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mutual gains™

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IF YOUR PORTFOLIO IS "TEXT BOOK" IT ISN'T SAFE

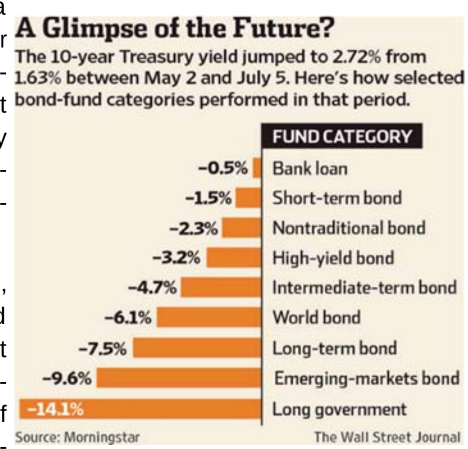
If you go into your bank and sit down with one of the "advisors" there in the branch, you could very well get recommended a traditional, text book and to some degree "cookie cutter", balanced portfolio. This text book portfolio is normally comprised of 60% equities and 40% "fixed income" (I'll explain what "fixed income" is in a minute). Often however, a portfolio with even higher weighting to fixed income is recommended with the objective of making it even more conservative. That may sound OK, but I'll explain why it isn't.

The text book view of a more conservative portfolio is to have a lot of what we in the investment world call "fixed income" investments. To make a portfolio as conservative as possible, that "fixed income" is often primarily comprised of government bonds including "real return" bonds (bonds with built in inflation protection).

What we have seen over the past couple of months is initial, strong and real evidence of what happens to these perceived safe, traditional "fixed income" investments in an improving and growing economy, one where interest rates go up (even if that eventuality will be slow and sometime well in the future).

From May to early July of this year, Long term Government of Canada bond prices declined by 14% with Government of Canada Real Return Bonds falling around 10%. Non-traditional fixed income investments and high quality "dividend growing" companies in comparison, weathered those few months quite well.

Over the past 30 plus years interest rates have trended downward with short bouts of rising rates sprinkled into this long term interest rate decline. This cycle, which started when I was still a teen, has been bouncing at or near the bottom over the past 5 years. Because bond prices go up as interest rates go down, this has produced very good looking returns on these traditionally considered, low risk "fixed income" investments.



With interest rates falling for so long, many people have never lived through a long cycle of rising interest rates. A rising interest rate environment will have the reverse effect of what has been experienced. A balanced portfolio that is text book or simply a cookie cutter to make creating portfolios easier, can inflict significant damage on what is supposed to be the safe side of the investment portfolio.

The secure way to diversify a portfolio is more to dividend growing companies and non-traditional fixed income and alternative investments, much the way a very well run pension plan or the Harvard University Endowment Fund is built. That means having much less in traditional fixed income.

I believe that safety lies in a portfolio weighted more to a selection of high quality companies; companies which over time, will grow their earnings through selling more stuff to a growing middle class, global population. That will mean increasing their dividends with increasing share prices as the inevitable, long term byproduct.

Inflation and higher interest rates will rise again. This is the arch enemy of traditional fixed income. Those who have traditional balanced portfolios, will see their 40% or more, traditional fixed income portion of their portfolio, drag down the positive returns of their equity portfolios for an overall portfolio return that will be mediocre at best.

P.E.— One Way To Calculate The Value Of A Company

When you buy shares in a company you are buying a part of that company. When people are optimistic, they will pay more for any given company. In some cases much more. When they are downright scared, they sell en masse and often sell a perfectly good company for much less than a company is really worth. It doesn't really make much sense however that is the downside of having something you can sell so quickly and easily.

But how do you actually know how much a company is worth? To know this is vital because investing isn't buying some intangible asset. Investing in shares of a company is really becoming a part owner in that business. Because of that, it's important to look at a company assuming you had enough money to buy the whole business.

There are several measurements used to value a company. The most common one is "Price to Earnings" ratio or PE. This tells us how much is being paid for each dollar of a company's profit. The PE Ratio helps to gauge the relative "expensiveness" of the company's shares. A low PE means you are getting more earnings for less money.

On the surface, it may seem intuitive to try a company that has the lowest PE ratio. Unfortunately however, you could still see the price go down significantly if the company's survival is in question (ie Blackberry) or if its future profitability changes (ie an oil or gold company whose profits are based the price of a commodity).

Likewise, another company's shares may look expensive now but may prove to be cheap because it's expanding its market share on the products and services it sells, thus its earnings could grow quite quickly. As well, a company that has and most likely will have very stable earnings based on its history and which has a strong "brand", will translate to people willing to pay a higher PE (price) for it's shares.

PE is one of many ways to calculate the value of a company. PE is much like valuing a piece of residential property simply on net income (rent after paying all expenses). If that was the only determining factor, property prices in virtually any small city would be considered to be a screaming deal because the rent is high considering it's price. However, the rent isn't as stable in a small lumber or ski resort location as rent is in a more diversified, big city. So is the case with a smaller or more cyclical company that has a low PE. So, if you are just using PE as a measuring stick, your investment could be underwater for a long, if not an indefinite period of time, should things in the investing environment change.

Bank Deposit Versus Insurance Company Deposit

We are all familiar with how a bank deposit (GIC) works because there are bank branches everywhere. The fact is many are forgoing insurance company deposits (GIA) which are actually far superior in may respects. These include:

Beneficiary Designation— when you do a GIA with an insurance company you can put exactly who you want the money to go to should you die prematurely. Because this money doesn't go through probate there are no probate fees. With a bank GIC, you will have to pay probate fees (in B.C. that fee is1.4%).

Privacy— because insurance company GIAs don't go through probate the beneficiaries in the Will won't be able to see who you gave that deposit to. That isn't the case with bank GICs, as those can be seen by any of the beneficiaries of an estate.

Pension Tax Break— insurance company GIAs are eligible for the pension tax credit and qualify for the 50% income splitting. This isn't the case with a bank deposit.

Deposit Protection— both insurance company and bank deposits have guarantees up to $100,000 if the institution runs into financial difficulty.

Redeemable— unlike a bank deposit, you can get your money out at anytime during the term. There is an adjustment made (much like breaking a mortgage) but at least you have a choice with an insurance company GIA.

(Continued from page 2)

Creditor Proof— The money that goes from you to who you want it to can't be grabbed by creditors should the recipient of your money be going through financial difficulty at the time. You don't get the protection with a bank GIC.

As you can see, an insurance company GIA is far superior in many ways in comparison to a bank deposit. Along with all of those benefits, you will get interest rates that are in line and often higher….. than bank deposits.

It May Be Time To Dump That Old Life Insurance Policy

Do you have a life insurance policy that was sold to you when you were a young adult, were just married or when you were just starting your family? I continually come across clients who have these old, neglected insurance policies, simply paying them month after month, year after year. Virtually every time I come across these old policies I find that there is no need to pay for them any longer and that the cash should be reallocated to a better use.

If you have one of these old life insurance policies it is either a "whole life" or "universal life" policy. What this means is that you are paying a fixed amount per month, part of which is used to pay the life insurance, the other is a savings or investment component. 2 parts, 2 purposes. One was filling the need for life insurance coverage, the other was really a forced savings account. So why did you buy this policy in the first place?

One of the unique features of a whole or universal life insurance policy is that you can save money inside an account and pay no tax on the interest, dividends or capital gains. This is much the way a TFSA works today and you didn't have the TFSA option back then.

The drawback in having life insurance attached to your forced savings account is, if you have no need for life insurance any more, you have to keep the life insurance part in tact to enjoy the tax free savings part.

With the TFSA (which came into effect in 2009), it could very well make sense to dump that old life insurance policy, take the proceeds of what you had accumulated (the "cash value") and put the money into a TFSA. This of course assumes you don't need the life insurance coverage anymore. There may be a bit of tax to pay on cashing in your old life insurance policy however this one time cost will quickly be offset by the ongoing cost saving of eliminating the cost of life insurance you no longer need.

Note: With any life insurance, I strongly advise having a Financial Planner look at it in the context of your situation, before you make any changes to it, ones that could prove to be permanent. It could make sense to keep it.

The Gradual Inheritance

How do you feel about all of your money going to your children in one shot after you pass on? Do you have 1 or more adult children who you think can barely handle their own finances? That they'd completely burn through an inheritance in a relatively short period of time? If so, here is an idea to solve or at least alleviate that potential problem.

The gradual inheritance idea gives you the ability to tailor how your beneficiaries will receive their inheritance. Instead of a lump sum going to them, an income stream could be paid to them instead and for a relatively long period of time. This applies to a charity as well. Instead of the charity receiving a lump sum amount of cash you could spread the donations from your estate over a period of several years. Normally you would have to set up a formal trust to do this which would mean initial and ongoing costs, however here is an example of how it could be done more easily.

You've added up your assets and calculate that your 2 kids will get approximately $1 million after your house, investments, RRSPs or RRIF's are sold and cashed out. You are OK with 1 of them getting their inheritance shortly after you pass on but you shudder at the thought of what the other will do.

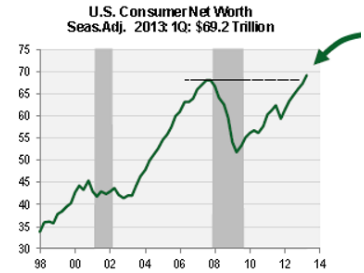
In your Will you can ask that a "Term Certain Annuity" be purchased for 50% in the above case. You can stipulate the length of the term and your financially scary adult child will simply have an income for that amount plus interest.

Web Gems — CAA.CA Car Costs Calculator

Operating a car is expensive. It eats a significant part of your income each and every month and depreciates with each passing day. With the CAA.COM Car Costs Calculator you can run very specific details exactly to your personal situation. Plug in the car you own (or are considering to buy or lease), the km's you drive in a year, how much city versus highway, insurance, financing and depreciation. At the end it will tell you how much your car is costing you each year including a cost per km. It's important to know that last number because no matter where you drive, that trip is costing you more than the gas you use. You can find the link to this calculator on our calculator page under Car Cost Calculator. It might even help you to downsize your vehicle use.

Hhhhhmmmmm……

We estimate that global equities will realize their post-1926 real return average of 9.93% over the next decade. This outlook may surprise some investors in light of the economic outlook and low-rate environment. Atul Tiwari, Managing Director, Vanguard Investments Canada.



Many investors seldom have a unique outlook on the businesses (stock) they own. They buy Apple because the company's phones are popular. The problem is, everybody knows these facts and they are already reflected in the company's share price by the time many get around to investing. When investors base investment decisions on common knowledge, their reward is almost always subpar performance. Tye Bousada, Portfolio Manager and co-CEO, Edgepoint

"If you're willing to roll up your sleeves and do the credit work that's necessary, you can still buy decent quality high yield bonds offering investors 7 to 8% return." Ben Cheng, President & CIO, Aston Hill Asset Management, June 2013

Data over the past 50 years shows that bear (down) markets on average don't start until 24 months after the U.S. Federal Reserve starts raising interest rates which is expected to start in 2015. Ned Davis Research

In 1984 a household headed by a 65+ year old adult had a net worth 10 times greater than a household headed by someone 35 years old or younger. More recently in 2009, this same comparison showed a difference of 47 times.

From 1984 to 2009, the proportion of households with no assets or a negative net worth increased from 11% to 20%. Advisor.ca, June 2013

"The standard of living achieved by the richest country in the world about 80 years ago, (the U.S.), is now the average for the whole world." Laurence Siegel, Director of Research, CFA Institute

The life expectancy of a 60 year old male today has increased to 87.3 years of age and the life expectancy of a 60 year old female has increased to 89.4 years. Canadian Institute of Actuaries, July 2013

Year 2000 was the first time in world history when people over the age of 60 outnumbered those under the age of 5.

Canadians receive more than $1.2 billion per week in benefits paid by life insurance companies, and more than 90% of payments go to policyholders that are living (ie disability). Canadian Life & Health Insurance Association, July 2013

10 years ago, urban residents generated an average of 0.64 kg's of household garbage per person per day. In 2012 that amount had nearly doubled to 1.2 kg's per person per day. Report On Business, June 2013.

In an Investors Group poll with couples who argue about money, 21% used an allowance system to control the spending habits of their partner. 99% who used this approach were satisfied with the outcome. Advisor.ca, July 2013

The US Postal Service spends $30 billion annually on mail delivery and lost $15.9 billion last year alone. Mail volume has dropped nearly 25% from 215 billion pieces delivered in 2006 to 160 billion currently. USA Today, July 2013

"People don't have to buy a 1.8 ton car to carry a 70 kilogram person. This is engineering from hell" Vaclav Smil, University of Manitoba energy expert who consults for Bill Gates and the World Economic Forum

When you enter an online contest (or any contest for that matter), why would you share it with your friends as the contest promoter is suggesting, if you are trying to win? Increasing the number of people in the contest reduces your chance of winning, doesn't it? Has simple logic changed or am I missing something?

Carey