Towers Perrin Market Review - July 1, 2008 to September 30, 2008

This past quarter (and particularly the month of September) has been unprecedented in market history, with governments in both the United States and Europe taking extraordinary steps to keep the financial sector from unraveling. The U.S., Canada, Europe and Japan are already in, or are on the verge of, recession. Central banks have responded to the crisis by providing liquidity to the market through lowering the rates at which they lend to banks and by providing explicit injections of cash to the system. Lehman Brothers was forced into bankruptcy in mid-September and the other major investment banks have also been forced to take extraordinary actions, with Merrill Lynch selling itself to Bank of America and Goldman Sachs and Morgan Stanley opting to become bank holding companies (subject to Federal Reserve Board oversight) and sell pieces of themselves to large investors in order to acquire needed capital. American International Group (AIG), one of the world's largest insurance companies was rescued by a U.S. government loan of up to \$85 billion. Similar bailouts schemes have been launched in Europe to aid Halifax Bank of Scotland, Fortis and Dexia. In early October, the U.S. government passed (after much wrangling and debate) the \$700 billion Troubled Asset Relief Program (TARP) to attempt to improve the balance sheets of U.S. financial institutions. The key element that distinguishes this period of market turbulence from prior periods is that it is a *true liquidity crisis*, with tremendous uncertainty about whether even the largest financial institutions can obtain the financing to remain solvent.

Bond markets are typically considered a place of relative safety in a storm. For the investor, this would be true if one were only invested in federal government bonds, as there tends to be a flight to quality during any period of financial difficulty. This did, in fact, happen as investors removed money from corporate bonds, provincial bonds (in Canada) and equities in favour of federal government bonds. However, bond indices and manager portfolios also include bonds issued by corporations, provinces and other non-federal government issuers; in Canada, less than 50% of the bond index is composed of federal government bonds. As investors fled to federal bonds during September, the commercial paper market seized and corporate bond yields skyrocketed. While corporations must have access to affordable financing for capital expenditure requirements (through bonds), the virtual inability to float commercial paper is particularly serious as corporations rely on these funds to finance day-to-day operations. Bank bonds, which represent a disproportionately large part of the corporate bond market, have been hugely affected. Bond returns for major indices posted negative returns for the quarter and investment managers who had a larger exposure to non-federal government bonds fared worse.

Equity markets experienced one of their worst months in history during September. While all of the headlines have rightly been focused on the problems of the financial sector, this was not the sector that drove equity returns over the quarter. In fact, most of the pain from the financial sector was actually reflected in portfolio returns over the period from July 1, 2007 to June 30, 2008. The seven major U.S. financial institutions that were in the press during September (AIG, Fannie Mae, Freddie Mac, Lehman Brothers, Merrill Lynch, Wachovia and Washington Mutual) had already lost around 70% of their market value over that period and only represented 1.7% of the S&P500 Index as at June 30, 2008. Thus, they actually had little real impact on stock returns in this quarter. The real story was a broad based sell off of equities by a variety of market participants: hedge funds looking to meet redemption requests, investors seeking to cover margin calls (investors who buy stocks by putting up less cash than the cost of the shares must pay up money when the value of the stock goes down), mutual fund redemptions and various other sources.

On a global basis, the largest impacts were felt in those sectors that had performed best over the past couple of years, namely Energy and Materials, as commodity prices (oil, natural gas, metals) dropped sharply. The Material sector was down 31% over the quarter, with the Energy sector close behind with a 25% drop. Four other sectors posted returns below -10% over the quarter. Only two market sectors posted positive returns (Consumer Staples at 2% and Health Care at 0%). The global Financials sector was only down 8% for the quarter.

Global equity markets (MSCI World Index) were down 11% for the quarter (in local currency and for the Canadian investor). The U.S. market was down 8% in local currency and 4% for the Canadian investor (as weakening of the Canadian dollar helped returns). The Canadian market was down 18% over the quarter, as it was particularly hurt by the drop in Energy and Materials (they make up 50% of the Canadian market) and by the 40% drop in the price of Research in Motion. Emerging markets were down 23% over the quarter (in local currency).

Over the next few months, it appears likely that the global economy will continue to slow and insiders are beginning to talk about deflation as a real threat. Governments will likely continue to provide aid to financial institutions to attempt to return them to health. In this environment, it appears unlikely that the capital markets will post strong returns over the remainder of the calendar year.