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# mutual gains<sup>tm</sup>

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FINANCIAL PLANNING— INSURANCE— WEALTH MANAGEMENT\*

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### IT'S TURNING AROUND AND THE RESPONSE IS QUICK

Yes, the effects and fallout of the credit crisis that started with subprime mortgages in 2007 and its significance fully being realized in the last part of 2008, is still affecting the economy. You or someone close to you may have lost their job or at least seen a decrease in their employment income. We've also seen a few company bankruptcies. However, for many of us, other than the still negative effects that linger on all of our portfolio statements, it seems that people's lives in general haven't changed that significantly. This is despite the worst economic slowdown we have seen in over 70 years.

There are 3 key contributing reasons for that. First, a quick drop in borrowing costs to very low levels is facilitating refinancing activity and promoting new borrowing. The Canadian residential real estate market is "close to home" evidence of that. Home sales hit record levels in June and why not? At the lowest point you could get a mortgage rate fixed for 5 years in the 3.5% range. Second, the large and lengthy period of inventory liquidation is coming to an end. When the crisis started, companies quickly stopped or significantly reduced manufacturing their various products and simply sold what they had already produced. As the economy starts to grow again these companies will have to fire up their production to meet the increased consumer demand. The third driver is the increase in government expenditures, much of which will be geared toward large infrastructure-related construction (bridges and roads).

The first and most powerful contributor, ultra low interest rates, is what is fuelling this buoyant mood. It is the primary reason for the relatively low level of pain we have felt economically. This "cheap money" is encouraging people to buy homes, cars and other items, more so if there are additional incentives. This is reducing inventories leading companies to increase production spurring more hiring and lower unemployment. That starts the whole economic cycle over again. What about those low interest rates you ask? They may stay low for now however, only for now.

This cheap credit and its encouraging effects have been the catalyst for the significant upward move in several investment areas over the past few months. High yield bonds, as I have talked about for the last several months, have done very well (more about that in the next section). Equities, particularly areas that declined the most during the panic, namely bank and insurance company share prices, Asian and Emerging Market equities, mining and small company shares have experienced the biggest increases in the first 6 months of this year (approximately +20 to 40%).

The swiftest gains are always off the bottom, when people are most pessimistic, and that is exactly what has happened so far since early March. Markets overall should perform well through the fall as evidence emerges that the healing process is well underway however, there definitely will be some hiccups along the way so expect them.

### HIGH YIELD BONDS STILL HAVE A LOT OF APPEAL

I've talked about this unique and very compelling opportunity since late last year during which I have seen very large sums of money invested by clients, both whom I've had long relationships with and new clients who I have just starting working with. If you have cash still sitting on the sidelines, earning a very paltry rate of return I would like to inform you that the upside has only just begun in this area.

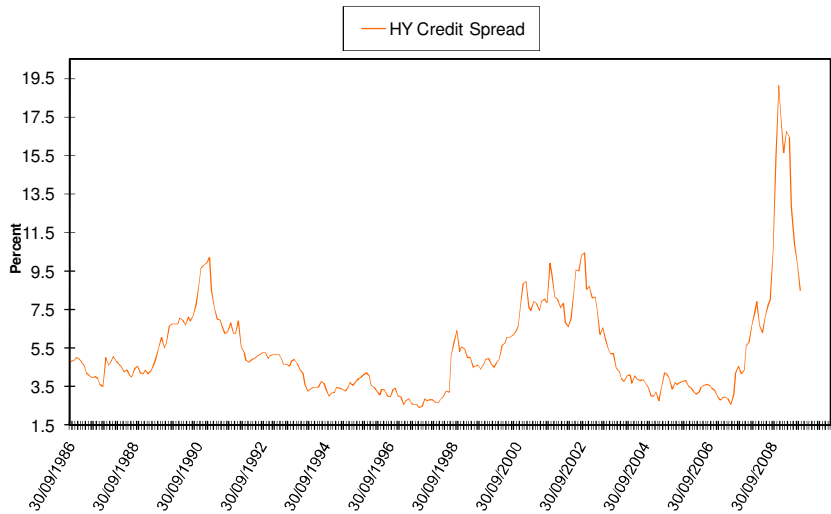
In the first half of this year the average High Yield Bond Fund earned a total return (interest and capital gain) of 16.9%. Despite high yield bond prices increasing in price over the past 6 - 7 months many corporate bond prices are still selling for well below

their par (maturity) value and paying very healthy rates of interest because of that.

The chart on the right shows the historic interest rate “spreads” between government bonds and high yield bonds. This is the amount of extra interest that a high yield bond earns over a government bond. As you can see the “spread” hit an extreme high at the end of 2008. It is still very high by historic standards compared to other peaks in the recessions of the past (1990 and 2000–2002). From that we can conclude that we are only at the beginning of very favourable returns for anyone who holds a diversified portfolio of high yield bonds.

As of July 31st 2009 interest rate spreads on high yield bonds was 852 basis points. In other words, as an example, if government bonds were paying interest at 3%, corporate bonds on average were paying 11.52%.

High Yield Credit Spread & Relative Premium



Source: Merrill Lynch, U.S. High Yield Master II Index & U.S. Treasuries 5 -10 Years Index

The biggest reason these bonds are paying such a high interest rate is simply because you can buy corporate bonds at less than their par (maturity) value. This discount is there because people are still concerned with bankruptcy risk. However, bankruptcy risk has been greatly reduced with the passage of time and the various government interventions.

Corporate Bond prices are up however virtually all are still selling for less than what you would get if held to maturity (par value). In the month of June alone bond prices have climbed to 80.27 from their June end prices of 76.47%. In other words, bonds that, when they mature will pay out \$100 are still selling for a discount. This means continuing price appreciation for buyers of high yield bonds along with a very healthy interest rate while you hold them.

Most investment managers that specialize in this area still see a great opportunity in High Yield Bonds. The average “Yield To Maturity” of the Index is approximately 12% which means the stage is set for potential returns in the low teens over the next 2 – 4 years.

*“We will be able to get quite powerful returns” Frank Naylor, Head of Investments at Hermes Pension Fund Management manager of BT Pension Scheme, largest pension fund in the UK*

Sources: Invesco Trimark, MFC (Manulife) Global Investment Management

## 2 MYTHS ABOUT PERSONAL FINANCE AND INVESTING

There are a number of misconceptions, fantasies and half-truths about getting ahead financially. Much of these myths are fed stealthily to us by the wild west of the internet and other information sources. These messages are dripped onto our minds and seep in over time, eventually leading us to believe them as the absolute truth. Here are 2 of them:

### Myth 1: Your investment performance is the main factor in the growth of your RRSP.

Reality: False. Your investment portfolio’s performance is the one factor over which we have the least control. The best way to increase your retirement kitty is more elementary and something you do have control over. Spend Less, save more.

Let’s say you earn \$50,000 a year and save 5% of your salary annually. Each year, you get a 4% raise. If your portfolio earns 10% a year, you’ll have \$651,000 in 30 years. Equities have averaged 10% or more a year in the very long term (US indexes, BusinessInsider.com). But the long term includes long stretches of poor performance. If you really need \$651,000 to retire, you shouldn’t bank on a 10% annual return. Better to assume a smaller return and save more rather than spending your efforts trying to get that hot investment which in fact can actually be detrimental to your financial well being.

*“I will admit that I was a mall rat at one time. I lived to find bargains. I loved going to the mall and hunting for sales. But then I had an epiphany. I realized that you never save when you spend.”*

*Michelle Singletary, Personal Finance, Washington Post*

### Myth: The more I know about investments, the less likely I am to fall for scams.

Reality: A study by Wise & Healthy Aging found the opposite was true for investors who fell prey to fraud. Victims tended to be more financially literate than non-victims. Why? Possibly because victims are often knowledgeable enough to feel confident about investing but not enough to detect scams.

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## TFSA—NAMING A BENEFICIARY CAN SAVE YOU PROBATE FEES

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With an RRSP or RRIF you can name a beneficiary on your plan. So is the case with a TFSA\*. If a beneficiary is named on a TFSA, the money will bypass the estate and be paid directly to the beneficiary. This means no probate fees (tax) will be paid which is particularly important in B.C. and Ontario as they have the highest probate fees in the country.

In the short term, there is no huge monetary benefit to naming a beneficiary on your TFSA... in the short term. As an example, if someone in B.C. were to die in 2009, the \$5,000 that isn't put in a TFSA would mean probate fees of 1.4% or \$70. However, assuming you put \$5,000 per year of money (ie existing investments) into a TFSA, over the long term the probate fee tax savings will snowball.

How can you use the TFSA most effectively if you plan on accumulating money in your TFSA long term? When long term growth investments, dividends, high interest investments etc (ie equity mutual funds, high yield bonds, principal protected notes etc) rather than paltry earning bank deposits are used inside the TFSA, the snowball "snowballs" that much faster. The tax and probate fee savings are that much greater.

\*So far only 4 provinces and one territory (Alberta, B.C., Nova Scotia, PEI and NWT) allow beneficiary designations on TFSA's. Ontario and the Yukon should soon be also.

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## CPP BENEFITS ARE GOING DOWN FOR SOME, UP FOR OTHERS

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Before I get a flurry of calls, I want to point out that if you are already receiving CPP, your monthly income will not change. The following applies to those retiring in the next few years... Or later.

I have said before in these pages and to many clients over the years, that there is an actuarial advantage to taking your CPP early. This advantage however will be disappearing in 2011.

If you are planning to retire after 2010 you will be getting less than what you may have originally expected. That is if you are retiring before age 65. On the other hand, if you plan on retiring after 65, you will be getting more.

CPP benefits are benchmarked by an age 65 retirement. They are currently reduced by 0.5% for every month before age 65 you start collecting your CPP. If you expected \$908.75 per month from CPP at age 65, for every year you start collecting, you will get 6% less (0.5% x 12 months). So, after 2010, if you start collecting CPP on your 64<sup>th</sup> birthday rather than at 65, you will get \$854 per month rather than \$908.75. The annual percentage reduction will now be 7.2% for each year you take your CPP early. At age 60 the total reduction will be 36% rather than 30% (\$6,979 per year rather than the now, \$7,633).

On the other hand there is an increased incentive to collect your CPP after your 65<sup>th</sup> birthday. For those, the benefits will be increased by 0.6% for every month they wait to collect. Wait until age 70 to collect your CPP and you will be getting 42% more rather than 30% with today's rules (\$15,485 per year rather than \$14,177).

Also, it used to be that you had to stop working for 2 months before you started collecting your CPP. That will not be the case after 2010.

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## WEB GEMS

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GOOGLE EARTH — In this age of technology everybody "Googles" but a much fewer number of people use Google Earth. [www.earth.google.com](http://www.earth.google.com) allows you to really see a specific location, any where in the world. It is a satellite picture of any place on earth. To illustrate, Cheryl and I had some friends of ours visit from Sprucegrove, Alberta a few years ago. They came around into our back yard and exclaimed, "That's what that big round blue thing was that we saw on Google Earth". That blue thing was a 18' round above ground pool. Most recently, I've been seeing how the topography on the San Juan islands look. I'd like to do some cycling there. In my reading I found that Orcas Island is the most challenging so I typed in "Orcas Island, Washington" and Google Earth zoomed in. With a bit of tweaking and I got a good sense of how the island's hills and valley's looked from various angles. I now know what I'm in for.

ULTRAMON— This isn't actually a website to use but rather software you can download. A while back we upgraded our office monitors to 22". Most recently however, I in particular, was finding that I needed more monitor screen space. Rather than get rid of my perfectly good 22" monitor I simply bought a second monitor. Downloading the Ultramon software at [www.realtimesoft.com/ultramon/](http://www.realtimesoft.com/ultramon/) allowed me to use the 2 monitors side by side, seamlessly. It feels like having one monitor but frankly, this is better. Also, it's cheaper to buy 2 modest sized monitors than 1 very large one. One caveat though. You do need special hardware installed in your computer to run 2 monitors on 1 computer. So, if you are in the market for a new computer, ask if it has that capability. I've found Dell to be a great help in that regard.

BERKSHIRE HATHAWAY— A few years ago I took a flight to Omaha, Nebraska to attend the AGM of BH. Warren Buffett, as always was readily willing to dispense advice and wisdom from his seat, taking sips of his Cherry Coke while a question was asked. There is lots of wisdom to be gleaned from the World's richest and most successful investor. Much of it has been written down in his annual "Letter To Shareholders". You can find these at [www.berkshirehathaway.com](http://www.berkshirehathaway.com) which is a very bare bones website. Simple and cost effective, just like Warren himself. I've read a couple of the Annual Reports over the years however I've been recently distracted by the reading of "The Snowball: Warren Buffett and The Business of Life".

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## HHMMMMmmmm.....

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The greenback (US dollar) has tumbled so far that it is now cheaper to produce steel in the U.S. than in China. (Fred Sturm, Mackenzie Financial's Executive VP and Chief Investment Strategist)

Within two years of retirement, 78% of former NFL players have gone bankrupt or are under financial stress, while an estimated 60% of former NBA players are broke within five years of retirement (*Sports Illustrated*)

3 of our largest non-bank enterprises earn the following share of their revenues in the US: Research in Motion (63%), Manulife Financial (62%), Potash Corp. (56%). (Dixon Mitchell, July 2009)

Currently, High Yield Bonds yield 9.44 percentage points above U.S. government T-bills. They averaged 5.36 points higher in the 10 years ended 2007. That means High Yield Bonds can generate further gains. USA Today, July 2009

Rex and his team believe we are still in the "early days" of the high yield story playing out and there are still opportunities to make sizable returns in this asset class. Invesco Trimark, July 2009

World proven crude oil reserves are estimated at almost 1.3 trillion barrels. Total world production stood at about 72.0 million barrels per day. At the rate of production in 2008, OPEC crude oil reserves are sufficient to last more than 85 years. (OPEC)

The U.S. imports more oil from Canada than Saudi Arabia. (Washington Post)

The first of the world's cheapest car, the Tata Nano hit the streets on July 17th. Automobile reviewers have compared it to the Smart Car and the VW Beetle. The car is produced in India. (Motoring)

A cell phone package that costs \$500 per year in Canada is \$131 in the Netherlands. Canada is the only OECD country to require cell phone contracts of 3 years. Everyone else is 2 years. In 2002 15% of the world's population used a cell phone. Today it is 60%. (UN)

Combining the GST and PST into the HST is endorsed by a ex-Prime Minister Paul Martin, the Fraser Institute, the Ontario Chamber of Commerce, The Forest Products Association of Canada, C.D. Howe Institute to name only a few because it encourages business investment and will make business more competitive nationally and internationally by lowering their costs. Also, when all has washed through the system, should be revenue neutral for the government.

Many beliefs of what are true are often based on a bias that is created by the culture a person lives and grew up in and therefore cannot be empirically confirmed that these beliefs are in fact true.

Will the "live for today" world view of many of today's teens and "20 somethings" (and even "30 somethings"), with their growing dependency on their parents, which we as parents have encouraged in the name of love, put them in a psychologically and in time, financially inferior position to their Non-Western World counterparts? That this will eventually span a new generation, one of "have nots"?

*"House don't trade like stocks, which tend to make U-bottoms,"*

*"Home prices tend to make L-bottoms".*

*Economist Ed Yardeni, Yardeni Research (New York)*



Chartered Financial Planner

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