Investing Tips and Traps

Steele Wealth Management

Raymond James Ltd.

February 2011

Five Traps

1. Principal Protected Notes (PPNs)
2. Guaranteed Minimum Withdrawal Products (GMWBs)
3. The Perception That A Low Share Price Means Lower Risk
4. Comparing Pre-Tax Investment Returns
5. Ignoring Stocks That Have Performed Well In The Past

Principal Protected Notes (PPNs) (Trap 1)

- Structured investment generally offering a principal guarantee with a return tied to a basket of equities or commodities
- They generally do not guarantee that you will get back materially more than you initially invested
- Maturity dates are generally between three and ten years
- Most PPNs have early withdrawal penalties – or adverse market conditions affecting liquidity

PPN Review (Trap 1)

Sample PPN: Canadian Bank PPN

- Invested Capital: $100,000
- Term: 5 years
- Principal Protection: 100%
- Minimum Return: 2.5% in the first year and 0% for the next four years
- Maximum Return: 7% per year
- Early Trading Fee: 4.5% of principal
- Equity Holdings: Diversified Basket of 10 Canadian Blue Chip Equities
- Positive price performance is limited to 7% per equity, ex-dividend
- Negative price performance is limited to -25% per equity, ex-dividend

PPN Review (Trap 1)

Sample PPN Returns: Canadian Bank PPN

Scenarios

- All Equities Earn 5.5% Per Year
  - Value of Canadian Equity Notes at maturity is $130,700
- All Equities Lose 6% Per Year
  - Value of Canadian Equity Notes at maturity is $102,500

PPN Review (Trap 1)

Sample : Alternative Strategy

- Invested Capital: $100,000
- Term: 5 years
- Principal Protection: ~90% (Based on BMO Strip Bond)
- Investment Management Fee: 1.25%
- Buy $70,000 worth of a 2017 BMO Strip Bond and sell it in 2016
- Buy $30,000 worth of iShares XIU currently yielding 2.16%
  - iShares XIU represents the S&P/TSX 60 Index
- Annually sell covered call options on the iShares XIU position which should generate ~3% in additional income while capping upside
  - Selling covered calls involves selling call options with a strike price approximately 5.5% above current prices
  - A call option gives the buyer the right to buy the underlying security from the call option seller at a pre-determined price at any time before the expiry date

Sample : Alternative SWM Strategy

Scenarios

- XIU Earns 5.5% Per Year
  - Value of Alternative SWM Strategy at maturity is $134,800
- XIU Loses 6% Per Year
  - Value of Alternative SWM Strategy at maturity is $114,700

Note: the maturity values presented above are estimates based on straight-line market performance. Volatility may impact the covered call strategy, which could result in different maturity values.

PPN Review (Trap 1)

Return Comparison Chart

	Canadian Bank PPN	SWM Strategy	SWM Advantage
Equities/XIU Earn 5.5%	$130,700	$134,800	**$4,100**
Equities/XIU Lose 6%	$102,500	$114,700	**$12,200**

- On the downside, our Alternative SWM Strategy only begins to underperform the sample PPN should equities lose more than 59% of their value by the end of the five year period
- Our PPN protects ~88% of capital but would only be worth 88% should equities be worth nothing in five years

PPN Conclusions

- PPNs are extremely complicated instruments (the information statement for the aforementioned Canadian Bank PPN is 39 pages long)
- We recommend transparency and liquidity be a major criterion in evaluating investment strategies
- Transactional or commission based products are generally not tailored to specific needs
- If you require a principal guarantee to invest in an equity portfolio, you need to re-establish your risk tolerance

Guaranteed Minimum Withdrawal Products - GMWBs Product Review (Trap 2)

- Also known as Variable Annuities
- Similar to PPNs, GMWB products offer a principal guarantee with a return derived from a related security portfolio
- Generally a guaranteed return bonus per year earned through longevity based on the principle you have deposited
- Fees based on two components: an investment management fee and an insurance/guarantee fee
- Review of information folder and contract on a popular GMWB product – 119 pages

GMWBs Product Review (Trap 2)

- Its main features include:
  - Guaranteed income of 4 – 6 % (age dependent) of one's portfolio value or initial capital, whichever is greater, at the time withdrawals begin.
  - 5% guaranteed income bonus for every year you do not make a withdrawal
  - 100% principal protection at death by provider

- Its main deterrents include:
  - Annual fees of greater than 3% when one chooses the most aggressive asset allocation
  - Most aggressive allocation is 80% equity and 20% fixed income

GMWBs Product Review (Trap 2)

Sample GMWB Product

- Initial Deposit: $500,000
- Age: 50 with first withdrawal at age 60
- Life Expectancy: 85
- Income Withdrawal Maximum at age 60: 4%
- Annual Bonus: 5%
- Initial Portfolio Option: Aggressive (80% Equity, 20% Fixed Income)
- Asset Allocation at age 60: 60% Equity, 40% Fixed Income
- Assumed Equity Return: 8% (based on historical returns)
- Assumed Fixed Income Return: 4% (based on historical returns)
- Assumed Fee Based on Aggressive Portfolio Option: 3.5%

GMWBs Product Review (Trap 2)

Sample Managed Portfolio

- Initial Deposit: $500,000
- Age: 50 with first withdrawal at age 60
- Life Expectancy: 85
- Initial Asset Allocation: 80% Equity, 20% Fixed Income
- Asset Allocation at age 60: 60% Equity, 40% Fixed Income
- Assumed Equity Return: 8% (based on historical returns)
- Assumed Fixed Income Return: 4% (based on historical returns)
- Investment Management Fee: 1.25%

GMWBs Product Review (Trap 2)

Pre Tax Analysis: GMWB Product vs. SWM

	GMWB Product	SWM Portfolio	SWM Advantage
Account Value at age 60	$719,000	$891,000	$172,000
Income Received to age 85	$750,000	$750,000	$0
Account Value at age 85	$389,900	$1,671,200	$1,281,300

- Due to higher fees embedded in a GMWB product, an SWM Portfolio need only achieve equity returns of 5.10% annual over the 35 year period to provide a similar income and final portfolio value
- It is fair to remember that for simplicity these are pre-tax calculations; after tax calculations will differ

GMWBs Product Review (Trap 2)

GMWB Product Conclusions

- They do address legitimate retirement concerns (sequence of returns, outliving retirement income, inflation) but they do not solve these problems

- A balanced portfolio can better address these concerns as it will better protect you in both inflationary and deflationary scenarios (GMWBs only protect you in deflationary scenarios)

- One should concentrate on transparency of investments and preparing a total retirement plan to achieve better results

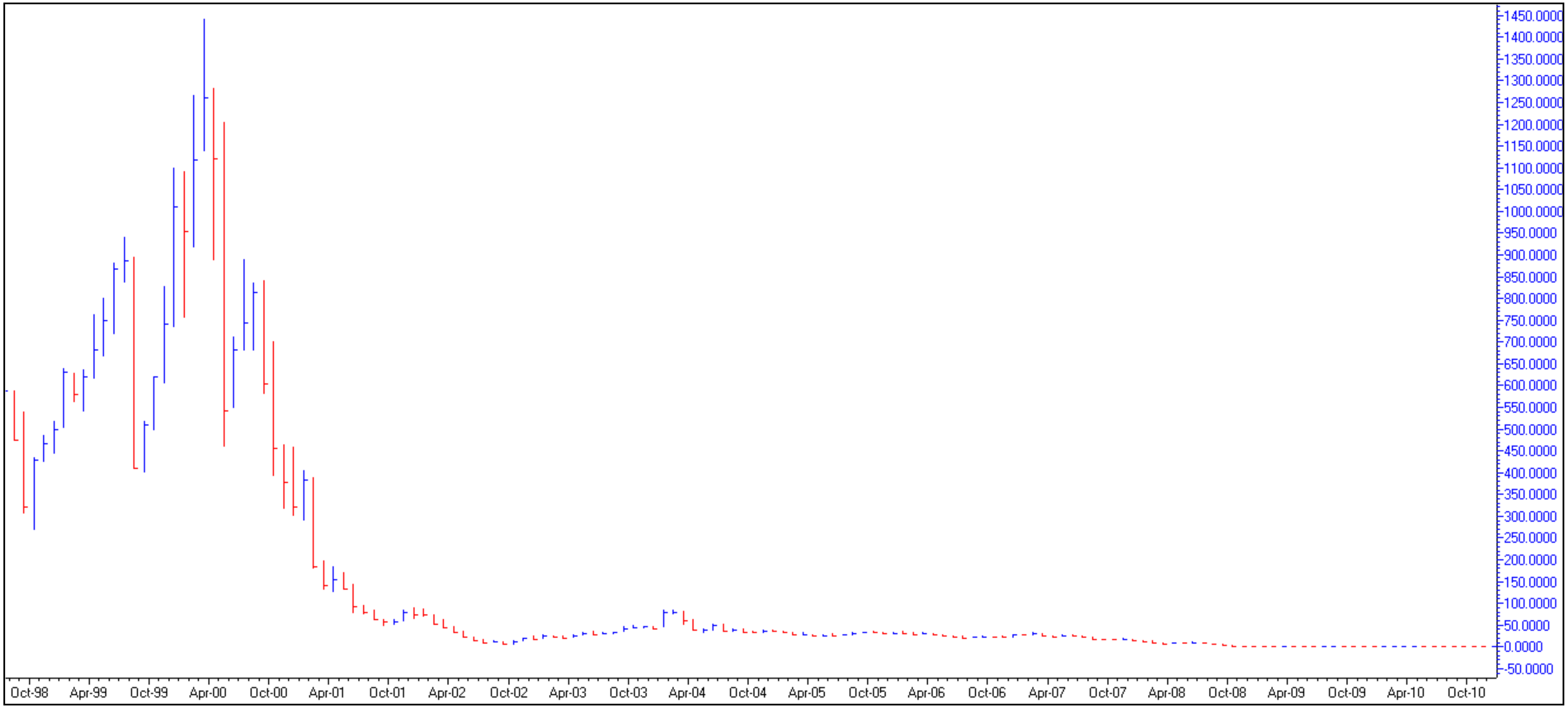
- Sequence of returns needs to be addressed at retirement

A Low Share Price Means Lower Risk (Trap 3)

- Investors tend to have the misconception that a company whose stock price has fallen materially is now less risky
- This misconception is mostly the result of an investor's expectation that the fallen can once again reach the prices seen in the past
- When a company's stock falls dramatically, changes to revenue, earnings and/or cash flow expectations are usually the culprit
- These changes in expectations are often the result of changing dynamics in the company's sector/industry or a change in the company's perceived competitive advantage

A Low Share Price Means Lower Risk (Trap 3)

Below is a chart of Nortel Networks from 1998-2010, exemplifying why a then perceived low share price was the perfect value trap. After trading below 10% of its peak value for over 9 years, Nortel shares are essentially worthless ($0.02/sh).



Comparing Pre-Tax Investment Returns (Trap 4)

- It is important to use after-tax investment returns when comparing past or expected returns
- Interest income is taxed at your full marginal tax rate, double that of capital gains and just under double that of dividends (assuming the highest marginal tax rate)
- Therefore, assuming the highest marginal tax rate, a stock's pre-tax yield need only be ~75% of the bond's pre-tax yield to result in the same after-tax return
- The benefit of dividend income over interest income grows as your marginal tax rate declines

Comparing Pre-Tax Investment Returns (Trap 4)

- One is able to receive up to $53,615 (in 2011) in dividend income tax free
- This is why we prefer to build non-registered portfolios consisting of dividend-yielding preferred shares and low-risk common shares rather than interest-yielding bonds
- Understanding how different sources of income are taxed and formulating tax-efficient portfolios can have a major impact on your financial well-being and quality of life

Comparing Pre-Tax Investment Returns (Trap 4)

Manulife Retractable Preferred “A” vs. Manulife 5 Year GIC

Security	Date of Maturity	Yield to Maturity	Highest Tax Bracket	After-Tax Return
Manulife 5 Year GIC	01/26/2016	3.30%	46.41%	1.77%
Manulife Preferred A	12/19/2015	3.35%	28.19%	2.41%

- Although they have similar pre-tax returns, the preferred share yields ~36% more after-tax
- It is important to remember the significance of taxation when building fixed income portfolios in non-registered accounts

Ignoring Outperformers (Trap 5)

- Similar to how investors tend to see underperforming stocks as less risky, investors tend to see outperforming stocks as increasingly risky

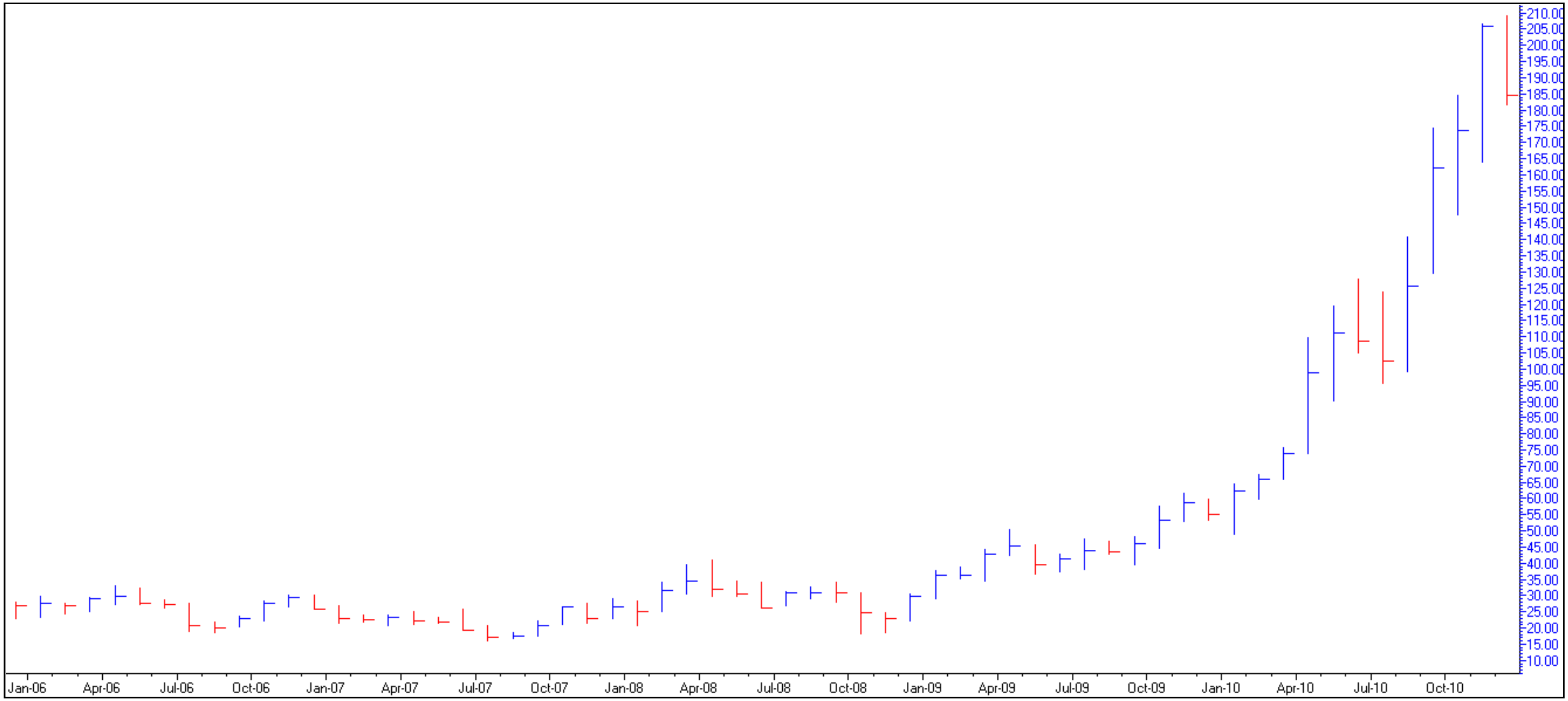
- In the same way that underperforming stocks often see a negative adjustment to growth expectations, outperforming stocks often see positive adjustment to growth expectations

- It is important to build expectations based on a stock’s future and not its past. A stock’s prospects change on a daily basis and expectations must be adjusted accordingly

- In fact, when growth expectations begin to shift upward, it may take a long time before a stock becomes fairly valued as not all investors will agree with the change in expectations

Ignoring Outperformers (Trap 5)

Below is a chart of Netflix from 2006-2010. As you can see, a major shift in growth expectations occurred in late 2009, early 2010, yet the stock saw its greatest gains in mid- to late-2010. A stock's greatest gains arise at the point of unanimity.



Five Tips

1. Ladder Fixed Income and Quasi-Fixed Income Securities

2. Identify Institutional Risk Versus GIC Risk

3. Understanding Asset Allocation and Value Of Transparency

4. Use Currency Values To Drive USD Investment Decisions

5. Remember To Focus on Portfolio Performance and Not Individual Investment Performance

Ladder Fixed Income Securities (Tip 1)

- A fixed income ladder is a portfolio of term-certain fixed income (bonds, GICs, debentures, or retractable preferred shares) with differing terms to maturity
- Fixed income ladders generally range from one-to-five or one-to-ten years but can be of any length
- Increasing your fixed income ladder length increases your interest rate risk
- Increasing your fixed income ladder length also leads to greater diversification and allows one to more comfortably purchase corporate bonds, debentures or preferred shares

Ladder Fixed Income Securities (Tip 1)

- Example: Assuming it is January 2011 and you wish to retire in 5 years you could assemble a 5 year ladder to provide for your retirement
- After one year has passed, your security set to mature in 2012 will provide you with cash flow to purchase a security maturing in 2017
- The ability to reinvest cash every year allows the investor to increase or decrease the credit risk of the ladder on an annual basis
- The current low interest rate environment has required alternative forms of fixed income such as preferred shares and corporate debentures to be considered

Ladder Fixed Income Securities (Tip 1)

Comparison of a 5 year GIC ladder and a 5 year fixed/quasi-fixed income ladder:

5 Year GIC Ladder

Year	Security	Yield
1	1 Year Coast Capital Savings	2.15%
2	2 Year Coast Capital Savings	2.55%
3	3 Year Coast Capital Savings	2.95%
4	4 Year Coast Capital Savings	3.20%
5	5 Year Coast Capital Savings	3.60%
	Overall:	**2.89%**

5 Year Fixed Income Ladder

Year	Security	Yield
1	Brookfield AM Preferred H	3.70%
2	Fortis Preferred C	3.10%
3	3 Year Coast Capital Savings	2.95%
4	Superior Plus Debenture D	6.00%
5	Manulife Preferred A	3.35%
	Overall:	**3.82%**

It is important to remember that maturities in the fixed income ladder are not uniform and that the goal is to establish an overall duration (average maturity) of the number of years in the ladder divided by 2 (i.e. 2.5 years in this case)

GIC Risk Versus Institutional Risk (Tip 2)

- GICs and corporate bonds/debentures of the same maturity carry a similar level of interest rate and inflation risk
  - Interest rate risk is the risk of a decline in value due to an unanticipated rise in interest rates
  - Inflation risk is the risk that the return will be eroded by inflation
- Corporate bonds/debentures are exposed to numerous risks above and beyond that of a “risk-free” GIC
  - Call risk is the risk that the security issuer refinances the bond prior to maturity and this results in reinvestment risk and cash flow uncertainty
  - Credit/Default risk is the risk that the issuer will not be able to pay some or all interest and/or principal
  - Event risk is the risk of negative company, country or industry specific news
  - Liquidity risk is the risk of being unable to sell the investment within a reasonable time and at a reasonable price
  - Sector risk is the risk of an increase in perceived sector risk

GIC Risk Versus Institutional Risk (Tip 2)

- It is important to remember that there may be one or many reasons why a corporate bond, debenture or preferred share has a higher yield than a GIC
- In most cases, the additional yield can be attributed to credit/default risk and/or call risk
- One should be familiar with a corporation's balance sheet, cash flow and underlying sector fundamentals before attempting to gauge a fair yield pickup on a corporate bond, debenture or preferred share
- Low cash and high debt often leads to credit/default risk
- It may make more sense to invest in a bank bond or preferred share over a bank GIC as the additional risk is often minimal

GIC Risk Versus Institutional Risk (Tip 2)

Manulife Retractable Preferred "A" vs. Manulife 5 Year GIC

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- So long as Manulife is a going concern at the retraction date, they are obligated to purchase the shares from you at par value

Understanding Asset Allocation (Tip 3)

- Most financial professionals can agree that a suitable asset allocation is the most important part of portfolio construction
- Research shows that over 90% of returns result from asset allocation decisions, debunking the oft-held beliefs that market timing and security selection are most important
- An appropriate asset allocation allows you to set an overall level of risk while maintaining exposure to a broad set of investments
- Exposing yourself to various asset classes allows you to simultaneously limit missed opportunities and class-specific risk
- Holding various asset classes will reduce overall portfolio volatility allowing for steadier growth and increased flexibility

Understanding Asset Allocation (Tip 3)

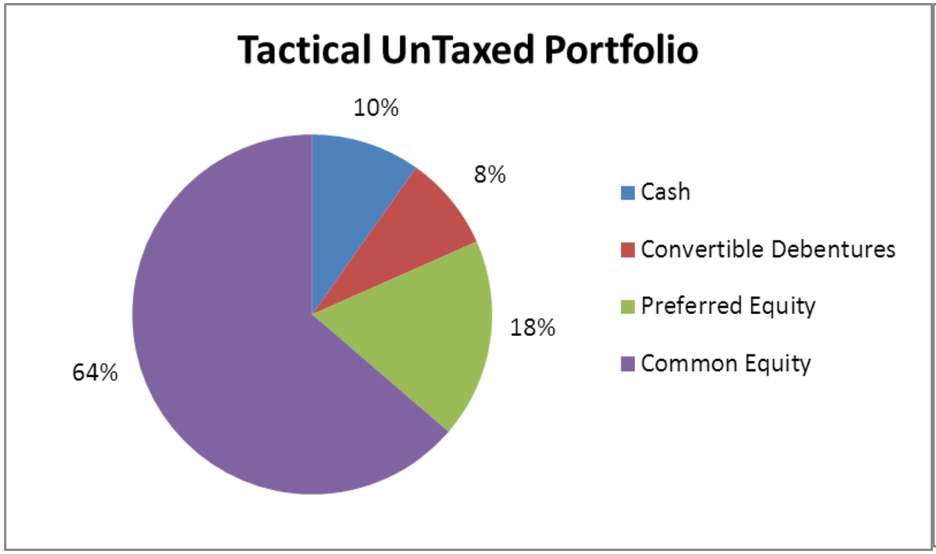
- Sometimes going overweight certain asset classes is prudent
- Currently, preferred shares and convertible debentures have much higher expected returns than corporate bonds, yet for companies with little senior debt, the additional risk is minimal
- We believe that one can currently achieve similar diversification and higher returns by substituting most of one's bond allocation for preferred shares and/or convertible debentures
- Preferred shares, convertible debentures and corporate bonds share similar correlations to equities and all will limit overall downside volatility in one's portfolio
- Preferred shares are taxed most favourably

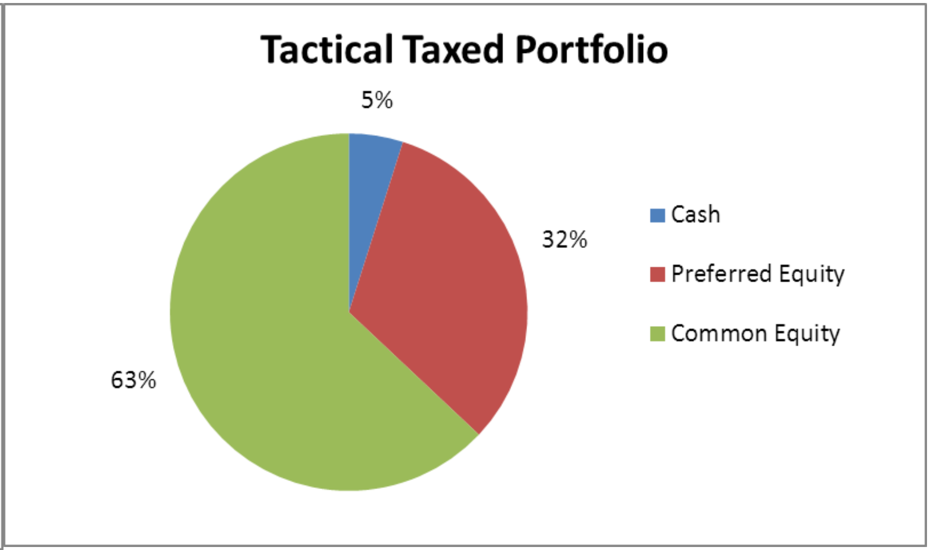
Understanding Asset Allocation (Tip 3)

- Now that we know why suitable asset allocation is important, lets talk about the importance of portfolio transparency
- In order to properly set, monitor and rebalance one's asset allocation, one's portfolio must be transparent enough to clearly identify what you currently own
- Despite this, many investors still have portfolios consisting of multiple, actively managed mutual funds, PPNs or ETFs which make it difficult to identify one's asset allocation at any given time
- Or, many investors will have holdings with several brokers, disallowing any one broker to assess one's asset allocation
- It is important to understand the importance of transparency

Understanding Asset Allocation (Tip 3)

- In our managed accounts where we have control over asset allocation we are currently using the following asset allocation for taxable and non-taxable accounts respectively





Use Currency Levels to Drive Investment Decisions (Tip 4)

- Since currency market volatility spiked in 2007, currency returns have become a major contributor to overall investment return
- When buying U.S. dollar denominated securities, it is important to build in currency return expectations over your planned holding period
- It is also important to forecast foreign currency movements when purchasing Canadian or U.S. exchange-listed securities whose ‘primary’ shares are listed abroad
- For example, when buying Banco Santander (STD-N) on the NYSE in U.S. dollars, it is important to recognize that it primarily trades in Euros on the Bolsa de Madrid, so one’s currency forecast should be formulated on the CAD-EUR exchange rate

Use Currency Levels to Drive Investment Decisions (Tip 4)

- Most of the time when buying U.S. dollar denominated securities they will trade primarily on the U.S. dollar, so the USD-CAD exchange rate is most often the one of interest
- The relationship between the Canadian and U.S. dollar relies mostly on general economic health and consumer and investor confidence
- In general, the more healthy the world economy, the stronger the Canadian dollar is, relative to the U.S. dollar, due to heightened demand for economically sensitive goods like energy and basic materials
- Therefore, the best time for investing in U.S. denominated securities is when you are looking to take a defensive position

Focus on Portfolio Performance (Tip 5)

- The goal of portfolio construction is to reduce overall risk while offering the prospect of returns required to achieve set objectives
- Portfolios should be constructed such that one has exposure to most markets and securities, reducing the probability of missing a rally in a “hot” asset class or sector while limiting one’s exposure to a “not-so-hot” asset class or sector
- Because the market return is just a composite of several securities, it is expected to own some individual securities that outperform and some that underperform
- If one focuses on individual security performance, one will lose sight of his or her goals and objectives

Focus on Portfolio Performance (Tip 5)

- When looking at your portfolio returns, it is important to remember your long-term objectives

- The poor short-term performance of a security, asset class or sector does not prevent it from being a holding which is compatible with long-term objectives

- The success of an individual security should be judged by the role its plays in a portfolio. An individual security is merely a tool used to construct an overall portfolio

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