend that has largely been reversed in July and August 2008.

The Canadian bond market was influenced largely by decreases in the yield on long-term government bonds. Most equity markets around the world have suffered as only two industry sectors, Materials (largely mining companies) and Energy, produced positive returns for the year. For most markets, these two sectors are relatively small components of the Index. The Canadian market clearly benefited from its large exposure to these sectors, which posted returns of 47% and 23% respectively for the twelve months, as these sectors represent more than 50% of the market. But, even for the Canadian market, the advance has been extremely narrow, as the returns on three stocks (Potash, Research in Motion and Encana) represent the entire positive return for the Canadian market. For global markets, things were made even worse by the market reversal in June 2008, as global markets dropped (in aggregate) 8% over the month.

Three major issues have dominated the global markets over this period and have affected investment returns on both bond and equity portfolios. The initial issue was related to the problems encountered in the U.S. sub-prime mortgage market. The second issue was the credit crunch that resulted from the issues around the sub-prime mortgage market. The third issue is the rapid increase in oil prices. These issues have combined to create huge asset write-downs on the balance sheets of most major North American and European banks, a significant tightening of consumer spending, significant slowdowns in corporate profits and concerns about recession (particularly for the U.S. economy). This, in turn, has led to very difficult markets for both equity and bond investors, as there proved to be very few safe havens available to investors.

Sub-prime mortgages refer to mortgages issued to individuals to finance their homes, but where they have put little or no money down on the home and where potentially the mortgage payment only covers the interest on the loan. Thus, the homeowner has little or no equity in their home. Underlying both these borrowing and lending practices was an expectation that house prices would continue to increase, thus allowing the homeowner to build an equity position in the home. Over the past five years, financial institutions who wrote these mortgages increasingly sold these mortgages into the financial markets in the form of various structured vehicles (such as credit default obligations, collateralized mortgage obligations and structured investment vehicles). You thus had a situation in which the organization that originated the mortgage had little concern with the creditworthiness of the borrower. When housing prices began to fall in 2007, mortgage default rates rapidly increased as homeowners realized that their mortgages were larger than the value of their houses. This in turn led to major write-downs in the value of these structured vehicles (as default rates were far in excess of those assumed in the value of the vehicles) and the huge balance sheet write-downs announced by major financial institutions (such as Citigroup, Bear Stearns, Merrill Lynch, etc.). This has resulted in large drops (more than 30% and, in some cases, as much as 70%) in the value of many financial stocks, which make up a large part of global stock markets.

As a result of these events, we also saw a significant tightening of credit standards (i.e., it became much more difficult for individuals and corporations to borrow money). Among the problems this caused was the defaults on Asset Backed Commercial Paper, which were held on the balance sheets of many companies and by some pension plans (although not the Brock plan); these have also created write-downs in value of balance sheets. The tightening of credit standards also resulted in a significant increase in the interest rates on corporate bonds (which make up 30% of the Canadian bond market) and thus hurt bond returns over the year.

With consumers, particularly in the U.S., feeling poorer due to the combination of the drop in value of their houses and rapid increase in oil and gasoline prices, consumer spending has slowed dramatically. This has affected the revenues of a wide spectrum of companies and has resulted in decreases in their stock prices, as a company's stock price tends to be directly related to its expected earnings in future. The impact of the economic slowdown in the U.S. and, more recently, in parts of Europe has also affected corporate revenues and thus stock prices.

Investing is a long term process which will encounter times of volatility and uncertainty such as this. We will continue to update the Brock pension web site with monthly rates of return so that Plan members can be aware of how the Brock fund is performing throughout the year. In addition, we will provide a market update in the new year to keep members informed of market conditions.