



## No Children in the Market

By CK Wong 2005.010.26

<http://www.ck-wong.ca/money%20matter/no%20children%20in%20the%20market.pdf>

### Introduction

John Budden wrote an editorial (<http://www.bearly.com/editorial.htm> Saturday, October 22, 2005. *The markets are not for kids anymore... It's dangerous out there!*) on his web site to send an extreme signal to his visitors to be careful with the market. I certainly agree with his advice. Today Canada's once biggest markcap company, Encana, lost 8% of its markcap today. The trigger is that in the last quarter there is has an item \$604M loss due to hedging from Tom Brown property acquired in 2004 even it has strong revenue growth and still in black. This article uses this event to illustrate the volatility of the market.

### Why are children in the market?

When we were small, we like to excitement to take an adventure to the market with our parent. Most of the time, we were asked to not play or run about. We should be close to the adult all the time. Market has different merchandize. For our young eyes, we fancy and distract by them. We may not withstand the temptation and take out our allowance in exchange to those amazing looking toy or ornament. We may cry at home when we find out what we see is not what we buy. Before we hand out the money, the vendor may tell you the marvel of the toy yet you are not allowed to touch it. As time goes by we know that we have to examine the merchandize in the great details. Wisdom comes after scar tissue. But we could gain the wisdom if we listen to the adults. Or we can ask them to help us to find what we want. If we do that and follow the adult closely, we would able to learn from them. So it is necessary to have children in the market so that they can grow in the right environment. No exposure, no learning.

Let me switch the scene slightly by replacing market by stock market and children by inexperienced small retail investor.

Small retail investors have becomes the bottom of the food chain in the last two decades in the ocean of stock market. As the baby boomer approaching mid-40 their saving allow them to take some financial adventure. There are a few period, everyone are just very happy with a single trend: up. Small retail investors are very forgetful. After the 1987 Black Friday, they did the same thing again for the tech boom. Not all of them are greed. They are sheep. They follow instruction from the mass media.

Murray Pollitt says it right: the stock exchange has to come up with different sexy ideas on how to sell its product. When the market is up, you hear they are promoting one thing. When the market is down, you hear them say another thing. It is used to be buy stock when the index goes up and buy mutual fund when the index comes down. With the introduction of Exchange Trade Fund, the market gets the business up or down. Retail investors just want to make a few bug; nothing more.

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This means you may jump out of a boiling pot into a frying pan if you do not do the home work. You are just like that little kid in the market.

## Homework

What would be homework for investor? Let's be very clear. It is not to find out the stock recommendations from the business section of the newspaper or from the radio. Basically you have to understand the mechanic of a company. You should equip yourself with decent accounting knowledge to read that convoluted pro forma balance sheet. You should have the patience to go through those boring 50 to 100 pages to find out what the company is doing. You have to stay on top of the business sector that company operates in to find out who are the competitor and the trend of the sector. You also have to compare the trend of this sector to that sector in order to find out the risk, exposure and margin of the company.

One could argue how I could have enough time to bring myself to the proficiency to understand all these not to mention about the background knowledge. It is hard work for a good reward.

Many people take a short cut to use the financial advisor. These advisors just like to toy vendors. Some may not have the best intention. Some of them bear the title but in fact salesman. Let me give an example. There is a big bank with an investment department. They advertise them as specialized to create tailored profile for you: you who are small investors. In fact they have research report done by a core group to create a standard profile for investment of ranges. You have asset value in that range, you will be invested with the basket of financial instrument the core group provide. So where is the tailored portfolio? If they would do that the cost will definitely much higher.

I have talked to the famous Spratt Asset Management. On their web site, they would serve qualified customers who have a quarter million. In reality, they choose the client just as careful as we should choose the financial advisor. I have been convinced that they focus their energy on their product with a very small team. It does not make any different if I buy their product through them or through other institutes. Of course I am the unqualified investor and they are very gently and politely turn me away. I would like to share with you the experience in contrast to those calls you up and solicit business.

## Rough Time

During the rough time, you must have the stomach to bear the down and the up. I keep on kicking myself because I pick the wrong stock. Even worst when I pick the right one but I close the position too early. If the trend goes up only, once could manage it easily. Small retail investors have a few places that they cause them lost money. When the price falls, they get panic and sell. Later, the stock overshoot and the investors found it attractive and buy in at a much higher price than when they sell. There are two problems: you pay a lot of commission and the keep on losing money by hopping at wrong timing. The most recent market trend is a good example. Natural gas producer likes Encana rammed up to \$69. The natural gas price has increased from US\$7 to as high as US\$14. Many financial

analysts produce report that forecast the natural gas could go even higher. We are at the end of October now. The natural gas price is about US\$13. If you look at the heating gas bill, it has climb about 3 times in the last 3 – 4 years. So the logical conclusion would be that profit for the latest quarter should be multiple of last year. The rationale is that the extra few dollars will be pure profit. Fording Coal Trust's profile increased from \$0.28 to \$2.9 due to the price jump.

There is a question: what is the reasonable price. Encana has cash flow of \$2.20 per share and up 51 percent comparing to the 2004 same period. So the cash flow is up almost on par with the natural gas price trend. However the culprit is \$604M unrealized hedging loss. 60 percent comes from the Tom Brown property acquired in 2004. So the question we should ask is what will the future looks like? This is the homework you should work on. You may take other financial analysts' opinion into consideration. The fact is that you should do the home work to understand. If you don't know how to than doing do it. See professional. That is another article.

When I seek a financial advisor, I ask he/she whether he/she has a million. Why? It is a gauge. You may have your method. My criterion is that if he/she does not have a million and have to serve clients whose aggregated asset is more than multiple million his/her experience does not match the challenge.

Most of the time they would huff my question away. So this is not the best method to choose a financial advisor.