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THE INTELLIGENT INVESTOR

Are You Following the Rules of Risk Management?

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Numerous questions are on our clients' minds right now – what do we do now that our investments are down? How should we invest our money in these times of uncertainty? Should we put it in cash and wait until things get better?

Getting It Right

The one answer we can give is that we cannot predict the future. This basic fact of life seems to elude many people, including professionals such as investment advisors, managers, financial gurus and investors. The financial pages of our newspapers are full of predictions; the reality is that most of these predictions turn out to be wrong. For example, all 43 forecasts by major institutions for economic growth in Britain in 1999 turned out to be erroneous. Yet forecasters continue to predict since that is their job; however, otherwise rational people continue to take their prophecies seriously and act on them.

Never has risk management been as important for the individual investor as it is right now.

Dealing with Risk

It is important to distinguish between taking risk and managing it. A key aspect of managing risk and a necessary first step is to recognize what risks you are taking, the potential consequences of each and what you can do to mitigate those risks.

Managing risk does not mean placing all your funds into the relative safety of a bank account, GIC or even a government bond. That strategy can be risky too, because the investor runs the danger of missing out on economic growth or simply being left behind by inflation.

As investors, we must accept that we live in an unstable and therefore uncertain world. Natural catastrophes and political upheavals are unpredictable, yet at the same time they are a virtual certainty. Our investments are affected by them and by a thousand and one other capricious certainties. We know that the price of oil will fluctuate, as will the major world currencies. We know that new technologies, some of them with revolutionary impacts, will appear. We know that companies will collapse and governments will fall. We know that terrorists will strike. These are all facts of the modern world. If we are to succeed as investors, we need to accept these facts before going into riskier investments.

Avoiding Risk

We don't know when these events will occur. So what do we do? We think hard about the scenarios, and design a portfolio such that no single occurrence will have a disastrous impact on it. We make sure that we select a portfolio with more upside than downside. We diversify our holdings and try to rebalance on a regular basis to take advantage of swings in different markets.

Rational investors envision a wide range of possible futures. Once they have assessed all the potential outcomes, they can adjust their investment portfolio accordingly – not to make it risk free, but to make it better able to maintain its value. At first glance, this might seem like simple common sense – and it is. However, in practicality, it is hard to maintain that discipline

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over a number of years. Most investors pay too much attention to past performance and short-term fluctuations and do not spend nearly enough time on the actual discipline of portfolio management.

Steps for Success

Good investors follow three main rules in risk managing their portfolios.

1. ***Know What You Own***
   If you cannot explain your investment process and holdings to a five-year-old, it is probably too complex. Each investment in your portfolio should follow a strict discipline for when to buy and when to sell.
2. ***Use Multiple Scenarios in Evaluating the Risk***
   Risk is a funny thing. In our experience, when times are good and returns are abundant, some investors throw caution to the wind and have a very high tolerance for risk. But the slightest disruption will cause those same investors to abandon a perfectly good investment and run for the hills. What you should be doing before you invest is understanding the upper and lower limits of the investment choices and then asking yourself: "I know I can live with the upside, but can I live with the downside?" If the answer is no, invest elsewhere.
3. ***Anticipate Regret***
   The one valuable piece of advice that every long-term investor will relate is that you are not always going to be right. There are times when you will regret your decisions. If you can accept this adage before you invest, it will help you to be more disciplined in your approach to portfolio management. Don't be scared off if an investment did not work out exactly as you thought it would – simply readjust your process so that you don't make the same mistake twice, and move on.

THE HIGH COST OF FEAR
How much should you pay for peace of mind?

J. Christopher Snyder, CFP, RFP

Every now and again we go through periods when a series of events conjures up an unusual amount of fear – 9/11, the SARS crisis, the current Maple Leaf meat scare and many day-to-day events come to mind. For some investors, such a time occurs when stocks market go through a period of volatility. The following is an update of an article I wrote some years ago which, I hope, will keep fear and the cost of it in perspective.

Have you ever thought about how much money you spend because of fear? Purchasing insurance, paying for lifetime guarantees, buying bicycle safety helmets, investing in GICs, locking in the interest rate on your mortgage or installing home security systems are a few examples.

Fear motivates people to protect themselves which, in turn, provides peace of mind. In the event of a calamity, the negative effects can be minimized. Buying insurance is often a prudent move but, on the other hand, people can overreact. The following stories dramatize this point.

The first story concerns a couple who, during one of the crises in Quebec, sold their home when the situation was at its worst. The parents of this couple had had their home confiscated in the 1930s in Europe. As a result, they were petrified that the same would happen to them. Because they sold their house during a crisis, they received far less than it was worth. The couple moved to Toronto but could never accumulate enough money to buy another home.

The second story is about an individual who was prudently invested in a mix of investment funds and was about five years away from retirement.

His investments had decreased by about 12% and he was frightened he would lose all of his money. Without consulting anyone, he switched into cash, thinking he would reinvest when the market turned upwards.

During the next year, although his old investments increased by more than 25%, he never got around to reinvesting. This move cost him more than $40,000.

The challenge for most people is to attain a balance between paying too much for peace of mind and having adequate protection against calamities. Here are a few guidelines on how to keep the cost of fear in balance.

Educate yourself about areas of concern to you. If the person who took his money out of his investments had

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person who took his money out of his investments had knowledge of how the stock market worked, and understood that it is normal for there to be a number of major upward and downward changes over a long period of time, he may have kept the investments. Financial education will help remove anxiety and allow you to take prudent risks.

Establish the parameters of the potential loss. Then ask yourself if you can afford to take the loss. For example, many people buy car insurance with $100 deductible. Why not have $250 deductible? The difference in cost is about 10 per cent of the collision premium. You could probably afford a loss of $250. Furthermore, it is possible you will not have an accident and you will save money on premiums. Protect yourself against losses you cannot afford, such as the possibility of being sued for negligence.

Have faith. You must have a certain amount of faith that things will turn out well. That does not mean blind faith, but many things that at first appear to be disastrous work their way out.

Do not buy or sell out of fear of a missed opportunity. You may recall many years ago that people lined up to buy gold for fear they would lose out on this great money-making opportunity. The price finally peaked around US$750 an ounce. Over the years it went down to about $360 an ounce and now, more than 20 years later, it is about $830. On the same note, do not buy solely because you believe that next week the price may be higher. This mentality is very common during heavily inflationary times.

Don't buy beyond your needs. If you need new tires for your car and your car will last only another year or two, good reconditioned tires may be the way to go.

Get professional advice. Some salespeople amplify problems and create fear in order to sell products. For example, some real estate agents can create fear – you may lose the house if you do not buy now, or if you wait until next year it will be much more expensive. Similarly, if you are selling your home, grabbing a low offer because a better may not come along could be costly.

Don't say no to something just because there are some risks attached. Lawyers are notorious for pointing out all the things that can go wrong in a situation. They do this partly to protect you and themselves if something does go wrong. Ask yourself – can I afford the consequences if something goes wrong or can it be fixed?

Find out the facts. How many times have we responded to situations not knowing the facts. The media keep us well informed of happenings, often negative, and so we often form our opinions and make decisions based on them. Take the recent Olympics. China made a fantastic showing both in the presentation and in their athletes' feats. Everywhere you look, products proclaim "Made in China." But is this the real China? Just go outside the big cities and you see an impoverished country. Those who are invested in Chinese companies understand there is more to China than the success of the Olympics. The Shanghai market has dropped 50% since the first of the year.

Shop around before you buy, and look for value. If you buy the least expensive item, you may keep your initial cost down but end up paying more in the long run. This reminds me of the astronaut's reply when asked what he was thinking just before blast off: "It suddenly occurred to me I was sitting on top of several thousand parts which were all bought by tender at the lowest price."

Following these guidelines may help you find peace of mind without paying too much for it.

PROBATE

Ian G. Johnson, CFP

When discussing estate planning and wills with our clients, we are often asked questions about probate. We hope the following will provide the answers to some of those questions.

What is Probate?

Probate is the official proving of a will. Many of us remember former Prime Minister, Jean Chrétien's quip about proof: "A proof is a proof. What kind of proof? It's a proof. A proof is a proof. And when you have a good proof, it's because it's proven." While that definition

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suited Mr. Chrétien at the time, I'm sure as a lawyer he knew it was not judicially correct.

Probate, in fact, is a much more formal process by which the original copy of a will is submitted to the court for certification that it is the last will of the deceased, and that the person (or persons) named in it as executor is entitled to administer the estate. While the court confirms the role of the executor, the actual authority is given by the will itself, not by the court-certified Grant of Letters Probate. Today in Ontario, the executor is now legally called an Estate Trustee with a Will and the formal grant has become a Certificate of Appointment of Estate Trustee with a Will. **This formal document provides evidence to third parties that the will is proved and registered in court, and that the executor can deal with the assets.**

If the deceased died without a will or the executor is unable or unwilling to act, the court will appoint a suitable applicant, and that person's authority will stem from the Grant of Letters Probate.

Is Probate Necessary?

The Grant of Letters Probate is usually required if:

- there are assets over a certain value held by a bank, trust company or credit union;
- there are securities to be transferred;
- the estate is in litigation;
- there are children who are direct beneficiaries;
- there is real property to be transferred.

There are, however, other situations where probate is not necessary. This can be tricky as it requires cooperation from the third parties holding assets that belonged to the deceased.

If the estate is relatively small and uncomplicated, it may not be necessary to obtain probate. And, with certain assets, it will probably not be required if the asset is:

- jointly held property with right of survivorship;
- life insurance, RRSPs or RRIFs proceeds payable to a named beneficiary;
- automobiles or boats;
- household and personal items, excluding valuable antiques and paintings or other effects of considerable value;
- CPP survivor benefits;
- modest bank accounts.

If third parties are asked to transfer the ownership of the deceased's assets by an uncertified executor, they will be naturally concerned about their liability if they proceed. For instance, there could be a later will, or the will could have been signed under duress.

In most cases, the executor will be asked to sign a waiver or disclaimer to relieve him or her from any future claims, demands or actions made with respect to the estate. With that properly completed, many organizations will accommodate the executor and proceed with the transfer. As soon as the asset is ascertained, the executor or administrator should contact the applicable third parties to determine if they will waive probate.

What Does Probate Cost?

Probate "fees" are, in fact, a direct tax since the amounts charged do not match the minimal administration work required to be done by the courts.

Probate taxes are calculated on the value of the eligible assets in the estate. In Ontario, there is no maximum amount and debts other than a mortgage are not deductible.

In Ontario, the probate tax is calculated as follows:

- $5 per $1,000 (or part thereof) on the first $50,000 value
- $15 per $1,000 (or part thereof) on the value over $50,000

For example, let's take Carl who is single and owned the following at his death:

- house worth $458,000 (mortgage $58,000)
- valuable personal effects, such as paintings: $30,000
- car and boat: $28,000
- Line of credit – outstanding balance: $18,000

Tax on the first $50,000 ($5 x 50)	= $250
Tax on the remaining $408,000 ($15 x 408)	= $6,120
	$6,370

Note – the mortgage of $58,000 is deductible but the line of credit is not.

So while there is a cost to probate, it is not exorbitant and is a lot less than the old estates taxes and succession duties,

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even with their large deductibles.

While one does not like to pay this fee, probate does offer protection to the executor as it provides court verification of his or her authority to act. This is important if a subsequent will naming a different executor is later discovered. Also, without probate, the executor could be successfully challenged by the beneficiaries, even if he or she thinks they conducted the administration of the estate with all the care and diligence of a prudent and reasonable person.

Probate is also important in determining the right of the deceased dependents. There is a six-month limitation period during which dependents can apply for support against the estate. But the limitation period runs from the date probate is granted, not the date of death. Should there be a dependent's application, the executor would be personally liable should he or she distribute any assets before that expiry date.

To conclude, unless the executor knew the deceased and his or her affairs well and is reasonably sure there is no later will, he or she would be wise to consider obtaining probate and the protection it affords.

However, in many cases, probate is not needed. The need depends on the mix of assets, the cooperation of the third parties and the approval of estate beneficiaries. If this is the situation, it is definitely a case of "Let the Executor Beware."

WOMEN AND INVESTING II
Managing your spending

Vicki Lungu, CFP

Born to shop: Women vs. men

When it comes to money, there's a world of difference between men and women. In general, men view money as a means of capturing and accumulating value. Women view it as a means of creating a lifestyle. Men don't spend, they invest. Women don't invest, they spend. Men buy things they need, not things they want. Women tend to buy the things they want.

Research has shown that much of a woman's spending is impulsive. Women are far more likely than men to:

buy something without needing it (36% vs. 18%)
buy something because it's on sale (24% vs. 5%)
shop impulsively (36% vs. 18%)
shop to celebrate (31% vs. 19%).

But when polled on their level of savings, just 49% of women said they were dissatisfied with their bank accounts, as compared to 60% of men.

The shop-till-you-drop syndrome is more than a harmless female pastime — it also means that many women have little left to save and invest. In their 20s and 30s, when their male counterparts are buying homes and investing in mutual funds, many women are spending most of their money on clothes, cars and decorating their home.

Budgeting and smart spending

It's not how much you make that counts, but what you do with what you have. By managing your money, you can get the most from the money you have.

You have likely heard much about budgeting. Many interpret this as doing without things you want: no eating out, no vacations, no new clothes. However, a properly drawn up budget has a spending component to it. In fact, a budget is a tool to help you decide how you want to spend your money over a period of time.

Smart spending starts with managing expenses and developing priorities about what you need and want. This action-oriented approach provides a feeling of control over your finances. If spreadsheets are not your thing, consider your grandma's envelope system.

If you are single and earn $50,000, you pay about 25% of that salary in income tax (Ontario). This leaves you with a disposable income of $37,500. This equates to $18.75 per hour. After paying your living expenses (such as shelter, food and transportation), you have about $12,000 left. This is your discretionary income. So for every hour you work, you would have about $6.50 to spend on discretionary items. To buy a $150 pair of shoes, you would need to work about 3 days.

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After determining your discretionary income, decide how much you want to spend each month in major categories (entertainment, takeaway meals, holidays, gifts, donations, clothing and savings), and put money in designated envelopes. You can transfer money from one envelope to another, but when the envelopes are empty, that's it for the month.

When you receive your paycheck, pay yourself first and designate a portion for savings (10% of your income including pension contributions is a good rule of thumb). Even better, have the amount automatically withdrawn from your bank account each month. If you contribute $5,000 to your RRSP, you could save some $1,700 in taxes. Earning 7% interest, this $5,000 would grow to $18,150 in 35 years. If you did this every year, you would have $691,000.

While you may agree that this is sensible advice, you may think you don't have enough money to do it all. Here are a few tips on stretching your income.

How to save money and maintain your lifestyle

- Try not to pay full price on anything. Factory and discount shops sell big labels at low prices.
- From time to time, try a month without unnecessary shopping. You'll be surprised how much you save.
- Take advantage of end-of-season-sales and buy quality items for a fraction of the price.
- Pay your bills in full and on time. Make sure your credit rating is in good standing.
- Try to get free banking and no-fee credit cards.
- Pay your mortgage biweekly. You will save a significant amount of money in interest over the term of the mortgage.
- Do not buy mortgage insurance; instead, buy a term policy for a fraction of the cost.
- Avoid impulse buying; try waiting a week (at least a couple of days!) and see if you still want to buy it.
- Use a list when grocery shopping.
- Use the Internet to read magazines and newspapers, and the library to obtain books, CDs and DVDs.
- Start a home-based business. Use your Internet connection to do secretarial-type work or bookkeeping for businesses and executives, or write articles for websites and other online publications. Start tutoring. Sell products you enjoy or start a home decorating or catering business. There are many opportunities out there. Use the Internet and your local library.
- Shop around for Internet/phone/cellular services and bundle them, if possible.
- Buy an answering machine (you can get one for about $15) instead of renting the service.
- Buy clothes or fabrics that do not need expensive dry cleaning.
- Cook your own food. It's not only healthier, but can save you a great deal of money.
- Buy a car that's two or three years old (it will have depreciated between 40-50% from its original price.) Keep it for at least three years before selling it. An added bonus is lower insurance costs.
- When getting a prescription, ask for generic drugs.
- Bundle car and home insurance and don't be afraid to bargain.

No doubt you can add many more suggestions.

People often say that money can't buy happiness. What it does provide is freedom, independence and choice, something women know and want. A successful relationship with money, like any other successful relationship, requires our attention, commitment and time. Only then are we free to design and live the life of our choosing.

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