

Story time

Don't believe everything you hear

April 24, 2009 – Investment ideas – stocks, mutual funds, investment trends and strategies – start with a “story.” We know this is true, because brokers have always framed their latest sales effort in the form of a narrative: “Have you heard about XYZ? It’s going to be the next Google. Really!” The question implies that there is, in fact, something to hear, that there’s a buzz building. It’s always been a tried and true way for brokers and stock promoters to generate interest in some new issue or offering they’ve underwritten and which must now be moved off the brokerage’s books – “distributed” is the usual term – and into the hands of investors.

Nothing at all wrong with that. It’s how companies raise capital. It’s how institutions and individuals “invest.” And it’s the essence of the free market system. Our job as investors and investment advisors is to peel away the layers of a good story, and find out what, if anything, is keeping the “plot structure” aloft. That means looking at the fundamentals of a company – its balance sheet and income statement, its sales and revenue forecasts, its debt burden, its business environment and prospects, and so on. All of that is public information, and readily available.

Still, given exactly the same information – and in this day and age, there’s plenty of it – not everyone agrees about the current value of a company. And that’s why the market exists: To provide an orderly venue for those who disagree about the value of a company – or any other type of asset, for that matter – to settle their differences.

At times, however, certain investment stories become so compelling that a large majority of market participants agree with it, propelling the asset steadily higher or driving it lower. Sometimes, the story even has merit. At an extreme, such stories take on a life of their own, *despite all evidence to the contrary*, and become market manias or busts.

One such story held Canadian investors rapt about a year ago. It’s hard to believe now, but the Canadian stock market benchmark, the S&P/TSX Composite Index, was flying close to the sun, striking new highs almost every day. The narrative of that time, if you’ll recall, had transformed from one concerned with debates over individual company value to an overarching story encompassing the entire Canadian economy.

Energy prices were soaring, as crude headed towards US\$147 per barrel. And “suddenly,” commodities had become the asset class of choice. Anything you could drill,

dig, grow, or suck out of the ground – and the companies engaged in the aforementioned activities – whether now or at some unspecified time in the future, became the obsessive objects of investors’ affections.

The story behind the mania was simple – as such stories usually are – and did not bear up under even rudimentary scrutiny. Nevertheless, investors’ imaginations were captivated by the hypnotic drumbeat mantra, repeated in the vast echo chamber of global business media, of allegedly endless growth in emerging markets, especially in Asia. It was there that explosive growth would support frenzied demand for key industrial commodities, including energy, while supply diminished and dwindled in a steady downward curve. “Peak everything,” you might say. Prices, naturally, would stay aloft forever.

One of the stranger subplots to this story was that the global food supply would dwindle to nothing. And rapidly rising prices of food staples, like wheat, rice, and corn, in that period seemed to lend credence to the argument. Food riots even broke out in parts of Asia and Africa – more on the rumor than on any real news. And new US government mandates to raise the ethanol content of gasoline added impetus to the shortage story.

All of that fed into the belief that more crops would have to be grown to provide for this insatiable demand. And way more fertilizer would have to be used. Enter Potash Corp. of Saskatchewan, the world’s largest producer of fertilizer, whose share price climbed 617% in two years, from around \$34 in mid-2006 to \$244 in mid-2008. The share price doubled in the first year, and then tripled in the second. But then reality bit.

Potash Corp. of Canada (TSX: POT), 3 Years



Courtesy Globeinvestor.com

It seems the world isn’t about to run out of food, or oil, or gas, or molybdenum, or anything else for awhile yet. What the world ran out of was credit. And quite suddenly the heated demand for all those commodities dried up, as consumption dwindled, output shrank, and prices collapsed.

And just as suddenly, farmers didn't need all that fertilizer. The collapse of Potash Corp.'s share price pretty much tracked the general collapse in commodity prices as the global recession began to bite in the last quarter of 2008. The stock has fallen 58% from its all-time high close of \$244 last June, closing last week at \$101. The company reported that earnings in 2009 will be between \$7 and \$8 per share, down from consensus forecasts of \$9.33 and well behind the company's January estimate of \$10 to \$12.

Inveighing against farmers' unwillingness to buy potash at inflated prices to grow crops that no one wants, Potash CEO Bill Doyle said reduced fertilizer use is already leading to lower crop yields in Brazil and Argentina and that "a dangerous game is now unfolding around the world," as he says food prices will soar once growth resumes and global food shortages again kick in.

You can see what's happening here. Mr. Doyle, hardly an impartial observer, is keen to revive the narrative that so happily led Potash Corp. shares to record highs last year. He may be right. But for the time being, at least, investors aren't buying it.

Potash Corp. presents a sobering object lesson for investors on the dangers of jumping onto a rolling bandwagon. If you invested in Potash at the height of the commodity mania in April and May last year, you've seen more than half your investment disappear. If, however, you had invested in April 2006 – and held on to it – *you've still seen your investment grow by 197%!*

That probably speaks more to the wisdom of having a plan and sticking to it than any great stock-picking acumen. And it goes even more to the point if you bought Potash, for example, as part of a diversified and disciplined asset allocation plan in line with your risk tolerance levels. In other words, your portfolio's performance over the longer term should be the only story that concerns you, and you should stick to it.

Meanwhile, markets lost a little steam last week, as the US indexes snapped a six-week winning streak. The Dow Jones Industrial Average slipped 0.7% on the week, while the S&P 500 Composite Index edged to a week-over-week loss of 0.4%.

Canada's S&P/TSX Composite Index, however, gained 1.2% on the week, as the materials, financials, and energy groups led the index to its seventh straight weekly. The story is that metals have been strengthening on stockpile buying by China. Financials were buoyed by US government guarantees of banks that might fail the so-called financial stress tests, the results of which are to be announced in early May. That may be the story. But don't believe everything you hear. ■

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