

As singer John Fogerty once crooned, "Things got bad and things got worse." Despite the market downturn, however, some experts are chiming a cautiously upbeat tune, noting that historic buying opportunities are among the pluses. The challenge, they say, is that with volatility 'the new normal,' the onus is on investors to adjust their strategies in order to capitalize in an environment that offers as much uncertainty as potential upside.

Investing smart



Since markets hit ugly new lows in March 2009, things have been looking up for investors. The major North American markets have risen as much as 30 per cent from their trough, and economic reports focus hopefully on the tender 'green shoots' of a promising recovery.

"Last fall, the global economy was truly on the fast track to the next depression. Fortunately, governments and central banks (responded with) an absolutely stunning level of support, and it is clear that those efforts are starting to take hold," says Murray Leith, vice president and director of research at Odium Brown Limited. At the same time, he says, "Investors have realized that the world is not going to end, and the stock market has rallied accordingly."

Whether the recent positive economic indicators are harbingers of better times in 2010 or later, however, it is clear that volatility is 'the new normal' for investors. And unfortunately, says Mr. Leith, most investors are not wired to take advantage of the opportunities that volatile markets present.

"Most investors follow the crowd; buy high and sell low," he says, citing a study by Dalbar that revealed that in the 20 years prior to the end of 2007, the average investor in U.S. equity mutual funds achieved

a compound annual return of just 4.5 per cent, while buying and holding an index fund reflecting the S&P 500 would have yielded returns of almost 12 per cent per year. In other words, "The average investor would have grown a \$1-million portfolio of equity mutual funds to \$2.4 million, whereas an unemotional and passive buy and hold strategy would have produced a \$9.3-million nest egg, almost a fourfold difference."

Part of the problem, says Adrian Mastracci, a fee-only portfolio manager, is that investors are smitten with market performance, in particular, past performance. "Often, the investors who are having second thoughts today bought investments that were 'top performers.'"

To avoid 'investor's remorse,' he says, it is essential to begin with the recognition that no investor, however wise, has control over what markets do. "I don't pin my hopes on the market outcomes. Instead, I aim to control as many factors as I can, including risk tolerance and time horizon, desired rate of return and asset mix targets, investing style and rebalancing frequency, capital loss thresholds and credit quality."

Mr. Leith believes the global economy is likely to begin to stabilize late in 2009 and then "muddle through for an extended period of time." He notes, however, that the U.S. spending binge is over for the foreseeable future and that Chinese consumers can't rescue the global economy. He

also believes there is a silver lining for investors. "There has never been a better time for great companies to get greater, to grab market share and build enduring shareholder value – and rarely have great companies been as cheaply priced as they are today."

A good example of the many great companies that have underperformed as stocks because of overvaluation, he says, is Wal-Mart. "Earnings per share have grown at a compound annual rate of 11 per cent over the last 10 years, but despite the impressive growth, the stock has trended down for the better part of the last decade because it was way too expensive at the beginning of the decade. Valued at 55 times earnings in 1999, it is priced at just 14 times annual

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He expects companies with scale, such as Wal-Mart and Nokia, to "devour their smaller competitors." He also likes companies with 'triple A' balance sheets, such as Microsoft and Johnson & Johnson. In Canada, he favours companies with limited competitors, such as the big five Canadian banks, Rogers Communications and CN Rail.

The key to successful investing, says Mr. Mastracci, is to take the long view. Even for people on the cusp of retirement, he says, "Depending on your lifespan, your decisions may affect your life over the next 20, 30 or even 40 years. It's important to consider all the facts."

Investing within the context of a comprehensive plan will reveal the amount of capital and rate of return required to meet lifestyle goals, he says. "People get to look at the figures and see for themselves whether the risk that they're incurring is too high."

Whatever the future holds, adequate fixed income and cash positions – invested with appropriate attention to stability ratings and CDIC or similar coverage respectively – can provide ballast against what would otherwise be uncomfortable market volatility. "You cannot avoid every risk, but this is not the area of your portfolio to seek excitement," says Mr. Mastracci. ■

Fixed income products offer stability, diversification

Fixed income investments – those on which the annual rate of return is predicable at the time of purchase – are an important component of any investment portfolio. Essential for investors who require income from their investments, these investments also provide stability and diversification for wealth-building portfolios.

Some of the more familiar varieties of fixed income investments are Government of Canada bonds, Provincial Bonds, Federal Crown Corporation Bonds, corporate bonds, stripped bonds and mortgage-backed securities (MBS).

While many types of fixed income securities are significantly less risky than stocks, they are not risk-free. Among the risks they face are inflation risk: the chance that inflation will reduce the buying power of your returns, and credit risk: the risk the organization that promises to pay back the money it owes may not do so.

Another risk to fixed income earnings might be termed 'tax risk': interest income is taxable at the investor's highest rate, so outside of a registered plan, investors may be required to hand over almost half of their returns.

The different effective tax rates on various types of retirement income streams must be taken into account when planning the portfolio, says Colleen Gibb, FCA, tax partner with Gibb Widdis in Ancaster, Ontario. "Interest income remains the most highly taxed at 46.41 per cent in the top tax bracket in Ontario."

By comparison, she says, capital gains are the most favourably taxed at 23.2 per cent in the top Ontario tax bracket, followed by eligible dividends at 24.64 per cent and non-eligible dividends 31.34 per cent.

Lessons learned

Education key to a financially healthy future

With apologies to Charles Dickens, it was – simply – the worst of times. The TSX

declined by 49 per cent from its June 2008 peak to its March 2009 nadir; the S&P 500 was off over 54 per cent from its

October 2007 high.

But it wasn't only investors who were faring poorly: according to the Vanier Insti-

tute of the Family, the average level of household debt in Canada is \$90,000, and the Office of the Superintendent of

Bankruptcy reported that almost 8,300 people went bankrupt in December 2008, up 47 per cent over the same month the prior year.

The precipitous decline in the stock and housing markets highlighted a trend that most experts had been downplaying for almost two decades: Canadian savings rates had declined to 2.5 per cent in the last five years, about half of the rate of the previous five years, and down significantly from the almost 15 per cent it hovered at during the previous 35 years.

How did all this happen? "There are a number of root causes," says Kristan K. Birchard, chair, Board of Directors, Advocis, The Financial Advisors Association of Canada. But one reality, he says, is clear: many consumers need to elevate their knowledge of financial planning, products and services. "For those who are drowning in consumer debt, the immediate need is take care of urgent financial pressures. Once those bills are addressed, consumers need to get serious about a long-term financial strategy."

Unfortunately, in recent years many consumers have been spending without a financial plan, he says. "Moreover, many Canadians have also purchased investments on an assumption of perpetual market growth. It is in the context of this annus horribilis that Canadians need to reflect on their knowledge of financial planning, goals and objectives, and also consider what

their children know about this subject."

Financial literacy at an early age is a common denominator among successful business and investment leaders, including Warren Buffett, says Mr. Birchard, yet it is a sorely neglected aspect of education. "A recent survey by Credit Canada noted 97 per cent of teens are interested in learning about money management, yet only 13 per cent say they know a lot about the subject."

As the subject isn't yet being thoroughly addressed in school, it is up to parents to ensure that their children are prepared, beginning with basic financial planning transactions such as opening and managing a savings account. He also suggests using an RESP as an educational tool as well as a savings vehicle for secondary education. "Depending on a child's age, parents can explain the creation and management of an RESP and involve the child in the decision-making surrounding those investments."

Sadly, he says, young people often accumulate high-interest credit card and student loan debt just as they begin their adult lives. "Parents who don't carry a credit card balance from one month to the next should use the example they've set as a demonstration of how to properly manage this financial resource, and students should establish a strategy early on for reducing or eliminating this financial burden – and ultimately achieving other financial goals." ■

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