# MUTUAL GAINS™

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Without money, possibilities are limited...... without personal relationships, life is barren.... without balance, happiness and fulfillment are just a dream.

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## Tomorrow's Performance

You probably would never know it from looking at your investment statements but the Dow Jones leaped to a high on October 3rd.

Almost 7 years ago it was all about investing in technology and listening to sales pitches of promoters hyping their "next big thing" stories. Many of us heard or personally felt how that all turned out… ouch. How things have changed.

Even though the Dow has hit new highs from it's lows in 2002, investors today are not euphoric. Also, companies aren't going out trying to raise buckets of money for new ventures. Outside of commodity related businesses, the investment world is quite level headed and it shows in the prices of unspectacular, "blue chip" businesses.

I said at the outset that you probably couldn't tell from your statements that the Dow is at all time highs again. The reason, which I have explained before, is the U.S. dollar has fallen 45% against the Canadian dollar. This means if U.S. equity prices are up by 45% and the U.S. dollar is down 45%, then a person investing in Canadian dollars is at break even.

If the past several weeks are any indication it looks like we could be in for a change of performance leadership. Here's why.

If you look back in time you will see that the rise in the Canadian dollar and the rise in the price of oil and other commodities are positively correlated. In other words, when the price of oil, gold and the commodities like it goes up so does the Canadian dollar. When oil prices fall, so does the Canadian dollar. With the perceived easing of geopolitical tensions and a potentially slowing of the U.S. economy, prices of various commodities (oil included) will probably continue easing. This will have a broad based negative effect on the heavily weighted resource based economy of Canada.

As has been communicated by all of the investment managers I use for my client's portfolios, Canadian companies are expensive when put side by side to comparable companies in other developed countries, namely the U.S. the U.K. and many European countries. The price of Canadian companies has run ahead of themselves over the past couple of years. If the past several weeks are any indication, it looks like those who switched much of their portfolios to Canadian holdings over the past several months could, a few years from now, be looking back regretting that they had chased yesterday's performance.

As has been told to me time and time again, during my past 19 ½ years as a Financial Planner, by some of the most highly regarded investment managers in the world, "You have to be willing to look wrong in the short term (1 – 3 years) to be right in the long term."

## $200,000 Invested, $273,600 Withdrawn and Still Have $435,563

A systematic withdrawal plan, or SWP (pronounced SWIP) is a common thing done when an RRSP is converted to a RRIF. The idea is to invest a lump sum of money and take a fixed amount of money from it per month, much like you would get from a pension plan. This idea can also be used for a regular investment portfolio, one that will grow over time and still pay you a monthly income:

Here are the numbers (unaudited) from one client of mine, who started a RRIF SWP at the end of 1997:

Total invested = $193,607.24 (Nov – Dec 1997)     Total withdrawn (Jan '98 – Sept 2006) = $125,175.22

Portfolio Value (as of October 6th 2006) = $252,535.22

This may look "too good to be true" however I ran some numbers in a software program for a similar scenario using a less than stellar performing Canadian Balanced mutual fund. I used a $200,000 initial investment on September 1987 and withdrew $1,200 per month from it through to August 30th 2006.

Total withdrawn equals $273,600. Portfolio value as of the end of August 2006 is………$435,563. All from a $200,000 initial investment. It isn't rocket science and it's something many people have been doing for years. You can too. (Source: Morningstar Research Inc.).

## Converting Your Bad Debt To Good Debt (The "Smith Manoeuvre")

Debt is a double edged sword and to a large degree a necessary evil. This is true when it comes to "leveraging" to better your financial position, or using the banks money to make money.

You can make money using the bank's money but, while this can be rewarding on the upside it can be very painful on the downside to the extent of financial devastation if not done prudently. That is the double edged sword. The necessary evil part of the equation is if you don't use "leverage" , the most common form of leverage being a first time home purchase with a relatively small down payment, you could slowly fall back financially. This has been particularly evident over the past couple of years for those who don't own a home.

When you buy your first home you most likely start with a relatively small amount of money and leverage this small amount with a much larger amount by a bank in the form of a mortgage; $10,000 down, $190,000 mortgage controls a $200,000 asset. As time goes on, and with each and every mortgage payment you make, you slowly pay down the amount owing on the mortgage. This feels good and reduces your risk however the drawback is you lose the benefit of leverage as your home is being paid off.

A strategy that has been getting a lot of attention lately, and one that talks about this in more detail is called the "Smith Manoeuvre". I have received many calls from people who have read articles in the paper written about this "concept". I say "concept" because the idea is not really anything new. The book, written by retired Financial Planner Fraser Smith however lays out a very detailed description of how this can be done.

A very simple explanation of this "Smith Manoeuvre" is this. For every time you make a mortgage payment, you take the amount you have paid down on the principal and simultaneously borrow an equal amount back and invest it. Over the course of several years you will, on a very systematic basis, be paying your mortgage down (bad debt) and simultaneously be building an investment portfolio using borrowed money (good debt).

Why is your regular mortgage bad debt? Because the interest you pay on it is not tax deductible. The debt incurred for investment purposes however is tax deductible.

The premise in the book is that the bad debt you have now will slowly be converted to good debt. That simple act has an ancillary benefit of slowly increasing your tax savings each and every year. This will in turn give you the ability to pay down your bad debt (mortgage) even faster. The suggestion from the Smith Manoeuvre is that as soon as you only have good debt you can keep that debt in place as long as you live. For most people that last thought is unpalatable and very uncomfortable. This doesn't mean that the concept is faulty or that you shouldn't use it. In your case I'd suggest a revised version of the Smith Manoeuvre can be used. In either case however partnering with a qualified Financial Planner is highly advised.

The concept of converting bad debt to good debt is a very sound financial planning strategy. Many of my clients have used this concept for years, I included. Fraser Smith has simply refined it and laid it down in a book so the broader public can understand the idea, and the benefits of it. It is something almost anyone can use to their advantage and customized to fit within their own comfort level.

## Virtually No Tax If Your Income Is Under $33,000

Thanks to the enhanced tax credit earlier this year, you'll keep a lot more of your dividend income and if your taxable income is low enough you will pay no tax on it.

First, you will need to be earning dividend income. To do that you will need to switch your bank deposit, bond or other cash investments to dividend paying investments. That change alone will reduce your tax bill, no matter what your income is.

A B.C. tax payer with $60,000 in taxable income will pay tax at a rate of only 6.14% on dividends. Tax on interest from bank deposits, bonds etc. is over 31%. In other words, if you earn $10,000 of interest income you will pay $3,115 in tax on it. If that $10,000 is dividends instead of interest you pay only $614 tax. All you have to do is change your investments and you can lower your tax bill for every year in the future.

The interesting part is this, the lower your income the more effective the new dividend tax credit is. If your taxable income is $33,000 or less than you pay NO TAX on the dividend income you earn. In comparison you'll pay 21.3% tax on your interest income. Time to consider moving those interest paying investments.

Do you want to do some more accurate calculation based on your own situation? Go to www.ey.com/global/content.nsf/Canada/Tax - Calculators - Overview

## Take CPP Now Or Should I Wait?

For most retired people the income they get from CPP is only part of their retirement income. Many don't need it at age 65. For some, "the sooner the better" is the motto. No matter what, the choice is yours on how early or late you start receiving your CPP income.

Before you go running around your house sticking notes to where you are going to spend that money, I must tell you that the earliest you can receive it is age 60. However, there is a strong argument for taking your CPP as early as possible and I'd like to show you the numbers on why that is.

For every month before your 65$^{th}$ birthday that you receive CPP income early you are penalized 0.5%. This equals a reduction of 6% per year, and if taken as early as your 60$^{th}$ birthday, a reduction of 30% from what you would have received if you starting getting CPP on your 65$^{th}$ birthday.

At age 60 the maximum monthly CPP you can get is $591.21. At age 65 the amount is $793.91. Yes, 30% is quite a drop but what you have to calculate is that taking your CPP at age 60 will give you total payments of $35,472.60 by the time you reach age 65. Sure, if you wait until 65 you will get a higher monthly income but it will take you until age 82 before you break even to taking it at age 60.

Having said that, just because you are between age 60 and 64 doesn't mean it always makes sense to apply for your CPP early. Your current tax or income situation along with your health will play a big part in that decision.

## Giving A Lot Can Cost Very Little

"The habit of giving only enhances the desire to give." Walt Whitman

Here is a personal story I heard from Tim Cestnick (author of many tax books) as was told to him by his aunt:

A 10 year old boy came into a coffee shop, sits down and asks Tim's aunt (the waitress) how much it is for an ice cream sundae. "50 cents" she tells him. He counts the coins in his hand and asks how much it is for a plain dish of ice cream. Tim's aunt is getting a little impatient as she has a number of other customers to wait on. "35 cents" she tells him abruptly. The boy counted the coins in his hand again to make perfectly sure he had enough money. He then asks for the plain ice cream.

After the boy finished his ice cream he paid the cashier by the front door 35 cents and left. When Tim's aunt came to wipe up the boy's table and clean up his ice cream dish she saw 3 nickels and was filled with emotion. This boy had sacrificed part of what he could have had for himself so he could give Tim's aunt a tip. That is sacrificial giving.

I want to say that even though you may have a similar sacrificial giving heart, maybe more so after hearing that heart warming story, I'm sure you wouldn't turn away a huge tax benefit for your charitable giving. That would enable you to give even more if you so choose. Well, the generous tax benefit is there for your taking. Here's how using an investment program that has been around since the 50's.

For the past 50 years the resource mining industry in Canada has been able to issue flow through shares to investors. You buy these shares from them and in turn they "flow through" certain exploration and development expenses they can't use to reduce your income taxes. In other words, they are transferring the tax deductions from these expenses to you. For a $10,000 investment this works out to approximately $4,600 in tax savings. That is the first part of the equation and again, it' been around since before I was born, which in my kids opinion is "old".

The second part of the equation came in the May 2$^{nd}$ budget which eliminated any tax on capital gains triggered from gifting an investment to a charity. This capital gains waiver is especially advantageous to flow through share investments, simply because you get a 100% tax deduction for making the flow through share investment in the first place. This 100% tax deduction (approximately $4,600 in tax savings) brings the "adjusted cost base" to $0.

This means that anything over $0 you get for selling the investment is considered a capital gain. Except if you gift or "tithe" it however. In this case, you have no tax on the capital gains and an additional donation tax credit. That is the second part of the equation, one which in my opinion is a very substantial annual benefit if you give or "tithe" year after year.

Assuming the investment is worth exactly what you paid for 18 – 24 months down the road you will save: $4,600 from the "flow through" tax savings and Another $4,600 in tax when you gift or tithe" the investment. That is $800 out of your pocket when all is said and done. If you had donated or tithed cash it is $5,400.

## HHHhhhhmmmm……….

It takes up to two years for the increase in the Loonie to translate into savings on the retail shelves.

With economic growth faltering in Canada's industrial heartland (Ontario) it is unlikely the Bank of Canada will allow the Loonie to climb higher. The only way they can do that is to reduce interest rates. (CIBC World Markets, Sept 7th 2006)

$10,000 invested in the TSX (Canadian) index in 1972 would have been worth $298,253 at the end of April 2006. A 75% Canadian and 25% International investment mix would have been worth $333,152. (Global HySales)

Defined Benefit Pension Plans now have more retired members than contributing ones still working. In 1970, average pension benefits paid to a company's retirees equalled the amount of money paid out in the company's payroll. This average pension benefit has since tripled and is as high as 6 times payroll at some companies (Insurance Journal, August 2006)

Over the past year American's extracted $250 BILLION from the value of their homes which was used to spend on consumables such as new cars, big TV's and vacations. (CIBC World Markets, Sept 7th 2006)

RBC Affordability Index for a detached bungalow for Canada's largest cities is as follows: Vancouver 68.2 per cent, Toronto 43.9 per cent, Montreal 36 per cent, Calgary 34.6 per cent and Ottawa 30.3 per cent. The RBC Affordability Index measures the proportion of pre-tax household income needed to service the costs of owning a home (mortgage payments, utilities and property taxes).

For families with incomes under $35,595 and a child born January 1st 2004 or later you can get $500 per year put into an RESP by the government. You don't have to put in a penny. That is free government money.

An RESP can stay open for up to 26 years. That means if your child doesn't attend post secondary education right away, not a problem. They can always use it later.

Rural Alberta has one of the highest rates of high school drop-outs in Canada at about 25% spurred by the promise of attractive pay for unskilled work (Globe & Mail, Sept 15 2006)

In the past 8 years the number of "Financial Advisors" has declined from 25,000 to 22,000. (Advisor.ca)

$15 billion was paid by consumers for extended warranties in 2004 of which 50% went straight into the pockets of the stores that sell these extended warranty plans. Only $3 billion was paid in claims. (Warranty Week)

Statisticians have compared changes in gas prices and Bush's ratings through his presidency and have found a steady relationship: As gas prices at the pump rise, his ratings fall. As gas prices fall, his ratings rise.

Chartered Financial Planner


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