

An investor's guide to 2011

Five costly investment mistakes Canadians should avoid in the new year

BY MARK JASAYKO AND NEIL MCIVER, SPECIAL TO THE SUN JANUARY 1, 2011

Not owning U.S. equities

It's become trendy to forecast the downfall of U.S. stocks and question America's economic future in light of fiscal struggles and the value of the U.S. dollar. This ignores the alternatives.

No other global economy has the U.S.'s economic power. It is unmatched in terms of size, the depth of its tax base and its ability to recover from recessions. Sure, it has a debt burden. However, its taxpayers can finance it fiscally. It won't be easy, but it will happen.

The U.S. is also unrivalled in the strength of its institutions (regulatory, social, charitable, and corporate), which will help it recover. It can also minimize social and political instability so that political reform or a change in power is never economically disruptive, unlike in other countries.

If we see credible economic growth on the horizon, investors will bid up the price of stocks. This may happen this year, or 2012, or perhaps it has begun. An investor's main goal is to buy equities in a market with the greatest capacity for growth, and at a time when that market is historically low and likely out of favour. The U. S equity market potentially offers both right now.

Despite its many machinations over the past 11 years, the Dow Jones Industrial Average has not grown.

The DJIA (currently in the 11,000 range) has crossed 10,000 over 20 times during this period, yet provided a near-zero rate of return.

In spite of this, its long-term average rate of return remains undamaged at over 10 per cent. The likelihood that the U. S equity market returns to its long-term historical average rate of return is high.

The greatest equity growth over the next 10 years well may be found in the U.S. Omitting U.S equities could be a costly mistake.

Not owning Real Return Bonds

Real Return Bonds issued by the Canadian government adjust to the rate of inflation so rising inflation will not impair the real yield that the investor receives.

The probability of inflation is significant because of the amount of money that has been printed by central banks to get economies out of recession.

While it's easy to print money, economists underestimate the difficulty of pulling it all out of the system once the economy has gained traction.

It is publicly and politically very unpopular for central banks to reduce the money supply, as this can seriously impact employment and economic growth.

It is also important to note that the long era of declining bond yields is over. During this period, Real Return Bonds would have been disadvantageous.

However, during the new era, which will likely last several years, investors must consider investments that protect the "real" yield earned (the nominal yield minus the impact of inflation).

This implies that your overall exposure to bonds should be reviewed and maturities shortened to reduce risk. Regular nominal return bonds will no longer provide the performance or safety they did in the past as rates rise.

Real Return Bonds will be written about in two and three years, after they have already risen in value. Your portfolio should contain them immediately.

Rear view mirror investing

One reason individual investors' portfolios underperform those of professional institutional money managers is that retail investors tend to look backward, investing in what worked over the past. This is called "Rear View Mirror Investing."

Professionals, by contrast, have a longer time horizon and understand that all markets eventually return to their historical long-term average rates of return. As they contemplate the future, they determine which markets have been outperforming, but perhaps unsustainably, and which markets have underperformed but could outperform in the future.

Most non-professional investors employ strategies designed to capitalize on previous market opportunities.

Investors are hoping we'll return to an environment of low inflation, easy credit and of corporations continuing to purchase obsolete technologies. That environment is gone.

It's more realistic to focus on companies and investments that can adjust to a slower-growing and more inflationary environment.

Unfortunately, aggressive financial services salespeople market these "rear view mirror" strategies because they know that from both a performance and comfort perspective, they will seem attractive to potential clients.

Getting seduced by the BRIC countries

It's hard to ignore the stories of runaway economic growth and wild stock-market gains in countries such as Brazil, Russia, India and China. However, this is for adrenalin-seeking speculators. These markets reverse suddenly and more often than markets in mature, industrialized nations. As a result, the speculator has to engage in market-timing, a strategy that hardly ever produces the results achieved through conservatively investing in established markets.

A broad analysis of these markets makes them appear similar to our markets and economy. However, analysts who visit these countries and scratch the surface regularly realize a different set of rules apply that hardly ever favour foreign companies or investors.

Not owning gold

For many years, gold was shunned as investors flocked to stocks and bonds in response to their stunning performance. This proved to be the best strategy in the 1990s.

However, since 1999, gold has been one of the best-performing asset classes, trouncing the performance of stocks and bonds over this period.

Over the last decade, gold has risen fourfold as anxious investors sought refuge here before the credit crunch hit.

When the generally positive psychology of stock-market investors caused them to overlook the potential devastation caused by the credit turmoil, gold investors were ahead of the curve, driving the price of gold higher as the U.S. housing market and the growth in mortgage debt looked unsustainable.

Although gold has been the champion asset class of the last 10 years, its advance could continue well into this decade.

Gold is an excellent market hedge, particularly as you take profits on the significant gains in the Canadian market and shift that exposure to U. S equities.

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