Issue No. 131

May / June 2009

mutual gains

published bi-monthly since 1987

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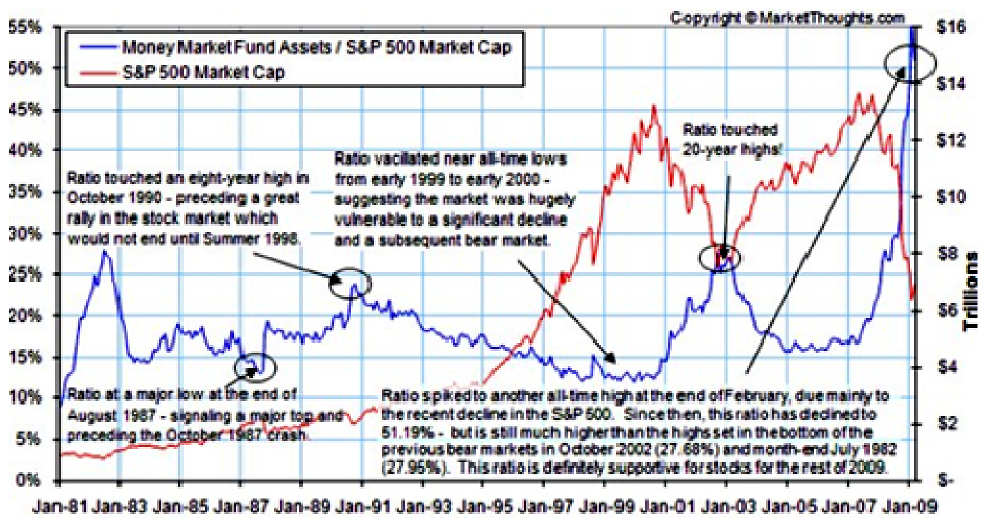
With Much Of The Panic Gone The Mountain Will Move

A mountain has developed among us and it sure is huge. You can't see it but it has been morphing out of a flat landscape. This mountain stands high. It pokes well beyond the clouds and is so large it takes up a large part of the horizon. It's enormous. This isn't your typical mountain though. It isn't made of rock but of cash and mounds of it. Bills and coins of all kinds, GIC's, term deposits, treasury bills short term government bonds and money market mutual funds.

This enormous amount of cash has been piling up around the world. It has been created by a flight to safety, something that happens during all economic turmoils. The people holding this cash are waiting for a sign, or two... or three... or more that shows an improving economy. They are wanting to see this, before they invest in equities and high yield bonds again.



Take a look at the graph above. It compares the total assets invested in money market funds (essentially a proxy for cash) to the market capitalization of the broad-based S&P 500 stock market index.

Note how direct the inverse relationship between these two assets has been, particularly since 1998. If you understand market history and the push and pull investor psychology has on prices you'll know why. Every time the market has been running upwards (a "bull market"), people pull their money out of their safe places and invest it. Conversely, every time a long and deep slide happens, investors start pulling their money out of their investments. Most of the investments are sold well after or near the end of the slide ("bear market"). The last bit of panic money exited in early March of 2009.

The most cash tends to go in just before the market peaks as investors chase performance. Conversely, the most cash goes out of the markets at or near the ultimate lows. In this way, the "cash in, cash out" graph functions as a kind of "fear gauge," measuring the amount of fear in the market. More fear means more in the mountain of cash.

You can see from the graph of the cash mountain, how extreme the fear has been during the current downturn. Simply put, there has never been another point in history where there has been such a dramatic shift in the ratio of cash to equities. That simply means opportunity to everyone who has cash to invest (or access to a cheap form of financing like a secured line of credit). The money will be made by those who are greedy when others are fearful.

This mountain of cash illustrates one of the strongest arguments for an eventual and potentially strong rebound in equities, particularly those equities that pay dividends, and as well, for investment grade corporate and high yield bonds that are currently paying high single to low double digit interest rates because you can buy them below their maturity values.

You'll notice in the graph that every time we've seen a similar mountain of cash holdings, there has been a market bottom. And it's easy to understand why it will happen again. This record level of cash is currently generating 1 to 3% return before taxes and inflation. Nobody is ever satisfied with this kind of meagre return for very long. Because of that, the money will move off the mountain soon. In fact, some of it already has.

The most successful investment managers in the world already have taken the cash in their portfolios and invested it in high quality holdings recognizing that the mountain of cash will avalanche, creating a tidal wave of rising investment prices.

Will there be further volatility? Almost certainly. Could the equity markets pull back? They most definitely will to some degree however that should be short lived as more and more signs of economic recovery create "green shoots". The mountain of cash will still be there and the longer time marches on the more courageous people will become with the paltry interest they are earning on their piece of this mountain of cash. Again, most everyone becomes courageous when it's too late.

It very much looks like we are at an inflection point. It is evident to me that the most financially successful clients of mine are starting to realize this, and they're entering the market before the majority of other investors move their cash "off the mountain. These people aren't successful simply because they have superior intelligence. That isn't it at all. It is their superior temperament. They stick to decisions they have made on investments that made sense in the past and they are opportunistic by making additional investments when the masses can't see the forest from the trees.

Over the past 22 years, I've noticed the following characteristics among the most successful investors and my most financially successful clients:

- They are contrarians. They don't follow the crowd. I've seen this evident most recently in the cash coming in from these clients. They are following Warren Buffett's advice, to become fearful when others are greedy, and greedy when others are fearful.
- They see opportunities sooner and they act quicker.
- They think longer term. They have a vivid picture of how they want their future to look, and they act today accordingly.
- They have more courage but they are not smarter. They are like everyone else in intellect. The difference is in their discipline to make what many would view as a bold decision.

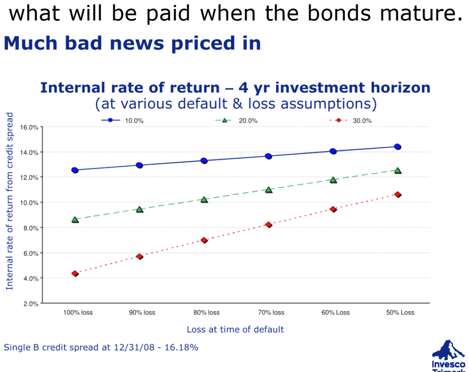
Getting back to that Mount Everest of cash. At virtually 0% interest it is only a matter of time before this money starts looking for a new home. Looking at Mr. Market's mood since early March, some of it has already and over time, there will I'm sure be more to come.

Get 5—13% Interest* On High Yield Bonds

Currently you can get a high 5—13% interest yield* on a relatively low risk portfolio of high yield bonds. Much of the new investment dollars I have seen come in are being allocated to this area and it's not coming in by a few thousand dollars per client. It's coming in in the hundreds of thousands of dollars at a time. It is so, not because high yield bonds simply sounds good but because they mathematically makes sense.

"Twenty years from now, you will be more disappointed by the things that you didn't do than by the ones you did do."
Mark Twain

These high yield bonds are selling for below their par or maturity value. This means you are buying the bonds at a discount to what will be paid when the bonds mature. Example: Recession Resistant Co. bonds. The bonds were initially offered to the public in 2004 at $1,000 paying 6% interest until 2012 or $60 of interest per year for each $1,000 investment. When the panic hit many people sold their RR Co. Bonds for whatever they could get for them and in some cases were willing to take as little as $550 for each $1,000 they invested in 2004. With the calming over the past couple of months they are now selling for $700 per $1,000. RR Co. is still paying the $60 interest. You as an intelligent investor can buy these bonds for $700 and the company now pays YOU the $60 interest. This works out to an interest yield of 8.6%. This isn't "too good to be true" just a buyers opportunity that a panicked market has created.



The risk you will lose money will ultimately be dependant on how bad the economy will get. If you strongly believe that we are going into a period where the Great Depression will look tame by comparison then holding cash is definitely the best option. In fact, I'd go further than that. Sell your home because that the value of that too will be greatly eroded as things get worse. However, if you like me and many others, believe that although this recession may get more painful, the chance of it getting Depressionary is not likely then I'd strongly suggest the following. Redeploy the cash you have sitting on the sidelines into a portfolio of high yield bonds. The combination of interest and capital gains you reap over the next few years could be in the low to teens per year. If by chance, things do get closer to Depression like than we expect then you should still reap approximately 4% per year over the next few years. That is a calculated downside, downside that is quite easily tolerable for most anyone. ***Morningstar**

A Guaranteed 5% Retirement Income For Life

If you are retired and depend on the interest you get from your bank deposits, bonds etc then I'm sure you are not especially enamoured with the rates being offered to you. The best 5 year GIC rate I can get for clients currently is 4.0% (as of June 9th). Rates for 1 to 4 years are generally in the 1 to 2% per year range although for my clients we can secure rates of 2.4 to 3.75%. However, no matter how you slice it, rates are simply too low for many people.

With the Bank of Canada saying they will hold their overnight rate at 0.25% until mid 2010 you either have to hold your breath as long as you can, which could be a few years still or look at other secure options.

First thing to consider is the tax on your interest income. For retired people this tax comes in 3 forms. Number 1 is income tax. For most people this will be somewhere between 20% to 44%. Number 2 are Old Age Security "claw backs". If your income is over $66,335, for each dollar of taxable income above that your OAS is clawed back $0.15. In other words, the OAS claw back is actually another 15% tax. Number 3 are probate fees. In B.C. most people will pay just under 1.4%. So, if you are in the highest tax bracket you are paying tax at a rate of 59% each and every year plus an additional 1.4% on your entire investment / estate when you die. Frankly, tax in the 60% range is highly excessive however, you don't have to pay that nor should you. All we need to do is structure things in a way where you can maintain 1) The Security of Your Money, 2) Stabilize AND Increase your Income PLUS, 3) Lower your Taxes significantly.

The most popular way to do this is using a Guaranteed Minimum Withdrawal Benefit (GMWB) plan. What you get is a guaranteed 5% income for life. It can definitely go up but it can never go down. Only a very small part of that income is taxable. Because of that you would be reducing or eliminating your OAS clawbacks. In other words, you would get more income from the GMWB plan AND you would be getting more in OAS every month. Also, because it is through an insurance company, you can name beneficiaries. Doing this allows the money you have in the GMWB plan to bypass probate when you die thus saving another 1.4%.

Another way to achieve similar results are through an insured annuity or what we financial planners call a "back to back annuity". The income you get for life can be higher than5% however you are giving up flexibility. The increased income, getting more on your OAS and not having to pay probate fees are all still there.

Currently there are 5 life insurance companies (I work with all of them) that offer GMWB plans and many more that do insured annuities. The world is your oyster. All you need to do is step onto the sand and you'll find many choices.

Save Thousands of $'s On Your Health Expenses

I've just finished spending a few thousand dollars on my teeth. The pain of paying is frankly more than the pain of getting the work done. Thankfully I have a Private Health Services Plan set up which has really lessened the financial pain.

I am self employed and pay for my own extraordinary medical expenses. Many of my clients are in the same self employment boat. Because of that, I thought I would AGAIN bring up why anyone who is self employed should have a PHSP set up.

Example: A self employed management consultant serves a variety of clients. He is the only employee of his company. His wife has chosen to stay home with their 2 young children. This year their family had 4 dental visits, a handful of prescription medications, 2 chiropractor visits, and one new pair of glasses. The total costs for these came to $3,400. With a 40% marginal tax rate and using the PHSP he saves $2,100 of tax in total** because he can pay the costs through his company. This is much better than having to take out $5,700 out of his company and pay the personal income tax of $2,300. He could only do this with a PHSP (**the $200 difference is the approximate administration costs charged by the PHSP).

Web Gems

MAPQUEST — may seem like a well known site, but seeing as we are entering the time of year when people tend to do a bit more travelling, particularly driving vacations, I thought www.mapquest.com was apropos. I recently used mapquest to plan an 8 day summer driving holiday. Although I have a GPS which will help when I'm actually driving, planning ahead using mapquest gives me a good indication of the driving times. Also, I can print out the directions and the map showing the whole trip. It also lets me get a satellite shot, which you can zoom in on, to get an idea what any particular area or spot looks like.

BIKELY— is a site you definitely will want to refer to if you enjoy cycling. Click on www.bikely.com and you can find a continually added to list of suggested routes for cycling, contributed by fellow cyclists. You can search by area and the distance you want to ride. Your search will give you a list of trips. Choose one with the kind of terrain you want to do (ie. Onroad, Smooth, Intermediate, Low Traffic, Urban). Click on the route and it shows the map of the area with a line showing where you will be cycling. My search in Vancouver listed 694 routes. You can narrow it down from there. Strap your bike onto your car, drive to the area and ride the route you've chosen. If you take a driving trip outside your own city, take your bikes with you and do a search on www.bikely.com when you get to your vacation destination. The world looks much different on a bike.

Hhhmmmmmmm......

There is currently an estimated $4 trillion U.S. in cash and near-cash sitting on the sidelines of the market, as investors wait for volatility to cool. During the Depression, the only cash available to the economy was that printed by the government. Advisor.ca, May 2009

A 5 year mortgage was 5.75% last November. You can now get one as low as 3.55%. (Globe & Mail, May 2009)

World oil demand this year will post the sharpest annual decline since 1981 as the economy struggles to bounce back, the International Energy Agency (IEA) May 2009

IRS statistics for 2006 show that 45 million households, one third of all tax filers, owed no federal income tax. This year, with the profusion of new credits in the stimulus package, about 65 million households (43% of all U.S. tax filers) are likely to owe no income taxes. (Tax Policy Center, a joint project of the Urban Institute and the Brookings Institution)

The median price in Los Angeles was $308,540 in February, down from $478,350 a year ago and $616,230 in February 2007. USA Today, April 2009

During the Spanish flu pandemic of 1918 to 1920, in which up to 100 million people died, the Dow Jones industrial average gained 83% from its 1917 low to its late-1919 high. Globe & Mail, April 2009

Behavioural scientists have found most people will tend to shy away from risk if they have suffered recent loss, even if the odds are strongly in their favour. Advisor.ca April 2009

Over the past 100 years there have been only three 10 year periods that have produced negative returns to investors, the last one being 2000—2009. The 10 years following the previous 2 negative decades produced exceptionally strong returns (Advisor's Edge Rport, February 2009)

In 2008 the average Canadian pension fund held 46% in equities, 29% in bonds and 25% alternative assets. "alternative assets," include holdings such as pieces of private business, infrastructure investments, commodities and real estate. Globe & Mail, May 2009

20% of U.S. households have only cell phones and no landlines. USA Today, May 2009

The amount of alcohol consumed by males is directly linked to the proportional increase of estrogen in the male body. CKNW, May 2009

Microsoft, which has a triple A credit rating and $25-billion in cash is planning to raise at least $3.75-billion more by selling bonds for the first time ever. Why? Just because it can. Globe & Mail, May 2009

With a 10% downpayment, mortgage payments for the average American are 13% of annual family income in the U.S. The previous low was in 1971 when it was 19% of annual family income. (CI Investments Conference Call, May 2009)

Over the past year (April 08 to April 09) food prices rose 7.1%. The biggest food price increases were for fresh vegetables, up 26%, fresh fruit, 16.8%, cereal products, 9.6%, and beef and chicken, both up 9%. StatsCan

Cloudless days are fine, but remember: some pottery gets pretty fragile sitting in the sun day after day after day. (Charles Swindoll referring to a life with long spells devoid of personal trials or adversity)

Carey

Chartered Financial Planner