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mutual gains™

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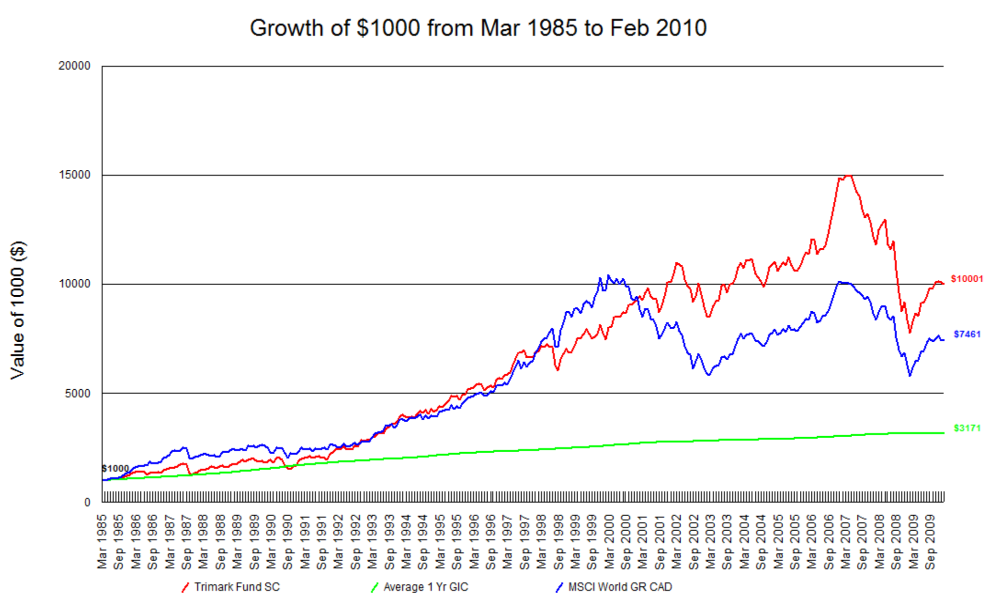
The Past 10 Years Have No Bearing On The Next 10

There's no question returns in the first ten years of this century have been a giant disappointment. Two significant down markets from two bubbles bursting seldom happens in the same decade. At one point, namely the end of December 2009, equities were down 24% over that 10 year period.

Clearly, when the long term average return of equities has been closer to 10% a year, suffering flat returns or even a loss over 10 years makes you wonder if times have changed.

It's human nature to worry that the most recent 10 years might somehow predict what's ahead. Projecting that the future will be the same as the present into infinitum is often done. It's been done by the masses as well when the previous 10 years have been absolutely beautiful. In both cases, it cannot be assumed that the past 10 years will produce anything close to the same results for the next 10 years.

Let's look at what you have done, the things that are within your control. You've saved habitually. You've invested in historically sound investments. You've diversified to reduce risk. You've been judicious and prudent with your financial house. You have correctly



managed everything in your control. What you could do, you have done right.

Now, it's time to have confidence in your plan and stop worrying about things that are out of your control. You can't control the economy or the business practices of banks. Don't let market volatility spoil your sound habits and your foundationally solid plan.

By owning a portfolio of equities, you own pieces of companies that have an infrastructure that would take a new company in its field, decades to replicate. These companies have significant amounts of money invested in their expanding businesses and reap profits as a result. Sometimes companies' profits are hit by unforeseen external events. But unless you think the end of the world is near, these companies' eventually will generate positive returns. Why? Because you and I and people around the world use the products and services these companies supply, in our everyday lives. The global population is growing and we will continue to need and use banks, gas, cars, electricity, food, clothes, pharmaceuticals, our computers, tv's, phones, alcoholic beverages, various entertainment etc. for years and years into the future.

Here's a fact to consider: Even with the many bear markets investors have suffered, equities as a long term investment have been extremely lucrative. Real returns on equities, adjusted for inflation, have been an attractive 7% annually over the past 200 years. Had you invested $10,000 in 1802 your investment in an equity portfolio would be worth $4.8 billion in mid-2009. That's billion with a capital B.

That blows away just about every other asset class you can imagine. That same $10,000 invested in U.S. T-Bills would have been worth just $13.5 million in mid 2009 (that's million not billion). How about gold? Isn't gold a good investment? Your $10,000 investment in 1802 would now be worth just $26,000, adjusted for inflation.

Will stocks continue to deliver nearly 10% average annual returns? Maybe yes maybe no. Even so, equity investments will continue to be the best way for investors to protect their money from the ravages of inflation as they have proven to do for 200 years. If prices go up those companies you have invested in will go up too. It just won't be in a straight line. It's quite elementary really. Source: USA Today, Feb 2010 Morningstar Analytics, Feb 2010

A Look Back Over The Past 12 Months On The Stellar Returns Of High Yield Bonds

Just 12 months ago corporate bonds were priced for an expectation that the economy was going to be worse than the 30's and with that more companies would go bankrupt than during the Great Depression. Because of that fear, many corporate bonds were selling for less than 50% of their maturity value. Since then, yes, default rates on bonds did increase as was expected during any economic contraction, but no where near the 30% that the market was fearful of.

To refresh your memory on how ridiculously cheap you could buy corporate bonds for, here are a few snippets from a piece I wrote last March in MUTUAL GAINS Issue #130…

"Assuming 30% of the companies held within a bond portfolio (where substantial work has been done in assessing credit / default risk for each of the corporate bonds held) are forced into bankruptcy (and there is 0% recovery on the bonds (100% write off and a scenario almost twice as bad as the Depression), an investor will earn a little over 4% per year over the next 4 years. Any scenario more positive than that will produce a higher return. With this kind of thoroughly analyzed default risk you can sleep and know your investment should be more than just okay."

"I am convinced the "intelligently bold" who uses the cash they hold, will benefit greatly."

This is exactly what happened for the clients of mine who invested in high yield bonds throughout 2009. The past 12 months (Source: Morningstar, to Feb 28th 2010) saw their investments increase in value (interest and capital gains) by 21.2 to 31.7%, all of which are still enjoying the ride.

So where are we now? The economy is improving and corporate balance sheets are improving. 3 months ago Moody's said that the peak in corporate bond default rates globally had passed at just 13% and that they were to decline sharply with the improving global economy. As of the end of March the global corporate bond default rates were down to 9.9%. The best is yet to come however. It is believed that the default rate could fall to just 2.8% by the end of 2010 and continue to fall in 2011. Despite all of that, banks are still not lending as freely as they used to. This equates to a continued great environment for investing in corporate bonds where you can currently get a very attractive interest rate AND potentially MORE capital gains on top of that.

PS. I invite you to review the articles I wrote why High Yield Bonds were expected to produce such excellent, low risk returns. You will find them in previous MUTUAL GAINS issues, namely #129, #130, #131, #132, #133 and #134 (or go to www.careyvandenberg.com/mutualgains.php)

Inflation Linked Bonds— The Inflation Protection Alternative To A GIC or CSB

There are billions of dollars currently in bank deposits and various forms of government debt (bonds, T-bills, Canada Savings Bonds etc). As interest rates rise to offset rising inflation, these "investments" will lose purchasing power. With food, gas and other staple product prices going up because of inflation, you'll want your investments to keep pace. That's where Inflation Linked Bonds (ILBs) have a distinct advantage over that bond or bank deposit you may currently have money in.

ILB's are set up so that the principal amount you receive back at maturity is the inflation-adjusted equivalent of the principal amount originally invested. In other words, the principal amount will go up with the general rise in prices. That is the first part of the equation. The second part is the interest. This you will receive each year and it's based on the ever increasing principal amount.

Let's use an example of a $100,000 principal amount and 4% interest on a ILB. Let's also assume your interest is paid annually to keep it simple.

Here's the first part of the equation. If inflation over the next year is 2.5%, your principal amount is adjusted upward to $102,500. That is what your investment is worth now, PLUS INTEREST. As long as inflation keeps rising, your principal amount will keep rising.

The second part is the interest you will receive, this being 4%. This interest rate will however be based on the inflation adjusted principal amount which after 1 year in our example is now $102,500. The interest in dollar terms is has risen to $4,100. By contrast, a regular bond, GIC or CSB would keep paying you the $4000. If prices rise but your interest stays the same it becomes quite evident that you are actually losing purchasing power.

Because ILB's are continually adjusted for inflation and the interest goes up on a compound basis in relation to that, RRB's are a conservative hedge against what could prove to be a rising inflation environment in the years ahead. When you compare them to most other Bonds, CSB's and bank deposits, ILB's are superior in the long term.

The Negative Effect Human Nature Has On Pursuing That "Great Deal"

Watch the news reporting on the long line ups at the border on a weekend and we can easily see people like deals. Those elusive deals so many strive to grab may actually be costing more than the deal seeker realizes or may really care to admit. Here are 5 reasons why you may be worse off in the quest to buy cheap:

- Most people assume unconsciously that buying things at a discount involves trading off quality for price. So, the less you pay for an item, the less you value it. The less you value it the less likely you are to take care of it. As a result, cheaper things, even if they are of high quality, will often wear out and break more quickly because we don't value them as highly. When that happens we justify it by a dismissing, "No worries. It was cheap".
- You travel a great distance to get to a store touting highly discounted prices. Visiting the retail outlet however demands an investment in time and gas. You justify the extra time and effort you spent on getting there by buying more than you normally would if it was closer to home.
- You buy an item because it has a money-off rebate, adjusting the price in your mind, even though there is a good chance you won't go through the trouble of trying to collect the rebate. Companies know this oh so well. Only 5 – 10% of people entitled to a rebate actually jump through the hoops to collect them. Also, the longer you're given to redeem a rebate, the less likely you are to do so.
- You can't resist buying items with rebates that refund the total cost of the purchase, even though you know deep down nothing is really free. Getting a free cell phone means you're locked into a rate plan for a few years. Even free servings of food can be cost you. Research shows samplers are very likely to buy the product they are sampling.
- We often convince ourselves that cheap goods are made to the same standards as expensive goods. But as big retailers demand ever lower prices, manufacturers have no choice but to cut corners and move their operations to low-wage countries that are notorious for substandard quality.

Source: CHEAP—The High Cost of Discount Culture, Ellen Ruppel Shell

Insuring Your Kids Can Save You Thousands In Tax

I am not an advocate of buying life insurance on ones children's lives. Sure the premiums are cheaper the younger the age of the life insured however life insurance is, in most cases, used to manage the big risks of an unexpected event and its financial repercussions.

That is, as I said, in "most cases". There are however significant tax benefits to buying life insurance on the life of your children (or grandchildren), namely the "cascading life insurance" variety.

Life insurance has characteristics that make it unlike any other financial tool at your disposal. The 2 key features are; a) life insurance proceeds are paid out tax-free when the insured person dies and b) you can accumulate investments inside a life insurance policy on a tax-sheltered basis, similar to your registered retirement savings plan (or a TFSA). Upon your life's expiration, both the face value or insured amount and accumulating fund inside the policy are paid out tax-free to your heirs.

The "cascading" ability is in subsection 148(8) of the Canadian Income Tax Act. This "law" allows you to transfer ownership of a life insurance policy to any of your children (natural, adopted, grandchild, step-child, or a son or daughter-in-law.), TAX FREE. That child must be the life names as the insured under the policy.

This idea makes sense when you have money you don't plan on spending in your lifetime and you want to transfer those assets to the next generation completely free of tax and probate. This can be continued for generations allowing it to "cascade" tax free.

Here is an example which starts with Ron who is 68. He has $100,000 which he won't need for retirement income. Ron however absolutely hates continually paying tax on the interest, dividends and capital gains his money triggers. Probate fees is also something that Ron wants to avoid. These "fees" (it's definitely another tax) would normally be triggered when the assets are transferred to his 39 year old daughter Jennifer and ultimately to his 5 year old granddaughter Ashley.

Ron secures a permanent life insurance policy and deposits the $100,000 in $20,000 increments annually over a 5 year time frame. Ron is the owner of the policy, but he named Jennifer as the contingent owner. The life insured on the policy is his daughter Jennifer's life, and Ashley, his granddaughter, is the beneficiary of the policy.

When Ron dies, Jennifer will become the owner of the policy and thus will own the investments inside the policy. It will have passed to Jennifer free of tax and Ron's estate wouldn't have paid any probate fees. She can choose to use the investments for her own purposes or she can have the whole policy eventually go to Ashley. To do that she would put Ashley as the contingent owner on the policy.

To ensure the tax free transfer of the policy at the time of death 2 things must be in place. One is naming a child as contingent owner on the policy, and another (or the same child) as the life that is insured. Second, the child who will be receiving the proceeds must not be paying anything to receive it.

The "Cascading" strategy can allow you to: Transfer assets to the next generation without giving up control during your lifetime; eliminate current taxes in your hands on the money deposited into the policy; eliminate taxes and probate fees upon death on those assets; and provide you with access to the funds in the policy if needed.

Home Ownership May Not Be The Best Thing For A Retiree Needing Income

The first option many people looked at in years past has been the Reverse Mortgage. These have been advertised on T.V. and on the surface look quite enticing. I however am not a big fan of them. The borrowing costs you are charged are much higher than regular mortgages. Also, the interest costs compound so the longer you have a reverse mortgage the more likely it is you will eat all of your home equity. That's an expensive price to pay for some extra income. There are however, other options.

Most people would agree that over the long term owning a home can form a "foundation" in retirement planning. It acts as a forced savings plan and the gains are tax free. That may be good for someone building their equity by saving and investing however, when needs change to one of producing retirement income, the house is a good place to look for creating that income. Retirees don't need or necessarily want more equity. Most often, they want more income.

Suppose a client couple aged 65 sells a $600,000 house, whose ongoing costs (property taxes and utilities but excluding major repairs) are $8,000 per year. They find a condo or townhome to rent for $1,800 per month ($21,600). A 5% minimum guaranteed return on the $600,000 would generate $30,000 of income ($24,000 after tax). With no ongoing home ownership costs a retiree now has an extra $10,400 of income every year.

That advantage doesn't stay there forever as rent will rise over time although so will those . Assuming 3% inflation (which would make that $8,000 of ongoing homeownership costs go up) it would take 17 years before your extra income advantage is even should you have stayed in your own home. In other words, it wouldn't be until you were 82 that your income would be the same (adjusted for inflation) as if you didn't sell your house today. That is 17 years of having more income than you would have if you did nothing.

Of course, there are lifestyle issues that one can't put a price on. Some like tinkering on their homes. That would leave your more time to do other things however that may be a negative for you. There may be extra space in your owned home which you may not have with a rented home. Neighbours you would have to leave behind if you sold your house. A rented home means a landlord and maybe a strata council that says what you can and cannot do. However, in renting you may find yourself in neighbourhood that has more of a community feel than in your current home. There are a lot of things to way out however, if extra income is desired or needed then that decision might be easy for you.

Web Gems

AMAZON— I have used ebay.com a lot for smaller household things like batteries, shaver parts, various electronic cables, parts to repair an ipod and even a pump and filter for our pond in the backyard. I've fairly recently discovered that www.amazon.com is not just for buying books. It's an amazing resource for sourcing hard to find larger items. Earlier in the winter I finally threw out my 28 year old snow boots. I wanted to find an equally good pair of boots and as my wife Cheryl will attest, when I want something I usually have a clear picture in my head of what I am looking for and won't settle for anything far from my picture. I finally found my picture, a pair of Helly Hansen snow boots, for a very reasonable price with free shipping.

Hhhmmmmmmm......

The cash holdings on the balance sheet of 103 publicly traded companies in Canada has more than doubled over the past 5 years. Investment Executive, January 2010

All the gold every produced (approx. 146,056 tonnes) could fit into 2 Olympic sized swimming pools. (Mackenzie Financial Corp.)

The S&P 500 has a PE (Price to Earnings) ratio of 15 based on expected 2010 earnings. This is well below the 19.4 long-term average. USA Today, January 2010

The last time U.S. government debt was this high compared with gross domestic product (70.4% of GDP) was immediately following World War II. After that time, the economy faster than the debt, pushing down the debt-to-GDP ratio and making debt payments easier to manage. But that generation also did some things that U.S. citizens and politicians don't seem willing to do today, that is pay higher taxes and have a smaller government. USA Today, Jan 2010

The Washington Post took a survey of the most recommended stocks at the end of 1999. Included in this list were America Online, Worldcom, and Lucent Technologies. This hypothetical composite portfolio didn't fare too well over the past 10 years. In fact, if you had allocated $100,000 of your hard earned dollars to the list, you'd have about $291,000 today. The Wall Street Journal also had a list of top stock picks at the time. Investing in that list at the end of 1999 you would have only lost half your money. Dixon Mitchell Investment Counsel

The number of Canadian homeowners in arrears has risen to a 7 year high. Those in arrears are households who have gone 3 or more straight months without making a mortgage payment. Canadian Bankers Association, February 2010

While consumers in some of the world's most damaged economies are cutting back in their borrowing, Canadian households continue to pile on the debt. Investment Executive, Feb 2010

There are currently 181 electric cars and trucks on the road in Hawaii. It is projected that by 2015 there will be 10,000 and in 2020 there will be 43,000. Honolulu Advertiser, March 2010

The cost of a new team in the IPL, the Indian Premier League (Cricket) is expected to rise to $500 million next year. That would make a new IPL team more valuable than the most expensive NHL franchise, the Toronto Maple Leafs, which is worth an estimated $470-million. Globe & Mail, March 2010

Over the past 184 years Greece has spent 92 years of those in default (bankruptcy). There have been long periods since 1800 that half of all countries defaulted on their debt at the same time. The most recent significant default period was 1980 – 95 when 20% of countries worldwide were in default. Globe & Mail, March 2010

Office vacancy rates have increase substantially over the past 12 months and are now 29.3% in Detroit, 25.3% in Austin, 25% in Palm Beach Count, 24.5% in Phoenix and 24.3% in the Inland Empire (Calif). CB Richard Ellis North America Office Vacancy Index

A client of mine who lives in B.C. has been off of work for 2 months due to pinched nerves in his back. This has been very painful. He was told that he must wait almost 3 months to get a public MRI and over a year for an operation. They classed him as "semi-urgent". He just had surgery at a private clinic. Total costs were $825 for the MRI, $500 for the surgical consult and $6,100 for the operation and overnight stay.

Carey

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