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Pictures Tell a Story

June 2012

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Over the last year or so, we have been adjusting client portfolio mixes more to the U.S. equity markets. This increase in U.S. investments is a reversal of the strategy that we have had for many years of overweighting Canada at the expense of the U.S.

The strategy has worked out well for clients, as Canada's resource industries and banking oligopoly have done well over more than 10 years: the Canadian market (TSX) has a 10-year return of 7% per year, while the U.S., hit by both the tech/growth stock crash and the financial crisis, has a *negative* 10 year return of -3% per year (10 years to December 2011, S&P500[C$]).

But since last summer, it seems the tide is beginning to turn. The U.S. market is showing signs of strength compared to Canada. The charts below will give you a sense of what I mean.

U.S. Market

May 2010 to May 2012

Canadian Market

May 2010 to May 2012

Source: GlobeAdvisor.com

The charts show the movements of the U.S. and the Canadian markets over the past two years to the end of May 2012. You can see from the charts that the Canadian market has a more pronounced rise and fall, and today sits roughly where it was last October and two years ago, in May 2010.

By contrast, the U.S. market fell less last summer, and has recovered much more smartly, so that today (May 2012) sits close to its highs of last summer, and is up about 30% from May 2010. Thus the U.S. is in an uptrend, where the Canadian market is flat.

So what? These squiggles on a chart are important because they are clues as to where future market leadership is likely to come from. The fact that the U.S. fell less last summer, and has recovered more strongly since, is a clue that U.S. companies look set to lead the markets when we emerge from the Euro saga.

The U.S. strength demonstrates recovery from the financial traumas of the 2000/3 tech stock crash[1] and financial crisis of 2008/9 (aftershocks from which continue today). These shocks drove major realignments in key elements of the U.S. economy.

For instance, American companies in general have refinanced at ultra-low interest rates and are now widely recognized as being in the strongest financial condition ever. Consumers are relieved that house prices have stopped falling, and are now competitive with renting. Banks have been recapitalized (at shareholder and taxpayer expense) and are in strong financial condition. The Big Three auto companies have cut capacity and labor costs, and make much better cars.

Most importantly, consumers, (who account for some 70% of GDP in the U.S.) have made significant improvements in their financial condition, taking advantage of low rates to refinance mortgages. Consumer debt is now falling in the U.S. Economic growth is forecast at about 2% for 2012[2], which may be slower than past recoveries, but is quite reasonable in the circumstances and against its long term average.

Much has been made of the U.S. recovery being tepid or weak compared to past recoveries, however, past recessions have typically been induced by interest rate increases, so the recoveries have tended to be ‘V-shaped’ rebounds. Today, the U.S. is recovering from a ‘balance sheet recession’ where consumers are paying down debt regardless of interest rates. In a balance sheet recession, consumer spending will grow only very gradually, as debt is reduced[3].

You might be surprised to know that the U.S. economy is NOT very dependent on the global economy: less than 10% of U.S. GDP involves foreign trade (versus about 40% for Canada). In fact, the U.S. is the least dependent on trade of any major economy[4].

This means that over 90% of U.S. economic activity is internal, and therefore independent of the global economy. As the U.S. economy recovers from its (self-inflicted) wounds, its momentum will be internally generated, and not particularly susceptible to external shocks. Another way to say it is if international trade involving the U.S. were to decline by (a precipitous) 10%, it would only reduce U.S. GDP by 1%.

The U.S. dominates *world* trade simply because it is so big. U.S. GDP is almost three times the next largest economy, Japan, and almost equal to the next five largest economies combined[5]. So the U.S. dominates everyone else’s trade, but none of us even show up on the U.S. radar.

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[1] The market decline erased about US $10 trillion of market value, the equivalent of a year’s GDP in the US. See www.chrishoran.ca archives: ‘The Mighty Have Fallen’, July 2001
[2] Economist, June 16, 2012.
[3] For a discussion of balance sheet recessions, see Richard C. Koo, ‘The Holy Grail of Macroeconomics’, 2009.
[4] Economist, World in Figures, 2012 Edition, p32.
[5] 2009 GDP, World in Figures, 2012 Edition, p24.

From an investment point of view, most of the Canadian market consists of only two sectors: a bank oligopoly and resources. The U.S. has a health care industry, consumer goods (iPods to boats), heavy manufacturing, aircraft, automobiles, technology, utilities, pharmaceuticals, and industrial chemicals. Companies in these industries are world-class and operate on a global scale, whereas Canada has almost none of these industries. Including these industries in your portfolio result in much better diversification, and present you with much better opportunity.

Tax the Rich Less

Here are some facts just in case you are ever in a conversation with someone who thinks the rich should pay more.

According to the Canadian Department of Finance, the top 10% of tax filers pay 53% of all personal income taxes in Canada, while they earned about 35% of all income. The top 10% of tax filers starts at $60,000 of taxable income.[6]

If you think the $60,000 income isn't elite enough, the top 1% starts at taxable income of about $169,000. The 72,000 people who earned over $250,000 [the top 0.3%] paid 15% of all personal federal income taxes in Canada, yet earned about 7% of total income[7]. That means three people out of 1000 account for 15% of all income tax – twice their proportion of income.

The lower half of tax filers earn about 20% of the income and pay almost no taxes. As a group they are net gainers from the tax system, according to Watson. It's a large group because a large proportion are either part-time, 2nd income, or student workers who file a return but aren't primary breadwinners.

The main group of taxpayers in Canada is the 'middle' 40% - those people in between the bottom half and the top 10%. This 'middle' group earns about 47% of all income and pays about 43% of all personal income taxes.

High income earners are politically easy targets, but there just aren't enough of them.

High Income Earners Pay No Tax?

There is also a lot of whining by the envious lefties about high income-earners who apparently don't pay much tax. Several points here:

1) This is nonsense, especially in Canada. There are no 'loopholes' - people with high incomes generally pay a lot of tax.

2) Warren Buffett pays very little income tax because his salary is famously low. Most envious lefties who claim wealthy people should pay more tax are making the elementary error of confusing wealth with income. Wealth is what you've saved. Income is what you earn. They are totally different things.

3) Critics took Mitt Romney to task for apparently paying only $3.4 million federal income tax on $21 million income. I'm no Romney fan (not yet, anyway) but critics leave out the important fact that $14 of the $21 million was dividends and capital gains. Dividends are paid from company income *after-tax*, having already been taxed in the hands of the corporation[8]. Jack Mintz, a tax policy expert,[9] estimates that corporate taxes of about $3 million would have been paid by the company(ies) prior to the dividends being paid to the Romneys. Add that in and the tax bill goes to $6.4 million.

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6 2006 data per Wm Watson, Financial Post, February 2, 2011.
7 Stats Can data, per Michel Kelly-Gagnon, Montreal Business Magazine, December 2001.
8 Companies already pay payroll tax, EI, capital tax, health tax, and property tax, among others
9 All figures per Jack Mintz, Financial Post. Mintz is Palmer Chair in Public Policy, University of Calgary.

In addition, the $3.4 million tax paid by the Romneys does not include state and local taxes of about $1.5 million; add these in and the taxes paid are $7.9 million. This works out to a tax rate of about 35%, which is higher than what even Obama was suggesting.

That's not all. Much as the whiney lefties like to ignore it, wealthy people tend to be generous. According to Mintz, Romney donated $4 million to charity in 2011 – an amount that ought to give all of us pause. If you look at charitable donations as a voluntary self-tax, Romney's total contribution to society was $12 million, closer to 60% of their gross income.

Q&A with Chris

Reducing Risk for Retirement

Q: How do I reduce the risk in my portfolio to get ready for retirement? I've heard that I should have lower risk.

A: This is probably the most dangerous question facing investors today. There are three basic alternatives:

1) Add bonds to the mix. This is (traditionally) the normal thing to do. The catch today is that government bonds are yielding 0 - 3% so you don't get much income. What's worse, the 3% bonds will be highly sensitive to increases in inflation and interest rates, which means they will lose about 20% of their value if and when long term rates increase from 3% to 4%. A larger rate increase would generate larger losses (bonds go down in value when rates rise, and they go up in value as rates fall).

   I would use corporate bonds, which yield more than governments. However, corporates are still risky; they are subject to the mathematics of rising rates, and higher yielding issues come with risk that the company might default. The best quality corporate bonds don't yield much more than governments. You can diversify the company risk away, but you can't diversify the interest rate risk so easily.

   Bonds will only work out well if inflation stays very low for say 10 years or more, or if we experience a deflation - an unlikely, but possible, scenario.

   My advice is to keep the bond allocation to the minimum required for 3 – 5 years of withdrawals (15% - 30%)

2) Your second alternative is to buy an annuity. This guarantees you a set dollar amount of monthly cash flow for life, similar to a pension. Because an annuity is partially a return of your capital to you, the monthly payments can be substantially higher than a GIC or bond. An annuity is a very good tool for ensuring you have cash flow for life, known as 'longevity risk'.

   The catch here is that inflation of 3% cuts the value of the cash flow in half in 24 years (5% inflation halves the value every 15 years). What actually happens, of course, is that the price of things increases with inflation, so your cash flow only buys half as much. Inflation these days is about 3%.

   So in 30 years of retirement the purchasing power of the cash flow will likely be cut in half, if inflation stays at only 3% (today's rate). If inflation goes to 5%, purchasing power would be cut in half twice in 30 years. This means that in 30 years you will need $4 to buy what $1 buys today.

   Yes, it's exponential. This should be terrifying to you (it is to me). Nobody that was around in the 70's (when inflation was 10% in Canada, 12% in the U.S., and 22% in Britain) wants anything to do with an annuity …

   Nevertheless, an annuity would be a good idea *to the extent that*:
   i) interest rates and inflation stay very low,
   ii) you were likely to live a long time, and
   iii) you didn't want to leave money to an estate.

   One alternative is to invest say 1/3 of your capital in an annuity. You could think of it as a substitute for the traditional bond allocation in your portfolio, for steady cash flow in the early years, while letting much of the balance grow for future years.

   Please also keep in mind that a couple retiring at 60 has a very high probability that one of them will live to age 90. Many people look at the longevity tables and think they'll be gone at 84, but that's a mistake. Life expectancy of 84 is the statistical midpoint of your life expectancy. This means that there is a 50/50 probability of living longer than 84, and once you reach 84, 90 isn't far off. Especially if there's two of you.

3) The lowest long term risk is – or can be - achieved with the growth from equities. The long term historical return from equities is about 8% - 10% per year[10], so obviously you have a much better chance of being able to withdraw 5% from an asset class that generates 10% or 11%.

   This does not solve your goal of reduced short term volatility. Volatility is critical because if you have a bear market decline of 30% while you are withdrawing say 5%, you can run out of money very fast. The volatility issue is addressed by diversification across different markets, and by having 2-5 yrs of withdrawals in cash or short term bonds (i.e. 25% of the total portfolio) to withdraw from if markets go down a lot (like 2008/9).

[10] Ibbottson Sinquefield data, Large US company stock returns from 1926 about 10%, small US company returns about 12%, before fees and expenses.

One strategy that works well with an equity oriented portfolio is to set your regular withdrawal rate very low, say 3% or 4%, and increase withdrawals - to say buy a car or go on a trip – only after a good year. Many business people and company owners identify with this type of flexibility, since they have lived with variable returns.

For more, see 'A Note on Risk and Regulation' www.chrishoran.ca newsletter archives, July 2007

I must emphasize that the question of asset mix for retirement is as tricky today as it has ever been. Never before have people had to invest for 30 years of retirement income (it used to be that you retired at 65 and died at 70). Nobody has the answer. But Eric Bushell, Portfolio Manager of Signature Funds with whom many of you have money invested, said in a recent discussion on the subject, 'It could be that today, risk isn't where you expect to find it. It could well be that safety today is in the traditionally risky assets'.

I must also comment that the extremely low interest rates are government policy and there just isn't a good way around it. Super-low rates are necessary to counter the deflationary shock of the financial crisis[11]. Just like inflation, artificially low rates are a form of 'financial repression' – a forced transfer of wealth from peoples' savings to governments and other borrowers.

[11] We all bear some responsibility for the financial crisis – subprime mortgages were politically correct and popular in Canada as well as the US. Please see 'Brief History of the Credit Crisis' www.chrishoran.ca Newsletter archives.