

THE
SMART
CANADIAN
WEALTH-
BUILDER



*Stepping Stones
to Financial
Independence*

PETER DOLEZAL

"...shines a light on many of
the financial issues that all of us
grapple with..."





UNIQUELY CANADIAN... A PRACTICAL STEP-BY-STEP GUIDE TO WEALTH-CREATION

"Peter Dolezal's newest book oozes credibility, and provides a practical insight into how to create and sustain wealth. Especially useful for young adults, this book should be mandatory reading for all high school and post-secondary students. A must read for all Canadians."

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"Congratulations to Peter for shining a light on many of the financial issues that all of us grapple with on our journey through life. I only wish this book had been available when I was younger, in order to have made better decisions myself. This book is a gift to all who read it."

BRIAN GILLESPIE, *Past President, British Columbia Institute of Technology*

"The interactive style in this book should produce useful dialogue between parent and child that will be of great value not only to the student, but also the adult. Its 120 TIPS bring an excellent focus to the critical messages found throughout the book. This work definitely fills a vital gap in the education of Canadians."

RICHARD J. CARTER, *Deputy Minister of Education (Retired), Province of British Columbia*

"This book is obviously the product of an experienced and astute practitioner. Peter Dolezal's clear and disciplined approach to wealth-creation and achievement of financial independence will prove invaluable to Canadians of all ages – from the high school senior to the retiree."

MEL COUVELIER, *Past Minister of Finance, Province of British Columbia*



PETER DOLEZAL, B.A., M.B.A., former CEO of major Canadian corporations, is now semi-retired in Victoria. Author of several books, he is a lifelong investor in, and student of the financial services industry. Through this book, he strives to share his knowledge and experience in a clear, yet comprehensive manner.

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Other Books *by* Peter Dolezal

The Naked Homeowner

The Naked Traveller

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NOTICE TO READERS

This book is intended for Canadians as a tool for broadening their knowledge of the many issues important to successful wealth-creation.

It is not intended for, nor should it be used by readers as a guide to specific investments.

Readers are urged to make specific investment decisions only *after* consulting with a qualified financial advisor, and *after* taking into account their individual circumstances.

What Readers Have Said

“Many Canadians mishandle their financial affairs, creating unnecessary stress and dependencies, simply due to lack of knowledge. Peter Dolezal explains the basics of personal financial planning in very clear terms. Everyone from novice to the financially-aware can benefit greatly. This book is a must-read for all.”

Bryan Wilson, Chief Financial Officer

.....

“*The Wealthy Barber* started the trend. Peter Dolezal’s book has pushed the envelope to a new level; full of contemporary easy-to-read-and-understand examples and TIPS. I have long felt, as a former university professor, that nothing is more important in a curriculum than financial literacy concepts. This book fills the bill – and then some. These are the lessons of life!”

G. Lorne Firman, Labour Lawyer

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“Peter Dolezal takes the reader on an easy-to-read-and-understand journey by defining all of the concepts covered in a well-organized, plain-language approach to building financial health and wealth. Reading it yourself will be very rewarding, but giving it to your children will be priceless!”

Bruce Clow
Human Resources Executive, and Past Trustee
Public Service Pension Plan

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“This is such an important subject which has largely been ignored. Congratulations on identifying the need and then doing something about it. Your book is both practical and, most importantly, understandable. I wish I had had something like this in my younger years.”

Claude G. Heywood, Deputy Minister of Labour (Retired),
Province of British Columbia

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“As a retired educator and Principal, I am impressed with the book’s common sense practices that point the way to long-term financial security, both for young adults, and for their parents and grandparents.”

William Smith, BPE, MA

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“Congratulations, Peter! Your simple and straightforward explanation of difficult financial concepts provides a great roadmap to wealth-creation and its management for all ages. I’d love to see your book incorporated into the life skills program in all high schools.”

Allan Crawshaw, IT Executive

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“For young adults and those of us who find financial material desperately ‘dry’, this book is an invitation to an excellent, easy, instructional and informational read! The 120 TIPS are a great guide for persons of all ages.”

Mary-Lynn Hyndman, Operating Theatre Nurse

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the smart canadian wealth-builder

“A challenge to educators! Use Peter’s book in your high school or college business class. Teach to his wealth-accumulation TIPS. Do the math activities he suggests to let students see how growth works. Both teacher and student will be the wiser and richer for it!”

Sandra Jaques, Educator

.....

“This book should be required reading for all who wish to learn to manage their money with a view to accumulating wealth.”

Richard Keogh, M.D., Radiologist

.....

“I wish I had had a family member share this crucial information with me when I was young. It would have saved me a lot of time and effort over the years. Lucky grandkids indeed, to receive this smart guidance while still young adults!”

Christina Issmer, Dental Hygienist

.....

“I really enjoyed pondering the possibilities, both personally and educationally, that this book offers. The style of writing is easy to follow and inviting to all age groups. The content offers much latitude for entry into the subject of personal financial management. I highly recommend this book to my own grown kids and suggest that everyone would profit from reading it!”

J. L. Shaw-Ringham, Educator

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INTRODUCTION

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Jenny and Kevin are the two oldest of our five grandchildren. Jenny, at twenty, is attending community college. Kevin is nearing high school graduation. Neither has yet settled on a specific career path.

Both Jenny and Kevin have always been intrigued by Grandma’s and my retirement lifestyle. To them, we seem to live better than many other couples, even when both partners are still working full-time. They often try to figure out how we manage to be so comfortable financially.

Guidance counselors at the high schools and colleges are available to help Kevin, Jenny, and their classmates sort out their career interests. A huge gap exists however, throughout the education system. It has not yet begun to address students’ needs for an understanding of personal financial management and wealth-creation.

Failure to equip our youth with at least the basics of financial literacy, does not serve society well. Graduates leave school poorly-equipped to manage their incomes once they enter the *real world* of employment. At best, this basic life-skill deficiency becomes a drag on their efforts at future wealth-creation, and their ultimate financial independence. At worst, it increases their risk of drifting into irresponsible financial behaviour.

Youth is smart. Generally they understand the basic concept – the better their education level, the greater their opportunity for a quality lifestyle, which they equate to making more money. No one teaches young adults however, how to develop even a simple financial plan, or how to save, spend and invest wisely, as their career progresses.

As a consequence, many of us are left to develop our money-management skills the hard way – through personal trial and

error. For many, this leads to an early, and at times lasting debt-trap, with potentially severe consequences for their and their family's future well-being.

Having had a lifelong passion and interest in all aspects of financial planning and investment, I jumped at the chance, when Jenny's and Kevin's curiosity became evident, to share my enthusiasm and knowledge with them.

The format I suggested was simple. Working around their school and part-time work schedules, we could get together at my home, for a series of Saturday afternoon discussions. I would share with them, in a simple yet comprehensive manner, my experiences, with lessons learned over forty years, and my own efforts at wealth-creation.

To my surprise and delight, both Jenny and Kevin embraced the idea, especially after I made *THE OFFER* – if they were interested enough to sit through the entire series of Saturday discussions, Grandma and I would stake them to \$1,000 each. With their new-found knowledge, they could invest this wisely, adding to their existing, very modest investment account.

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We three enjoyed our project immensely. Because I love writing, I told Jenny and Kevin to relax as we talked, without taking notes, since my plan was to write a book capturing the essence of our chats.

This book is a summary of those Saturday sessions.

It serves as a practical guide for a relatively safe, and predictable path to personal wealth-creation and long-term financial independence.

The contents will provide not only all our grandchildren, but also Canadians of all ages, with a reference point for lifelong use.

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At the outset, I emphasized to Jenny and Kevin that our discussions were not intended to make them experts in all matters related to the principles of financial management, financial planning and investment. Nor is this book so intended.

My purpose instead, is to provide a sufficient basic understanding of these subjects, so that they, or you, the reader, could act knowledgeably, and perhaps independently, in a prudent, and financially beneficial manner.

This book is not meant to replace the need for an *independent financial planner* or *advisor*, whose services can be invaluable as you navigate your way toward a financially stress-free retirement.

The key conclusions reached in our discussions are highlighted in the form of easy-to-understand **TIPS**. Taken together, these **TIPS** are the framework that Canadians can adopt to greatly enhance their ability to build their own net-worth and ultimately, to achieve financial independence.

Because few of us have been exposed to formal lessons in the basics of financial literacy, it is my hope that this book will prove beneficial to a cross-section of Canadians of all ages. Hopefully you, the reader, will benefit personally, but also, will emerge better equipped to provide guidance to your own children and grandchildren.

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Throughout this book, I have often used the masculine, singular form in making specific points. This is done simply for the sake of convenience. I hope that the many female readers will accept that no sexist bias is intended.

.....

Read on. Eavesdrop on a chat between a wise old goat and two voracious youngsters who, eager to evolve into financially-savvy adults, are convinced that they too, will achieve financial independence – probably a lot sooner than their grandparents.

CHAPTER THIRTEEN

.....

THE MAGIC OF COMPOUNDING

“Well, here we are again! Our fourth Saturday get-together. We’re actually making good progress. So far we’ve discussed how to:

- Manage our cash spending;
- Control our debt, especially credit cards and mortgages;
- Save regularly;
- Utilize three key, tax-efficient savings vehicles – the TFSA, the RRSP, and the RESP.

Today, as I promised you, we’ll become familiar with several topics and terminology key to understanding future investment decisions which we’ll be called upon to make throughout our lifetime.”

.....

“The first of these is the *power of time and compound interest*.

Kevin, have you any objection to our using *your* finances as an example? You might enjoy discussing *your* investments which with my advice, you’ve been accumulating since your early teens.”

“Go for it, Grandpa,” enthused Kevin.

“Great! In round numbers, I believe your present *portfolio* is worth about \$5,000. Am I right?”

“*Portfolio* – I kind of like the sound of that; it makes me feel like a successful businessman. But yes, according to my last *statement*, it was within a hundred dollars of that,” replied Kevin.

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“Wow! How did you manage to save so much, Kevin?” asked Jenny.

“Kevin’s too modest to answer. It’s mainly because his wants and needs are few. Up to now, he’s been able to save far more of his allowance and part-time earnings than he has spent. He has shown an incredible degree of dedication to savings, which is most unusual not only for someone as young as he is, but for most of us at any age. Of course, we’ve been careful to invest his savings prudently, and they’ve grown significantly.

If Kevin is able to maintain this same discipline throughout his working life, he and his family will end up very wealthy indeed – due in great part, to the magic *power of compounding and time.*”

.....

“We understand the basic concept of *simple interest*. But now let’s understand what is meant by *compounding* interest when we use it in terms of investments.

Usually we are most interested in the *compounded annual rate-of-return* achieved on our investments over a set period of time. In simplest terms:

COMPOUNDING is a process by which the original value of an investment increases exponentially over time. As periodic dividends or interest are automatically reinvested, they escalate the dividends or interest earned in future.

Let’s clarify this with an example. You have a \$1,000 investment. It earns 5% interest annually. All interest earnings are *reinvested*. At the end of:

- Year One – the investment has grown to \$1,050
- Year Two – the investment has grown to \$1,103

- Year Three – the investment has grown to \$1,158
- Year Ten – the investment has grown to \$1,629
- Year Twenty – the investment has grown to \$2,653.

By contrast, had you chosen to *not* reinvest the interest earned each year and instead spent it, you would have been earning only *simple interest* on your \$1,000.

By the end of year twenty you would have earned but withdrawn **\$1,000** in total interest payments. Compare this to the **\$1,623** interest which accumulated when you allowed the annual interest to compound. The magic of compounding earned you an extra \$653 over 20 years.”

“Maybe rabbits are nature’s example of compounding,” joked Jenny.

“The annual effect of this *interest-on-interest* growth doesn’t at first, seem particularly significant; but as the definition states, it increases *exponentially* over time.”

.....

“Let’s look at Kevin’s current investment of \$5,000.

Kevin, how much do you think you would end up with if, never touching the interest earned, nor adding to the original investment, you had invested this \$5,000 at 5% annual and compounding interest, for a 40-year period?”

“I guess it could be worth over \$10,000?” ventured Kevin.

“You’ll both be shocked!

Invested today, at 5% compounding interest, for 40 years – about the length of your working life, Kevin, your \$5,000 would actually become worth approximately \$35,000.”

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“No way! That’s so awesome,” exclaimed Kevin.

COMPOUND ANNUAL RATE-OF-RETURN is the percentage by which a given investment would need to increase each year, over a specified period, to reach a desired end value.

“So, if we were asked what the annual compound rate-of-return would be if Kevin’s \$5,000 increased to \$35,000 after 40 years, our answer would be?”

“Five percent,” promptly replied Jenny.

“Right you are! These two definitions are crucial to our understanding of the differing results we might achieve with various types of investments. But more on that later.”

.....

“For now, let me share with you some more compounding magic.

To keep it simple, we’ll again use Kevin’s \$5,000 investment, the same 5% compounding interest yield, and the same 40-year term.

But we’ll add another component – an additional \$200 monthly contribution to the original investment.

Kevin, would it be reasonable to assume, since you’ve managed as a teenager to achieve a \$5,000 portfolio value, that once you have a full-time job, you should be able to add at least \$200 a month to your initial \$5,000?”

“Sure!” exclaimed Kevin. “That should be easy.”

“Easy for *some* of us,” muttered Jenny.

“If you were disciplined enough to actually do that, Kevin, and I’ve no doubt you will be, then your initial \$5,000 investment would after 40 years, amount to an impressive **\$332,000!**”

“Incredible!” exclaimed a stupefied Kevin.

“The actual cash you invested would have been:

- The initial **\$5,000**, *plus*
- \$200 monthly for 480 months, for an additional **\$96,000**.

Your total *combined* investment would be **\$101,000**.

That \$101,000 would have mushroomed by another **\$231,000** due solely to the 5% annual interest earned on all invested contributions *as well as* all the extra interest earned on the *reinvested* interest. This is the ***magic of compounding***.”

“That’s truly unbelievable!” declared a shocked Jenny. “It’s like buying one Lamborghini, and getting two more for free!”

.....

“I’m getting a kick out of throwing surprises at you two. Let’s look at another scenario.

Let’s assume that instead of investing your \$5,000 in a fixed-interest instrument, you invested it in the ***Toronto Stock Exchange (TSX) Index***. We’ll also factor in the impact of your continuing to add \$200 monthly to your initial investment.

The TSX Index produced an actual average annual rate-of-return over the years 1940 through 2007, of 10.6%. At this rate of return, your initial \$5,000 over 40 years would become:”

	<i>Initial Investment</i>	<i>TSX Average Annual Yield (1940 to 2007)</i>	<i>Value After 40 Years</i>
<i>With No Additional Investment</i>	\$5,000	10.6 %	\$281,000
<i>With an Extra \$200 Per Month Invested</i>	\$5,000	10.6 %	\$1,592,000

“Wow!” exclaimed Kevin. “That is *some* difference! All that extra benefit from only \$200 a month of additional investment.”

“Kevin, you are the *only* one I know who would say ‘*only*’ when referring to saving \$200 every month!” teased Jenny.

.....

“If you’re impressed by *that* example, here’s another which illustrates the startling effect of ***early-in-life investments*** on ultimate wealth accumulation. Let me start by introducing you to two lifelong friends, ***Jake*** and ***Larry***.

Jake, at age 25, begins investing \$400 a month. He’s able to keep this up for 10 years, and then, at age 35, stops making further contributions. His investment averages a 7% annual return through those 10 years and continues to do so, until he retires at age 65.

His friend ***Larry*** also invests \$400 monthly, earning the same 7% return. He however, is a few years older and only begins investing at age 35. He continues to invest the same amount monthly, for thirty years, until he retires at age 65.

Larry started investing at an older age than Jake. However he was diligent in keeping up his monthly contributions for the next 30 years, compared to Jake's relatively brief ten years of contributions.

Who do you think will have the larger portfolio at age 65?"

"Logic tells me that Larry, by investing the same monthly amount over a 30-year period instead of just ten years, should end up with the most money," offered Jenny.

"Well, Jenny, most people would agree with you.

Surprisingly, despite having contributed a total of only \$48,000, Jake would end up with **\$521,000** at age 65.

Although Larry's monthly contributions would have totaled a much greater \$148,800, he would end up at age 65, with only **\$468,000.**"

"How can that be, Grandpa?" asked Kevin. "Somehow it doesn't seem possible."

"The sole reason, Kevin, that Jake's investment grew so dramatically is that, despite his much shorter contribution period and smaller cash investment, his money not only compounded over the initial 10-year period during which he contributed, but *then*, the accumulated sum had a full 30 more years of compounded growth.

Larry on the other hand, had a total of only thirty years for compounding to work its magic. In other words, the effect was less dramatic than in Jake's case because Larry's accumulated savings and earned interest after ten years, had only 20 years of growth remaining, compared to Jake's 30 years.

Jake was able to contribute only one-third as much as Larry, but by starting ten years sooner, ended up with a larger nest-egg."

“Wow, I still can’t believe it!” exclaimed Jenny.

TIP #37..... The combined magic of compounding, time, and self-discipline, can produce phenomenal results, especially for those whose saving and investing habit begins early in their working life.

“I’m beginning to understand how we can actually become millionaires by the time we retire,” exclaimed Kevin. “But there’s a slight problem. What I know about *investing* is basically zero.”

“Don’t worry about that, Kevin. You’re not alone. Many of us lack this knowledge at first. Later in our chats, I’ll describe investment products that will eliminate much of the mystery for both of you.”

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“What about *inflation*?” asked Jenny. “Forget the Lamborghini. What if forty years from now, Kevin can’t even buy a basic clunker for the \$1.6 million he might have accumulated in the example you just used?”

“That’s stretching it a bit, but still a great question, Jenny! This is a really good time to understand the eroding power of inflation.

In terms of inflation’s *effect* on all of us, it means that our dollar generally, will buy less in future than it does today.

If we say that inflation is running at 4% annually, we mean that the average cost of goods and services is expected to be about 4% higher than it was a year ago.”

“So what do you think my almost **\$1.6 million** in today’s purchasing power, would be worth after forty years, Grandpa?” asked Kevin.

“To begin, I used 4% as an example because that was the *actual* average inflation rate that existed over the period 1940 to 2007 – the same period that averaged 10.6% in stock market returns. If we were to apply the same 4% inflation rate to *your* 40-year investment horizon, we would find this sum of money to be *worth* about **\$330,000** in today’s dollars.”

“All those years of saving, investing, and planning, and that’s all my efforts would be really worth?” exclaimed Kevin.

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“Now you’re beginning to see, Kevin. Because of the very real effect of inflation, targeting a one million-dollar retirement fund by the time you reach sixty, may be way too low a number, *unless* at that time you have other sources of income, like pensions.

Fortunately, in the last twenty years inflation in Canada has moderated greatly, averaging only 2.3% annually. Nevertheless, to be on the safe side in our calculations when trying to set your long-term investment goals, we may be smart to use a higher inflation figure of 3%.

Using this 3% rate of inflation over a 40-year period would make the **\$1.6 million** worth about **\$485,000** in today’s purchasing power.”

TIP #38..... Because of the eroding effect of inflation on purchasing power, savers and investors must adjust their long-term objectives to compensate for inflation’s drag on future values.

“So what you’re saying, Grandpa, is that having \$1.6 million today is a lot of money, but forty years from now, because of inflation, that amount may buy only the equivalent of what \$485,000 will buy today?” queried Jenny.

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“Assuming a 3% inflation rate, yes, that’s correct, Jenny. It will still buy a lot, but not nearly as much as we might have wished for, or expected.

And we *must* take into account that eroding purchasing power, when we do a *Financial Plan*, later in our discussions.”

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“Does it now make sense why *sheltering* your growing investments as much as possible from income taxes becomes extremely important? Imagine if, in addition to the *inflation drag* we’ve just discussed, your investments were further eroded by *taxes* on increases in value!”

“I’ve heard people complain about the high taxes they pay, but this is the first time it’s really hit home for me,” observed Kevin.

TIP #39..... Protecting investment gains from income taxes is an extremely important element of every individual’s wealth-creation strategy.

“The *TFSA* and *RRSP* savings and investment vehicles we discussed earlier are the primary tax-minimization tools available to every Canadian investor.”

“I definitely get the importance of putting my money in a long-term savings plan, like an *RRSP*,” agreed Jenny. “But the thought of *investing* in the stock market or something like that, makes me very, very nervous. It strikes me a bit like gambling. I’ve heard a lot of horror stories about people who’ve lost tons of money in the market.”

“It’s good that you’re nervous about it, rather than flippant, Jenny. There’s nothing wrong with wanting to invest more conservatively. But I think that a good part of your concern is based more on a lack of understanding. One *can* invest reasonably safely in the stock market, in a manner that greatly reduces risk, especially over the long term. I think our next discussion will help you with that.

It’s also important to realize that any long-term investment plan needs to be *balanced*. The stock market is only one investment possibility. Our discussion on various investment options will I think, make you feel more comfortable.”

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UNDERSTANDING INVESTMENTS

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CHAPTER FOURTEEN

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FIXED-INCOME INVESTMENTS

“Before contemplating actual investments, we need to become familiar with the various investment *options* available, and their associated risks.

We’ll go slowly. This subject can be overwhelming for the novice investor. There are literally thousands of investment options in existence. By grouping them into main categories, they become easier to understand.

Given your concerns, Jenny, you’ll probably be at your most comfortable with our first category – the various **Fixed-Income Investments**.

As the name implies, these investments will produce a yield or *fixed-income* which is largely predictable. Let’s look at the main ones:

- **Bank or Credit Union Savings Accounts**

These usually pay a very low rate of interest, often less than 1%. Useful for very short-term saving purposes, they should be avoided for larger savings, or for longer-term investments.

These accounts are 100% secure in that your *principal* (the cash deposited) is government-protected, at least to \$100,000 per account, by the **Canadian Deposit Insurance Corporation (CDIC)**.

- **High-Interest Savings Accounts**

Many financial institutions offer the option of higher interest rates on larger minimum-balance savings deposits. For example, because they are expected to grow to a significant amount of money over time, TFSA savings accounts are generally able to attract higher rates.

The CDIC protection applies to TFSA accounts *if the investment is in a savings account*. This makes the high-interest savings account a risk-free, modest-return savings vehicle. At best however, it is unlikely to keep up with inflation.

- **Treasury Bills (T-Bills)**

Treasury Bills are short-term investments issued by both the federal government and some provinces; as such, they are risk-free. They can be purchased for various terms, generally ranging from 30 days to one year. A minimum investment of at least \$1,000 is required. Yields may be better than in a typical savings account, but at best, still barely on pace with inflation.

- **Money Market Funds**

This is the most conservative type of *fund*. Most such funds are *not* CDIC-insured. The fees charged by the mutual fund service-provider are generally low, but so are the returns earned.

Most money market funds are invested in government or government-guaranteed securities. Some may include *somewhat* riskier investments such as mortgages. Investment returns are neither guaranteed, nor are they specified. Over time however, the returns tend to be better than savings accounts or T-Bills.

- **Guaranteed Investment Certificates (GICs)**

Also CDIC-insured, these certificates are issued by the lending institution, such as a Bank, for specific terms, usually ranging in length from one year through five years. Generally, the longer the term, the higher the rate paid. Yields will be better than savings accounts, T-Bills, or most money-market funds. Your investment however, is usually locked-in for the duration of the term selected.

- **Government and Corporate Bonds**

These are *debt* instruments issued by governments or corporations. In buying them, you are lending the government or corporation a sum of money. In return, they offer a specified interest rate, and a return of your capital at a set maturity date. Since North America's government bonds are considered to be risk-free, they pay a much lower rate of interest than do corporate bonds.

Bonds are such an important category for most investment portfolios, we'll delve into them in greater detail shortly.

- **Mortgage-Backed Securities (MBS)**

These are fixed-income securities that are invested in a *pool* of residential first mortgages. These mortgages are insured under the National Housing Act. As such, they are unconditionally guaranteed by ***Canada Mortgage and Housing Corporation (CMHC)***. Though these investments are very safe, their returns will not be very attractive when interest rates are low."

"So, Grandpa, you're saying that all these types of investments are really safe, and if we invest in them, we're not likely to lose our money. Is that right?" asked Jenny.

"That's right, Jenny, but keep in mind that because they *are* safe investments, they don't earn you very much. In fact, remember what we discussed about the impact of *inflation* on your investments? If all your money were for example, in only government bonds, you would be very lucky over the years to even keep up with inflation.

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So yes, all of these investments are safe, slow and steady earners. On the other hand, they don't contribute substantially to growing your wealth much beyond covering the effect of inflation.

If we're to achieve financial independence, we'll need to at least *balance* these safe investments by also investing in products that can earn us more."

"Sounds like you're still suggesting we risk a good part of our hard-earned money, Grandpa. Why not just go to Vegas and take our chances there?" asked Jenny.

"By the time I finish explaining in detail the other investment options, Jenny, I think you'll agree that investing in a *prudent* manner is nothing like the gamble you'd take in Vegas.

Look at it in terms you're both familiar with.

When you play cards with the family, you're holding a hand with cards of various values. You try to build up a solid winning hand (a portfolio). To do this, you want some high-value aces and face cards (high-risk) which will net you higher points, but if caught with them in your hand at game end (market downturn), it could result in a loss. The boring lower-value cards (low-risk) won't add up to a lot of points (interest), but they also won't lead to huge losses. To win the game (a comfortable retirement), you need, and try to achieve, a balanced hand."

"Cards, I understand," commented Jenny. "But with cards I'm only playing with points, not my retirement funds."

TIP #40..... The prudent investor will always consider, and almost always include in his portfolio, some very conservative, cash-preserving investments. To prudently balance risk, the closer an investor is to retirement, the greater should be his proportion of fixed-income investments.

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“Grandpa, how do you know when you *have* achieved financial independence?” asked Kevin.

“I’ll give you *my* definition, Kevin. It should work pretty well for most of us.”

FINANCIAL INDEPENDENCE exists when, without having to be employed, one earns sufficient income from investments, pensions, or other sources, to maintain a desired lifestyle.

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“I mentioned earlier that *bonds* are such an important investment option for any portfolio, that they’re worth a more detailed examination. Let’s talk more about them right now.”

CHAPTER FIFTEEN
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BOND INVESTMENTS

A BOND is a debt instrument. It is used by governments, municipalities, and corporations to raise capital. It represents both a promise to pay periodic interest at a set rate (coupon), as well as a promise to repay the principal on a specified date (maturity).

“An investor who buys a bond becomes a **creditor** of the issuer; he is **not** a shareholder.

A *bondholder* has a priority claim over that of a shareholder, on an issuer’s income. This means that a bondholder must receive his interest payments in full, *before* any dividends can be paid to a shareholder.

Every bond has a **par value**, set by the issuer.

PAR VALUE of a bond is the predetermined amount to be paid out on its maturity date.

When an investor buys a bond, the price he *pays* may be above or below par value. This is because the prevailing interest rates in the market may have changed up or down since the bond was first issued.

If comparable-term interest rates have *decreased* since the bond was issued, then the bond will be more valuable and priced higher than when first issued. This is because the interest rate paid on the bond is now more attractive than that of the general market. In this situation, a bondholder who bought at issue date, could sell his bonds for a capital gain.”

“Whoa, Grandpa!” exclaimed Jenny. “What exactly is a capital gain?”

A CAPITAL GAIN is the increase in value of an asset, from its purchase price to its selling price – not taking into account either interest or dividend payments.

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“Let’s look at the other side of the coin. If interest rates have *increased* since the bond was issued, it will now be worth less. If this occurred prior to its maturity, and the bond were sold, the selling price would be below its purchase price, to make up for its below-market interest rate.”

“I guess in that case you would have a *capital loss*?” asked Jenny.

“Exactly, Jenny. But keep in mind that you can avoid the loss by holding on to the bond until its maturity date.”

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“To put all this another way, the interest rate (*coupon*) attached to a newly-issued bond does not change throughout the bond’s life. The original purchaser, and any subsequent buyers on the resale market, will always receive the same pre-determined interest payment. However, the *effective* interest rate of the bond *will change* as, until maturity, its market value slides up or down relative to its par value.

As you might expect, a bond’s *market value* will approach *par value* as the maturity date nears. That is because, regardless of prevailing market interest rates, par is the value payable to the bondholder at maturity.”

“Grandpa, this is a tough one. If we were on a golf course, I’d definitely understand ‘*par*’. I *think* I understand, but could you please clarify in *simple* terms, the value movement of bonds, just to be sure?” asked Kevin.

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“I’ll be glad to, Kevin. The key principle to remember, is that individual bond values will fluctuate up or down over time, generally in the ***opposite direction*** to changes in market interest rates. These fluctuations matter little to the bondholder if he holds the bond to maturity – ***as long as the issuer remains financially sound.***”

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“Financially sound? Does this mean that when I invest in a bond, I *could* actually lose not only my interest earnings, but even my capital investment too?” asked Jenny.

“Unfortunately, Jenny, the answer is yes. There are *some* circumstances under which a bondholder *can* lose. But with a little care, the risk is minimal:

- Government bonds, considered risk-free, will pay the lowest interest.
- Investment-grade corporate bonds will pay a higher rate because the issuer has *some* risk of encountering financial difficulties.
- Below-investment-grade bonds, sometimes called *junk* bonds, pay a much higher interest rate to compensate for their increased risk.”

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“When buying an individual bond, it’s very important to carefully consider the *credit rating* of the bond issuer.

Bond ratings range from AAA (highest quality) to D (highest risk). If an investor seeks a very low risk to his bond-generated income and invested capital, he should probably avoid individual bonds with a rating below AA.”

“Sounds a lot like school,” observed Jenny. “Aim for an *A*, avoid a *D!*”

“And I,” added Kevin, “cannot believe anyone could be tempted by something called a ‘junk’ bond!”

“You’re right, Kevin. Investing in an individual *junk bond* would be sheer folly. But what some investors do is buy a *fund* holding a large number of such bonds. This reduces the risk of individual bonds failing. Because of their high risk individually, such bonds pay very high interest rates. The much higher average yield of the corresponding bond funds makes them attractive to some investors.

I personally, would never put more than 10% of my total bond holdings into such funds.”

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“There is a category of bonds that *can* protect the long-term investor against the risk of *inflation*. In Canada, these are called ***Real Return Bonds (RRBs)***.

RRBs are similar to regular bonds in all respects but one. The interest rate they pay floats at a fixed percentage ***above*** the official rate of inflation. Hence the protection from inflation.

RRBs are not great investments when inflation is low. But because their interest rate is pegged at a constant percentage *above* the rate of inflation, they will outperform regular bonds when inflation is high.

Several notes of caution with RRBs:

- RRBs are long-term investments, maturing some 15 to 20 years in the future. Your capital investment is protected *if held to maturity*. Like all bonds however, they are subject to market fluctuations if sold before maturity.
- Unless held in a TFSA or RRSP account, all interest earned by RRBs is, as with all bond products, fully-taxable at the same rate as other earned income.”

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“Another bond category with which it is useful to be familiar is known as the ***Strip Bond***.

Also known as *zero-coupon* bonds, they differ from regular bonds in that they pay no periodic interest. The interest coupons have been *stripped* from the purchase price of the bond.

An investor buys strip bonds at a discount to the bond’s face value, which he will receive at the bond’s maturity date. The difference between the purchase price and maturity value is the investor’s return.

Federal, provincial, municipal, and some corporate bonds are available as *strip bonds*. Terms may range from less than a year to several decades.

Some investors like strip bonds because, not needing an ongoing interest income, they are happy to defer it. They prefer to have the foregone interest reflected in the cash value of the bond at its maturity.

An investor can buy this bond and forget it, knowing precisely how much he will receive at a future date.

Even though payment of interest is deferred to maturity, these bonds should not be held in taxable accounts. The investment will be taxed as if interest were received annually.

These bonds can be a useful investment component of a tax-sheltered account such as an RRSP or RESP.

As an example, a family celebrates the birth of a child. An RESP account is immediately established. A deeply-discounted strip bond with a 17-year maturity date is purchased for the newborn’s RESP account. This provides a safe and fully-predictable value when the child is ready to begin post-secondary studies.”

TIP #41..... Bonds are an extremely valuable, low-risk element of any portfolio. If carefully selected from enterprises with very high investment-grade ratings, individual bonds represent little risk to capital, when *held to maturity*. Corporate bonds generally produce a higher annual return than do savings accounts and GIC alternatives. They also offer the *potential* for capital gains if sold prior to maturity.

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“Grandpa, instead of buying just one bond, can’t you hold a *bunch* of them so that you don’t have all your eggs in one basket?” asked Kevin. “I’m thinking that if you spread your investment among several bonds, it would reduce your risk, and reduce the pain of any one bond failing.”

“That’s a very good observation, Kevin. Just like my reference to *junk bonds*, there are easy ways of diversifying your bond investments:

- Buy a selection of individual high-quality corporate and government bonds.
- Buy *bond funds*, each of which will hold a wide variety of individual bonds.

The upside of owning *bond funds* is that you achieve broad diversification and reduce risk.

The downside however cannot be ignored, and must be carefully evaluated:

- As you will come to understand when we talk about any kind of mutual fund, investment in *any* fund comes with a management fee – *sometimes* a very significant one. A fee can seriously erode your interest yield.
- With a bond fund you lose an important protective feature of individual bonds. With a single bond, the issuer guarantees a specific interest rate, *as well as* the payment of par-value at maturity. A bond fund can guarantee neither. Bond funds never *mature*. They are invested in a large number of bonds, each with a different interest payment and maturity date.

The consequence of this difference between individual bonds and a bond fund is twofold:

- Because a *fund* often sells bonds, or redeems maturing ones and replaces them with other bonds, the interest rate paid by a bond fund will fluctuate, though not significantly. More importantly, the fund's redemption value will change up or down, depending on the direction of interest rates in the marketplace.
- When you sell a *bond fund* you *may* achieve a capital gain if interest rates have decreased since you bought. However, you are also exposed to the possibility of a capital loss, if rates have risen since you bought into the fund.

Because a bond fund does *not* have a specific maturity date, you *cannot*, as with individual bonds, eliminate this risk of capital loss by holding the fund to maturity.

If your bond fund is valued below your purchase price, you can hold on until prevailing interest rates again decline, and the value of your Bond Fund increases. This means you have *some* control over an eventual gain or loss. However you do not have a specific date at which the risk will disappear, as you do with individual bonds.

If prevailing interest rates are very low when buying into a bond fund, your risk of future capital loss is magnified, because a high probability exists that market interest rates will increase at some future time.

For example, with interest rates at historically-low levels during most of 2009, I was very hesitant about purchasing bond funds. For the bond portion of my portfolio in 2009, I chose instead to invest in high-quality corporate bonds. Their guaranteed par value at a fixed maturity date was for me, the better investment.”

TIP #42..... Bond funds are useful for diversification among various bonds. This benefit however, must be balanced against the reality of some fluctuation in interest paid, as well as capital-value changes if market interest rates change after the date of your fund purchase.

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“Whether you buy individual bonds or bond funds, they serve not only as a solid fixed-income investment, but also, as a great hedge against major downturns in the stock component of your portfolio.

When stock markets trend downward, it’s generally the result of a sluggish economy, and poor corporate performance. In such circumstances the **Bank of Canada** tends to lower interest rates. As we’ve discussed, when market interest rates go down, bond values tend to go up – because the interest rate at which they were purchased has become more valuable to the new investor.

In addition to their other benefits, this stock-market-balancing feature of bonds and bond funds makes them a key component of a well-balanced investment portfolio.”

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“Thanks, Grandpa, for explaining this so thoroughly,” acknowledged Jenny. “I know this is kindergarten stuff for you, but for Kevin and me, it’s all brand new. We appreciate your patience.”

“No problem, Jenny. I enjoy sharing this information with both of you. If you really *do* grasp the basic principles, then every minute we spend on this is worthwhile. You’ll find it much easier to manage your lifelong wealth-building efforts.

Shall we continue? Since I’ve just mentioned *stocks* as an investment option, we may as well discuss them next.”

“It just may bring me to my knees, Grandpa,” moaned Jenny. “But if you take it slowly, maybe it’ll get easier.”

“I’ve just three words for you, Grandpa,” added Kevin. “Simplify, simplify, simplify!”

“I’ll do my best, Kevin, without overlooking anything important.”

CHAPTER SIXTEEN

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STOCKS (*also referred to as* EQUITIES)

A COMMON STOCK or SHARE, denotes an ownership position (called equity) in a corporation.

“A *common shareholder* has a claim on the profits and assets of that corporation. He in fact, is one of the owners of the company. His ownership interest is in proportion to the number of shares he owns relative to the total number of shares issued. For example, if he owns 1% of the shares, he will have a 1% claim. Common stocks also provide voting rights to shareholders on certain, major corporate decisions.”

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“The ***risk vs. benefit*** spectrum of equity investments (stocks) has the widest range of any investment we have yet discussed, except perhaps for ‘junk bonds’.

Generally, the higher the risk-profile of a stock, the more volatile its trading value. It’s therefore worth some extra elaboration to help you understand this trade-off for various types of stocks.”

“Grandpa, I actually heard of something called a ‘*Large-Cap*’ bunch of stocks. What are they?” asked Kevin.

“Interesting that you’ve heard of them, Kevin. They aren’t exactly everyday vocabulary. There are actually *three broad categories* of common stocks. ‘Large-Cap’ is one of them. By the way, ‘Cap’ is an abbreviation for *Market Capitalization*.”

MARKET CAPITALIZATION is a company's share value, multiplied by the number of shares it has issued.

COMMON STOCKS – THREE BROAD CATEGORIES

“Because fund companies tend to use these definitions, it is important that the prudent investor at least be familiar with these three categories of common shares. In order to select the investment category that is right for *his* level of risk-tolerance, an investor must understand the differences.

1. Large-Cap Shares (\$\$\$\$\$)

A LARGE CAP corporation is a long-established business, among the largest of publicly-traded companies. Although definitions vary widely, it will usually have a market capitalization of over \$10 billion. Many corporations in this category pay regular dividends to their shareholders.

Often, large-cap shares will be referred to as *Blue Chip stocks*. In Canada, approximately thirty companies fall into this large-cap definition.

While there are no guarantees of positive performance with *any* common stock, large-cap stocks tend to be the least risky of the three categories, particularly if held over an extended number of years. This is especially so for those that pay dividends.

Dividends provide shareholders with regular cash payments which, when added to market-value increases of the stock itself, serve to enhance the overall return to the shareholder. Dividends also serve to moderate the effect of periodic market-value declines in the stock.

2. Mid-Cap Shares (\$\$\$)

A MID-CAP corporation's capitalization will generally fall between \$2 billion and \$10 billion.

Mid-cap shares are those of generally solid companies, with the potential to become large-cap corporations. Some may show phenomenal growth and hence great market returns. Others are susceptible to major negative value swings.

Some mid-cap shares may also pay dividends.

If an investor selects carefully, or is lucky, or perhaps both, he *may* receive great returns from mid-cap stocks, even in a short-to-medium investment period. However, value volatility risk will tend to be greater than that of large-cap companies.

To reduce the downside risk of individual mid-cap stocks, an investor is wise to moderate his risk by using either *actively or passively-managed funds*. Such funds provide broad diversification across many such companies, and hence reduce the volatility and risk of individual investments.

As I said earlier, we'll deal separately with the important subject of *funds*, and key differences between them, when we discuss the broad category of *mutual funds*.

3. Small-Cap Shares (\$\$)

SMALL-CAP companies typically have a market capitalization of between \$300 million and \$2 billion.

Small-cap share values will tend to be the most volatile. They are therefore riskier than investments in both large-cap and mid-cap companies. Small-cap companies are very unlikely to pay dividends.

The prudent investor with a somewhat conservative risk-tolerance, would be wise to place only a relatively minor portion of his portfolio in this category. Again, broad diversification through various funds is advisable.”

TIP #43..... As a general rule, the higher the capitalization (cap) of your equity (stock) investments, the less risky the profile of your investment.

TIP #44..... The lower the capitalization (cap) value of your equity (stock) investments, the more important it is to achieve a high degree of diversification by using carefully-selected funds.

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PENNY STOCKS

“This is a fourth common stock component of Canadian equities. This category is highly volatile and extremely risky, relative to the three I’ve just outlined.

Although the conservative investor is not likely to invest in *penny stocks*, it’s useful to understand what they are, along with their risk and potential reward.

PENNY STOCKS, as the name implies, are those with an individual share value of less than one dollar.

As you might expect, penny stocks represent the riskiest end of the spectrum among common stocks. In Canada, they trade primarily on the *TSX Venture Exchange*.

Sometimes you get lucky. For instance, you happen to buy a stock in a fledgling mining company, at 80 cents a share. Suddenly, because the corporation has just announced a major new find, the value zooms to over \$8 a share. Very excited by your savvy investing, you’re tempted to buy more penny stocks to add to your net-worth.

Unfortunately, this winning example is little different than the one-in-a-thousand luck of the individual who hits a jackpot in Vegas. It can happen, but it's very unlikely.

Far more penny-stock corporations fail financially, with major losses to their shareholders, than succeed dramatically.

On the other hand, many current large-cap companies, such as Canada's own ***Research In Motion (RIM)***, founded in 1984 by two university students, once started as a penny stock. Now trading at over \$65 a share, it enjoys the highest market capitalization of any equity listed in Canada. Occasional success stories of this nature represent for their original investors, the equivalent of a major windfall. Such examples serve as a beacon for other hopefuls in today's penny-stock market.

Unless you are particularly knowledgeable about a specific company, its business, its market, and most crucial, its management, it is generally wise to refrain from investments in penny stocks. Buying penny stocks is often closer to gambling than to investing.”

“That's what's so scary,” observed Jenny. “Even though they call it investing, I've heard of some people who practically throw away their futures on a hodge-podge of what they call ‘investments’, when what they're really doing is gambling.”

“You and Kevin won't be among those ‘gamblers’, Jenny. You're already asking the right questions.

Despite the high risk, the lure of even a slight potential for an astronomical return causes a significant number of investors to buy penny stocks.

Understandably, this tendency is welcomed by fledgling and start-up companies. Such investments are an important financing vehicle for them. With little to no established track record, issuing bonds is next to impossible. The equity market therefore becomes their main source of both initial funding and expansion capital.”

TIP #45..... Due to the extraordinarily high-risk profile of penny stocks, the prudent investor is wise to limit his investment in this sector to *no more than 5%* of his portfolio.

DIVIDEND-PAYING STOCKS

A DIVIDEND-PAYING STOCK is one which pays a regular cash distribution to shareholders.

“As we saw, penny stocks are at the highest end of the risk spectrum. At the opposite end of that scale are dividend-paying stocks which over time, tend to have the lowest portfolio-risk of any common stock investment.

Historically, *dividends* have accounted for more than 40% of the overall returns of the Canadian **S&P/TSX Index**.

Dividend-paying equities are much better long-term risks because:

- Dividend-paying corporations are usually among the largest, well-established businesses, with proven long-term track records. They typically represent a *minority* of the companies listed on an exchange.
- Dividend-paying companies tend to have the most secure financial outlook. As the cream-of-the-crop listed on any stock exchange, they can afford to pay regular dividends to their shareholders, while continuing to invest capital for future growth.
- If invested in dividend-paying equities, an individual’s portfolio will benefit from the regular dividend payments, in addition to any gains in capital value. In a market downturn, these dividend payments moderate the negative impact on the portfolio.”

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“An investor *must* realize however, that despite these advantages, dividend payments of individual corporations are *not* guaranteed. A company can reduce or eliminate dividends at any time, particularly if it encounters difficult economic circumstances.”

“How do these companies decide when to pay a dividend to shareholders, and how much to pay?” wondered Jenny.

“It’s a major decision, Jenny. The Board of Directors of a corporation must first decide whether it’s financially strong enough to pay a dividend. In determining its magnitude, the Board must take into account capital requirements for future growth, and the company’s ability to withstand economic downturns.

Perhaps most important, the Board must weigh the corporation’s continuing ability to sustain or increase the dividend in future years. It knows the market will react very positively to a new dividend announcement. On the other hand, it will react extremely negatively, to future decreases or worse, elimination of a dividend.”

TIP #46..... Dividend-paying stocks, or funds which contain them, represent a *significant* percentage of the equity investments in a well-designed portfolio.

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“An added advantage of owning *individual* dividend-paying stocks, is that many such stocks offer the investor a ***Dividend Reinvestment Plan (DRIP)*** option.

A DIVIDEND REINVESTMENT PLAN (DRIP) offers an investor the option to automatically reinvest all dividend payments toward the purchase of additional shares.

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No commission is charged for these additional share purchases. Effectively, your current dividends will generate more dividends in the future, through the extra shares bought in this manner.”

“Is this another example of compounding at work, Grandpa?” inquired Kevin.

“Absolutely, Kevin! The extra shares acquired in this manner pay dividends, which in turn buy more shares which pay more dividends, and so on until you sell that particular investment. It’s a great example of compounding at work.

And here are a few other features of ***Dividend Reinvestment Plans (DRIPS)*** which are worth noting:

- Some DRIPS further enhance their value by offering a reduction of up to 5% on the cost of additional shares purchased through dividends;
- Many DRIPS require the ownership of a minimum number of shares. That number however, tends to be quite low;
- Toronto Stock Exchange lists more than one hundred companies offering this advantageous DRIP feature.”

“This is more like it, Grandpa,” enthused Kevin. “I invest enough to meet the minimum share requirement, then just like watching dandelions re-seed themselves, my number of shares keeps increasing. Cool.”

“It is cool, Kevin. Now you’ll understand that I wasn’t being insulting when I told you that all of your present portfolio investments are DRIPS.”

PREFERRED SHARES

PREFERRED SHARES issued by a corporation yield a specific dividend which must be paid to its preferred shareholders, before any dividends may be paid to its common shareholders.

“Unlike dividends on common shares, dividends on preferred shares *must* be paid. They are a contractual obligation. If their payment is suspended due to economic difficulties, the company will be considered to have defaulted on its obligation. It will be prevented from paying any dividends to its common shareholders until after the default is first remedied to the preferred shareholders.

- *Like* common stock, preferred shares represent an ownership interest in a corporation;
- *Unlike* common stock, preferred shares confer no voting rights on their holders.”

“You’re kidding! The owner of preferred shares owns part of the company, receives a more or less guaranteed dividend payment, but has no say?” questioned Jenny.

“And the common-shares holder also owns part of the company, receives a slightly less secure dividend payment, but gets some say,” continued Kevin. “Weird!”

“Because of their *preferred-dividend* feature, the market prices of these shares tend to be less volatile than those of common shares. On a risk scale, preferred shares would fall between the somewhat riskier dividend-paying common stock of the company, and its more secure corporate bond.

Due to their slightly-higher risk profile compared to bonds, the yield (dividends) on preferred shares will tend to be somewhat higher than the yield (interest) on the same company’s bonds.”

TIP #47..... For an investor striving to achieve a good return at a very modest risk, preferred shares can play a useful role in his portfolio.

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“Grandpa, you’ve mentioned *funds* as an effective way to diversify investments,” commented Kevin. “Can I presume that this includes all these different stock investments too?”

“Yes, Kevin. A huge variety of funds exist for pretty well all the products we’ve talked about since our discussions first began.”

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“This might be a good time to stop today. But when we return next Saturday, it makes sense to spend some time better understanding these funds. Usually they’re called *Mutual Funds*.”

“We’re in *mutual* agreement about calling it quits for today, Grandpa,” agreed Jenny. “My brain is just about overflowing! It’s been interesting. But I’m curious. What about real-estate related investments? Way back when we started these discussions we talked about Great-Grandma and Great-Grandpa investing in real estate. How does that fit in with all these financial options?”

“You’re right, Jenny. We should cover that subject too. Real estate investments are an important way of adding to our net-worth. We’ve talked about it, but only as it related to ownership of our *personal* home.

Since you’ve raised the subject, let’s delay our discussion on mutual funds, and instead begin with a discussion of real estate investment options when we meet next Saturday. Then we’ll return to understanding mutual funds as an investment vehicle.

How about lunch first, as usual? See you around noon?”

“No argument there, Grandpa. Thanks. See you then,” echoed Kevin and Jenny.

CHAPTER SEVENTEEN

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REAL ESTATE INVESTMENTS

“Here it is, our fifth Saturday already. I don’t know about you, but I’m impressed by the number of topics we’ve discussed.”

“Just don’t expect us to pass a test,” retorted Jenny.

“It’s so beautiful outside, what do you say we have our chat in the fresh air, on our balcony?”

“Great idea, Grandpa,” replied Kevin as Jenny nodded her head in agreement and led the way to the outdoor deck.

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“For starters, remember we agreed that generally, we buy our own home primarily as a comfortable and secure place to live? Only secondarily do we view it as a proven, excellent long-term investment.

There are however, a number of other options for investing in the real estate sector, in which our *primary* purpose may well be the potential *investment value*.

In some cases it may be a fortunate combination of both personal enjoyment and the expectation of long-term appreciation.”

1. THE SECOND HOME

“Long a favourite of many Canadian families is the *second home* – in most cases, a cottage. About 9% of Canadian families own a second home.

As with a family home, most second homes are bought primarily for family lifestyle. However the investment value may play a greater role in the purchase decision, than it does with a primary residence.

Canadians are well aware that cottages, particularly those on a waterfront, have over the past decades, increased dramatically in appeal, and therefore, value. Many have in fact, shown a capital appreciation often greater than that of the owner's principle residence.

Once a homeowner's main residence is substantially mortgage-free, purchasing a cottage property can bring great satisfaction to the family, as well as superb long-term growth in the homeowner's net-worth."

"I'd love to be able to afford a getaway cabin one day," mused Jenny. "I remember how much fun we had when we rented them for family vacations."

"Well, I'd rather have a little ski shack," reflected Kevin. "Hey, Jenny, you get the summer place and I'll get the winter one. That way we'll have one of each in the family!"

"It costs nothing to dream. Not only is a second home both a getaway haven, and a great investment, but it can also *work* for you, by earning income. It could be rented out when not in use by family. You could even be fortunate enough to not only cover your ongoing operating and maintenance costs, but also put a few extra dollars in the bank."

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"Because your country cottage, ski chalet, city condo or farm getaway is a *second* residential property, tax issues will force you to make a key decision when selling."

TIP #48..... Canadian tax laws permit an owner to designate *either* his second residence *or* his personal home, as his *primary residence* for income tax purposes. This choice must be made by the filing date of the first tax return, *after* the sale of either property.

“When you sell the property you have designated as your tax-exempt primary home, you are not required to report a capital gain on the sale. However, if you subsequently sell your other home, you *must* report, after all costs and improvements are factored in, any profit on the sale. You will then be assessed the *capital gains tax* on that profit.”

CAPITAL GAINS taxes in Canada are currently assessed at your marginal tax rate, on 50% of the increase in capital value of your investment.

“Grandpa, it’ll be a long time before either of us have *one* home, let alone two! But just in case, how would we decide which home to select as tax-exempt?” asked Kevin.

“Most likely, Kevin, you would exempt the one that had gained the most in value. But the best idea is to consult with an accountant just before you make the first sale. That way he can point out the tax consequences of choosing one home over the other, and guide you in the correct procedure to follow.”

TIP #49..... A secondary home or cottage, if clearly affordable, can be a great asset both for family enjoyment, and as an investment for long-term capital appreciation.

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“By the way, interest or dividends earned on investments are taxed differently. They are *not* included in the calculation of capital gains. Of course as we have discussed, if your eligible capital asset is held in an RRSP or a TFSA, any capital growth, interest, or dividends, are *not* taxed within either plan.”

“By ‘capital asset’, Grandpa, do you mean only financial investments, or can Kevin’s ski shack or my cottage also be held in an RRSP or a TFSA?” asked Jenny.

“I should have been more clear, Jenny. No, a real estate asset cannot be held in either a TFSA or an RRSP. However, under some circumstances, a first mortgage in a real estate property *may* be included as an RRSP investment. Before considering that however, it would be wise to consult an accountant to make sure that your mortgage qualifies, and that you follow the complex rules imposed by the *Canada Revenue Agency* on such a registered investment.”

2. RENTAL-INCOME PROPERTY

“Think back to our early get-togethers, when we chatted about your great-grandparents’ investments in rental properties. Because of their underlying property value and rising income stream, they were an excellent long-term investment.

Over the long term, a rental property’s value should increase in roughly the same proportion as personal residences in the same area.

As always, several cautions are appropriate:

- Owning a rental property is *not* a hassle-free exercise. Don’t underestimate the amount of work and expense required of you, the owner. Unless your budget includes paying a property manager 10 to 15% of your revenues to oversee the property on your behalf, you will be the one responding to all tenant issues, and arranging for ongoing maintenance.

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- Before proceeding with the purchase of a rental property, do your homework. Check out the rental market in your target community. Satisfy yourself that a sufficient long-term rental demand exists, to minimize vacancy risk.
- Calculate carefully, *all* the costs of ownership. Include mortgage payments, property taxes, maintenance, and an allowance for vacancies. Match those total figures *realistically*, against your projected rental revenue. Satisfy yourself that the economics make sense for you.
- As with any real estate investment, remember the three key rules for selecting any property – *location, location, location.*”

TIP #50..... With at least a 20% down payment on the purchase price, the addition of a rental property to a family’s asset mix can provide an impressive boost to its net-worth. With the combination of tenants paying down the mortgage, and capital appreciation over time, the positive net-worth impact can become substantial.

3. MORTGAGES

“Mortgages as an investment can be made available on a direct basis, to both individuals and developers.

More common however, is the purchase of a *share* in a pool of mortgages managed by a third party such as a ***mortgage fund***.

Many companies, large and small, exist for the sole purpose of lending funds as mortgages. These firms may choose to invest in first mortgages, second mortgages, or a combination of both. By creating a *pool* of funds, raised from individual investors, the mortgage fund managers acquire the necessary financial resources.

An ownership share in a *pool* of mortgages reduces investor risk through diversification.

These mortgage-based investments can produce impressive returns for the investor, at times in the 9 to 12% annual range.

Again, a few cautions:

- Careful *due diligence* is in order, in researching the caliber and reputation of the company with which you plan to invest. We've all read or heard of more than a few unfortunate examples in which investors, at times due to outright fraud, lost most or all of their capital.
- Be sure you recognize and accept that, with higher potential returns, comes higher risk. This is particularly so with investments in *second* mortgages.

First mortgages are considered to be of much higher quality and therefore less risky than second mortgages. Should foreclosure become necessary due to default by a borrower, *second mortgages* rank behind first mortgages.”

TIP #51..... Mortgage funds *can* be a useful, modest component of an investment portfolio. If carefully chosen, they can add significantly to the income stream within the portfolio.

“Kevin, are you thinking the same as I am?” asked Jenny. “We’ll probably be old and retired before we can handle more than our *own* mortgage, let alone invest in someone else’s.”

4. REAL ESTATE INVESTMENT TRUST (REIT)

A REIT is a corporation or trust that uses the pooled capital of many investors to purchase and manage income-property (an equity REIT) and/or mortgage loans (mortgage REIT).

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REITs can be bought as individual stocks in either a corporation, or an individual trust.

Again, maximum diversification will be achieved if these products are bought as a **REIT Index Fund**, such as the **iShares CND REIT Sector Index Fund (XRE)**.

REIT investments offer an investor a number of advantages:

- By definition, a REIT will provide an investor with far more diversification of risk, than could any single property or mortgage investment.
- Contrary to the purchase of an actual property, no minimum investment amount is required.
- Contrary also to property ownership, a REIT investment, no matter in what form, is extremely liquid. REITs can be bought or sold on any business day.
- Yields are typically paid as tax-efficient dividends. As such, they are usually taxed at much lower rates than most fixed-income investments. Tax issues disappear of course, if the investment is held in either an RRSP or TFSA.

Investors *must* accept however, that despite the promise of attractive yields at time of purchase, the returns will fluctuate over time, as will the value of the investment itself. REITs therefore are *not* a fixed-income product.

For some investors, their potential for much higher yields *may* compensate for the higher risk level.”

“Jenny, maybe investing in a REIT is the closest we’ll ever get to being landlords,” mused Kevin.

TIP #52..... A REIT may be an excellent addition to one’s portfolio as a modest-risk investment in the real estate sector. The broad, low-cost diversification achieved through investment in an index-based REIT product will serve to reduce risk.

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“It’s important to understand, Jenny and Kevin, that in no way have our discussions exhausted all of the many and varied investments available to investors.

In addition to those we’ve touched upon, there are many other, often very complex investment options, such as:

- Hedge funds,
- Foreign-exchange products,
- Limited partnerships,
- Commodity futures,
- Options,
- Flow-through shares,
- and other, even more exotic-sounding investments.”

“Grandpa, my eyes are crossing!” exploded Jenny.

Don’t let it worry you, Jenny. Actually, my advice is to always stick to the *KISS* principle of investing:

KISS ... KEEP IT SIMPLE, STUPID!”

“That doesn’t sound very politically-correct, Grandpa,” retorted Jenny.

TIP #53..... Unless you are an experienced investor, avoid investment products that are complex and difficult to understand. The less one understands an investment, the riskier it usually is.

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“Wow, Grandpa, there’s a lot more to this investment game than I thought!” exclaimed Kevin.

“Now I’m beginning to understand why so many people get confused, and why so few of us do really well with our investments,” added Jenny.

“You are both so right. It *can* be very complicated. What is important right now however, is that you gain a sufficient understanding of the investment *categories* we’ve discussed. This will equip you in future, to more intelligently decide the best fit for both *your own investment plan* and your *risk profile*.

I promise that when we finally begin to discuss your personal investment decisions, I’ll share with you some simple techniques that should serve well over the long term, to help you make smart and uncomplicated investment decisions.”

“Grandpa, the word ‘simple’ is music to my ears. But I really hope you’re keeping good notes for your book,” interjected Kevin. “It’s for sure we’ll need it!”

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“Grandpa,” added Jenny. “You *really* have talked a lot about *investment risk*. I’m not sure though I really understand how anyone can actually *manage* that risk. Can you tell us how a person can deal with risk and still be able to sleep at night?”

“That’s an excellent point, Jenny. It’s almost impossible to separate investment and risk. And since you raise it, I think it would be appropriate to discuss that topic now, before we turn to my long-promised mutual fund discussion.”

CHAPTER EIGHTEEN

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INVESTMENT RISK

“Jenny, hopefully I’ll now answer your concerns on risk, and help you see how an investor *can* understand and manage the role it plays in making investment decisions.

Remember, we agreed that if we’re to grow our net-worth by much more than the level of inflation, *prudent* measures of risk are *necessary* in our investments.

But to be ready to assume that risk, we *must* understand it. We must know both how to balance it against its potential benefits, and when to vary our level of risk-tolerance.

First you need to understand the ***risk-versus-benefit tradeoff***, over the long term. These figures show the actual, *compounded annual rates-of-return* for different Canadian investment categories, over the 67-year period between 1940 and 2007:

- Stocks (Equities) 10.6%
- Bonds 6.5%
- Treasury Bills (T-Bills) 5.2%

By comparison, during this same period annual inflation in Canada averaged 4.0%.

The next set of figures shows the growth of *a single Canadian dollar* invested in 1940, in each of these three categories. It assumes that *all* income from each investment was reinvested annually, through to the end of 2007.

This example is for illustrative purposes only since realistically, one would be unable today to invest only one dollar.

- Equities: \$1 in 1940 - Value in 2007: \$854
- Bonds: \$1 in 1940 - Value in 2007: \$ 68
- T-Bills: \$1 in 1940 - Value in 2007: \$ 30

These results show the huge incremental returns achieved by stocks over an extended time-frame, as compared to those of the much lower-risk bonds and T-Bills.”

“By the way, Grandpa, this looks like another example of the power of time and compounding. It sure works miracles,” observed Kevin.

“You’re so right, Kevin. It’s the power of compounding that makes all three of these growth figures so dramatic.

Despite the benefits of compounding, did you notice the compelling differences in value growth between the three asset classes?

As you both made abundantly clear throughout our discussions, you acknowledge the importance of *controlling risk* in any investments you make. Given that none of us is too likely to be dealing with a 67-year investment time-frame, we need to strike the right balance for us, between *risk* and potential *return*.”

“You’d better believe it, Grandpa,” exclaimed Kevin. “I’ll be lucky 67 years from now, if I can remember the *name* of my bank, let alone what I have in it!”

“History shows us that equities, while providing a dramatically higher return over the very long term, have much greater volatility over shorter time frames. We need therefore, depending on our stage of life and investment horizon, to balance our investment portfolio to produce what is for us, an ***acceptable level of risk***.”

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“Grandpa, you’ve convinced me that we have to take *some* risk when we’re investing,” said Jenny. “But I still don’t have the faintest clue how I’ll get a good night’s sleep. I’ll be a nervous wreck!”

“I think this next part of the discussion should help chase away those nightmares, Jenny.

Controlling risk effectively may at first seem a daunting task. You’ll be relieved though, to learn that *investment risk* can be broken down into simple, ***individual risk elements***:

- Expense
- Advisor
- Tax-erosion
- Investment term
- Lack-of-diversification
- Political and currency issues
- Trading frequency
- The ‘sure-thing’
- Timing
- Inflation
- Age
- Lack-of-a-plan

Each of these individual elements is easy to understand; most are easy to manage.

Let’s examine these risks one at a time, and see what we can do about reducing their negative impact on both your portfolio, *and* your peace-of-mind.”

1. EXPENSE RISK

“We’ve all heard that ‘*location, location, location*’ is the single-most important criterion when buying a home or an investment property.

By the same token, when making *financial investment* decisions, perhaps the three most important considerations over the long-term are ‘*expense, expense, and expense*’.

Let's elaborate, using a real-life example:

Remember our young friend, **Sam**? Let's say she inherits **\$100,000**. She wishes to invest it for the long-term, in a well-diversified, Large-Cap fund.

Sam has narrowed her choices down to either an actively-managed mutual fund, or an exchange-traded fund.

The management expense ratio (**MER**) on the actively-managed fund is **2.5%**. On the exchange-traded fund it is **0.5%**. We'll define all these terms in our pending discussion of mutual funds. For now, it simply indicates the difference in fees that Sam will have to pay for the management of her potential investment.

We'll make the assumption that over the **40 years** before Sam retires, both funds will be able to achieve an average annual return of **7.5%**, **before** expenses. This is a reasonable expectation in view of the very long-term time frame.

At the end of 40 years, a comparison of the two options shows Sam the difference in end-values:

	Original Investment	MER Expense (Annual)	Net Value to the Investor (40 Years)
Actively-Managed Mutual Fund	\$100,000	2.5%	\$704,000
Exchange-Traded Fund	\$100,000	0.5%	\$1,497,000

Earlier we learned about the positive power of compounding. However, compounding can either work *for* you, or *against* you. In this example, the *adverse* compounding effect of an extra 2% annual MER cost ends up eroding more than half the potential return on Sam's investment.

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The *extra* annual 2% management fee in this example, would cost Sam \$793,000 over a 40-year investment time frame. Another way of looking at this, is to conclude that by reducing her investment expense by 2%, Sam could more than *double* her total investment gains over a 40-year period.

The message in Sam’s case is a simple one, and leads to the next tip.”

TIP #54..... Minimizing the costs associated with an investment will over time, have a huge, positive impact on investment returns. If paying a higher fee, an investor must ensure that the long-term return of that particular investment is proportionately higher, to at least compensate for the higher fee.

“When we talk about *investment costs*, MER costs may not be the only expense. We have to include all other costs such as:

- front or back-end loads on funds;
- commissions charged when purchasing stocks;
- monthly or annual fees charged on accounts.

To minimize the potential high costs of investing in stocks and in many funds, *online* discount brokerages are available. Using a discount service can result in the cost of your purchase or sale being as little as one-tenth that charged by a full-service broker.”

2. ADVISOR RISK

“Given the relative complexity of the investment world, it’s understandable that many of us prefer or require financial planners or investment advisors to assist us.”

“Ha!” interjected Jenny. “Here I am having a nervous breakdown about all of this, and you call it ‘relatively complex?’”

“Financial advisors or planners can be very helpful. Unfortunately however, we often end up consulting an advisor who also sells financial investment products. He is both an advisor, *and* a vendor of specific products from which he earns fees. Even though, by law, any potential conflict of interest must be revealed to the investor, it is often glossed over by investors themselves as being not terribly important.

The conflict however, does become an issue if the advisor guides the client toward an actively-managed mutual fund for example, when a comparable product, such as an exchange-traded fund also exists, but at a much lower cost.

The advisor can't be blamed for encouraging clients to invest in one of his mutual funds. That fund gives him an initial purchase fee, as well as an annual *trailer fee* of perhaps 0.5% of the entire value of the investment, for as long as the client holds it.”

“That's probably why,” quipped Jenny, “I've heard the comment that even as your mutual fund is crashing in value, your financial advisor may be buying a new set of luxury wheels!”

“Grandpa, would ‘*Buyer Beware*’ be another of your famous tips?” asked Kevin.

“To be fair, Kevin and Jenny, advisors are generally very honest individuals, trying to earn a living. Simply put, unless they are truly *independent*, they have no incentive for pointing out comparable investment options with much lower fees. Many advisors probably believe in fact that their recommended fund will through better performance, more than make up for its higher fee. If they were correct, then this would be a win-win scenario for both the advisor and his client.

We'll examine *actual* performance differences when we finally get to our mutual fund discussion.

Truly *independent* financial advisors do exist. They do *not* offer for sale, specific products. Usually you will be charged either an

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hourly, or a flat fee for their advice. The cost in this case is well worth it. The independent advisor, having nothing more to gain, will provide totally objective input and advice.”

“Grandpa, you’re an anomaly,” chuckled Jenny. “You’re our advisor, you have nothing to sell, and you’re free to boot! What a deal!”

TIP #55..... For objective financial advice, consider consulting a truly *independent* professional who has no vested interest in the advice provided.

3. TAX-EROSION RISK

“To refresh your memory, Jenny and Kevin, investments *within* TFSA or RRSP accounts are tax-protected.”

“*That* fact is pretty well etched into our brain now – but I guess it doesn’t hurt to keep reminding ourselves,” agreed Kevin.

“If however, your portfolio is invested *outside* these accounts, its value, no matter how well-invested, will be severely eroded by income taxes.”

TIP #56..... Only if the maximum allowable investment in both a TFSA and an RRSP account has been utilized, should funds be invested outside these two tax-efficient investment vehicles.

“Let’s look at a few facts about *income taxes* on investments *outside* TFSA or RRSP accounts:

- All interest earned by your savings account, GICs, treasury bills, bonds or bond funds, is taxed as *ordinary income* in the year it is earned. This means that the tax you pay on

earned interest will be no different than the tax you pay on earnings from your job.

- Dividends from common or preferred stocks receive *preferential* tax treatment. This means that you pay much less tax on dividend income than on interest income.
- Capital gains, whether on the *sale* of real estate, stocks, bonds, ETFs, mutual funds, or any other investment, are taxed at the investor's normal tax rate. Fortunately however, the tax calculation is applied to only *one half* the increase in value."

"So what exactly does this mean for us when we're investing, Grandpa?" asked Jenny.

"The simple rule, Jenny, is twofold:

- Invest everything possible in either a TFSA or an RRSP;
- If you have additional investments (other than an RESP), beyond the maximum capacity of these tax-sheltered vehicles, be sure that at least your *interest-generating* investments are in either your TFSA, or your RRSP."

TIP #57..... Different tax treatments on investments, and their impact on returns, should always be considered when deciding *where* to hold investments.

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"*Before* you ask, I'll clarify. Because it is taxed the most severely, an interest-generating investment should be in either a TFSA or RRSP account. It doesn't matter which account, *if* you are not drawing down the earnings.

If however, you are planning to draw income in the shorter term, try to favour your TFSA, because you will pay no tax on your

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withdrawals. Withdrawals from RRSPs on the other hand, attract full taxes as if they were earned income.

That tax penalty is usually mitigated by the *retiree* withdrawing funds from an RRSP, because he has likely dropped to a lower tax-bracket than when he was contributing.”

“So in withdrawing funds from an RRSP or RRIF, the retiree will usually pay less tax on the withdrawal than the amount of the tax refund he received when he originally made the contribution? Is that correct, Grandpa?” asked Kevin.

“Generally, that’s true, Kevin. But remember the original contributions are likely to have grown dramatically over time. More *actual* tax will eventually be paid on withdrawals, but only because the amount withdrawn will be far greater than originally contributed.”

“So originally, you might have received a tax refund of 40% on the \$10,000 you contributed to your RRSP. Once you retired, your marginal tax rate may have dropped to 28%, but it will be applied to say, the \$30,000 that the investment had become?” asked Jenny.

“That’s exactly the point I was trying to make, Jenny.”

4. INVESTMENT-TERM RISK

a) Fixed-Income Investment

“Generally, your *missed-opportunity risk* is greater, the longer the term of your *fixed-rate* investment.

Consider for example, a 5-year GIC. Because the return of your principal is guaranteed, your *capital risk* is zero. However, your interest rate is locked in for the full five years. This means you lose any *opportunity* to take advantage of higher rates which may become available before your GIC term ends.

To partially compensate for this risk, longer-term fixed-income investments usually pay a higher return than those offered for shorter terms.”

“Fixed-income investments certainly are attractive to those of us who like to feel safe,” commented Jenny. “Maybe we just have to live with their being locked in for some years.”

“There is a way, Jenny, to reduce this risk of locking in for the longer term. You can ***ladder*** your fixed-income investments.”

LADDERING is the staggering of investment maturities over various terms.

“The intent of laddering is to help smooth out the impact of interest rate fluctuations, and to allow a gradual reinvestment at current rates. This strategy also prevents drastic changes to the earnings generated by your fixed-income portfolio.

For example, you decide to place \$25,000 of your investment portfolio in GICs or bonds. You split it into five individual investments of \$5,000 each, with 1,2,3,4,and 5-year maturities. The first matures after one year, the second in two years, and so on, until the fifth reaches maturity in five years.

At the end of year one, you will reinvest the now-matured one-year investment (with or without the interest earned) in a new 5-year term. Repeat the procedure each year, with every subsequent maturity.”

TIP #58..... Laddering of fixed-income investments is an effective tool for gradual adjustment to rising or falling interest rates, thereby avoiding drastic rate changes and earnings fluctuations.

“As an added benefit, this 5-year laddering strategy also provides for the investor, annual access to one-fifth of his invested capital.”

“So, Grandpa, if I eventually decided to go back to school for a PhD or something,” asked Kevin, “I could crater one-fifth of my GIC investment each year, and still leave the other GICs earning me interest till I need more money the following year?”

“That’s exactly how it could be done, Kevin.”

b) Equity Investments

“For equity investments, the risk is different. *The shorter the time frame, the higher the risk*, whether invested in stocks, or in equity mutual funds.

We do know that over many decades, a *well-diversified* portfolio of high-quality equity investments has consistently outperformed all other categories of investments, by a wide margin.

Equity investments, unlike fixed-income investments, have neither an underlying guarantee of value, nor of regular dividend payments. They are subject to the ups and downs of the economy, and to the changing fortunes of individual corporations. Equity market returns in the shorter-term do *not* gravitate around the high, average long-term gains. Instead, they tend to *spike* above or below the average.

This extreme example will illustrate:

In 2008, the TSX Index plummeted by approximately 35%. However, over the preceding 67-year period, from 1940 to 2007, it produced on average, an annual rate-of-return of 10.6%.”

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“This is frustrating, Grandpa,” complained Jenny. “If I invest in stocks for a short time, I might lose money. If I invest for a really long time, like my *whole* working life, I’m likely to make a great deal. But then, because of inflation, it will be worth less anyway. Yikes!”

“It isn’t as bad as it seems, Jenny. Although *time* is only one investment risk factor, this TIP may help simplify your decision.”

TIP #59..... To reduce the risk of negative, short-term market fluctuations, equity investments should always be made with a longer time-horizon than fixed-income investments.

5. LACK-OF-DIVERSIFICATION RISK

“Putting all your eggs in one investment basket, or even in a limited number of products, is clearly a higher risk than investing across a wide range of options. Let’s consider a few examples:

- *Owning one stock only, no matter how highly recommended, is at the extreme high-end of the risk spectrum for equity investments.*

*The safest place on the equity-risk spectrum, would be to own shares in the **total equity index**, whether through an actively-managed mutual fund, an index fund, or an ETF.*

- *Owning equities only is riskier than having a portfolio with a **mix** of GICs, bonds, and equity investments.*
- *Owning fixed-income investments with a single maturity date is riskier than laddering the investment to staggered maturity dates.”*

TIP #60..... Diversification *within* an investment class, *across* investment classes, and over varying time-frames, are all key to achieving a well-balanced portfolio, with a prudent level of risk.

6. POLITICAL and CURRENCY RISK

“If you, as a Canadian investor, were to invest in only one nation’s financial products, it should be Canada. That’s where you live. That’s where you’ll spend the benefits of your investments. By sticking to Canadian investments only, you won’t encounter exchange-rate risks. You’ll be earning returns in the same currency that you spend.

Also, if your investment is held in taxable vehicles outside an RRSP or a TFSA, it’s important to keep in mind that advantageous dividend tax-credit rules are applicable to Canadian investment products only.

Canada, however, represents barely 3% of the world’s investment opportunities. By limiting yourself to Canadian-based investments only, you *may* be missing out on some great growth opportunities.

On the other hand, if your investments were to include those of other countries, such as for instance, Brazil, Japan or Germany, you’ll add a major new dimension to your risk exposure, namely political and currency risk.

Global diversification is worth considering for every long-term portfolio, but *only* with the appropriate level of *currency protection*, and with due regard to *political* risk.

Currency risk can be substantially eliminated through Canadian *currency-hedged ETFs* or other funds. You will pay a slightly higher annual fee for the hedge cost, *but* you will have eliminated the currency risk.

There is no real hedge available, other than wide multi-national diversification, against the risk of, for example, a third-world country defaulting on its government’s bond obligations.

The prudent investor is wise to ensure that any international fund in which he invests holds only a small proportion of its total investments in the products of less politically-stable countries.”

“I’m sorry, Grandpa,” interrupted Jenny, “you just lost me again. The only hedge I know about is the one in our back yard, and I know that’s not what you’re talking about. So what is a ‘hedge’?”

“Sorry about that, Jenny!”

A HEDGE is an action taken to protect against an unfavorable price move of an investment product.

“Now I understand – I think,” replied Jenny.

“And now you’ll understand the next TIP.”

TIP #61..... A modest diversification into international investment products should be considered as an element of a prudent investment portfolio, but ONLY if it can be purchased on a fully-hedged basis, to eliminate currency risk.

“Failure to hedge foreign financial products greatly magnifies the investment risk. If an international investment were to decline due to cyclical economic or political upheaval for instance, *and* at the same time, the currency-value of the investment falls, the double-whammy could be catastrophic for your portfolio.

On the other hand, the opposite can also be true. If the international investment value were to increase dramatically, and its currency-value relative to the Canadian dollar were to rise at the same time, you could stand to make a huge return.

Relying however, on *two* key factors moving in the right direction at the same time, is more akin to *speculating* than to prudent investing.

TIP #62..... In considering international financial products, the prudent investor always balances currency and political risk against potential benefits, and errs on the side of caution.

7. HIGH-FREQUENCY TRADING RISK

In today's world of easy, accessible, and inexpensive *online* trading, the temptation for frequent trading – buying or selling of almost any financial instrument – arises all too often.

Many of us, believing in our abilities as independent investors, trade too often, at times making several online trades weekly, or even daily. For the most part, these individuals are not investors. At best they're *traders*; at worst, *gamblers*."

"This reminds me of another question, Grandpa," interjected Kevin. "Remember on our last trip to Mexico, you were talking with a woman who said she pays for all her vacations with her earnings as a *day-trader*? Exactly what is a '*day-trader*'?"

A DAY-TRADER is an individual who buys and sells a financial instrument in the same trading day, and often, multiple times in the same week.

"That sure sounds like gambling to me," exclaimed Jenny. "Why would anyone want to take that kind of risk?"

"It definitely is not an activity for the faint-of-heart, nor for those who cannot afford to comfortably absorb losses. I'm certain that a *very small* percentage of day-traders do quite well, but in the greatest majority of cases, trying to outguess the market's movement in such short time spans is not a winning strategy."

TIP #63..... Day-trading is one of the riskiest strategies for most individuals. In fact for many, it is not an investing strategy, but at best, speculation.

“We already know how very difficult it is to time the market properly. The odds of making *frequent*, successful, buy-and-sell decisions over extremely short time-frames, are very slim to none.

This point is important enough to merit another TIP, a corollary to the previous one.”

TIP #64..... If you do plan to *try* to predict market moves on a frequent, short-term basis, do so with no more than 5% of your total portfolio. Be aware that frequent trading rarely leads to long-term success.

“Etch the following in your brain. It won’t let you down:

PRUDENT INVESTING combines the elements of:

- ***QUALITY***
- ***DIVERSIFICATION***
- ***MAGIC OF COMPOUNDING***
- ***PATIENCE, and***
- ***TIME.***

Prudent investing is *not* the impatient flipping of investments in a perpetual search for the get-rich-quick fortune.

Trying for a quick return is best left to buying the odd lottery ticket or heading to Vegas for a fun holiday. It is not for the prudent investor.”

“After all this, I doubt I’ll have the nerve to buy even a raffle ticket,” quipped Jenny.

8. THE ‘SURE-THING’ INVESTMENT RISK

“Unless it’s a GIC, or other *guaranteed* investment, there is no such thing as a *sure-thing* investment. If someone tells you there is, run the other way fast!

By the time the average person learns about a truly exceptional investment opportunity, you can be sure many others are also aware of it. Chances are that by the time you buy in, the price will already have reflected the higher value.”

TIP #65..... Leave *tips* for servers in restaurants. Never use them as a basis for investment decisions.

9. MARKET-TIMING INVESTMENT RISK

“Regardless of *when* you make a major investment in the equities market, you are always at risk of making it just before a major downward market correction. This could in the short term, see your initial investment plummeting.

No matter how we reassure ourselves that the investment will serve us well over the long haul, such a quick drop in the value of our investment can be traumatic. It may even lead us to doubt the very wisdom of investing in equities.

But a simple technique, available to all of us, virtually eliminates that risk.

Remember our *Pay Yourself First* strategy? We talked about combining it with an automatic investment program that regularly diverts 5 to 10% of our gross income to specified investments. This same approach can benefit our portfolio, even during periods of equity downturn.

During downswings, our *regular* contribution to our portfolio will buy a greater number of *units* of our chosen investment product, at the lower price. This tends to average-down the per-unit cost of our earlier purchases. Once the market recovers and turns up again, our portfolio will recover more quickly than had we not averaged-down.”

TIP #66..... Regular, periodic investments in the equity portion of a portfolio will serve to smooth out the impact of major market corrections.

10. INFLATION RISK

“As Jenny continues to remind us, the effect of inflation is a key factor in the *actual* future value of our investments. We saw how the purchasing power of our investments can be eroded, even by modest 3% annual inflation rates. This impact becomes even more dramatic when continued over several decades.

Inflation is a fact of life. For your investment portfolio, it presents such a huge potential risk, that it warrants more emphasis. Investing exclusively in fixed-income instruments presents the real risk that over time, our returns may barely keep pace with inflation.

On the other hand, *equity indexes*, pretty well world-wide, but most certainly in Canada and the U.S., have over the decades, dramatically outpaced inflation. So why not invest everything in either an index-based equity product, or in individual, high-quality equities?”

“Trick question, right? I think we answered it earlier, Grandpa,” retorted Jenny. “We know there’s an added risk from having too many eggs in one asset class, or any other *single* basket.”

“You really have been listening! Good for you, Jenny.”

“And, Grandpa,” added Kevin, “we know the three magic words this time.... ‘*balance, balance, balance*’ – a little bit of this, a little bit of that.”

“Well put, Kevin!”

11. AGE-RELATED RISK

“In your 20’s – your early investing years – your investment strategy is not unduly risky, even if 70 or 80% of your entire TFSA and RRSP portfolio is in equity-based products. This is especially so if the majority of these investments is in dividend-paying equities.

At this age, you have the advantage of the magic power of *compounding* and *time*. As we have seen, these two factors dramatically reduce risk while at the same time, enhancing your ultimate returns.

On the other hand, a 55-year old investor who plans to retire at 60, and who plans to draw on his investments as soon as he retires, will need a much different mix. By this age, his portfolio should have gravitated toward a more conservative investment mix – perhaps 60 or 70% in fixed-income investments, with only 30 to 40% remaining in riskier equity-based products.”

TIP #67..... Every investor must strive to balance the assets in his portfolio between equities and fixed-income instruments, in a proportion appropriate to his circumstances at each particular stage of his life.

“Over shorter periods of for instance five years, stocks can be highly volatile. The near-retirement individual cannot afford during his last few working years, to risk a significant portion of his portfolio on the possibility of an equities downturn. On the other hand, he

must still protect against inflation. Knowing that he may live into his 90's, he still needs to keep a *portion* of his portfolio in equities, or he risks outliving his funds.”

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“Grandpa, is there some easy *formula* that we can use to determine the best mix at various ages?” inquired Kevin.

“Unfortunately there isn't one that fits everyone, Kevin.

We each have different circumstances and personal levels of risk-tolerance. These differences will influence how we build, balance, and manage our individual portfolio.

Let's look again at a real example:

*Meet **Mike**, an electrician with 35 years of government service. He enjoys a defined-benefit pension plan which, when he retires, will pay him 70% of his pre-retirement income. Knowing this, Mike can comfortably maintain a higher proportion of his portfolio in equities, even after retiring. With such substantial pension income, he will not have a major need to regularly draw on his investments.*

For those *without* a significant pension plan or other safety-net, the reverse will be true.”

“A public-sector career looks better and better,” quipped Jenny. “What do you say, Kevin, should we go for municipal, provincial or federal?”

TIP #68..... As one ages, the age-driven risk to an investment portfolio can be moderated by a gradual shift in emphasis from equities to fixed-income investments. The degree of the shift should be governed not only by the timing of planned withdrawals, but also by the magnitude of such withdrawals.

12. THE LACK-OF-A-PLAN RISK

“It’s important that each of us, as potential investors, educate ourselves on:

- The various investment classes;
- The products within them;
- The various risk factors we’ve just talked about; and
- How to manage them.

All of this knowledge however, will prove to be of little value if we don’t have an individualized *plan*.

Take the vehicle owner who gets into his car. He knows how to drive, but has no idea of where he wants to go, how best to get there, or how long it will take. The driver needs a destination, and a travel plan to reach it.

So too, does the investor need both a goal and a plan. He needs to determine his:

- Periodic shorter-term objectives as he moves through various stages in life;
- Long-term objective for his retirement years;
- Strategies for achieving these goals, including prudent risk-decisions.

These various elements are all part of what is commonly referred to as a **FINANCIAL PLAN**.

A Financial Plan is so critical to an investor’s success that we’ll make time on a future Saturday to dig in and really understand what we mean by such a plan.”

TIP #69..... A periodically-updated financial plan is one of the most crucial stepping stones to successful wealth-creation.

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“Grandpa, that’s quite an eye-opening insight into investment risk,” observed Jenny. “What amazes me, is that when you break risk down into its individual elements, it’s so much easier to understand – and not so scary.”

“I’m glad you now see that, Jenny. Not only is risk easy to understand, but also, relatively easy to reduce to acceptable levels.

As a result of today’s rather lengthy discussion, I hope we’ve laid the foundation for your becoming wise *and* prudent risk-takers. If you succeed in blending this with the other information you’ve acquired, you should both become very successful wealth-builders.”

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“Grandpa, you keep teasing us with this ‘wealth-building’, but we still have to get to the good part – the actual investing,” prompted Kevin.

“Patience, we’ll get there, Kevin.”

“Actually, I’m beginning to see how, if I plan it right, I can actually become a millionaire,” added Kevin. “But I’m still worried about inflation chewing up the value of my million bucks.”

“And that’s why, Kevin, I said that one million dollars may *not* be the right objective for you. This will become more clear when we eventually put together a customized *financial plan* for each of you.”

“I’ll probably be as grey as Grandpa by the time we get around to it,” muttered Kevin to Jenny.

“I heard that, Kevin! But first, I’ve been promising we would delve deeper into mutual funds, particularly the pros and cons of actively and passively-managed funds.

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I think though, you've had enough information for today."

"You can say that again, Grandpa!" two voices echoed in stereo.

"Let's meet again for lunch before we head back to our place next Saturday. Is that still OK with both of you?"

"You've got a deal, Grandpa," replied Jenny. "But if we can talk about something other than wealth-building during lunch, *we'll* buy *you* the dessert!"

Free sample – intro & chapters 13 to 21

MUTUAL FUNDS

Buy this book at www.amazon.ca

CHAPTER NINETEEN

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MUTUAL FUNDS – An Investment Vehicle

“Our sixth Saturday – we’re moving along nicely, Kevin and Jenny. I’m impressed! If you stick with me for a few more Saturdays, I think you’ll have a really good foundation for managing and investing that money you’ll eventually be earning – not to mention building your long-term financial independence.”

“We do appreciate your spending this time with us, Grandpa,” replied Kevin. “But we’ll remember these Saturdays even more fondly once we become millionaires!”

“You certainly don’t lose sight of your objective, Kevin! And by the end of today’s discussion, your understanding of mutual funds is almost certain to become a very important part of your future success in wealth-creation.

As we mentioned near the end of last Saturday’s session, most of the investment options we’ve discussed so far can be purchased individually, or through some form of *Mutual Fund*.”

A MUTUAL FUND is offered by a company that attracts many individual investors who wish to own stocks, bonds, or other securities, on a pooled basis. Each investor buys into the fund, purchasing shares or units, which represent his proportional investment.

BENEFITS OF MUTUAL FUNDS

- “Mutual funds are an investment *vehicle*. An investor can buy units (shares) of the fund on a one-time, or regular-contribution basis. The latter allows over time, for automatic averaging of unit-costs, thereby smoothing out the bumpy effect of major market changes.
- They are instruments of easy diversification, allowing individuals to own a share in a basket of investments in any category of their choice. This averages the investor’s risk across many products.
- They are easy to invest in, providing opportunity for achieving easy balance between equities, bonds and other fixed-income investments.
- They are easily convertible on short notice, into cash.
- Over the long-term, consistent investment in solid mutual funds should produce a significant, cumulative return. This helps the investor achieve his wealth-creation objectives.”

TYPES OF MUTUAL FUNDS

“Mutual funds fall into two basic categories:

- Actively-Managed Funds
- Passively-Managed Funds

It’s extremely important, *before* choosing a mutual fund for his portfolio, that an investor understand the differences between these two types of funds.”

1. Actively-Managed Mutual Funds

An ACTIVELY-MANAGED MUTUAL FUND is one in which its managers make many individual decisions to buy or sell specific investment products, in an effort to outperform a particular benchmark index.

“These funds are operated by an investment firm or bank. It raises money from individuals and invests the proceeds in a particular group of assets, in accordance with a stated set of objectives, which it shares with its investors.

Each fund will purchase various investment products such as stocks, bonds and money-market instruments, depending on the fund’s objectives. They can focus on various sectors such as mining or financials, or on individual countries or regions.

Many actively-managed mutual funds require a minimum initial investment.

Because of its *active* portfolio management, each fund charges an annual fee, called the ***Management Expense Ratio (MER)***.

Many funds also charge:

- An entry fee (*Front-End Load Funds*) or,
- An early-exit fee (*Back-End Load Funds*).

The **disadvantages** of *actively-managed* mutual funds are their ***high fees***, and very *spotty* performance relative to index benchmarks, such as the overall S&P TSX Index, or many of its sub-indexes, such as the Resources or Financial Index.”

2. Passively-Managed Mutual Funds

PASSIVELY-MANAGED MUTUAL FUNDS simply strive to track, rather than exceed, the performance of a particular index or sub-index.

“There are two main avenues for acquiring passively-managed mutual funds. They can be bought either as:

- Index funds, or
- Exchange-traded funds (ETFs).”

a) Index Funds

An INDEX FUND is a passively-managed mutual fund that strives to mirror the performance of a specific index such as the S&P 500 (broad-based U.S. Stock market index) or TSX 60 (top 60 companies on the Toronto Stock Exchange).

“As of 2009, index funds in Canada are offered primarily by Banks.

Index funds enjoy exactly the same advantages as actively-managed mutual funds, but with much lower management fees.

Since portfolio decisions are relatively automatic, and transactions infrequent, costs incurred by the fund are lower. As a result, the fees charged to investors are dramatically less than those of actively-managed mutual funds.”

b) Exchange-Traded Funds

An EXCHANGE-TRADED FUND is very similar to an Index Fund. It also tracks a specific index. It is however, bought and sold like a stock.

“Even fewer decisions are required of the fund manager, since the index is tracked relatively automatically. Fees as a result, are even lower than those levied for Index Funds.”

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“So, Grandpa,” clarified Jenny, “do I hear you saying the main difference between an index fund and an exchange-traded fund is basically the way you buy and sell them?”

“That’s generally correct, Jenny. But as I’ll explain in a minute, there *are* nevertheless good reasons for choosing one over the other.”

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“Grandpa, in comparison to the *individual* investments we discussed, how *risky* are all these different types of mutual funds?” asked Kevin.

“Well, Kevin, it depends on the *specific* products in which a particular fund invests:

- Clearly, if a mutual fund is invested in a diverse basket of *fixed-income* products, it will be very safe.
- If the investment is in *equity-based* products, then due to the inherent volatility of stock markets, the risk will be greater, especially over the short term.

On the other hand, particularly over a longer period of time, equity-based mutual funds will have a much greater upside.

Because mutual funds by their very definition contain a broad basket of individual investments, the ***diversification*** factor makes *any* type of mutual fund less risky and less volatile, than if you were to invest in specific stocks or bonds.

The real challenge for the investor is to invest in funds:

- With a low cost-base; *and*
- Which strike the right balance between fixed-income and equity-based products.

With this careful balance, such a portfolio will often be referred to as a ***balanced portfolio***.”

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“It seems to me,” suggested Jenny, “that what’s important is whether the actively-managed mutual funds do well enough to make up for their higher fees, compared to how Index and Exchange-Traded Funds do, with their much lower fees. Right?”

“Absolutely correct, Jenny.

Remember our reference to the TSX Index performance over the years 1940 to 2007? Over that period, we saw that the Index increased by an average, compounded annual rate of 10.6%.

Many of today’s financial products such as Index Funds and Exchange-Traded Funds did *not* exist decades ago.

But if, using products available *today*, and over that *same* time span, you had been invested in the TSX Index through either of these *passively-managed* funds, you would have netted an annual return of at least 10.1%, because the average management fees would have been no more than about 0.5%.

Now, let’s assume the same 10.6% rate-of-return over the same 67 years. But this time the investment is in an *actively-managed* mutual fund. The actual yield to the investor would have had to be reduced by management fees of some 2.5%. This would have resulted in a much lower net annual return to the investor of only 8.1%.

The 2.5% figure represents *approximately*, the average annual Canadian ***Management Expense Ratio (MER)*** of actively-managed mutual funds. If the fund had also had a *front-end* load cost, the yield to the investor would have been even less than 8.1%.

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In this example, with both types of funds performing equally, the net return to the investor of the actively-managed fund would have been at least 2% less on an annual basis, than if he were invested in the low-cost, passively-managed fund.”

“I remember in our earlier discussion, when you showed us the incredibly negative effect of a 2% greater annual cost on our friend **Sam’s** investment returns,” recalled Kevin.

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“This is so important, Kevin and Jenny. Because of these much higher fees, actively-managed mutual funds represent a *higher* level of *risk* to your investment returns than does either a passively-managed index fund or an exchange-traded fund.”

“Charging the same high fee, whether the actively-managed mutual fund goes up or down in value, doesn’t seem fair,” offered Jenny. “Why would the cost be the same to the investor if the fund has a bad year?”

“Well, Jenny, the fund management’s argument is that their costs continue at the same level, whether a fund is up, down, or unchanged in value. To be fair, the same also holds true for index funds and exchange-traded funds. At about 2.5% however, the average MER of an actively-managed mutual fund is about five times the approximate average of 0.5% charged by index funds and ETFs.”

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“I’m glad we don’t need to write a test on all this,” commented Kevin. “It’s a pretty convoluted subject, even for someone like me who *enjoys* math problems.”

“This subject *can* take some time to digest. I’ve been at it for decades and there’s always something new to learn.

It may become more clear as we look at the specific performance of actively-managed funds, compared to that of passively-managed funds.

It makes sense that an investor would *not* mind paying higher fees for an actively-managed fund, *if* its long-term performance were to more than compensate for the higher fees.

Let's consider that next, as we compare the relative performance of these two categories of funds.

But first, a short break?"

"Yes, yes, yes!"

TIP #70..... A successful investment portfolio will often include in its investment mix, well-managed mutual funds with good track records. However, great care must be exercised to properly consider each fund's performance for the investor, after the impact of all costs: Front-End Load (entry) and Back-End Load (early-exit) charges, as well as annual Management Expense Ratio (MER) fees.

CHAPTER TWENTY

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ACTIVELY-MANAGED MUTUAL FUNDS

“Earlier we referred to the choice faced by our young friend *Sam*, as she deliberated how to realize the best potential long-term return on the investment of her \$100,000 inheritance. She mulled over whether to opt for a broadly-diversified, actively-managed mutual fund, or a passively-managed fund, such as an ETF. She had *assumed* that before fees, both funds could achieve the same average annual return of 7.5%.

Sam was shocked to discover that, with *no* difference in fund performance, the 2% extra cost in annual fees of the actively-managed fund would, after 40 years, produce about 43% less total return than would the low-cost ETF.”

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“I remember discussing Sam’s situation,” commented Jenny. “I also remember wondering if the 2% higher fee could have been justified by the possibility of better performance of the actively-managed mutuals.”

“You’re right, Jenny. We did wonder if her *assumption* of an equal rate-of-return from both types of funds was a valid one.

If in fact, the actively-managed fund *did* produce a higher return than for example, an ETF, Sam’s underlying assumption that they would both achieve the same average annual return would have been false.

But why speculate? Let's look at some real data, extracted from various reliable publications which regularly track actively-managed fund performance compared to the key benchmark Indexes."

EQUITY FUND PERFORMANCE

"Fund performance statistics show:

- Over the three years, 2005-2007, only 13.3% of actively-managed Canadian equity funds outperformed the TSX Index.
- Over the five years ending June 30, 2009, only 7.6% of actively-managed Canadian equity funds beat the TSX Index.
- In the 15-year period from 1993 to the end of 2008, the TSX Index returned an average of 7.1% per year. Canadian actively-managed funds averaged a return to the investor of 5.4%.
- In the 25 years from 1980 through 2005, the average U.S. actively-managed equity fund provided its investors with an average annual return of 10.0%. The average annual rate-of-return for the S&P 500 Index (U.S. benchmark index) during the same period, was 12.3%.
- A 2009 study by *MyPrivateBanking.com* found that over the previous five years, the *equity funds* of about 80% of the world's largest wealth-managers lagged behind benchmark index returns."

"With the odds of beating the index so low, it's a wonder that anyone invests in an actively-managed mutual fund," offered Kevin.

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“I’m with you, Kevin. There are *some* select situations, especially for higher-net-worth individuals, where an actively-managed mutual satisfies a unique niche that the investor wants. But I for one, would not look too far for such exceptions for my portfolio.”

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Investors can remain current on the latest fund performance comparisons by going online and googling: Index Versus Active Funds Scorecard for Canadian Funds.

“The poor long-term performance of the *actively-managed* mutual fund sector, compared to index performance, as reported in detail by *SPIVA (S&P Indices Versus Active Funds)*, will astound you.”

“I bet Sam’s actively-managed mutual fund provider wouldn’t be too likely to refer her to this site!” quipped Jenny.

“This site also provides an up-to-date statistic on the 5-year survivorship rate of actively-managed equity funds. Early in 2009 for instance, it indicated that survivorship of the average Canadian equity fund was 44.9%. This ***does not*** mean to imply that more than half the investments were lost. Funds may either have merged, or been discontinued. Regardless of the reason, this indicates a huge turnover of actively-managed funds.

Market indexes by contrast, tend to survive for the long term. New ones may be added, but few disappear.”

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“Is this difference in performance the same for actively-managed funds that invest in other products – like bonds?” inquired Kevin.

“Good question, Kevin. Let’s take a look at the performance of Bond Funds.”

BOND FUND PERFORMANCE

“Actively-managed Canadian **equity** funds have average MERs of about 2.5%. Actively-managed **bond** funds tend to have MERs on average, about 1% lower, mainly because there are many fewer investment options for bond funds to evaluate.

In its October 3, 2009 issue, the **Globe & Mail** newspaper listed Canada’s largest funds, as measured by asset values. The list included 18 *actively-managed* bond funds.

As a useful reference point, the list also included these two *exchange-traded funds (ETFs)*:

- The **iShares CDN Bond Index Fund** (*listed as XBB on the TSX*). This fund seeks to track the Scotia Capital Universe Bond Index. This in turn tracks the performance of a large collection of short-, mid-, and long-term bonds, with an average duration of 6.49 years.

The 5-year performance of this ETF showed an average annual yield to the investor of 5.35%. The MER was a low 0.3%.

- The **iShares CDN Short Bond Index Fund** (*listed as XSB on the TSX*). This fund seeks to track the performance of an Index of short-term bonds only, with an average duration of 2.56 years.

The 5-year performance of this ETF showed an average annual yield to the investor of 4.86%. The MER was an even lower 0.25%.

And now, the results of a comparison between these two ETFs and the 18 actively-managed funds:

- *Not one* of the 18 actively-managed bond funds showed a return to the investor over the previous 5 years, that exceeded or even matched the returns of either of these two ETFs.

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- Of these 18 funds, the *average annual yield to the investor was 3.99%*.
- The average **MER** of the 18 actively-managed funds was **1.53%**.

Clearly, an investor would have been much better off investing in either of the low-fee *passively-managed* bond ETFs during these five years, than in any of the eighteen actively-managed bond funds.

For the investor, most of the shortfall in performance of the actively-managed funds, was attributable on average, to the **1.2%** higher fees these funds charged through their MERs.”

Had the MERs for the two fund categories been competitive, the yield to the investor would have been fairly similar.”

“This pretty well hammers home your previous comment that ‘**expense, expense, expense**’ is an investor’s number-one risk-factor,” commented Jenny.

“You’re right about that, Jenny. Particularly when considering the impact over a long-term investment, keeping the management expenses low can be the greatest enhancer to overall returns.”

MANAGEMENT EXPENSE RATIO (MER) – COST COMPARISON

“A recent international academic study found that world-wide, more than 50,000 actively-managed mutual funds are available to investors. Of this total, over 4,000 are available in Canada.”

“No way!” exclaimed Kevin. “No wonder we see so much glossy advertising by mutual fund companies. The competition must be fierce.”

“It is, Kevin, and that high advertising cost is one of the key reasons why the investor pays such high MERs with actively-managed funds.

The *MER* for the average actively-managed **Canadian equity fund** was reported to be **2.68%** – the highest of all 18 countries surveyed.

By comparison, the average **U.S. equity fund MER** was found to be much lower, at **1.42%**.”

TIP #71..... *In any given year the average actively-managed Canadian mutual fund manages to outperform its comparable Index only 20 to 30% of the time. When making an investment decision, an investor must be cognizant of this industry-wide, much-below-average performance.*

ADDITIONAL FUND COSTS

“When an individual chooses to invest in an actively-managed mutual fund, MERs may not be the only expenses he faces.

Many actively-managed funds also have either a **Front-End Load** or a **Back-End Load** charge. Often the investor is given a choice between the two:

- The **front-end** option – effectively an entry fee, can lead to a one-time charge of 2%, or even more, of the initial investment.
- The **back-end** option – the early-exit fee, replaces an up-front fee. The fund *may* charge up to 5% of total value, if an investor terminates his fund ownership during the first seven years after purchase. After seven years, this fee obligation generally disappears.”

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“Are you saying that *in addition* to the MER it’s almost impossible to buy into actively-managed mutuals without being nailed by a bunch of additional fees?” asked Kevin.

“In fairness, Kevin, actively-managed funds offered by Canadian Banks do not have either a front-end or back-end load. They do however, charge a substantial MER. So if you purchase one of these Bank funds, you can generally limit your costs to their MER charge.”

TIP #72..... It is not unusual for investors whose portfolio largely consists of *actively-managed* Canadian mutual funds, to incur total annual expense charges approaching 3%. Such high costs make it very unlikely that the portfolio will over the long-term, exceed or even match the overall yield of a well-chosen, passively-managed fund.

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“But, Grandpa, surely *all* these under-performing funds aren’t run by incompetents,” exclaimed Jenny. “How come so many of them can’t beat the Index averages?”

“Good point, Jenny. You’re absolutely correct. Many of these actively-managed funds are run by extremely smart professionals.

The problem however, is that with such a high fee-structure for actively-managed funds, the fund manager must on average, beat the comparable Index by close to 3%, simply to achieve a break-even performance for the investor.

Remember we just finished talking about the 18 actively-managed Bond Funds where the performance shortfall on average, was essentially due to their higher MERs? The funds themselves may have produced comparable results to ETFs, but their much higher fees resulted in a much lower *net* return to the investor.”

TIP #73..... It is virtually impossible for an individual investor, or fund manager, to consistently outperform a comparable Index by 3%.

This reality is why *actively-managed* mutual funds often produce a lower return for the investor than a *passively-managed* fund such as an index fund or exchange-traded fund.”

“So, Grandpa, what this means is that if **Sam** had chosen to invest her \$100,000 inheritance in actively-managed funds, she likely wouldn’t have done nearly as well, as opting for *passive funds*, such as index funds or ETFs. Is that right?” asked Kevin.

“That’s generally correct, Kevin. But we must recognize that in any given year there *will* be exceptions to the general reality of underperformance by actively-managed funds. Those exceptions however, are very difficult to identify in advance.

We can look back on which fund did very well last year or over a number of years. But there is absolutely *no* assurance that its extraordinary performance will continue into the future, or over the long term. Often, it does not.”

TIP #74..... Strong past performance of an investment, particularly actively-managed mutual funds, provides absolutely no assurance that it will continue to excel, relative to index-benchmarked funds.

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“Here’s another compelling statistic that may surprise you. Studies have shown that more than one-half the managers of actively-managed funds have **none** of their own money invested in the funds they manage. This pretty clearly suggests that even they themselves feel there are better investment options.”

PERFORMANCE-REPORTING DEFICIENCIES

“For an investor to remain current, and to know exactly how his actively-managed fund is performing, he must receive accurate comparative performance data. He needs to see the cumulative year-to-date and year-over-year performance data for his fund, with comparisons, not only to other funds in that class, but particularly to relevant *benchmark market Indexes*.

Very few rules specifically govern required reporting. Although investors do receive reports from their fund managers, these reports can be of minimal value for making meaningful performance comparisons.

Some funds may do well in a given year. Managers are happy to report the fund’s position in the top quartile of their category. Unfortunately, the investor cares little even if the fund is number one among its peers. What really matters to an investor is how well the fund’s *net* growth (after all fees) compares to benchmark index funds with their much lower fees.”

“This sounds like my prof giving out test results – Zack gets the best mark, but no one gets higher than a C,” commented Kevin.

“Only if the *net* performance of the fund matches, or exceeds index fund benchmarks *over the long term*, can the much higher fees of the actively-managed fund be justified.

Fund managers are reluctant to provide detailed comparative performance reports. They will contend that *their* fund is unique and cannot be compared to a simple index fund. That’s nonsense.

Regardless of the fund’s holdings, it surely is the investor’s *right*, in return for the high fee he is charged, to *expect* that his investment will perform at least as well as an equity or Bond Index – especially over a longer period like five years. The key reason fund managers do not provide this comparison is, as we have seen, that very few actively-managed funds can *consistently* outperform an index over the long term.

You can bet that if actively-managed funds were consistently outperforming Indexes, fund managers would very quickly find a way to report that data!”

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TIP #75..... Primarily because they charge much lower management fees, and do not try to second-guess the market, passively-managed funds have a record of consistently achieving better net returns for the investor.

*“Equity and bond **markets** are the result of many thousands of individual investor decisions on what values should be. As such, these aggregate markets (indexes) are smarter over time than any single investment manager can be. The weak long-term performance of most actively-managed funds has proven this conclusion to be correct.”*

TIP #76..... The wise investor will always be mindful of the fact that the entire financial services business is an industry unto itself. It is designed for maximum profitability. The hefty fees charged on investors’ portfolios feed it handsomely, regardless of actual performance.

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“But, Grandpa, if we invest only in passively-managed funds like ETFs or Index Funds, we have to make our *own* fund selections,” worried Jenny. “Doesn’t that seriously increase the risk of an investor doing something stupid?”

“Good question, Jenny. But if you think about it, you would have to take similar risks in selecting a specific, actively-managed fund.

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The key is to stick to the *basic* ETFs and Index Funds. Stay away from the more exotic varieties, particularly those that leverage their investments.

This issue of selection isn't as difficult as you might think. In fact, once an investor, regardless of education level, has the same modest level of knowledge that you now have, he can select appropriate passively-managed funds without losing too much sleep.

Remember too, that for extra peace-of-mind, an investor can consult a truly *independent financial advisor* to help make the best choices. As we said before, a few hours of such advice can be well worth the cost.

Jenny, once we've finished our discussions, you *will* have the basic knowledge you need to make good investment decisions. Really, all you lack now, is the confidence to trust yourself."

"And the small matter of a dollar or two," added Kevin.

"If we spend a little time looking at a typical *passively-managed portfolio*, I think you'll gain some of that confidence."

"I'm willing to be convinced, Grandpa," replied Jenny. "I need a good share of your confidence. But once I'm investing on my own, don't be surprised if I call you in the middle of the night because I can't sleep."

CHAPTER TWENTY-ONE

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PASSIVELY-MANAGED PORTFOLIO

“The lowest-risk passively-managed portfolio is one that invests exclusively in a mix of the broadest-possible *Indexes* in both the equity and fixed-income markets.

ETFs and *Index Funds* are the simplest vehicles for such investments.

If you, the investor, plan to build your investment portfolio through regular monthly contributions, it is best to utilize *index funds*, such as those available from most Banks. While the management fee will be slightly higher than that of an *ETF*, you will, by using an index fund, avoid the brokerage fee on each monthly purchase.

On the other hand, you may opt to make larger but infrequent contributions, perhaps only once a year. Your lowest cost in this case, would be to invest in *ETF* products *online*, through one of the many discount brokerage services available in Canada.”

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“Excuse me, Grandpa,” interrupted Jenny. “I think this is the first time you’ve mentioned a brokerage fee. What exactly is it?”

A BROKERAGE FEE is the cost you pay whenever you buy a stock or an ETF that’s listed on any stock exchange. The brokerage firm, and its broker who is licensed to buy or sell securities, earn the commission.

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The commission can be extremely low, as little as \$4.95 per trade, *if you are using your online discount brokerage service*. Using a full-service broker may cost several hundred dollars for the same trade.

For the cost advantage, I tend now to almost always use the online discount broker.

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As of 2009, the major Canadian *exchange-traded fund (ETF)* providers are:

- Barclays Group,
- Claymore Securities Inc.,
- Horizons BetaPro Management Inc.,
- BMO Financial Group.

As of 2009, *Claymore Securities Inc.* is the first Canadian ETF provider to offer a ***Dividend Reinvestment Plan (DRIP)*** feature. Others are sure to follow.”

As of 2009 there are:

- More than 100 TSX-listed ETFs,
- More than 700 New York Stock Exchange-listed ETFs,
- More than 50 Nasdaq-listed ETFs.”

“Grandpa, ...,” began Jenny.

“I’m way ahead of you this time, Jenny.”

The NASDAQ Composite Index is a U.S. Index of primarily technology stocks. It is value-weighted for all the stocks listed on this exchange – it thus takes into account not only share prices, but also the market capitalization of the companies it tracks.

TIP #77..... To minimize the ongoing costs of managing your portfolio, choose ETFs for large, infrequent contributions. For regular, perhaps monthly investments, consider using index funds.

“By constructing a portfolio using these two index-driven products, several key advantages are achieved:

- Lowest-possible acquisition and management cost, leading to higher net returns;
- Broadest-possible, and therefore least-risky, diversification of products within the chosen investment class;
- Ease of broad geographic diversification, with optional hedging of currency-risk.”

TIP #78..... Whenever considering international investments, the most prudent course may be to choose *only* those products which are fully-hedged against the Canadian dollar. Hedging eliminates foreign-currency risk, usually at minimal cost.

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“You both know that learning about new financial products, and applying new investment strategies have always been among my favourite interests.”

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“I bet you even read the financial pages *before* the sports pages!” teased Jenny.

“After many years of experimentation with variations on the passive-investor strategy, the best one I have yet come across, is the ***Couch Potato Investment Strategy***, proposed by our excellent all-Canadian, ***Money Sense*** magazine.”

“With a name like ‘Couch Potato’, I’m already in favour of it!” declared Kevin.

“The ***Couch Potato Strategy***, brilliant in its simplicity, is outlined on the magazine’s website: www.moneysense.ca.

It provides all the detail an investor might require. The site also provides historical data, demonstrating how their uncomplicated strategy has consistently *outperformed* the average actively-managed mutual fund.

To follow this investment strategy, the only decisions required of the investor, are to determine:

- What proportion of his total investment should be in *equity vs. fixed-income products*?
- Should the equity component represent an *entire Index*, or a more focused sub-index, such as the *financial index*?
- Should the *bond index* be in shorter-term bonds, longer-term, or a combination of both?
- Should the investments be wholly Canadian, or a mix of Canadian, U.S., and/or other international products?”

“This sounds too simple, even for me,” commented Jenny. “What’s the catch?”

“There is none, Jenny. It really is a straightforward and conservative approach to investment.”

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“Let’s think back to our earlier discussions, when we determined that the answers to these questions are very *personal* individual judgment decisions, very much dependent on our age and risk-profile.

We also agreed that for *your* age group, the 20’s and 30’s, having 70 to 80% of your portfolio invested in equities, and only 20 to 30% in bonds or other fixed-income products is reasonable, given the long-term investment horizon.

At the same time, we also concluded that as we approach our retirement years, it may be wise to gravitate toward a much less aggressive split, to reduce the risk of shorter-term market volatility.

On the question of geographic diversification however, the decision was a little trickier. We considered that on the one hand, we’re living and spending our investment proceeds in Canada. We initially concluded that the majority of the portfolio should be in Canadian investments.

But then we also realized that since Canadian equity investments account for less than 3% of those available world-wide, we really should not ignore the potential of that other 97% of investments, available internationally.

We also concluded that if we do decide to invest in indexed products outside Canada, we are wise to do so in a manner that substantially eliminates the currency-risk. Fortunately, both partially and fully-hedged Index products are available, for both U.S., and many other international investments.”

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“With these broad guidelines in mind, here’s *one* scenario demonstrating how, as we age, we might achieve an increasing *comfort level* with our portfolio:

	Ages 20 to 40	Ages 40 to 60	Retirement (60 +)
Canadian Equity Funds	50%	40%	30%
U.S. Equity Funds (Hedged)	15%	15%	10%
International Equity Funds (Hedged)	15%	15%	10%
Canadian Bond & Other Fixed-Income Funds	20%	30%	50%

As I said, this is only *one* potential plan. *Money Sense magazine’s ‘Couch Potato Strategy’* provides other options for investors to consider.”

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“At the very least, an *annual* review and rebalancing of your portfolio is a simple but necessary process during which you:

- Sell a portion of the category that has increased beyond your target allocation;
- Use the proceeds of the sale to buy more of the categories that have declined;
- Confirm that you have re-established your targeted percentages between asset classes.

Not only are you rebalancing, but you’re *selling high and buying low* – a rather sound approach to investing!”

TIP #79..... The wise investor will review and rebalance his portfolio at least annually, to re-establish his targeted allocations between investment categories.

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“Grandpa, I really do like the sound of this ‘*Couch Potato*’ strategy! I know I already said the name alone appeals to me,” enthused Kevin. “But if such a simple strategy can be the path to our millionaire’s club, with less risk and least cost, why on earth would anyone do anything else?”

“I can’t argue with that, Kevin. I’ve used this approach for some time, and it certainly works for me.

However – that’s not to say that no actively-managed funds will beat our passive investment strategy. That would be misleading and unfair. In any given year, a *minority* of actively-managed funds may perform exceptionally well for their investors.

Our problem as investors however, is how to consistently pick that minority of winners, in advance of their successful years. No one has yet found a crystal ball that does that.”

“And we know, Grandpa,” teased Jenny, “the only magic *you* believe in is the power of compounding and time!”

“You’re right, Jenny. I for one, have no intention of playing Russian roulette with my investments. Nor does it make sense to incur much higher investment costs, while *trying* to pick one of the few funds that end up producing a superior return in a particular year.”

TIP #80..... The power of time and compounding is proven. So is the fact that indexes increase in value over time. Combining these realities into a passive, index-based investment strategy should, with least risk to the investor, produce substantial long-term benefits.

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“I’m bushed. I think *explaining* everything is as exhausting for me, as trying to understand it, is for you. We’ve covered a lot of ground in just six sessions.

Next Saturday, I’d like to discuss with you the important subject of *Financial Planning*, and one of its key components, *Investment Planning*.”

“Great, Grandpa! Thanks for today. Speaking of planning, should we *plan* to meet for lunch again next Saturday?” begged Jenny.

“Thanks, Grandpa,” exclaimed Kevin. “It gets better and better. I can’t wait to see how soon I can take up residence on millionaire’s row.”

POSTSCRIPT

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Writing this book was prompted by the obvious interest of two of our grandchildren, in saving and investment with their own modest, but growing investment portfolios.

I enjoyed sharing my knowledge, often acquired the hard way, over some 40 years of experiences.

It is my hope that other Canadians, of all ages, will benefit from the key principles underlying this book, and from the individual **TIPS** highlighted throughout.

It is important that every reader view my advice as only one key source of information, as they make their own strategic saving and investment decisions.

Although I believe very strongly in the outlined principles, I recognize that every individual is different, with unique needs, aspirations, and levels of risk-tolerance.

Only by carefully considering your own combination of factors – age, family size, income level, and retirement expectations, can you arrive at the ***best strategies for you.***

Never be shy about retaining the services of an *independent financial planner, advisor, or accountant*. Test my advice, as well as the advisor's, as you develop *your* personal approach. A good advisor may help you arrive at a low-risk plan which you can then implement and manage yourself.

As a rule, Canadians are living longer. Many spend almost as many years in retirement as they did in the workforce. Retirees tend to live reasonably well, thanks largely to our first-rate social support systems and favorable seniors' tax laws.

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It is my hope that the contents of this book will help readers enhance their net-worth, and eventual retirement income.

But why be merely comfortable for all those retirement years when, with a little knowledge and effort, we can become *very* comfortable?

Here's to your becoming a successful and *Smart Canadian Wealth-Builder*.

One last *TIP*:

SPEND SMART!

SAVE SMART!

INVEST SMART!

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Your comments are welcome. I can be reached by e-mail at
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