

# Take Note

Winter 2009

For clients, associates and friends of,

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## TAX-FREE GIFTS - RSPs AND TFSAs

It is that season again when the government of Canada gives us the **gift** of an annual tax-free opportunity to invest.

We are all familiar with the RSP which allows you to invest in a tax deferred Registered Retirement Savings Plan. During January and February when you contribute up to 18% of your earned income (to a maximum of \$20,000) to your RSP you will receive a tax refund for 2008 when you file your taxes.

This year the government has increased the gift by \$5000 through the Tax-Free Savings Account (TFSA). You can contribute \$5000 per year (increasing with inflation) to the TFSA without paying any taxes on the interest, dividend or capital gains earned in the account. Another attractive feature of the TFSA is that you can withdraw and re-contribute money to the account and continue to have it grow tax-free.

When you withdraw money from this account it will not be considered as income and, consequently, will have no impact on old age security benefits or change your tax bracket.

Both the RSP and the TFSA form an important part of your Retirement and Investment planning.

When your income tax rate is high the RSP allows you to receive a good tax refund which potentially can be used to fund the Tax-Free Savings Account.

When your income tax rate is low, you can use the TFSA to save money. At a later date when your tax rate is higher, funds from the TFSA can be contributed to your RSP. The tax refund generated from this contribution can then be used to partially repay your TFSA.

The TFSA can also be used as a tool to income split with your spouse as the income from the gift is not attributable back to the gifting spouse.

If you have not yet established a TFSA please give us a call. It may be a small part of your total assets today, but it will grow over time and can ultimately provide substantial benefits.

### Reminder of Upcoming Dates to Mark on the Calendar:

Mailout of T5 income-related slips and materials	Begins February 17
25% Payment Reduction for RIF Cutoff	February 27
Last date for RSP Contribution for 2008	March 2
* Maximum RSP Contribution in 2009 is \$21,000.	

## Winter 2009 Commentary

# Is This the Golden Era of Opportunity or the Dark Ages?

As a young investment counselor during the “dark ages” of the early 1940’s, Sir John Templeton bought all the fundamentally sound stocks he could afford that were trading for less than a dollar per share believing that most were undervalued. In 2000, during the Golden Era of technology, he shorted Tech stocks whose enterprise value was a derivative of zero sales and a “reasonable” capital burn rate. Templeton saw the need to distance himself emotionally from the actual events and focus on the longer term opportunity.

It’s human nature to feel comfortable when share prices are trending higher but, when stocks are cheap, we are afraid to buy in case prices fall lower. When the pain of loss is far greater than the enjoyment of gain we call this “loss aversion”: we need twice as much positive reinforcement to overcome one negative thought. If we were certain that the markets would eventually move higher, we would remain invested. Therefore, it is necessary to examine the signs that indicate such a positive outcome is possible.

The year 2008 was one for the history books. From the highs of 2007 and 2008, the S&P 500 Index lost 53% and the TSX fell 49.5%. In the flight to safety, American ten-year treasury notes hit a multi-generational low yield of 2%. Three-month treasury bills now have virtually no yield and, at one point in December, even had a negative yield. The Federal Reserve Board has taken its target rate to an unprecedented level of zero and has acted aggressively to replace the massive amounts of cash that were withdrawn from the private sector by corporate and consumer deleveraging. Since the collapse of the large American brokerage firm, Lehman Brothers, in September, we have seen investor and consumer confidence plummet while governments and central banks around the world have responded with aggressive injections of liquidity into the system.

In the past few weeks, the turmoil in the credit and financial markets has abated somewhat and commercial lending is resuming at sub par rates. Strong lending is necessary for the economy at large to resume expansion and to allow stock markets to recover. The world is

hopeful as a new U.S. administration enters the White House on January 20th with the promise of a large increase to the already substantial TARP lending program. The Canadian situation is similar to other global economies and the federal government will deliver a budget later this month that also promises to stimulate growth.

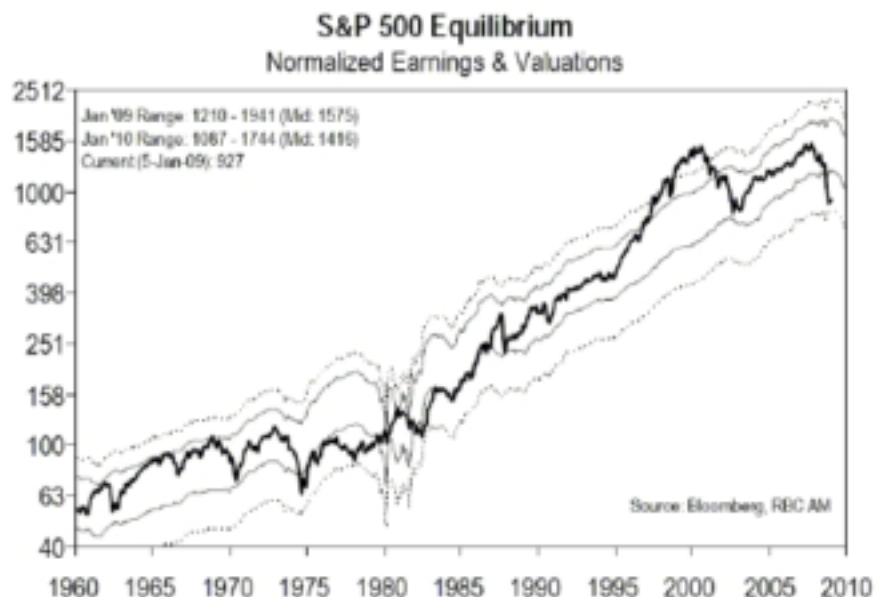
The Canadian economy is very dependent on strong price performance in commodities, basic materials, energy and precious metals. Global deflation is the current peril and so there is a universal weakening in demand for the goods that Canada produces in such abundance. Thus, the Canadian equity market is oversold relative to its historic growth trend. These lower prices may represent the buying opportunity of a lifetime. One has to look back to the depths of the bear markets of 1973-74 and 1981-82 to find periods when equities were this oversold. In the former period, the key market dislocation was caused by accelerating inflation while, in 1981-82, the economy faced deflation and recession. However, in 1981, interest rates soared and the yield on 3-month treasury bills was 22%; the unemployment rate was 13%. Therefore, the current market decline is hard to justify with 3-month T-bills yielding 0.8% and the unemployment rate at 6.6%.

In terms of the business cycle, the

previous market bottom was reached in October 2002. The S&P 500 American index has made no net progress over six years. The level then was 768 and the November 21, 2008 low was 741. The highpoint was reached in October 2007 at 1576 making the one-year decline 53%. The experience for the TSX has been somewhat better. The low of October 2002 was 5678 while the low reached on November 21st was 7647. That was 49.5% below the high of June 2008 at 15154. The numbers in themselves may be meaningless but they do suggest that much of the risk has been removed from the stock market and, no matter what the future portends, buying stocks today is less risky than it was six months ago in Canada or a year ago in the U.S. Because equity prices are dynamic and eventually there is a regression back to the mean or average point, it is a fair assumption that stocks will tend to move upward from here.

We believe that, while there will continue to be problematic economic data, markets have largely “priced in” the bad news. According to Fidelity Investments, “for the stock and bond markets, we believe we are getting close to the point at which we can say that the worst is behind us.”

The massive amount of fiscal and monetary stimulus will work to propel the economy forward



although the timing for this effect is unknown. As confidence is restored and trust in the credit system is rebuilt, the way forward will be easier. Therefore, we believe that all investors should be positioned to take advantage of even a mild recovery. We are encouraged by the increase of insider buying, by the number of management teams that are confident in their products and services and by the perception among professionals that investors are undervaluing assets.

In Canada, the fundamentals for commodities deteriorated much more dramatically than anyone had predicted. However, the long-term global demand is positive because of the urbanization and industrialization in China, India and other emerging countries. In fact, India and China have enacted fiscal stimulus policies of their own. While commodity prices have seen a massive correction, the drivers of a fundamental supply-demand imbalance have not shifted. No additional capacity has been added, in fact it has been constrained by production cuts and shut downs.

Government capital spending on infrastructure has been announced for the coming months. Shortages may develop as energy and commodity producers are cutting back significantly on capital expenditures and reinvestment during 2009 in order to operate within

their free cash flows. As demand picks up, we shall likely see prices move higher, driven by supply constraint dynamics. Emerging economies will likely use their sovereign funds and massive foreign reserves to acquire more commodity assets and producers, providing additional technical support for commodity stocks. This may take place as early as the end of 2009.

The Federal Reserve Board has cut its target rate by 500 basis points since September 2007 and has indicated more cuts to come. The Bank of Canada has dropped its overnight rate to 0.88% and has revealed a concern about the effect of the U.S. slowdown on our own growth prospects, particularly in central Canada, which makes future easing likely. Inflation is not a factor this year as commodity prices move down and wage demands recede. Bond yields indicate a protracted recession feeding off growth worries and risk aversion. Major world markets all lie below valuation levels consistent with their long-term trend lines. Most indices are at their greatest discounts to fair value in fifty years. Lack of clarity in the outlook is a great concern to all investors but the probability for a regression to the middle ground outweighs the likelihood of further stock market deterioration.

We favor stocks over bonds and hold a below-normal exposure to fixed income. The current RBC asset allocation range suggests 7.5% in short-term interest accounts, 32.5% in bonds of two to ten years

duration and 60% in common stocks. If our reacceleration scenario holds true, government bond prices will fall as yields rise. As a more balanced view of economic prospects and risk in general emerges by mid-2009, yields are likely to climb, perhaps sharply.

We recommend that clients add to positions in high quality, dividend-paying stocks. Cash distributions will support the portfolio value while we await a change in sentiment, which could swing around quickly and without much warning. In fixed income, we recommend fairly short maturities in taxable accounts so that liquidity is available for better opportunities. High grade corporate bonds and mortgage-backed securities are offering very attractive yields versus government bonds. Until now, the yields on corporate debt have been relatively high. Monetary easing should help to lower borrowing rates on corporate debt thus boosting capital values. As confidence is restored, the wide spreads between government bonds and commercial debt will likely narrow thereby providing investors with a positive advantage.

We are optimistic about seeing a turnaround in the economy later in 2009 but the stock market will respond positively a few months sooner. There is a tremendous amount of stimulus in the system and sooner or later it will start to be effective. We are forecasting that growth in the Canadian economy will be below par in the first half of 2009 and move up to 1.5% in 2010. We suggest you add to RBC DS recommended stock positions over the next few weeks.

## ***Whats Going on In the Office...***

### **14TH ANNUAL MUSIC LOVER'S HOUSE TOUR**

This year the *Wetherall Wealth Management Group* will be among the proud sponsors of the day long tour which will take place on Saturday May 23rd.

If you are unfamiliar with this event it is put on by the Volunteer Committee of the Kingston Symphony Association along with the help of sponsors from the Kingston community. This event offers an eclectic blend of heritage, history, music, architecture and décor at locations from a variety of areas around Kingston. Proceeds from this event are also put

toward supporting the Symphony itself as well as the Volunteer Committee's Music Awards program for young local musicians studying classical music. We are looking forward to being a part of this fun and unique event and encourage anyone who is interested to contact the Kingston Symphony Association (613)546-9729 for tickets in late April.

### ***Sharing the Warmth of Christmas...***

*This past holiday season our office chose to sponsor a local family in need. Pooled donations from the members of our office allowed our gift committee to buy over \$500 in gifts which included pyjamas, hats and mittens, two toys and a new outfit for each of the 5 kids. A few new clothing items and \$300 in Gift Certificates for Groceries was also given to their mother. We appreciate Interval House's help in making this possible.*

# Mutual Fund Book Values Can be Deceiving

Using **book values** from statements to calculate the performance of a mutual fund often leads to a wrong answer. When the fund is up, book values tend to make performance look lower than it really is. The same is true in down markets, as shown in this article.

To calculate the rate of return on an investment, the basic inputs are 1) the original investment amount; 2) its current market value; and 3) the time since the investment was made. For example, an investment of \$10,000 a year ago that is now worth \$8,500 represents a loss of \$1,500 or 15% for the year.

Of course, all three inputs must be accurate to get the right answer. But mutual fund investors often see the cost basis or **"book value"** on their statements and equate this with the original investment amount. This can give them the wrong idea of how their funds are doing.

## WHY DOES BOOK VALUE DIFFER FROM THE ORIGINAL INVESTMENT AMOUNT?

The difference between book value and original investment arises when distributions are reinvested.

When a fund distributes income or capital gains, most investors automatically use the proceeds to buy more units. The book value of the fund goes up as a result. But since no new money is added to the fund, the amount of the original investment stays the same.

To illustrate, here's an example:

Year	Amount	Reinvested Distributions	Book Value	Market Value
0	\$10,000	--	\$10,000	\$10,000
1	--	\$1,000	\$11,000	\$11,500
2	--	--	\$11,000	\$8,625

## ASSUMPTIONS:

- \$10,000 investment with no subsequent purchases or redemptions
- \$1,000 distribution reinvested in Year 1
- 15% growth in market value in Year 1
- 25% decline in market value in Year 2

In this scenario, no new money was added to the account after the initial \$10,000 investment. But book value rose from \$10,000 to \$11,000 when the \$1,000 distribution at the end of Year 1 was used to buy more units. In Year 2 book value stayed the same because there was no distribution.

Meanwhile, market value rose from \$10,000 to \$11,500 then fell to \$8,625. Over the full two years, the \$10,000 investment fell to \$8,625 for a loss of \$1,375 or 13.8% (an annualized two-year return of -7.1%).

A loss like this is never pleasant, but an investor who mistakes book value for the amount of their initial investment could overstate the loss. That's because an \$11,000 investment that falls to \$8,625 represents a loss of \$2,375 or 21.9% (or -11.5% annualized over two years).

## CONCLUSION

To be clear, our aim is not to criticize

the use of book values for statement reporting. In fact, book values can be useful for calculating taxable capital gains in non-registered accounts.

But using book values to calculate performance usually results in a number that is lower than it should be. This is shown in our example, where the true cumulative return on the original investment was -13.8% but the same calculation using book value produced a return of -21.9% – a significant difference.

If you have questions regarding the **book values** in your portfolio, please call us and we would be happy to clarify what they mean.

## Get on our Emailing list!

As a member you will receive occasional research updates that will keep you up to date with trends in the market. To join, please send an email to [christina.parfitt@rbc.com](mailto:christina.parfitt@rbc.com) from your primary email.

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