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Client Letter – Winter 2011

Uprising in the Arab World

As we go through life there are high impact events that have a major influence on the lives of many and also come as a complete surprise. Often referred to as Black Swan events, sometimes they are natural such as the massive hurricane Katrina or the once in centuries floods that have engulfed Brisbane Australia recently. The terrorist attacks of 9-11 and the assassination of politicians are examples of man made Black Swan events.

Today, we may be in the midst of one of these rare, surprising and unpredictable historic occasions. An uprising in the Arab world against the ruling class is unfolding and has the potential to spread amongst many nations with far reaching and potentially destabilizing effects. The Persian Gulf region which includes Saudi Arabia, the world's largest exporter of oil, accounts for a good percentage of the world's oil supply. Any disruption in its delivery would cause prices to rise rapidly and that, potentially, could damage the global economic recovery. Though I am sure most would agree that a democratic process is best, the road leading there can be difficult, rife with unintended consequences.

As to what actually caused the recent turmoil, which started in Tunisia and has spread quickly, no one can pin point for sure. It wasn't just that poor guy who lit himself on fire. But one thing is certain as the late Bob Marley once wrote, "A hungry mob is an angry mob."

Years of oppression and current economic deficiencies, especially in employment opportunities for the youth, indeed provided some motivation for the uprising. Gerald Celente, a noted prognosticator of trends, reiterates that "When people lose everything and have nothing left to lose, they lose it!"

In any event, the price of necessities is increasing around the world; commodities, encompassing the most basic of food and energy components, are rising and in some regions of the world, quickly. What would anyone be expected to do if they could not provide food for their family? Protestations have led to outright revolt where the carnage has been horrific especially to the residents of Libya as hundreds, perhaps thousands, have been mowed down by Gadhafi's (I don't think anyone really knows how to spell this guy's name) loyalists who desperately try to retain power. And when one oppressive regime collapses it emboldens the constituents of similarly oppressed neighbouring nations to press for change, any change, as it surely must be better than the status quo. I wish them all luck with limited peril on the road to freedom.

We who reside in nations with mature economies, though fortunate compared to many others, are not immune to the winds of discontent. The less fortunate are getting squeezed by increasing prices for the most basic of goods and services such as food and energy. A checkout clerk at my local Zehrs store told me she doesn't know how families are coping with the increases and that more of the pleasantries exchanged between her and the public revolve around such hikes. What is one to do?

It would be prudent to apportion investment and retirement accounts in part in line with one's spending habits. Think of it. If you're spending money at the Petro Canada gas station, heat your home with natural gas and you like to put Heinz ketchup on your burger and fries, maybe it's a good idea to participate in the ownership of the companies or commodities which reflect your expenditures`. It is one way of helping to insulate from price increases in things we consume with a degree of predictability.

Today there are myriad Exchange Traded Funds (ETFs) that offer the safety of diversification, the preciseness of sector focused investing while also offering the benefit of low management fees. ETFs are one of the fastest growing investment vehicles today in Canada and the trend is momentous. A few examples of ETFs are the Claymore Agricultural Fund which appropriately trades under the symbol "COW" while iShares offers up the Canadian Government Bond – "XGB" – which has hundreds of millions of dollars under management. "X" stands for index and "GB" stands for Government Bond. The operating costs and management fees (often referred to as the Management Expense Ratio) are typically amongst the lowest cost to operate when compared to conventional mutual funds. More and more, the funds that are entrusted to me by clients are finding a home in the Exchange Traded Funds. By keeping the costs down it should help to enhance returns over the long term.

<u>David M Walker's New Campaign</u>

"Since my time as U.S. Comptroller General, I have been warning lawmakers and the American people that the U.S. government's addiction to debt will eventually result in a debt crisis if it is not addressed in a reasoned, responsible and timely manner. We are now headed for a fiscal abyss, and we must change course to prevent a global economic collapse." David M Walker, February 2011

I've mentioned David Walker before in client letters but he is initiating a new campaign called the "Comeback America Initiative." The goal is to bring lawmakers together, from both sides of the aisle, to foster a national discussion on the debt, future deficits, and what action America needs to take to avert an economic collapse. Quite sobering, isn't it?

Some time soon, there will be more attention brought to the burgeoning US deficit which stands at approximately $14.2 Trillion. For those of you doing the math in your head right now, a trillion is a thousand billion and a billion is a thousand million. Congress had a self-imposed limit in place for the debt at $14.3 Trillion which will be breached over the next several months. There's a whole bunch of Boomers coming over yonder hill and they're all expecting the government to come through on the promises of Medicare, Medicaid and prescription drug plans, not to mention Social Security. The US Government is going to be short another $1.5 Trillion over the next year.

Here’s an interesting question-Who is lining up to lend them the money? Well, it’s not as voluminous as before and likely will be fewer and less enthusiastic in the future. True, the Chinese have loaned them some money and hold a pretty big bag of America’s IOU’s but more of their debt is being gobbled up in the Caribbean Banking System these days than in China. Fact is, a lot of this debt isn’t being funded with IOUs anymore; it’s being funded with “IO ME’s.” It’s called Quantitative Easing and we’re about midway through what’s being referred to as QE II. Once this round is finished, if a QE III isn’t implemented, I’d fully expect to see rising interest rates south of the border. You see, this artificial stimulus, the buying up of America’s debt with funny money, has been keeping rates low. Once that demand softens, rates will have to rise to what the real market rates should be for US Government Bonds. Hold onto your hats as this could get very interesting. I am avoiding long term bonds.

Tax Free Savings Accounts and RRSPs

Tax Free Savings Accounts or TFSAs are still a relatively new arrangement for individual investors. They are different from RRSPs in that when you make a contribution they don’t save you any taxes up front – but the benefit comes over time as there aren’t any taxes on the gains that are made. Interest, dividends and capital gains are all free of tax. In many cases, the TFSA arrangement is superior to the RRSP.

You see, one day when money is taken out of the RRSP it will be added to your income. We don’t know what the tax rate is going to be on that withdrawal, especially in light of the fact that we have a rapidly aging population who will have great demands on the public sector; I’ll bet tax rates will go up, not down. Today, depending on one’s income level, the current tax rate could be as low as zero or as high as 46.5%, not including the effect it may have on such things as the Ontario Property and Sales Tax Credits, the Age Credit, Medical Expense Credits or possibly even the dreaded Old Age Security Claw Back. This year, if a senior has net income in excess of $66,733, the government claws back 15 cents for every dollar beyond that line in the sand. Ouch!

One way to avoid this is to make sure that when you look at the long term projections on your income and RRSP values that you try to coordinate taxable income flows such that one day when you turn 71 (the age at which you’re forced to bring RRSP assets into income - either all at once or systematically through RIFs and Annuities) that your net income isn’t over that $66,733 level. You might remember that old Farm Auto commercial where a mechanic is talking about the importance of preventative maintenance on your car’s engine, such as doing timely oil changes. The famous line in the commercial was, “You can pay me now or you can pay me later”. The big bill “later” occurred because you didn’t take care of things along the way.

Taxes at death can be punitive too. If there is going to be in excess of $127,000 in RRSPs when that last of a husband and wife die, it may be prudent to cash in Registered Assets along the way at lower tax rates. The highest tax rate in Ontario, the one where income is beyond $127,000, is 46.5%. Your beneficiaries would be pleased if along the way you reduced the amount in RRSPs to the extent it reduced your tax bill thereby retaining more money in the estate.

Housekeeping

I will be heading south to Tampa from March 5th through the 10th for a brief respite with some other RBC Dominion Securities Advisors from Edmonton, Kitchener and Sarnia. We keep heading back to the same area each year and it’s interesting to gauge the economic climate from one year to the next.

At the end of April I'll be heading back to Omaha one more time with a group of friends for the Berkshire Hathaway Shareholders Meeting. Being that Warren and Charlie are getting on in age, you never know how long this annual event will last. Nonetheless I guess I'll keep going until I can't. That, by the way, is from April 28th through May 1st.

Beyond these two dates, I will be away the odd day in May attending the Memorial Cup junior "A" hockey tournament. This year it's just down the road in Mississauga.

Though the RRSP season is pretty much over on March 1st, the Tax Free Savings Account opportunities are year round. During this coming tax season, should you have any questions, require assistance or would like a review, Erin and I, supported by a cast of thousands are here to help.

On behalf of myself and Erin, I thank you for your ongoing support. Here's wishing you a happy upcoming Spring.

Sincerely,

John Davies, CFP
Investment Advisor