PRIVATE WEALTH MANAGEMENT

CIBC WOOD GUNDY
THE KRATZ FINANCIAL GROUP

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THINGS I'VE HEARD

"An investment in knowledge pays the best interest."

- Benjamin Franklin

How do you define "safety"?

How do you define "risk"?

"My last car cost more than my first house"

"Soon after we were married, we moved into the most sunny and beautiful one-bedroom apartment in the world. Our apartment was in a building near downtown and rent was $30 per month. Recently, I passed by there and noticed a sign advertising a parking space for rent in that same building – it was advertised for $150 per month. A parking space for five times what we paid to rent that beautiful apartment – and I'm pretty sure that they won't let you live in the parking space."

"When my wife was pregnant with our first child, I went to the Ford dealership and asked what kind of car grown-ups drive and I left there with a family car – a Ford Galaxie 500 – LOADED. I got it for $3,500. My daughter – the child my wife was carrying when we bought that Galaxie 500, is now pregnant with her first child and recently she went down to that same Ford dealership and bought a Ford Explorer for $45,000."

"I retired in 1980 after 35 years of work. It seems hard to believe, but this year marks the 35th anniversary of my retirement. From here on, I will have spent more time in retirement than I spent working."

These are all observations of 'regular' retirement. 'Regular' means that without any extreme fitness or diet regimes, it is probable that your retirement will be three decades long. We are long-lived not by our virtues but our advances in medicine, pharmacology and medical devices (all things that you can invest in by the way).

In this regular retirement, you will experience change and your ability to confront those changes will be tested. Think back over the last twenty years to today. How much did things change in those twenty years? If you thought that those twenty went by quickly, how fast do you think the next twenty will go?

Change can't be noticed year-by-year but pretty soon you turn around and things are a whole lot different. For those who have prepared for change, times passage can be something to savor and enjoy. Those who do not plan will forever be forced to react to the changing world around them. In investing as in life, *action* usually beats *reaction* – unfortunately by the time some realize that change requires action – it's often too late.

Let's take a look at two couples who are in an identical situation. How you look at the world and your choices today have significant implications on the older you in the years ahead.

A tale of two couples:

It is 2015. Twenty years ago, in 1995, two couples retired… we'll call the first couple 'the Boones' and the other couple 'the Klausens.' Each couple had saved a nest-egg of $500,000 and although they had pension income, they needed to supplement their pension incomes with investment income of $12,000 per year from their $500,000 nest-egg. Both couples had witnessed some of the highest inflation and interest rates in Canadian history – they remember a time when inflation stood at over 12% per-year and the prime

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lending rate was up over 18%.

Both couples agreed on two things: they could not afford to take risk and needed to keep their money safe. The gulf in how each of our two couples defined these terms resulted in substantially different choices and, as you will see, substantially different outcomes.

The year 1995, all four people are aged 65:		
	Boones	**Klausens**
Income Required	$12,000	$12,000
Nest-egg	$500,000	$500,000
Goal	"Safety"	"Safety"

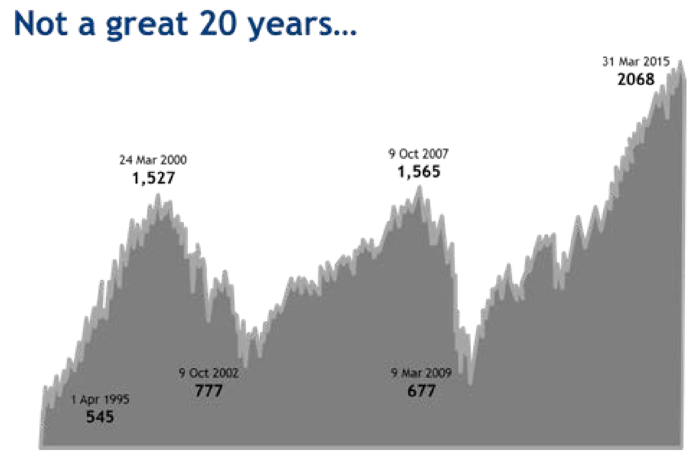
Both couples had similar needs and both faced the same interest rates, market conditions and economic environment.

First, The Boones:

Topmost in the Boones' mind was "safety." The Boones' worked hard to accumulate this money and they did not want to risk the loss of any of their principal. So they restricted their investment options to those where their principal amount was guaranteed. Fortunately for the Boones', interest rates were pretty good in 1995. A 20-year government of Canada bond was paying 8.35%. This means that a sum of $500,000 would be guaranteed $41,750 per year for twenty years – and of course would also have 100% of their principal returned upon maturity… Remember that this is guaranteed by the government of Canada – the same people who own the printing press!

The Boones' thought about this for about a nanosecond, then put their entire nest-egg into this 8.35% government bond before the government changed their mind. The Boones felt that they were set for life – they had more income than they would ever need and were very happy with their investment.

The Boones – newly retired – with much more income than they needed, lived very comfortably and ended up spending more than they planned for. But a funny thing happened, as time went on, their income seemed to buy less and less stuff… which we will get to in a moment.



The Klausens:

Like the Boones, the Klausens agreed that they must avoid 'risk' and keep their money 'safe.' But, there is a substantial difference in how the Klausens define risk. The Klausens believed that their greatest financial risk is rising costs. Thus, safety to the Klausens is growing their income and capital at a rate that after-taxes exceeds inflation over the remainder of their lives.

With the goals set for their investment outcomes, the only investment that historically meets their criteria is stocks. To be successful investing in stocks, the Klausens would need to have two things working for them: First, a long-term view. Second, a firm grasp on history. The combination of these two attributes together help investors from getting scared out of stocks at times of short-term stress. The life experience that the Klausens bring to what I call history is this: they were both born in 1933 and the market topped out that year at 6.5. Years later on their wedding day, the year was 1954 and the market had more than quadrupled to 32 in their lifetime (of 21 years) and in 1995 at the time of their retirement, it stood at 545 – 17 times higher than when they were married!

Two basic ideas fuelled their decision. First, they believed that first and foremost they were investing in *companies*. Second, their entire life experience with "the market" is that although it goes up and down, the ups are greater and it rises over time.

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The Klausens in keeping with their investment objective of growing capital and income, invested their $500,000 nest-egg in 45 of the greatest companies in Canada and the world at that time.

The Klausens put equal amounts (a little over $11,000 each) into companies that produced products or services they used and then did not change their investments – although at times they were really tempted. The Klausens were primarily investing for the dividend income, which in 1995 was an annual rate of 2.5% of their investment amount of $500,000. That meant they took an income of $12,500 in dividends in 1995 – just the amount of income that they needed. When the market went up, their companies went up. When the market went down, their companies went down but the dividends kept flowing in – except for two of the companies: Nortel and Enron. These two companies saw dividends stop altogether and even the capital invested in these two (representing almost 4.5% of their portfolio) went to zero – a permanent loss of capital.

But a funny thing happened… even with market gyrations and setbacks, most every year the Klausens' income grew… it seemed like a little at first (and it was) but it became substantial over time.

Twenty years on: 2015

Back in 1995 when both couples retired, a first-class postage stamp cost 45 cents. Today, it takes $1 to buy the exact same thing. The costs of things rise over time and the postage stamp works well as a proxy, since just about everything rose at about that rate: in 2015, it takes more than $25,850 to buy what $12,500 bought in 1995 (a little more than double).

The Boones' started out so far ahead with their income that right up through this year, their annual income of $41,750 from their bond has worked great. Unfortunately, this is the year that their bond matured. Exactly as promised, they got every penny of their $500,000 capital back. The new 20-year government of Canada bonds now yield 1.9% which means that they would see their income drop to less than one quarter of what it was to $9,500. Not a great scenario when your costs have more than doubled. When your costs double and your income is quartered, you only have 12.5 cents for every dollar of expenses. Although every last dollar of their principal remained intact, its value has dropped by half. I think by any reasonable and rational definition, the Boones ended up doing the thing that they tried to avoid happening to them: they lost money (a lot of money).

Agnico Eagle Mines Limited	Canada	Power Corporation of Canada	Canada	The Kroger Co.	United States
Agrium Inc.	Canada	Rogers Communications Inc.	Canada	McDonald's Corp.	United States
Canadian Natural Resources Lim	Canada	Royal Bank of Canada	Canada	3M Company	United States
Canadian National Railway Comp	Canada	The Toronto-Dominion Bank	Canada	Nike, Inc.	United States
Canadian Tire Corp. Ltd.	Canada	George Weston Limited	Canada	Pepsico, Inc.	United States
Canadian Utilities Ltd.	Canada	The Boeing Company	United States	The Procter & Gamble Company	United States
Empire Company Limited	Canada	The Clorox Company	United States	The TJX Companies, Inc.	United States
Enbridge Inc.	Canada	Cummins Inc.	United States	BHP Billiton Limited	Australia
Fortis Inc.	Canada	Costco Wholesale Corporation	United States	AXA Group	France
Finning International Inc.	Canada	The Walt Disney Company	United States	Danone	France
Great-West Lifeco Inc.	Canada	Enron	United States	Bayer AG	Germany
Imperial Oil Ltd.	Canada	General Mills, Inc.	United States	Honda Motor Co., Ltd.	Japan
Magna International Inc.	Canada	The Hershey Company	United States	Nestlé S.A.	Switzerland
Methanex Corporation	Canada	International Business Machine	United States	Diageo plc	United Kingdom
Nortel	Canada	Johnson & Johnson	United States	Unilever plc	United Kingdom

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The Klausens' experience was wholly different from that of the Boones. They had no guarantees and they did suffer some setbacks (Nortel, Enron, and market corrections) but over time their income rose and that income that started out at $12,500, although not guaranteed, slowly grew. By the end of 2015, their dividend income will have risen to **$112,080**! In fact the total income that they will have received over the whole 20 years comes to a total of $858,938, which is about $25,000 more income than the total that the Boones received over the twenty years. What about their principal? Well, unlike the Boones' guaranteed principal the value of those 43 (45 – 2) companies moved up and down quite a bit but over time it was mostly up. Although the values of many of these companies are not near their all-time highs, the value of their original investment of $500,000 is now over **$4,800,000**.

How do you define "safety" and how do you define "risk"?

About Luke Kratz:

Luke has a process that he has refined over the past 27 years to help people maintain their lifestyle and independence in retirement – allowing them to enjoy the peace of mind that comes with increased confidence.