The central message of ClienTel is that I value my clients.
I'm as close as your telephone, and available
and anxious to serve you.

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Welcome to another edition of *Clientel*. In this issue I shall discuss:

- Today in History
- Interest Rates, Up or Down?
- Conservative Investment Strategies

Today in History

I am composing this newsletter in early April; the war in Iraq has been in progress for several weeks. While it appears that a lull in the fighting is at hand, the long-term implications are very difficult to fathom and we are now faced with a new enemy called "SARS." The long-term social and economic implications of this are also difficult to predict.

I shall be sending my annual Investment Letter (with an enclosed "Andex Chart") within the next few weeks. However, I shall preview a couple of the observations that I shall be making in that letter in this edition of Clientel.

Despite weak economic news, there has been a modest upward movement in stock markets (punctuated by extreme volatility) since last October. While the year-to-date numbers for major markets are at a break-even level, many Canadians have lost money in their global and U.S. investment holdings. In part, this is a result of the appreciation of the Canadian dollar relative to the U.S. currency. Thus, many investors continue to be (understandably) nervous and inclined towards conservatism. I have, therefore, made "conservative investment" the primary theme of this newsletter.

Interest Rates: Up or Down (or Sideways)

Are interest rates going up or going down? Popular consensus is that interest rates are going to rise. I judge popular consensus by the articles that I read in the newspaper and comments made in other media.

Before expanding on my theory of interest rates (and some practical comments on strategies that we may wish to follow), let me comment on the phenomenon of "popular consensus."

Occasionally, a client will make an absolute statement such as, "Interest rates are going up." Often, this position has been formulated by information received from the media.

In fact, if it is a certainty that interest rates are going up, then all prudent investors would keep their money in short-term deposits rather than long-term deposits. We would then want

to lock our money into longer investment terms after interest rates have risen.

There are a number of borrowers in our society who want to fix the interest rate for their loan for a relatively long period of time. For example, if the federal or provincial government is borrowing money, they might like to know what interest charges are going to be for the next five or ten years (or longer) and thus want to issue a long-term bond. However, if it is a “certainty” that rates will be going up, no investors are willing to buy long-term bonds. The borrowers are desperate to secure their long-term financing and thus offer higher interest rates in order to attract lenders to these longer terms. This causes long-term interest rates to rise.

The point I am making is that if it were, in fact, a certainty that interest rates were going to rise, then the rates would have already risen. This same principle applies to any market force. If it were a certainty that the price of houses was going to fall by 90%, then everybody would try to sell their house now before the price falls. This would cause prices to fall.

Therefore, a simple economic rule to remember is, “If a future event is a certainty, then it has already happened.” This concept, which can also be called the theory of “efficient markets,” can have some interesting outcomes. I once heard of an economist who saw a loonie on the sidewalk. He did not pick up the coin because he knew that if it were really there, somebody would have taken it by now.

Now, let’s get back to interest rates. The future direction of interest rates is anything but certain. I believe that one of the biggest single determinants of interest rates is the level of borrowing by governments.

The United States was predicting a $350 billion deficit prior to the commencement of the war in Iraq. This deficit will be pared back somewhat, as there will be a rollback of some of the promised tax cuts. Meanwhile, the war in Iraq and its aftermath is likely to cost a lot more than the $80 billion budgeted.

The U.S. government will need to borrow money to finance this deficit. This should push up interest rates south of the border.

A rise in U.S. rates should cause a rise in Canadian rates (otherwise Canadian investors will sell their Canadian bonds to buy U.S. bonds at higher rates, causing a flow of money from Canada to the United States, which, in turn, would cause the Canadian dollar to fall).

The Canadian dollar has risen without a premium of interest rates being paid in Canada (in my opinion) due to a lessening of popular international consensus that the U.S. has the safest currency in the world. Therefore, it is possible that Canadian rates can rise more slowly than U.S. rates and we can still keep our dollar within the desired trading range.

While all the above appears to be an argument for an increase in rates, let us examine another scenario. If the long-term repercussions of the war in Iraq (and the war against SARS) have extreme negative economic implications, this could push the world into a deeper recession or even a depression.

If we have a repeat of the great depression of the 1930s, we are likely to experience deflation and very low interest rate levels. Even if we do not have a depression or a deeper recession, investors may still prefer fixed-income investments over equity investments in a time of economic uncertainty.

Thus, investors (such as those reading this newsletter) might be quite happy to purchase government bonds or guaranteed investment certificates at low interest rates as an alternative to stocks or mutual funds. If enough investors think this way, then governments can borrow all the money they need without interest rates rising.

Interest Rate Strategies

Having determined that the future direction of interest rates is, at best, unclear, this introduces the question as to what strategies investors should follow. Let me address this topic under the headings of "Amount," "Macro Strategy" and "Micro Strategy."

Amount

The first strategy is to have the right amount of money earning interest. In other words, one has to have the correct asset allocation for one's individual circumstances with an appropriate amount of money invested conservatively.

Macro Strategy / "Laddering"

Over the long term, we cannot predict changes in interest rates. Thus, I believe that the best strategy is to "ladder" one's interest-bearing investments. This means that we organize monies so that you have a portion maturing and being reinvested each year over, for example, a five-year cycle. (We can also set up a "ladder" over a cycle longer than five years.) If you stick with this strategy, you will earn the average interest rate over a long period of time. Thus, the "worry-free" portion of your investments can indeed be worry-free.

Micro Strategy / Timing

Many of my clients have had fixed-income investments mature over the past several weeks. As I have expressed an opinion that there is some reasonable chance that interest rates will rise, many of them have placed money in a money market fund or other short-term deposits rather than renewing their maturing investment for a fixed term.

I recommend that most of these clients continue with the macro strategy of laddering. The question is, should we fix a rate now or wait several weeks in hopes that interest rates will rise? The dilemma is that you earn a lower interest rate while money is "on hold." So if rates rise only marginally, you may not be any further ahead as a result of the timing strategy.

I have kept a list of all clients who have money "on hold," and I shall be contacting each one over the next few weeks. Having given the subject of the timing of interest rates a great deal of thought, my overall conclusion is that we should just go ahead and fix the best rates that can be obtained today. While it is my personal theory that interest rates will rise by a small amount through the balance of this year, there is still a significant risk that interest rates will drop. I shall be discussing this individually with each client who currently has money in a short-term deposit or a money market fund, and I shall have a similar discussion with each client who has money maturing over the next few months.

Conservative Investment Strategies

Given the uncertainty of today's economic conditions, many investors are seeking ways in which to earn an attractive investment return while at the same time minimizing investment risk. Here are a few ideas:

Laddered GICs or Bonds

This is the "old standby." If one follows the strategy of laddering fixed-income investments, then one earns the average interest rate over a long period of time. It is a reasonable assumption that the average interest rate will exceed the average inflation rate over a longer time. Thus, the expected result is an investment return that will at least beat the rate of inflation.

Annuities (generally appropriate for clients age 60 and over)

Annuities are an often overlooked investment alternative. A life annuity provides guaranteed income for life. The income that is provided by an annuity is substantially higher than the interest income from most fixed-income investments. If an annuity is purchased with non-registered funds, a significant portion of the income is tax-free.

Thus, we can increase your stream of conservative income and, at the same time, lower your taxable income (which, in turn, lowers exposure to such things as the clawback of the Old Age Security benefit).

The primary concerns that most people have with annuities are the lack of flexibility and the loss of capital for the next generation.

One way of addressing the issue of a lack of flexibility is simply to limit the amount of money that is placed in an annuity. It does not make sense to put all of your eggs in this basket, but it could make sense to use an annuity for a portion of your retirement capital.

The reduction in your estate, as a result of the purchase of annuity, is a valid concern. It is possible, however, to structure an annuity so the minimum guaranteed number of payments will either equal or exceed the annuity deposit. The purchase of an annuity with funds that are currently in a RRIF does reduce your estate; however, had the capital been left in the RRIF, it would have been fully taxable at your death. A potential reduction in your estate can also be addressed by holding an insured annuity (to be explained in the next section).

Another concern with respect to annuities is the fact that an annuity locks in an interest rate for your entire lifetime. However, it is possible to establish a "ladder" of annuities, just as one does with GICs, and thus attain an average interest rate experience.

Insured Annuities

An insured annuity is the simultaneous purchase of an annuity and an insurance policy. The results from an insured annuity will vary depending upon the age of the client and his/her tax bracket. For clients who are over age 60 and who are in a relatively high tax bracket, an insured annuity provides a very attractive result. Many clients can expect to earn the equivalent of an investment return of 10% or higher without undertaking any risk.

Annuities and insured annuities are worth considering. Please do not hesitate to give me a call if you would like me to review these with you at our next meeting.

Conservative Investment Funds

The stock market has been problematic over the past three years. As a result, many investment funds or mutual funds have not done well (although a great many have done much better than "the market").

There are number of funds, such as those that focus on preferred shares or income trusts, that have not only done well over a long period of time, but have continued to do well during the recent market decline.

Preferred share or income funds also have a tax benefit when they are purchased with non-registered capital, as the investment income produced is only partially taxable.

Market-neutral or Hedge Funds

There are also a number of investment funds that hedge their position with respect to the stock market. It is possible to earn a profit when a stock goes down in price or when a market index falls through the use of "put options" or "short-selling strategies."

There are several investment funds that utilize these strategies in order to provide for the protection of capital if the market falls, while at the same time investing a portion of their capital in assets where they see some investment potential. For example, there is one investment fund that uses a combination of investment strategies such that it has produced a positive investment return in every month since its inception three years ago.

"Guaranteed" Investment Fund Products

There are several investment products that combine fixed income investments and market-based investments in such a way that the initial capital investment is guaranteed. Thus, there is an opportunity to participate in the stock

market (or in other "risk" investments) yet still have a guarantee of the return of one's initial capital. These investments come in many forms, including index-linked certificates, full-pay products, and segregated funds.

Risk and Reward

All investment products embody some combination of risk and reward. A conservative investment fund may reasonably be expected to have a lower "downside" than a more aggressive fund. There is still, however, investment risk. No matter how well a fund has done in the past, "past performance is not a guarantee of future results." Similarly, funds that have successfully employed hedging strategies in the past may not be equally successful in the future.

Investment products that guarantee a return of your initial capital do provide some measure of security. One should note, however, that there is usually no guarantee of a positive investment return (and usually some implicit cost for the capital guarantee).

Annuities and insured annuities provide the disadvantage of locking in your capital. They do, however, provide for the guaranteed positive investment return.

Finally, laddered guaranteed investments are very widely used and are quite easy to understand. There is a guaranteed positive result and there is no loss of flexibility. The disadvantage is that the investment returns are modest, especially if interest rates stay at their current levels — and in a non-registered account, the interest from GICs is fully taxable.

Given the complexity of our economic situation and a bewildering array of available investment products, it is very difficult for any client to know what the correct allocation of assets should be, and which specific products will be best for them. My challenge is to try to find that "best possible solution" for each and every client.

Finally, the selection of investment products should be made within the context of an organized financial plan that addresses each client's specific long-term objectives.

Clientel

Thank you for reading this edition of *Clientel*. Please do not hesitate to call me if I can provide any additional information on any of the items discussed in this newsletter, or on any other aspect of your long-term financial security.

As always, the central message of *Clientel* is that I value my relationship with each one of my clients and I am as close as the phone.

Sincerely,

ROGERS GROUP FINANCIAL

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David N. Chalmers is a Financial Advisor with Rogers Group Financial Advisors Ltd. The views expressed are those of the author and not necessarily those of Rogers Group Financial, which makes no representations as to their completeness or accuracy.

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