

# RBA's FOCUS ON FUNDAMENTALS

## **A look at demographics, and the 20-year trend to preserve capital, generate income, and maintain purchasing power through tax efficient investing**

At RBA Financial, we believe that in financial planning, the simpler you keep things, the greater your chance for success. Be aware of what's happening in the marketplace, but don't allow yourself to get caught up in all the noise that surrounds you.

As Warren Buffet says, "To invest successfully over a lifetime does not require a stratospheric IQ, unusual business insight, or inside information. What's needed is a sound intellectual framework for decision and the ability to keep emotions from corroding that framework."

As we talk to investors, we find their main concerns when making investment decisions are simple

- 1) Preserve my capital over time.
- 2) Provide a fair rate or return on the capital invested.
- 3) Do it in the most tax efficient manner possible, and maintain my purchasing power over time.

As an investor, you have to build an intellectual framework that will keep you focused over time and keep emotion out of the process. You need to do more than simply understand each investment. You need to ask yourself, "Why am I making the investment? Is it part of the strategy or plan to attain my goals over time?"

This is why it's important to develop a "**Long-Term Strategic Approach**": focus on fundamentals; be patient; and exercise good judgment based on common sense. We've seen too many situations in which investors purchase or sell investments for the wrong reasons, because they've got caught up in the emotion of short-term market fluctuations or have reacted to an idea appealing to the greed factor.

If you follow a simple process, it helps ensure solid decisions based on fundamentals and common sense. Looking in the rear view mirror is a common mistake. Investors often base decisions on past experiences rather than looking forward based on their financial plans.

There are three types of risk when it comes to investing.

- 1) Market Risk is the day-to-day fluctuations in the stock market.
- 2) Investment Risk is affected by the quality of the business or fund you own. Ask yourself a couple of simple questions when looking at a potential fund or business: Will the fund or



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business be around a year from now, five years from now, ten years from now? Will it continue to grow and pay a dividend annually? If you can answer yes to those questions, you have a reasonable expectation of succeeding long-term.

3) Interest Rate Risk happens when interest rates decline. With lower interest rates, clients see their income from GIC's reduced, which has an impact on their income as well as purchasing power. The loss of purchasing power caused by the taxes on interest income compounded by lower interest rates can be devastating to your retirement income.

Managing risk is easier said than done. This is why at RBA we focus on long-term investments which have a history and proven track record of success. With the challenges of sub-prime issues, lower interest rates, a strong Canadian dollar, and stock market volatility, it's not good enough to look at the past. We need to develop strategies to ensure our clients' success going forward.

Our strategy is simple. We are investing in well managed, dividend producing investments on a global basis, which allows our clients to take advantage of some of the finest dividend producing companies in the world today. It's an excellent way of coping with lower interest rates. Owning quality dividend paying companies or funds provides you with

- 1) favorable tax treatment on your dividends,
- 2) potential long-term growth on your investment,
- 3) and the ability to maintain purchasing power of your capital over time.

With the baby boomers approaching retirement and living longer, the need for income continues to increase. Dividends provide the investor an opportunity to create income, receive favorable tax treatment, and participate in the long term growth of quality companies that have proven themselves over time. With interest rates continuing to fall, GIC rates become less attractive, and GICs create less income – that's fully taxable. Although the GIC is guaranteed a fixed rate of return and principle protection in the short-term, it also guarantees a loss of purchasing power over time.

The demographic trend over the next twenty years will focus on capital preservation, income and maintaining purchasing power through tax efficient investing.

Demographics, or the statistical study of population, can account for past, present, and developing trends in North America and the globe. Comprising one third of the North American population, the baby boomers (1946 – 66) have influenced the development of our society through their behaviour. Demographics can explain past and present trends and will influence the future. This report is designed to predict and understand the future trends to assist our clients with their comprehensive financial planning. The study of demography is based on one simple assumption: every year you get one year older and once beyond 50, you tend to view the world more conservatively.

Looking back over time, the baby boomers have had considerable influence on the development of the North American economy. In 1981, when the baby boomers ranged in age from 15 to 35, we saw the prime interest rate top out at 22.75%. At this point, a significant portion of the boomers were in **consumption** mode, acquiring real estate, automobiles, furniture, appliances, etc. to start their working and married lives. Demand for mortgages and loans skyrocketed, and we experienced rising interest rates due to this credit demand and the inflationary pressures they caused on the price of the goods they were buying. Banks were unable to keep pace with the

demand for credit. The baby boomers' parents and grandparents, being depression survivors, had small deposit accumulation and did not use the advantages of credit and asset leveraging for wealth creation and lifestyle expenses. The banks had never witnessed such a demand for loans.

As the boomers aged, they paid down their loans and moved into **accumulation** mode. In 1987, the TSE was at the 3,000 level and the DOW at the 2,000 level. The last twenty years of investing have produced rates of return of just under 10% in both Canada and the U.S. while GIC rates averaged just over 6%. The baby boomers have trended the stock market to great returns as their RRSP's, pension plans, and investment plans have witnessed large deposits to the stock markets during their accumulation years. Toronto real estate prices rose in the 80's by 13.1% as the boomers bought their first homes. Toronto real estate cooled off in the 90's to pull back 0.6%. Toronto prices have risen 7.1% this decade, mainly driven by immigration and the echo effect of the baby boomers.

Today, we see over one million Canadians over the age of 80 and almost 5,000 greater than age 100. The baby boomers will start to retire at normal retirement age of 65 in 2011. Modern healthcare, adjusted lifestyles and positive attitudes are resulting in longer lives. A 65-year-old Canadian male has a 56% chance of living to 85 and a 22% of living to 95. Females have a 69% and 32% probability of reaching the same milestones. What does this mean for the future of financial planning for Canadians?

As we retire and live longer, a well-developed and properly accumulated retirement plan is critically essential for the preservation of lifestyle. All Canadians have an increased need to review their financial plans on a regular basis to ensure they have a wealth plan to well beyond age 90. This solid wealth accumulation plan needs to support a manageable, more conservative, enduring withdrawal rate during their retirement years. This is the next wealth lifecycle shift for the baby boomers as they prepare to enter the **income** Mode. In the next 25 years, we expect the number of Canadians over 65 to double and the number of people aged 100 and more to grow to about 15,000.

Traditional thinking would first and foremost predict a shift from equities to more conservative investments, such as bonds and GIC's, by the baby boomers. In theory, this strategy reduces market volatility, increases capital preservation and produces a greater percentage of income from the interest payments. The downside to this shift to fixed income is the potential continued growth in selected equities. As timelines for investors move out to beyond age 90, investors will still be willing to weather the equity markets with a significant portion of their assets, in order to protect their purchasing power from inflation and to have capital appreciation for the long term.

If we go back and analyze the **consumption** mode where interest rates peaked in 1981, the inverse trend is expected over the next 20 years during the **income** Mode. As traditional thinking towards fixed income investing occurs, deposit rates will be driven to all-time lows as the banks or bond issuers do not require the volumes of deposits for their lending needs and decrease the interest rates accordingly. My prediction is that the five-year rates will spend more time under 3% than over 5% after 2011. This will cause a systematic shift for the baby boomers to re-evaluate their asset allocation away from these low interest rates. Their parents, whom many still look to for investment advice, have encouraged them to save in GIC's similar to themselves (some even stipulating in their wills "for GIC's only"). But as the boomers broke tradition by borrowing money in the 80's against their depression-era parents' advice, they'll continue to allocate a higher than traditionally expected amount of their portfolio to equities.

Not all equities will be considered by the boomers, as there will remain an emphasis on a reasonable need for capital preservation and income from their portfolio. The trend will be towards high quality, large capitalization dividend paying equities from politically and economically stable countries. These dividend paying companies are a blend of income and growth which will be required to support the long term financial security of retirees. Dividend paying stocks will become the investment trend of the baby boomers.

Demographics will never explain quarter-by-quarter results of the stock market, but it will definitely assist in the statistical understanding and predictions of market and investment trends over the long term. With current market pullbacks, based on the wall of worry created by subprime writedowns and an expected short lived and mild recession, there has never been a stronger case for considering adding some conservative, undervalued dividend funds to your portfolio.

At RBA Financial, we are focusing our clients, both young and old, towards this developing investment trend as the core holdings in their well-diversified portfolios. We strongly believe that some dividend funds and managers are better than others, based on their previous track records and discipline to their investment management style. We believe some funds are just too big to be considered (such as those over \$1.5 billion), as they lose their ability to move large positions and look beyond the traditional large cap holdings. We have developed a list of dividend funds that meet our strict requirements. One of our investment advisors can discuss these with you in relation to your financial planning requirements.

Baby boomers have had a reasonably unchallenged, progressive accumulation mode with great job opportunities, real estate and market appreciation. It is about to get tough. Good fortune will no longer be on your side; good planning is the only strategy.

### **Other trends we see over the next twenty years**

1. Increased political pressure on environmental, health care, and retirement living issues.
2. Increased marginal tax rates for high-income individuals to support the health care and government income programs of the aging retired population and to get the large deficits under control. I expect a bigger concern in the US than in Canada. Higher taxes bring less consumption. Europeans did not experience the baby boomer effect and I expect their markets to do well, with decreasing interest rates, maintained consumption, and level taxation.
3. The US accounts for about one third of the global economy today and will decrease to below 20% in the next thirty years. The US has not gotten poorer; it's just that the rest of the world has gotten richer. This is good, as we will find rich foreigners to sell our stocks to.
4. Increased philanthropic giving and community-based volunteering.
5. We will trade in our real estate that has dirt (lawns and acreage) in favour of maintenance fees in condo living. Condos will be the biggest growing class of real estate. Most boomers will need the equity in their homes to subsidize their retirement income.
6. Travel will significantly increase.

7. The societal drift towards income and wealth inequality will continue to broaden economic inequalities.
8. Family will not provide as strong a social safety net as it did for the previous generation.
9. A portion of baby boomers will extend midlife, or the accumulation mode, as they enjoy good health, need to pay for kids' and grandkids' education, and need to accommodate their lack of financial preparedness for retirement. They desire to stay actively engaged in some form.
10. Jobs of the future will focus on brainpower, not brawn. More jobs will be created in the healthcare, government, professional, and advisory services.