June 12, 2006

Dear Client(s),

Enclosed is a year 2005 “Andex Chart”. As I have done for many years now, I am sending this chart to all clients along with some comments with respect to the information on the chart.

Commentary

Here is a summary of the information that is most relevant to this year’s commentary:

From 1950 to mid-2005, the average inflation rate was 4%. This is represented on the chart by the pink colored line entitled "Consumer Price Index". If you look in the white box that is inset into the chart you can see that the rate of inflation has been decreasing. While inflation has been 4.5% over the past 30 years it has been only 2.3% over the past five years.

The return on fixed income investments over the past 55 years has been about 7.5% (7.3% for Guaranteed Investment Certificates and 7.7% for Bonds). These are represented by the orange and green lines on the graph. These returns have also been decreasing in recent years, although there is a bit of an anomaly when it comes to the return on bonds as the price of bonds rises when interest rates fall.

The return of the Canadian stock market (the red line) and the return of a balanced portfolio (the gray line) have both been about 10.5% since 1950.

Theoretically, therefore, an investor who held a balanced portfolio over the past 35 years would have had a return of about 10.5% and would have experienced an inflation rate of about 4%. Thus, theoretically one would have “beaten inflation” by 6.5% per year.

Real Return

To a certain extent, one of the most significant numbers for a Financial Adviser to ponder is the amount by which he or she expects the investment return of his or her clients’ portfolios to beat the rate of inflation. Thus, if we expect to achieve a 5% investment return in the future and we expect to experience a 2.5% inflation rate, then the projected spread between the two numbers is 2.5%. We could also refer to this "spread" as being the "real return".

What Really Matters

I and my colleagues are very interested in the relative performance of different investment asset classes and their relationship to inflation. In my 33 years in the financial services business, I have noted that this actually matters somewhat less to our clients.

What we believe that our clients really want from their investment portfolio is:

-A secure retirement income that will keep up with inflation on an after-tax basis

-Financial freedom and independence

-Money that will be available in times of emergency or opportunity

-The ability to help their children, their church and their favorite charities

-Protecting their loved ones against financial catastrophe

-Spending meaningful time with the people they care about and doing the things that they want to do

- A trusted Advisor to help them meet these goals

Back to Economics

Our role as Financial Advisors is to try to help our clients achieve their objectives. In doing so, we need to pay a lot of attention to the mundane economic information that comes our way every day.

Financial Projections

We use computerized financial projections to simulate outcomes of clients' financial futures. We make assumptions about long-term investment returns, inflation and taxation. Then, taking into account each client's financial resources, pension entitlements and retirement income, and estate objectives, we build a projection of what the future might hold. This type of "scenario analysis" allows us to optimize our strategy in order to help our clients meet their financial objectives.

As these projections are based on a series of economic and other assumptions, we know that they are only an educated guess as to what the future might hold. Although we make many assumptions in each projection, perhaps the two most important are:

- The projected future return on each client's investment portfolio

- The projected future inflation rate

When we subtract the projected inflation rate from the projected return, we get the projected "spread" or "real return".

It is in fact the spread or real return that is the most important number. If you are saving for retirement or if you are retired, a high spread is good news. However, if you are very deeply in debt, then a low spread is good news.

We tend to use a relatively low spread in our long-term projections. Our current default position is to use a projected investment return of 5% and inflation of 2.5%. This creates a spread of 2.5%.

There are several reasons why we are using a projected spread that is considerably lower than the historical spread:

1. The world is more competitive today than it used to be. It is harder to make money and perhaps the easy days of high investment returns and low inflation might be behind us.

2. We are projecting average results over a long period of time. In fact, when one invests money one tends to have some good years and some bad years. It is quite significant whether or not good results occur in early years and less favourable results occur in later years or vice versa. Similarly, it is significant whether there is higher inflation in the early years and lower inflation in the later years or vice versa. Thus, we would prefer to be conservative in our assumptions to account for the variances that occur as a result of year-to-year changes in inflation and investment return.

3. While it would be hard to describe any of our clients as being "very deeply in debt", it would be easy to describe many governments in this way. Specifically, the government of the United States is very deeply in debt and going more deeply into debt every day. It thus behooves the US government to foster an economic policy which will lead to a low spread between interest rates and inflation.

4. They say that only two things are certain in life: "death and taxes". While none of us wants to spend too much time contemplating our demise, we have to worry every day about taxes. The rate of tax and the way in which it is applied has a profound effect on the investment return and the "spread" that our clients achieve.

Money that is in a registered account such as a pension plan or RRSP can grow (according to current tax rules) in a fully sheltered environment. When one converts his or her RRSP to a RRIF, there is an amount of income that one is compelled to take (and pay tax on). This amount of income might be quite different from the optimum amount of income that is required in order to meet financial objectives.

Money that is invested outside of a registered account is subject to taxation as it accrues. The amount of tax that one pays depends on whether the investment earnings are characterized as interest, dividends or capital gains. Each dollar of tax reduces one's net investment return. This in turn reduces the spread.

5. Many pension plans including the Canada Pension Plan are supposed to be indexed to inflation. It is unlikely, given the current demographics of our country that this will happen. We thus generally assume that these pensions will not be indexed at all or will be indexed at a rate somewhat lower than the projected inflation rate.

The Old-Age Security program is already subject to a "Clawback" (elegantly referred to as a "Social Benefits Repayment" on your tax return).

Asset Allocation

The Andex chart tells us what has happened in the past. If we knew that the future was going to be the same as the past it would be very easy to make investment decisions. The best-performing asset class on the Andex chart is the US Small Stocks Total Return (represented by the purple line on the chart). If one would have had the stomach to "hang in" during the period from 1969 to 1975, one would have done very well in this asset class.

We do not know which asset class will perform the best in the future, nor do we know what economic surprises might be coming our way. Thus, we recommend a diversified and defensive approach to investing. We would rather achieve reasonable investment returns while reducing the risk of losing capital, than putting our clients at undue risk in order to try to achieve higher investment returns.

Inflation

Finally, it is hard to define what is actually meant by inflation. While there is a number published by the Government of Canada called the Consumer Price Index, it is really not representative of the total increase in the cost-of-living. Some very significant items are left out of the calculation of the "CPI" and we note that every family's individual inflation rate differs from that of every other.

For example, if you have just taken on costly in-home medical care because you have lost your mobility, you will take little comfort in the fact that the stated inflation rate is around 2%.

Back to Financial Planning

Our role as Financial Advisors is to help our clients achieve the goals that are important to them. In so doing, we pay a lot of attention to economic and investment data when we recommend portfolios to our clients. We work hard to optimize each client's strategy with respect to taxation and to deliver an effective portfolio strategy at a reasonable cost. Finally, we try to put our recommendations in the context of a long-term strategic plan in order to help our clients achieve their personal goals.

The Andex chart is an interesting tool as it provides a very good visual depiction of a number of economic trends that have occurred in the past. This is one of a multitude of economic tools and commentaries that we use to formulate our strategies.

Thank you for reading this year's Andex letter and thank you for our ongoing relationship. Please don't hesitate to give me or Dylan or Nathan a call if we can provide you with any additional information.

Sincerely,

David Chalmers