

# STRONACH'S *Smart Money*

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## Skeptical about Stocks?

**R**ight now, the glamour of the stock market isn't glistening like it has in the past. Besides being down more than 30% since the August 2000 highs, confidence in stocks has been shaken by the excessive greed of several corporate leaders who through financial engineering have enhanced their own net worth at the expense of their shareholders. In addition, concerns have been raised about the accounting profession because some large firms have compromised their objectivity by helping some unscrupulous companies "touch-up" their books to enhance their appeal to investors.

Over the past 15 years to July 31, 2002, both the TSE 300 (now the S&P / TSX) and the MS EAFE (Europe, Asia and Far East) earned less than T-Bills. And the S&P, earned only 1.25% more per year than the SC Bond Universe. So, even with the favourable tax treatment granted to stocks, if you factor in management fees, any perceived advantage would likely have evaporated.

There is a fundamental assumption that your investment returns *should* be greater with stocks than with bonds because investors expect higher returns when assuming a higher level of risk. Without the benefit of higher returns, why would you bother holding stocks at all?

But in spite of the negative press directed at stocks, many seasoned academics suggest that history has simply repeated itself and things will turn around in the not-so-distant future. In fact, many believe that July 24, 2002 was the bottom of the market.

Ian Notley (an institutional specialist in price fluctuating phenomena) indicated that scandals like Worldcom, Enron and Tyco have occurred in the past (but maybe not to this extent). He notes that these incidents appear when the cycle reaches certain levels - a point he refers to as the "orgy of speculation" where investors get so caught up in the excitement they'll throw money at any scheme without knowledge of what they're buying. This type of market activity also attracts corrupt individuals whose intent is to get investors to buy "castles in the sky" through deception.

INVESTMENT RESULTS TO JULY 31, 2002				
	1 Year	5 Years	10 Years	15 Years
TSE 300	-12.65%	0.70%	8.83%	5.94%
S&P 500	-20.79%	3.27%	13.36%	11.23%
MSCI EAFE	-13.83%	-1.18%	7.69%	4.33%
SC 91 Day T-Bills	2.93%	4.46%	5.02%	6.85%
SC Bond Universe	8.67%	6.45%	8.37%	9.94%

The U.S. authorities have been busily working to rebuild confidence in the stock markets. An advantage to having a capitalist market like that of the U.S. is that the holes in the system will be fixed and fixed quickly.

Several initiatives have been implemented to curb corporate abuses. Corporate governors within every public company have had to sign declarations stating that they are not aware of any reporting irregularities. Those caught abusing the system are arrested and taken away in handcuffs. Stock options are beginning to be expensed to ensure earnings are not overstated. And the accounting profession will separate their accounting and consulting firms to ensure objectivity can be maintained.

Investment returns like those above, although accurate, tend only to enhance anxiety and should not be a significant factor in evaluating your investment results because they can be misleading. To have achieved these poor returns over the last 15 years, you would have had to invest on August 1, 1987 - which, if you recall, was just before the "Black Monday" on October 19, 1987 when the Dow dropped 22%. So your 15 year performance would have been based on 2 points in time - the top of the market in 1987 and the bottom of the market in 2002. It is much more meaningful to view the market results

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***"Adding new asset classes  
can enhance returns whilst  
lowering volatility"***

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using a graphical format because the slope of the long term trend line provides a better understanding of market returns than 2 points in time.

When the markets are expected to bounce back will depend on investor confidence – which seems tenuous in light of the looming terrorist threats and the U.S. situation in Iraq.

It is easy to be skeptical about stocks at this point in the cycle, as we may believe this market is unique and history will not repeat itself. But we must remain rational.

As an experienced investor, you can't exclude the stock markets because if history does repeat itself, you cannot afford to miss the rebound. But if the stock markets have lost some of their lustre, it makes good sense to limit your dependence on one asset class. Rather, it may make sense to diversify your asset classes – to unconventional and possibly more creative solutions.

***"Right now you can't afford to risk that history won't repeat itself. You could miss the rebound"***

The Yale University Endowment Fund has been a leader in the movement to less traditional asset classes (see shaded article). With nontraditional asset classes, they expect to earn considerably higher returns with lower volatility.

Although some of the asset classes they invest in historically required significant assets to participate, it seems there is a movement to access these nontraditional assets classes through mutual funds and

trusts (i.e., absolute return strategies can now be accessed through hedge funds, private equity through venture capital funds, oil and gas through partnerships and trust units, real estate through various sources).

It may therefore be worth considering the addition of small allocations (i.e., 5% - 10%) to nontraditional asset classes (i.e., small cap funds, emerging markets funds, hedge funds, oil and gas partnerships, venture capital funds and real estate) to limit your dependence on traditional stocks and bonds.

## Yale University Endowment Fund

**T**he Yale University Endowment Fund is recognized as a leader in portfolio innovation using a structure which yielded annual net investment returns of 18.3% over 10 years to June 30, 2001. At the time, this fund was worth \$10.7 billion (US).

The endowment recognized the need to limit their exposure in conventional asset

classes (i.e., domestic marketable securities) by reallocating assets to nontraditional asset classes.

In 1986, approximately 65% was committed to U.S. stocks, bonds and cash. Today, target allocations call for 25%, while the diversifying assets of foreign equity, private equity, absolute return strategies and real assets dominate the

endowment, representing 75% of the target portfolio.

The heavy allocation to nontraditional asset classes have significantly higher expected returns and lower volatility than the 1986 portfolio.

The rationale is that these alternative assets, by their nature, tend to be less efficiently priced than traditional marketable securities, providing an opportunity to exploit market inefficiencies through active management.

Even within their allocations to domestic and foreign equities, the Yale Endowment has concentrated on maximizing their nontraditional asset classes. They overweight small capitalization stocks in their Domestic Equities and \_ of their Foreign Equities are allocated to developing countries (emerging markets).

### THE TARGETED PORTFOLIO IS AS FOLLOWS

	Yale	Avg. Educational Institution
Domestic Equity (US equities)	15.0%	43.3%
Fixed Income (US bonds)	10.0%	23.1%
Foreign Equity	10.0%	12.4%
Absolute Return (hedge funds)	22.5%	9.1%
Private Equity (venture capital & leverage buyout partnerships)	25.0%	6.1%
Real Assets (real estate, oil & gas and timberland)	17.5%	2.8%
Cash	0.0%	3.2%

## The Back to Back Annuity: A way to increase your retirement income without any risk.

Eventually, everybody retires and will have to convert their investments to provide a regular cash flow. The problem today is that the income returns from fixed income investments are not at all enticing. And at this time, I can safely say equity investments are not making it any easier.

A vehicle which has not received much attention in recent times is the “**prescribed annuity**”. Its attractiveness is threefold:

- Investment returns are enhanced due to mortality.
- It has favourable tax treatment.
- Income is guaranteed for life.

In the chart, are 2 male doctors (60 years old) in good health, Dr. Wilson and Dr. Shultz - both with \$200,000 outside their RRSP.

Dr. Wilson invests his funds in a GIC which earns 5%. He therefore earns \$10,000 of interest income per year - for as long as he lives. And after-tax, he would be left with approximately \$5,400. When he dies, his beneficiaries would get \$200,000 because the principal would remain in tact.

Dr. Shultz buys a “prescribed straight-life annuity” which pays him \$15,106 annually for as long as he lives (current rates). Because of the favourable tax treatment, he is taxed on only \$5,475 – so after-tax he is still left with \$12,588 per year.

What sometimes dissuades people from investing in annuities (especially straight-life annuities) is that when you die, the income flow stops. So, for the most part, to minimize their risk, they buy an annuity with a 10, 15 or 20 year guarantee (which in essence is a form of insurance). This way they’ll be sure their capital will not disappear if they were to die prematurely.

A more creative solution is to allocate some of the after-tax advantage from the annuity (i.e., \$12,588 - \$5,400 = \$7,188) to a permanent life insurance contract - thus referred to as a “back-to-back annuity”.

In the case of Dr. Shultz, a \$200,000 level term-to-100 policy would cost him \$4,254 per year. So, after paying the life insurance premium, he would have a cash flow (after-tax) of \$8,334 - still ahead of the GIC by \$2,934 per year after-tax. The result would be that his before-tax equivalent return (fully guaranteed) would be 7.72% (assuming a 46% marginal tax rate).

You should note in the chart, the 70 year old would fare slightly better than Dr. Shultz (assuming he would qualify for the insurance coverage).

	GIC	PRESCRIBED ANNUITY	
	Dr. Wilson 5.0%	Dr. Shultz Male age 60	Male age 70
Capital Invested	200,000	200,000	200,000
Annual Cash Flow	10,000	15,106	19,301
Taxable Income	10,000	5,475	4,709
Tax Payable at 46%	4,600	2,519	2,166
<b>NET INCOME</b>	<b>5,400</b>	<b>12,588</b>	<b>17,135</b>
Annual Insurance Premium	0	4,254	8,226
<b>NET CASH FLOW</b>	<b>5,400</b>	<b>8,334</b>	<b>8,909</b>
Net Cash Flow	2.70%	4.17%	4.45%
Cash Equivalent Return	5.00%	7.72%	8.25%
Annual Advantage over GIC		2,934	3,509
% Increase in Income		54%	65%

More visionary investors recognize that the cost of increases with age and this is just one more reason why having some permanent coverage may provide future flexibility.

For example, if Dr. Shultz was 15 years younger, it is likely he would need life insurance to fill the gap between his current savings and the amount needed to fund his retirement. So, he could have opted to have a portion allocated to permanent insurance. Keeping the permanent insurance in place would increase his net cash flow from a prescribed annuity at 60 from \$8,334 to \$10,982 - thus increasing his “Cash Equivalent Return” from 7.72% to 10.17%.

The future benefits of permanent life insurance may include:

- Higher retirement cash flow from prescribed annuities.
- Estate preservation by minimizing erosion from future taxes.
- Enhanced liquidity to estate.
- Tax savings if assets are held in a corporation.
- Ability to save current taxes through tax-free compounding.

*(see Stronach's Smart Money Fall 1999).*

- Tax free liquidity in the event of a Critical Illness.

Life insurance is designed to ensure your family (or partners) do not suffer financially due to your premature death. It can be bought to address a single and current risk or can be bought to address current risks with the flexibility to adapt to future risks – foreseen and unforeseen. The cost of insurance increases as you get older, so with the clarity of a financial plan, decisions can be made today which can improve your situation in the future.



## WHO IS THE STRONACH FINANCIAL GROUP?

Stronach Financial Group has been advising wealthy individuals since 1983.

Our advice does not earn us commissions or finders fees, so this way you get what's best for you.

Rather than managing money ourselves we either work with your existing advisors or will recommend one that we feel will look after your needs and temperament.

We have established working relationships with many prominent financial professionals to ensure you get the best advice available.



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