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WINTER 2010-11

WHAT NOW?
... A MARKET COMMENTARY

By Greg Farries, BSC, The Nakamun Group, Calgary

As we enter 2011, the world's economies, and in particular the economies of the developed world, continue to be affected by the global financial crisis we experienced in 2008 and early 2009. The global financial crisis led to a global recession, and during 2010, we started to see signs of a recovery, albeit at a very slow pace.

Governments and central banks around the world responded to the recession by using all the tools at their disposal. The dynamics and interrelationships of the world economies can be very complicated, but at the end of the day, in simplified terms, most governments and central banks have three tools they can use to stimulate economic expansion:

1. Lower interest rates
2. Devalue their currency to make their exports more competitive
3. Provide fiscal stimulus by increasing government spending and tax cuts, or, as we have recently found out, printing more money — "quantitative easing" is the term being used

US "QUANTITATIVE EASING"

In early November, the US central bank announced an additional $600 billion in stimulus by way of "quantitative easing". During the subsequent six months, the central bank intends to buy virtually all new debt that the US Treasury issues to finance the country's obligations.

Normally when the US issues debt through the sale of t-bills or government bonds, third parties such as individual investors, financial institutions, or other countries purchase them.

The net effect of the latest "quantitative easing", the US central bank hopes, is to flood the system with liquidity, keep interest rates low by creating artificial demand, and likely keep their currency low, to stimulate the economy. The risk is inflation. However, at the moment, the bank is more concerned with deflation and the need to stimulate the economy.

Governments and central banks appear now to have done all they can to stimulate the economy. However, the US is prepared to provide further "quantitative easing" if necessary.

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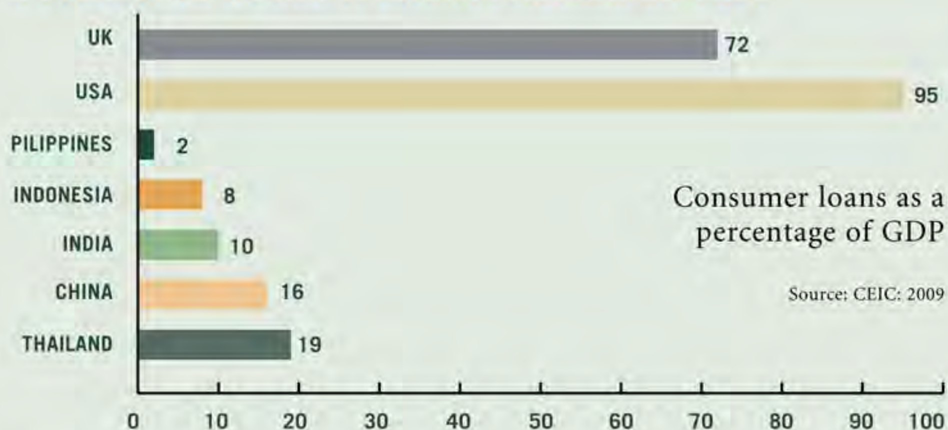
PLENTY OF PURCHASING CAPACITY, DEVELOPING WORLD IS UNENCUMBERED BY DEBT



WHAT THIS MEANS TO YOU

Investors are worried. Unemployment is high, government and consumer debt levels in developed countries are near record levels, and the housing market in the US and most other countries — excluding Canada — has plummeted. Government stimulus efforts have driven interest rates to historic lows.

The challenge for investors is to find reasonably safe investments that will provide the income necessary to meet their needs now and into the future.

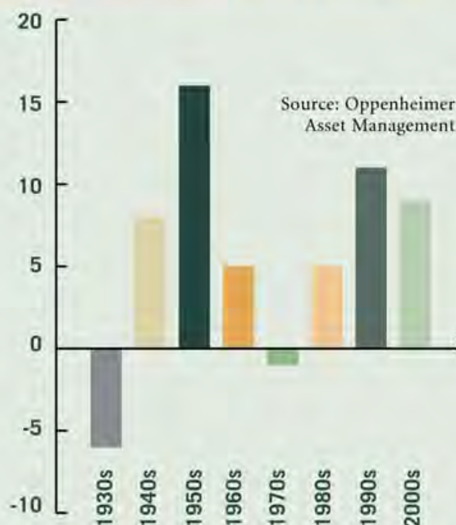
CASH

Most investors perceive cash to be safe. Right now, though, short-term rates are only about one percent. For most people, a one-percent return is not sufficient to meet their needs.

BONDS

Recent data from both Canada and the US shows that during the last year, investors have been taking money out of equities and pouring money into bonds. At first blush, this seems to make sense — see accompanying chart. During the last decade, investors would have been far better off owning bonds than stocks.

AVERAGE ANNUAL STOCK LESS BOND RETURNS BY DECADE



Some investors do not realize that bonds have an inverse relationship to interest rates. In other words, when interest rates go down —as they have for the last 30 years — bonds go up in value. When interest rates go up, the value of bonds will go down.

Right now, interest rates have nowhere to go except sideways or up. While government bond yields are still at historic lows, corporate bond yields are still relatively high.

Bond investors could be disappointed in the coming years when interest rates go up. To quote one of the grandfathers of investing, Benjamin Graham, "The investor's chief problem — and even his (or her) worst enemy — is likely to be himself".

REAL ESTATE

Real estate has also been an attractive investment. However, according to the International Monetary Fund (IMF), residential real estate in Canada is approximately 60 percent above its historic average, and on a price-to-rent basis, is the most overvalued in the world.

EQUITIES

With the crash in the equity markets still fresh in everyone's minds, coupled with the reality that over the last ten years, on a global basis, equity markets have been basically flat or down, people are justifiably fearful of investing in equities.

However, I would argue that investors should take another look at equities. Stock market valuation measures such as price/book and price/cash flow are below long-term averages. Corporate balance sheets have not looked better in decades and most corporations are flush with cash.

Although prospects for growth in revenues in the developed world are worrisome, demand from emerging markets is strong and growing fast and exponentially. As the Plenty of Purchasing Capacity, Developing World is Unencumbered by Debt chart illustrates, the emerging market consumer is not subject to the same debt levels as the consumer in the developed world. This should keep commodity prices strong, as these countries need to build the infrastructure to support their economies and help companies that do business there.

You don't have to invest directly in the emerging markets to benefit from their growth. What many people don't know is that the 500 largest US corporations that comprise the S&P 500 Index, now derive more than 50 percent of their revenues from outside the US. With a declining US dollar, overseas revenue could also be subject to currency gains.

KEY TO SUCCESSFUL INVESTING

As always, the key to successful investing is to make sure your investments are properly diversified and designed to meet your goals and objectives. Contact your Nakamun Advisor to review your investment portfolio.

WATCH OUT FOR POTENTIAL PITFALLS WITH YOUR TFSA

By Floyd Murphy, CFP, CLU, CHFC, The Nakamun Group, Vancouver

When the Tax Free Savings Account (TFSA) was introduced in 2009, a significant number of Canadians jumped on the bandwagon. Here was a way to save $5,000 a year without paying income tax on the growth. While there is no question that the TFSA is indeed an advantageous way to save money, there are some potential pitfalls that are becoming evident for some people.

REPLACING WITHDRAWN FUNDS

Withdrawals from a TFSA have no tax implications. The potential pitfall emerges when the withdrawn funds are replaced into the TFSA. *Funds withdrawn from a TFSA cannot be reinvested until the following calendar year.* For example, if a withdrawal is made in March of the current year, the funds cannot be replaced without penalty during the same calendar year, if the maximum annual TFSA contribution has already been made. Canada Revenue Agency (CRA) deems the replaced funds to be an overpayment and imposes significant penalties.

MOVING TFSA FUNDS

When moving funds from one TFSA to another, *transfer the funds directly through the financial institutions involved.* The process is similar to transferring funds from one Registered Retirement Savings Plan (RRSP) to another. Otherwise, CRA considers the withdrawal from the original TFSA as a redemption that cannot be reinvested in another TFSA without penalty until the following calendar year.

TRACKING TFSA CONTRIBUTIONS

Particularly when an individual has more than one TFSA and periodic contributions are made throughout the year, knowing if and when the maximum annual contribution has been made could become a challenge. The risks are exceeding the maximum contribution limit and facing penalties or contributing less than the maximum allowed and not taking full advantage of the tax-free investment growth opportunity.

YOUR NAKAMUN ADVISOR CAN HELP

Your Nakamun Advisor can coordinate your TFSA contributions to ensure you take maximum advantage of the tax-free savings plan. As well, if you wish to withdraw funds from your TFSA, your Nakamun Advisor can work with you to ensure you avoid the potential pitfalls.

By Floyd Murphy, CFP, CLU, CHFC, The Nakamun Group, Vancouver

2010 TAX RECEIPT REMINDERS

Most income tax receipts are mailed by the end of February, however there are some that are not required to be mailed until as late as March 31st. To avoid having to file an amendment to an income tax return, ensure that all the tax receipts have been received before taking your information to your tax preparer or filing your return. If you are unsure whether or not you have received all your tax receipts, wait until early April. Failing to report all your income could result in penalties and interest.

YEAR-END STATEMENTS FOR NON-REGISTERED INVESTMENTS

For non-registered investments — those not in registered plans such as a Registered Retirement Savings Plan, Registered Retirement Income Fund, or Pension Plan — the year-end statement is crucial for preparation of an income tax return. The December statement summarizes activity, gains, losses, and income generated during the entire year — all relevant information in calculating taxes.

Year-end statements are typically mailed in mid-January.

ON-LINE STATEMENTS

If you have requested on-line statements for your non-registered investments, remember to print your year-end statement for your tax preparer.

If you have any questions regarding your income tax receipts, please call your Nakamun Advisor and we will be pleased to help you understand when to expect these important documents.

By Shauna Blackburn-Cook, BCom,
The Nakamun Group, Edmonton

NEW PRICING OF GENERIC DRUGS ENHANCES APPEAL

In 2010, the provinces of British Columbia, Alberta, Ontario, and Quebec introduced new pricing for generic drugs. While the new pricing rules and regulations differ from province to province, four fundamental components are common to each:

1. **Price ceilings on generic drugs relative to previously patent-protected brands** — some provinces make a distinction between existing and new generics while others don't. In BC, for instance, the October 2010 ceiling was 50 percent for existing generics and 42 percent for new generics, but by April 2012, the price ceiling for any generic drug will be 35 percent; in Alberta the April 2010 ceiling was set at 56 percent for existing generics and 45 percent for new generics
2. **Professional allowances (rebates) from generic drug manufacturers to pharmacies** — some provinces such as BC and Alberta allow this practice to continue, while Ontario imposes restrictions
3. **Maximum dispensing fees** — some provinces have an escalating scale while others establish a set maximum. BC, for instance increased its maximum fee to $9.60 in October 2010 and will escalate that fee to $10.50 by April 2012; while Alberta's maximum fee is already set at $11.93
4. **Transitional allowances to assist pharmacies to adjust to the new revenue model** — some provinces such as Alberta offer a diminishing amount from $3 per prescription in April 2010 to zero in April 2013, while others such as BC offer none at all

WHY NOW?

The timing of the new pricing structures is not arbitrary. With a number of widely used brand drugs — such as Lipitor, Crestor, and Norvasc — losing their patent protection within the next three years, new rules and regulations were implemented in anticipation of the large number of generics that will become available.

Historically, generic drug pricing was very high in Canada relative to other parts of the world. The price of generic drugs ranged from 70 to 80 percent of the cost of the brand drug, and was kept high because of agreements between generic drug manufacturers and pharmacies.

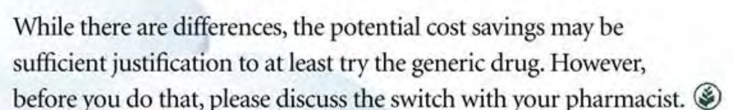
WHY SWITCH?

With the new provincial rules and regulations regarding generic drug pricing, there will be progressively increasing cost savings for switching to generics from brand drugs.

ARE GENERICS DIFFERENT FROM BRAND DRUGS?

Generic drugs are required to have the same active ingredients and the same medicinal effect as the brand drug. However, the fillers that are used may differ and may impact the rate of absorption. Some people might also be allergic to the filler in a generic drug.

While there are differences, the potential cost savings may be sufficient justification to at least try the generic drug. However, before you do that, please discuss the switch with your pharmacist.



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