

June 2004

Dear Client:

Enclosed is a 2003 "Andex Chart". I send this chart with a covering letter each year in order to take the opportunity to make some comments with respect to long-term economic trends.

I have divided this covering letter into four sections:

- A brief review of long-term economic trends.
- A forecast on what might happen over the next several years.
- An economic theory.
- Advice on how to position one's self in order to provide the best chance for financial success.

#### Review of Long-term Economic Trends

I shall make several observations with respect to long-term trends. The first is that, over the long-term, interest rates have exceeded inflation and stock market returns have exceeded interest rates. Theoretically, therefore, one's money will grow faster than the cost of living if one earns interest and somewhat faster still, if one invests in Equities.

Of course, in Canada, "Non-Registered" accounts are subject to tax on a year by year basis; therefore, one could invest in Interest Bearing Investments and fall behind the cost of living due to the effect of income tax. In a "Registered" account (an RRSP or Pension Plan) where investment earnings are sheltered from tax, there is a reasonable expectation that Interest Bearing Investments will beat inflation over the long-term.

While Equities have out-performed Interest Bearing Investments over the long-term, the reverse has been true in recent years. Note that (referring to the "percentage returns" chart on the right side of the Andex Chart) the ten-year return in the Canadian Stock Market is 7.8% whereas the ten-year return in Five Year Guaranteed Investment Certificates is 5.3%. However, over five years, the return in the Toronto Stock Market is 0.5% versus 4.5% for Five Year Guaranteed Investment Certificates. This is as a result of the significant stock market correction we had from 2000 to 2002 and underscores the fact that there is risk in investing in Equities.

Another observation I would like to make, with respect to long-term trends, is that virtually all of the numbers are lower this year than in the previous year. For example, the thirty-year return on the "S&P 500" is 12.6%, down from 13.1% last year. The thirty-year return on Five Year Guaranteed Investment Certificates is 9.1%, down from 9.2% last year and

the thirty-year measurement of the Consumer Price Index is 5% down, from 5.2% last year.

In other words, by moving the thirty-year measurement period forward one year, we see the effect of a long-term reduction in inflation, interest rates, and stock market returns.

An interesting feature of this year's Andex Chart is a comparison of "linear" and "log" charts.

When one looks at the linear chart to the left, one can see just how dramatic the rise in stock markets was from the early 1980's until the year 2000 and just how dramatic the fall was from the year 2000 to the year 2002. (Next year's chart will show the rebound from 2002 to 2003 and the "leveling off" that is happening in 2004. Please note that the stock markets are going through some re-trenching as I am writing this commentary).

### The Forecast

In my February 2004 newsletter (Clientel) I made a number of predictions as to how the future may unfold. (As always, I note that my advice is to hedge one's bets regardless of what predictions one hears).

We have experienced a long-term drop in interest rates and inflation. The tremendous rise in borrowing that has occurred in the United States and Canada (driven somewhat by the reduction in interest rates) provides the fuel for future inflation. The U.S. Federal Reserve has been very concerned in recent years about "disinflation" and even "deflation". I believe that the concern will now move towards "inflation" and thus there will be a change of economic policy which puts some upward pressure on interest rates.

I, thus, predicted in my February newsletter that interest rates (which to that point had been falling) would soon level off or begin to rise and that stock markets (which to that point had been rising) would soon level off or begin to fall.

The U.S. will walk a fine line with interest rates as they want to keep their currency low, relative to other world currencies, and they do not want any dramatic action to plunge the economy into a recession.

Canada will follow the lead of the United States and set our interest rate policy in such a way as to keep our dollar at an appropriate level relative to the U.S. dollar.

Thus, I believe that there will be a very slow upward movement in long-term interest rates in both countries.

Short-term interest rates may stay level or even reduce slightly (thus, we may have a greater future differential between short-term and long-term rates).

The long-term decline in interest rates starting in the early 1980's and continuing to the end of the century, was a key factor in the rise in stock markets over that period of time. (Take another look at that linear chart). We were also spending the "Peace Dividend" in the 1980's and 1990's. The United States no longer had the huge military expenditures that were associated with Vietnam.

The Peace Dividend is slipping away. This, combined with slightly increasing interest rates does not bode well for the stock market. I, thus, hypothesize that the stock market is more likely to move sideways or down, than upwards over the next several years. (Again, I may well be wrong with my predictions, and thus the advice I give to clients is to hedge one's position).

### An Economic Theory

As one gets older there is increasing pleasure derived by reminiscing about the "good old days". As we look backward in time, the economic conditions in which we lived look better than those of today.

Think back to the 1960's. Daddies went to work and mommies stayed home. Jobs were easy to get and houses were easy to buy.

I remember, however, watching television shows in the 1960's where the 21<sup>st</sup> Century was presented as a time when we would all fly around in our cars, and advances in technology would mean that we would all work less.

In fact, the opposite has happened. Today, two incomes are needed to support most families and both partners work longer and harder than they would have done back in the 1950's or 1960's.

Yet, there have been tremendous technological advances and the efficiencies with which we conduct business have been dramatically enhanced by computer technology.

Why, therefore, have we not reaped the rewards of this technology and translated it into a higher standard of living? Why has there been a long decline (and I predict a future ongoing decline) in our standard of living? The answer, in my opinion, is that there is a long-term transfer of wealth taking place on our planet.

While there continues to be a relatively small number of "super rich" people, the general standard of living of the "somewhat rich" people (which describes virtually everybody reading this letter) is declining.

While there are still an alarming number of very poor people in third world countries, there is a very slow improvement in the standard of living of many of the world's very poor people. Countries such as China and India are starting to have a middle class.

Thus, the rich people of the world are very slowly getting a little bit poorer and the poorer people in the world are very slowly getting a little bit richer.

(I also believe that, in addition to the transfer of wealth, there is an absolute decrease in the wealth that is being re-distributed. There are more people competing for fewer natural resources. We will also have to spend a considerable amount of our future "wealth" cleaning up the environment which we continue to over-exploit).

While I am actually quite happy to see the redistribution of wealth taking place, I note that it is somewhat problematic to be a Financial Advisor while this is occurring.

One of the manifestations of this "transfer of wealth" is that it is more difficult to create more wealth purely with invested capital.

If one goes back a couple of hundred years in time to the days of the English Lords, the Lord and Lady had their Manor and were supported in grand style by the Serfs and Peasants.

In the 1950's, we all enjoyed the television show "The Millionaire" where a mere million dollars bestowed upon you by Michael Anthony would enable you to live in luxury forever.

Today, a million dollars is probably not enough to support one's retirement. The ability to generate investment returns easily from one's capital is diminishing and we are faced with increasing tax burdens.

Thus, one's ability to simply have a block of capital, and rest assured that one can be wealthy forever is rapidly diminishing.

I believe that the transfer of wealth will manifest itself in several ways:

- Interest rates will continue to exceed inflation...but not by a wide margin so it will be increasingly difficult to have risk-free investments that generate an "inflation-adjusted" income.
- Over a very long time, Equity returns will exceed interest rates, but there may be short-term pain for the long-term gain. (The sharp decline that you see in the linear graph may not yet be finished).
- There will be an increased tendency towards the taxation of wealth and the taxation of consumption (the GST is not going away).
- Increasingly, the people who have "money" will have to pay for things (like Health Care). People who have saved will subsidize those who have not. People with fortunes will subsidize the unfortunate.
- Eventually there will be a price correction in real estate. This will be driven by an increase in interest rates, an increase in taxation on real estate, and a decrease in the income of people buying real estate.
- (While I am in a pessimistic vein) I also believe that the price of gasoline will rise to the same levels as Europe over the next several years...which will reduce the resale value of Hummers and SUVs. Look for lots of little cars on the streets in the future.

All of this adds up to a very slow deterioration in the relative position of the "somewhat wealthy" constituents of our society.

#### Advice and Strategies

In my February 2004 newsletter, I outlined a number of strategies that I believe are appropriate for today's economic environment (if you would like another copy of the newsletter, please do not hesitate to give me a call...or you can view it on our website at

[www.rogersgroup.com](http://www.rogersgroup.com).. go to Financial Advisors... go to David Chalmers... click on the button that highlights "Clientel Newsletters").

A brief summary of my advice is as follows:

- As Equity Investments are somewhat uncertain, one should also have an appropriate amount of money in Fixed Income Investments.
- Notwithstanding the fact that I believe that interest rates are going to slowly rise, I recommend continuing with a "laddering strategy" for Fixed Income Investments.
- It is important that the advice that one receives and one's investment portfolio is both effective and cost-effective.
- As long-term interest rates creep upward, Bonds will start to experience Capital Losses rather than Capital Gains. Thus, Bond Funds and Balanced Funds will look less attractive than they have in the past. One, therefore, may be better served to break a Balanced Fund into its component parts of Equity and Fixed Income. Holding individual Fixed Income products such as Bonds and Guaranteed Investment Certificates as the Fixed Income component of one's portfolio, reduces management expense.
- Equity Investments such as Mutual Funds that are managed on a "Value" basis still make sense. One should endeavour to hold only those funds where managers have demonstrated an ability to add "value" in the past and one should take a diversified position.
- One should try to include investments that generate cash flow such as Preferred Shares or Income Trusts and one should also look at some smaller company investments. Thus, I am now including investment funds that hold these products in my portfolio recommendations.
- While I think that Equity Markets as defined by the Indices are not going to do well in the next several years, I note that I could be wrong. I, thus, recommend that one continues to participate in Equity Funds that will tend to reflect the direction of the stock market, with some portion of their portfolio. For some clients, the most effective way of doing this will be to hold Index Securities directly (in order to reduce the cost of participating in Equity Markets). (An Index Security simply reflects the investment returns of an underlying Stock Index. These investments have low costs).
- When there is a relentless upward movement in stock markets, it is relatively easy to make money by randomly buying stocks and holding those stocks. When markets move sideways or downwards or are punctuated with extreme volatility, more complex strategies are needed. There is a whole new class of investments emerging called "Hedge Funds" that use alternative strategies in order to generate investment returns. These funds are full of opportunities and also full of risks. I am increasingly using a select group of these funds in small measures within client portfolios.

In short, I recommend that one holds an appropriate portion of one's investments in risk-free investments and that one should take an extremely diversified position with Equity Investments. (None of this should sound particularly new to any clients).

I also recommend that one should avoid debt (expect the cost to go up) and that one should seek to live somewhat below one's means. If I am right about the financial future, we will all see a reduction in our disposable income. Those who over-spend their means will find the resultant adjustment quite painful.

Those who under-spend their means and who can be adaptive and philosophical should have every reason to be happy going forward.

Thank you for reading this letter. I hope that the enclosed Andex Chart is interesting and I thank you all for our ongoing relationship.

Sincerely,

ROGERS GROUP FINANCIAL

David N. Chalmers  
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Enclosure

David N. Chalmers is a Financial Advisor with Rogers Group Financial Ltd. and Rogers Group Investment Advisors Ltd., Member CIPF. The views expressed are those of the author and not necessarily those of Rogers Group Financial.

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