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mutual gains™

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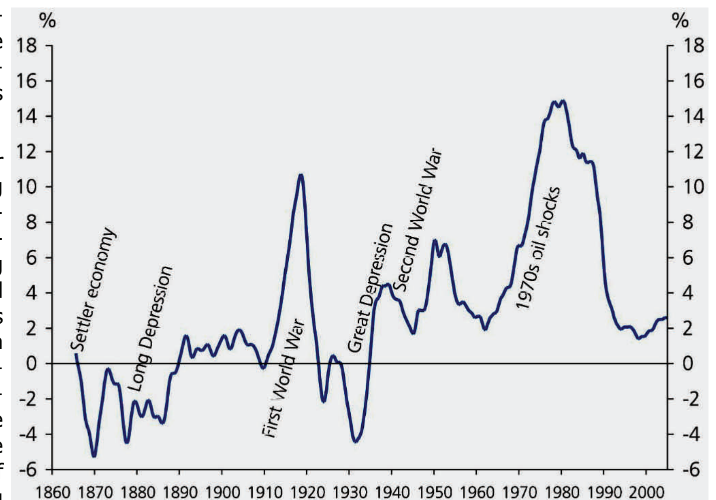
Inflation or deflation? The answer is .... "yes"

Despite the biggest economic crisis since the Great Depression of the 30's, central banks around the world have managed to create an environment in which just about every type of financial asset, stocks, bonds, gold etc has headed up with hardly a hesitation since early this year.

This "all boats are lifted with the tide" makes absolutely no sense from the viewpoint of standard investing logic. A big run-up in the equity markets like we have seen always signals an expectation of a strong recovery where company profits will increase. However, a surge in government bond prices, such as we've experienced over the past year, implies the exact opposite. It suggests buyers see a weak, faltering economy ahead and want the security that only government bonds can provide.

Things get even stranger. Bonds are supposed to be at their best during times of deflation. In contrast, gold is supposed to shine during periods of inflation as do many "hard assets". Investors as a whole expect both a strong recovery and a weak one, both inflation and deflation. And you thought you were confused? It's nothing compared to how Mr. Market feels which it seems is, baffled and unsure. Not about whether we are out of the credit crisis. That has definitely passed.

The confusion has more to do with the question of will we see inflationary or deflationary times ahead. This uncertainty isn't unfounded. There is a tug of war between two galactic events. First is the financial earthquake we felt from the shifting of the tectonic plates created by debt pressures have built up for many years. The second is the tidal wave of money created out of thin air by governments around the world. The first is deflationary. The second is inflationary.



Digging a little deeper doesn't prove anything either. The governments of the G20 nations seem to be saying that the situation is still dire and interest rates will remain low for a long time. That suggests buying government bonds is the smartest idea. On the other hand, the size of the stimulus spending suggests corporate profits will be boosted by a tidal wave of government spending. This will push up equity prices.

Yet another way to look at the situation is to wonder how countries will ever pay for the massive stimulus they're doling out. Rather than raise taxes to pay for it, governments may inflate away the debt they're running up. That would suggest that gold is today's asset of choice.

As you can see all three of these interpretations can be justified and their repercussions extrapolated into the future but all of them can't be right.

So is there any safe place in which to have your money? Well first, I believe as most do that inflation is inevitable. The government bond markets have recently softened and are starting to say that is what will happen.

Many would believe that the best way to protect against deflation and inflation is by holding high quality U.S. companies such as Johnson & Johnson, Wal-Mart, Microsoft, Nestle, Nokia and Coca-Cola. These name brand, highly profitable companies continue to get cheaper by virtue of their steadily improving financial fundamentals. In general they have low or very little debt (this is good during deflation or a very slow economy) and in many cases are sitting on wads of cash which they can use to buy up any of their smaller competitors. Also, they can boost their prices during inflationary times because of their strong footing in their respective markets and their sales and in turn, profits, are derived from selling right around the world rather than in just one country and currency.

These Will Provide Our Retirement Income

As the average age in the world increases, we will see an ever increasing appetite for income producing investments. This is currently being demanded from those age 60 plus in North America and other developed areas around the world. Yield or a monthly income on investments is what retired people (and you may be one of them) are looking for.

These investments must create stable income that will increase over time so as to offset the increasing prices (inflation) of the needs and wants of western world retirees. The investment areas that will fit this best are:

Blue Chip companies – companies with strong financial positions, the ability to grow their earnings and payout dividends. Companies that supply the products and services that we continue to use and need in our everyday living.

High Yield Bonds – in a rising interest rate environment (which will happen at some time) government bonds will actually fall in price. As I said already, this is starting to happen. Ironically, 4 out of 5 dollars being invested by Joe Public today has been going into government bonds. This could prove to be a huge mistake going forward. High yield corporate bonds offer much higher yields and if chosen intelligently will produce very healthy returns (high single digits) over the next few years.

Real Return Bonds - they say "bond" in the name but they are much better than a regular government bond, the bonds that so much investment money is going into now. Real Return Bonds have the principal amount you invested go up with inflation PLUS the interest rate paid is based on the ever increasing inflation adjusted principal of your bond. More on this in a future issue of mutual gains.

Commercial Real Estate – this is a "hard asset" most often participated in through REIT's (Real Estate Invesment Trusts). REIT's own office buildings, apartment complexes, shopping malls etc. Because real estate is a hard asset it will increase in value over time. Also, the rents on the properties will be increase over time as will the income paid out to investors in REITs.

Infrastructure – you will be hearing a lot more about these kinds of investments going forward. Governments are spending a lot of money building new highways, bridges, public transportation systems (including airports) and power generation systems. Many governments will go into a P3 (Public Private Partnership) with a corporate entity to pay for these projects. These companies will receive a portion of the income derived from them on a long term basis. This income that will continue to go up with inflation over the course of many years and will be paid out to investors in these infrastructure companies.

Two High Yield Corporate Bond Examples

I've talked about High Yield Corporate Bonds for the past 12 months almost without ceasing as it seemed to be one of the best areas to invest, particularly if you had new money to invest and were nervous about it's security. Those who heeded that advice and recognized the compelling nature of the timing of such an investment, have so far been very highly rewarded in the neighbourhood of +19 to +30% (Dec 1st 2008—Nov 30th 2009). Having said that, I want to give you some examples of evidence why, although big gains have been made, there are still very healthy returns available over the next 2—3 years for conservative investors and their savings account and GIC monies.

Whenever you make an investment you want to be confident that the company you are investing in will be around for the long term. When you are buying a piece of a company you want to make sure that the price being paid for the company's shares, after assessing all the financial metrics, is a cheap price if not, a very good price.

With high yield corporate bonds, it's definitely preferable that the company is around for at least the time during which you hold their bonds. However, what if the company fails? That is where deep analysis of a professional portfolio manager can determine what your downside would be and through that, sort out what bonds are low risk and which bonds aren't.

Here are 2 examples from one of the portfolio managers I use for my clients, the ones who have invested millions in High Yield Corporate Bonds over the past several months and since then have done very well.

The first example is the largest grocery chain company in Canada. Three years ago this company decided it should diversify by selling general merchandise in it's stores. It felt it needed to do that to compete with Walmart. The implementation of this was poor and thus their financial results started to look less than stellar. The companies share price fell and many who owned their bonds didn't want to own them anymore. Many sold the bonds they held in their portfolios for less than they would have gotten had they held them to maturity. They wanted their money out because many were questioning whether the company would survive the increased competition Walmart and their other competitors, were bringing.

The deep digging by the investment management team I work with found that the company's real estate holdings were significant and in prime locations. Also very important was this real estate was recorded on the company's books at historical cost, not what the real estate was all worth today. Crunching the numbers showed that the real estate value was between $4 and $5 Billion yet the total debt of the company was 90% of that. In other words, if the company did go into bankruptcy bond holders would quite easily recapture their bond value through the real estate.

The second example, a well known, name brand food company. This company didn't have the best financial statements which is why it's bonds were selling way below their maturity or "par" value. Like the first example, this company owns a lot of real estate, mostly farmland, in Hawaii, California, Central and Latin America. A bit of research by one of the investment management teams I work with showed that the average price per acre to completely secure the bonds was $18,000. The average price per acre over the past 10 years has been $15,000 at the low end and $50,000 per acre at the high end of the real estate cycle. If the company folded the bond holders would be completely covered and that doesn't even include the company's real estate holdings in Europe and Asia where their packaging is done.

As more and more people gain confidence about the future and find that their government bonds aren't giving them the interest income they need and actually seeing their government bonds fall in price due to rising interest rates, Corporate High Yield Bonds could prove to be the primary recipient of investors monies. The result will be increasing prices on Corporate High Yield Bonds. While you hold them you will continue to get a healthy interest payment.

IMPORTANT COMPARISON NOTE: The average High Yield Corporate Bond is paying almost 700 basis points (7%) more than a government bond and the average price of a High Yield Corporate Bond is approximately $85 (maturity / par value is $100). By contrast, the 3 biggest "short term bond funds" in Canada (Investors, RBC and TD) are earning an interest yield of 2.8% and virtually every one of their bonds is trading for above the maturity / par value. If you hold an Investors, RBC or TD short term bond fund I'd seriously consider a review of those investments for replacement.

You May Not Have Your TFSA Invested In The Right Place

The TFSA has been the most significant tax sheltered savings plan to come around since the RRSP in 1967. With all new things there is always a long learning curve. During this first year of the TFSA, people have tended to do the right thing by contributing to a TFSA. You take up to $5,000 sitting in your regular savings or chequing account and you start a TFSA. Every year you take whatever cash you have and stash up to another $5,000 into your TFSA. That may only be partly right.

To determine if you are being only partly right you have to ask yourself, 1) "What am I going to use this money for?" 2) "How long will it stay there?" and 3) "Will I be withdrawing all of the money in (insert answer from question 2) months / years?".

The "partial right" I've been seeing is the wrong investment being held inside a TFSA. Since many people have a chequing or savings account, the default investment for a TFSA is that same savings account. That isn't a bad thing but it really doesn't do as much good as it could.

Example: A "high interest" savings account currently pays 1.05% interest. $5,000 for 1 year earns you $52.50. Held outside a TFSA you would pay a maximum of $22.94 in tax (assuming you are earning over $126,000). So, if you put it in your TFSA you are saving a maximum $22.94. If you don't have any other investments (non RRSP) and you are going to need the money for a trip, furniture or a new car within the next 12 months or so then yes, the TFSA with a savings account is your best choice.

However, do you have investments that are outside your RRSP? If your answer is "Yes" then the strategy to use is this. Set up an annual, automatic transfer of $5,000 of your existing investments into a TFSA. The investments don't have to change. It is simply taking investments you already have and put it into a TFSA. Over a period of a few to several years you can SAVE THOUSANDS OF DOLLARS IN TAX rather than just saving hundreds.

Let's assume you have 2 investments, a High Interest Savings Account and and a High Yield Corporate Bond mutual fund. The savings account will earn 1 - 2% over a longer period of time. The mutual fund should earn you much more than that. Historically, that has been the case. You want the higher earning investment inside the TFSA.

Let's look at January 1st 2010 at which time you could have $10,000 in total put into your TFSA. The 2 options (as above) would look as follows:

ING Acct	$10,000 @ 1% interest	=	$100 interest	=	$40 tax
High Yield Bonds	$10,000 @ 5% interest	=	$500 interest	=	$200 tax

A TFSA is geared to saving tax on any investment earnings (interest, dividends and / or capital gains) you earn inside the TFSA. The higher the potential earnings on your investment the more a TFSA will save you in tax. Using up TFSA room with a savings account when you have investments (mutual funds, bonds, stocks, principal protected notes etc) outside your RRSP is not using the TFSA to it's full tax saving advantage. Make the change if you need to.

There Are Significant $'s Available For Disabled Members Of The Family

The Registered Disability Savings Plan (RDSP) has been available for almost 1 year and finally the snowball is starting in terms of the number of institutions where you can set one up and of course the number of people who are contributing to

an RDSP.

Yes, you need money... to be contributing money... to get money however, with the RDSP a relatively small contribution can get you a much greater contribution to your plan by the government.

First, let's look who qualifies first and then we'll get into the numbers.

To qualify, a person must have severe and prolonged physical or mental disability that entitles them for the disability tax credit under CRA guidelines. This includes blindness, the need to receive life sustaining therapy, being restricted in the basic activities of daily life such as dressing, feeding and walking or lacking the mental functions necessary for everyday life.

The amount that the government will contribute to an RDSP depends on income. If a person is under 18 it is based on their parent's income. Assuming that is the case, when income is less than $77,664 for the family, you can contribute $1,500 to an RDSP and you will get up to $3,500 contributed to the RDSP by the government through the Canada Disability Savings Grant and the Canada Disability Savings Bond. That is an annual contribution amount. They will pay that annually to the RDSP up until the disabled person is 49 years old. This is a potential total of $171,500 which you can get from the government.

The catch? Money can't be taken out of the RDSP for 10 years otherwise all the grant and bond money would have to be repaid. An understandable hurdle considering the amount of money being handed out.

Your Will—The Courts Can Change It

You know that Will you drafted? The one that left out or short changing a family member in comparision to the others you will be leaving money to? If you don't change your Will and it is contested by that family member, the courts could rebalance the scales so your estate is split up, in their opinion, equitably. That may make your blood boil simply hearing such a statement but those are the kind of changes being made in B.C. through the "Wills Variation Act".

Most of the conflict will show up in the contestation of wills of people who are in their second marriage. This is particularly true if the second marriage family is more heavily favoured in the will than members of the first family. Should any of the short changed members of the family contest your Will, the named heirs could find themselves faced with adversarial, upsetting and expensive litigation .

One way to help the case for your Will's instructions is to have memos documenting your reasons for any potentially contentious wishes you may have. Don't discount that. Intention carries great weight. It shows there is reason behind the way you have written up your will other than spite or revenge.

Could this be your situation? It may then be time to review and rewrite your will. There are other ways to ensure your wishes are carried out outside the Will. You should be looking at those because if you are relying on your Will as it is written, it may not be exactly adhered to, as it is written. In any event, seek the counsel of a lawyer when drafting it.

Giving Can Reduce Your Taxes Now And At Death

I've talked many a time over the past few years on how charitable donations can cost you virtually $0 when using the 1,2 punch of investing in flow through shares and then making donations to the charities of your choice.

But that isn't what I want to talk about here. I want to make you aware that charitable donations can also reduce your taxes substantially on the year of your death. This is most effective when you have assets that will trigger a taxable event and you don't have a spouse to pass those assets to on a tax free basis. These would include real estate other than a principal residence, stocks or equity mutual funds. Any capital gains investment you may have held for years and / or a RRSP or RRIF.

To achieve that tax reduction most effectively, an innovative clause called an "Estate Tax Eliminator Clause" can be attached as a codicil to your Will. The clause can instruct your Executor to calculate the taxes owing at your death as well as in the previous year, and make charitable donations just large enough to eliminate those taxes. The wording would ensure the majority of your estate would pass to your beneficiaries however the government's tax share would be replaced by the charities you want to support. Again, seek the counsel of a lawyer in doing this and if you need a name of one or two, let me know.

Web Gems

LIVING TO 100 — Ever wondered how long you'll live? Interestingly enough I find that when I go through a series of questions with a client in helping make Retirement Projections, most seem to think they won't live as long as what the averages say. Although we can't know for sure, we can at least make an educated guess.

That is where www.livingto100.com comes in. To discover your life expectancy you take a quiz. The website was created by Dr. Thomas Perls, the founder of the New England Centenarian Study which is the largest study in the world looking at Centenarians and their families. The results are calculated based on your personal habits and family history. You also get tips on how to add potential years to your life expectancy. Did you know that flossing your teeth can add an entire year to your life? I wonder. If I do it twice per day rather than only once will I add 2 years to my life instead of 1? Hhhmmm...

Hhhmmmmmmm……

The Dow Jones industrial average has topped 10,000 for the first time in a year. The Dow crossed five figures seven months after it hit a 12-year low of 6,547.05 on March 9 2008. USA Today email bulletin, October 14th 2009

At the end of October 2007, the 5 year average annual return of the S&P/TSX Index was 21%. 16 months later, at the end of February 2009, the average annual return was only 1% per year. Yet, the two 5 year periods share 44 out of 60 of the same months. (National Bank, July 2009)

Let's imagine that you had bought gold at its peak in 1980. Your cost? US$850 an ounce. A short time later gold prices plummeted to around US$350 and stayed there for the next two decades. Even if you had bought gold for US$350 an ounce in the early 1980s, you would have made no money on it for 20 years. Factor in inflation and you would have lost close to half your purchasing power. Long, long term? If you had bought gold between 1415 and 1765 or so, you would have to wait until around the mid-1960s to be back to even in terms of purchasing power (inflation). Globe & Mail, November 2009

There are hundreds of out-of-operation container ships and oil tankers moored in international waters off the coast of Malaysia. 1 year ago oil tankers were leased out for $72,169 per day. In the beginning of this year it was $42,188. Today it's $24,633 because of the "Great Recession". Globe & Mail, Oct 2009

Detroit had an auction to sell over 3,000 homes because of property tax non payment. Despite a minimum bid of $500, less than a fifth of the Detroit houses and land were sold after four days. Washington Post, Oct 2009

More than 127 banks have gone under in the U.S. this year, and I expect 300 to 500 to become insolvent over the next 12 months. Compare that to 10,000 failed banks during The Depression. (Benjamin Tal, CIBC Senior Economist, Nov 2009)

1 in 4 U.S. homeowners owe more on their mortgage than the properties are worth (Manulife)

59% of Canadian employees would have trouble making ends meet if their paycheque was delayed by even 1 week. That adds up to 6 out of 10 working people. Advisor.ca

The typical home in Canada right now is about 12% overpriced. The most likely outcome is a soft landing and stagnation of home values over the 2011-13 time frame. TD Economics, Pascal Gautheir

The costs of private residential care range from about $4500 per month up to over $7,000 per month, based on size of suites, location, services provided, and the market being targeted. Diamond Geriatrics

Tim Hortons now has more than 500 stores in the United States. Globe & Mail, Oct 2009

Based in Vernon, Kal Tire, a family owned private business is among the 5 largest tire retailers in North America. Globe & Mail, Oct 2009

Saskatchewan is the new Alberta. This year's top-ranked entrepreneurial city in Canada is Saskatoon. Saskatoon has also experienced its largest population increase since 1952. Financial Post, Oct 2009

Early morning on October 13th the cost to buy 60 litres of gas in South Surrey was $61.14. In the U.S. it was $48.25 Canadian dollars.

If you think the U.S. is a graveyard when it comes to investing all you need to do is look at Warren Buffett who made his biggest purchase to date in Burlington Northern. As he put it, "it's an all-in wager on the economic future of the United States." Globe & Mail, Nov 2009

"Buying 100 shares of a stock is like buying a piece of a business. If I don't know enough about a company to buy the whole business, I don't know enough to buy 100 shares." Warren Buffett

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