The Hudson Report

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Surviving Market Volatility With The Experts

Several times during the past year, the markets have taken investors on a roller coaster ride. The latest ride was during the week of October 27, 1997 when the Hong Kong equity market, measured by the Hang Seng Index, dropped 4.7% during the week, as the government raised interest rates in order to defend the Hong Kong dollar's peg to the U.S. dollar. Following closely on the heels of the Hang Seng, markets around the world fell sharply.

It is precisely at times like these that many investors get the jitters and begin to question their investment strategy. It is always tempting to pull money out of the market and wait on the sidelines until it seems that stocks have bottomed out and it's safe to go back in. Sharp drops are especially difficult for those who are new to investing and aren't prepared for such events.

What Causes Market Volatility?

It is useful to understand several factors behind market cycles. One key factor is corporate profitability. Basically, when profits go down, the market follows. When profits go up, the market goes up.

The markets have also historically been weak when inflation is rising rapidly. As inflation leads interest rates up, alternative investments to stocks become more attractive.

A third variable that can affect the market is unanticipated, large-scale events such as war or natural disasters. An excellent example is the 1990 Kuwait crisis which saw 500,000 US troops enter Saudi Arabia. The market dropped rapidly from 3,000 to 2,200 points, effectively ending eight years of recovery from the 1981-82 recession.

It's Time, Not Timing

Although market volatility may be unnerving to investors, there is nothing new about equity market volatility and declines. But trying to time the market by getting in and out during these periods does not make sense. If investors sell, there is always the danger that they will miss out on any subsequent rise in the market.

Historically, rises have come after steep falls in the market, as stocks recover from setbacks to resume an overall upward trend. Investors who are able to maintain a long-term outlook have historically been rewarded with strong returns. For example, if investors had stayed fully invested in U.S. stocks (as

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measured by the S&P 500) from January 1, 1986, to December 31, 1995 - including the dark days of 1987 - they would have earned annual returns of 14.8%. If investors had tried to time the ups and downs of the market, they would have risked missing out on days that registered some of the biggest gains.

During a recent presentation in Toronto, Peter Lynch, portfolio manager of Fidelity's Magellan® Fund from May 1977 to May 1990, stated that over the past 96 years there have been 53 occasions when the New York market has fallen at least 10%.

"Last week we saw the 54th time that's happened in 97 years - so it happens about once every two years," he said. "However, over the longer term - 10, 20 or 30 years - the market is very predictable."

If profits increase fifty-fold, you make fifty times your money - all other things being equal. This is very different from owning corporate bonds, for which you receive your $10,000 back at maturity plus interest earned along the way.

"You must be prepared to sit through the fluctuations, and the only thing that's going to keep you from bailing at the wrong times is a belief in the company's true value."

It is important to remember that past performance is no guarantee of future returns. However, sitting tight could yield big returns when you consider the performance of the S&P 500 which has posted a 19.71% return for the past 10 years. Recent returns have been 31.23% and 32.55% for two and three year periods respectively. (All returns as of November 30, 1997).

Corporate Profits Drive The Market

Market declines often represent attractive buying opportunities and it is important to focus on the underlying fundamentals. Lynch believes that over the coming years, markets will be driven by individual corporate fundamentals, and therefore a stock-picking approach should be especially rewarding.

He recommends building portfolios by selecting stocks based on fundamental financial indicators rather than on short-term industry or market trends. A focus on balance sheets, cash flows, and earnings reveals a company's true potential for long-term growth.

"What drives the stock market in the long run," Lynch says, "is corporate profits. Since World War II, profits of companies as measured in the Standard and Poor's 500 stock index have been growing at a compound growth rate of 8% to 9% per year. The stock market has kept pace, on average, achieving its gains in its inevitable up-and-down style."

The world is an ever-changing place, and volatility is the nature of equity markets. Investors who maintain a long-term outlook for their investments have an advantage over those who do not.

Successful long-term investors understand that the market will always experience periods of decline, and that although stock investments are considered riskier, history has shown that stocks have a record of outperforming more conservative investments over longer time periods. In the past, equity investments have offered the highest returns.

Ultimately, the key to surviving market volatility is a long-term approach and diversification.

Final Tax Preparation Tips

Here are some quick tips that could save you money!

Charitable Donations - Line 349

Firstly, they should all go on one return. That's because the tax credit for charitable donations are claimed at two different rates - 17 per cent on the first $200 and 29 per cent of the rest, so to get the maximum benefit one spouse has to claim everything. It doesn't matter which spouse made the donations - either one can claim them all. Also, don't forget the government is allowing donations made in January to be included on 1997 tax returns because of last December's postal strike.

Medical Expenses - Lines 330 to 332 on Return

Normally we think of the usual prescription and dentist bills, but you can include chiropractic care, naturopathy, psychoanalysis and speech therapy, as well. You can take any 12-month period ending in the 1997 calendar year, so you can pick the one with the highest expenses.

Receipts are required. Generally, the lower-income spouse should claim the medical expenses. He or she can can claim the expenses of a husband or wife and dependents. A new regulation allows families with net incomes below $26,000 and one spouse working to claim refunds for up to $500 in medical expenses.

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Equivalent to Spouse Credit - Line 305 and Schedule 5
This $915 credit can be claimed by anyone who is single, separated, divorced or widowed who is supporting and living with a dependent child under 18 or a relative who is physically or mentally infirm. A single parent can claim it for a child. The amount is reduced by any income earned by the supported person in the same manner as for a spouse. A doctor's certificate is required to prove mental or physical problems.

Pension Credits - Line 314
Seniors can claim a $1,000 credit against income from registered retirement savings plans, registered retirement income funds or company pension plans. It's commonly missed.

Child Care Expenses - Line 214 and Form T778
Babysitters and summer day camps count for this tax break. The maximum is $3,000 per child under 16 and $5,000 for kids under 7 or children who are severely disabled. The deduction must be claimed by the lower-income spouse and is limited to two-thirds of earned income. Note that babysitters must be over 18 for their bills to qualify.

Tax Returns for Your Children
Very simply, a child, normally a teenager who has some income, let's say from a summer job should file a tax return. The reason is that it creates RRSP contribution room.

Education Credits - Lines 320-324
It doesn't matter if mom or dad paid the bill, students must use the maximum $5,000 tuition credit first. They can transfer any unused portion to a parent once their own taxable income has been reduced to zero. Students living on their own can also carry the credit forward and use it the first year they enter the working world to reduce taxable income.

Should I Prepare My Own Tax Return?

In his book, “2015 After the Boom - How to Prosper Through the Coming Retirement Crisis”, Garth Turner states that until such time as the tax return form is so simple that it can fit on one page, you should not even consider doing your own tax return. Except in the case of a single person living alone with one T4 slip to worry about, I would have to agree with the former Minister of National Revenue.

A recent article in the Toronto Star by Dana Flavelle using a test subject revealed that three different tax preparer's gave three different returns. Her (the test subject) tax return ranged from $650 to $2,160.

Her first stop was U&R Tax Depot in a Wal-Mart store where she was charged $56 and her return was $650.

Her second stop was at an H&R Block outlet in an Eaton's store. She was charged $206, but also got the highest return - $2,160.

Her last stop was a with a Chartered Accountant. His fee was the highest, at $254. The refund he got her was the second highest at $1,861.

So what does all of this mean?

Very simply, even the experts have a hard time making sure that you pay as little tax as possible.

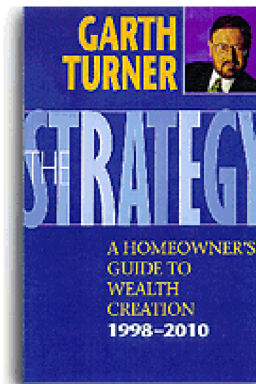
You have some control over how much your return will be with a tax preparer. The most important thing that you can do is list all the people who live with you in your home and determine what their incomes and expenses were and from what sources.

You may be a single person with one T4 slip, but if you support a parent with little income and you don't indicate this to the tax preparer you will lose out.

The problem lies in the fact that we simply fill in the blanks when we fill out a tax return. This problem is not lessened by the fact that you may have purchased tax preparation software for yourself.

A well-trained tax preparer will be skilled in the art of asking questions relative to your personal situation that may result in your getting a higher return.

Book Review - Recommended Reading



Garth Turner is the author of several books on real estate and personal financial planning. He is Financial Editor and on-air newscaster with BBS television, contributing editor with Canadian Business magazine, and a regular contributor to newspapers across Canada. He is a former Minister of National Revenue.

Imagine if there was one strategy you could follow to retire in wealth and comfort. Even if you are middle-aged today, and haven't started to save or invest. Even if you don't think you can ever get the $500,000 or $1 million in assets most Baby Boomers are going to need to finance long, long years after working. And even if most of what you've got is tied up in your house.

There is such a strategy, and today hundreds of thousands of people are employing it, preparing for a future which will shock most Canadians who today have no idea what is going to hit them.

In his gripping new book, Garth Turner outlines The Strategy, offering a step-by-step guide to building wealth in this unique time of cheap money and runaway financial markets. Starting with an asset most Canadians have - residential real estate - Garth Turner shows how average middle-class homeowners can turn that into what everyone ultimately needs - cash flow to finance the rest of your life. And just in time, because the future of residential real estate - at least the kind most people have - is a bleak one.

The Strategy is about the future, and in that future:

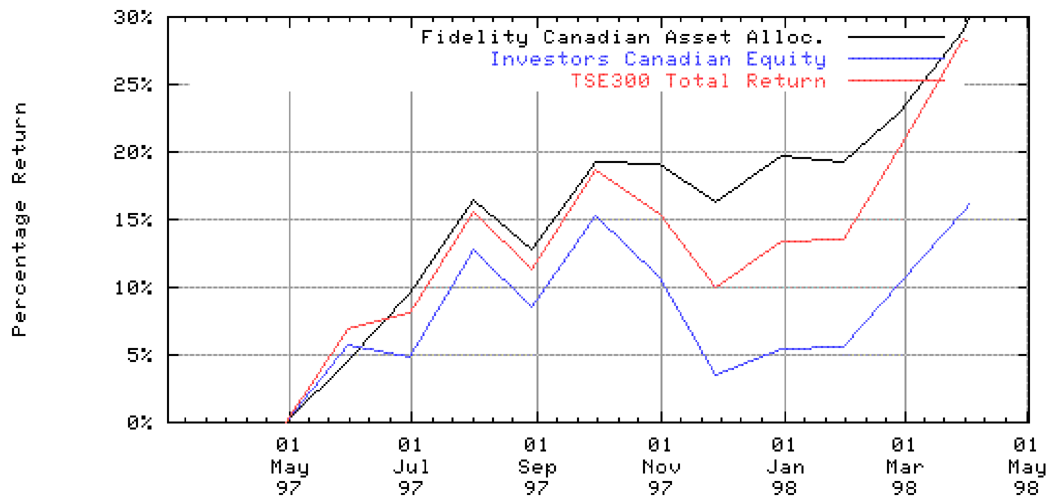
•Much real estate will become a wealth trap. There will be many sellers but few buyers for traditional multi-bedroom homes. •A giant retirement crisis will materialize as the Boomers begin to retire after 2011, creating 300% more seniors. •Interest rates will stay low and stock markets boom for at least the next ten years. •Savers are going to be losers, and investors will be winners. •Those who bail out of real assets and into financial assets will have the best chance of security. •Most Canadians who shun risk and believe GICs are safe will not believe what's about to happen.

The Strategy offers hope. It explains how you can build wealth while avoiding the real risks that lie ahead. With life expectancy rocketing higher, and with the value of money (interest) collapsing, the biggest threat to most Canadians will be running out of money. And there is virtually no chance government pensions will survive after the year 2015, certainly not in a form that will give most people what they need to live on.

But if you know what to do, and start now, you can avoid what most people will not. You can build assets, pay less tax and secure your future while others wonder how they could have been so wrong in the decisions they made.

It's called The Strategy. It is a must read. Now in bookstores across Canada, from Key Porter Books.

Fund Review - The Fidelity Canadian Asset Allocation Fund



Take a close look at this graph, especially the months from October to March. What do you see? I'll tell you what I see. I see a fund that out-performed the TSE without all the nerve wracking volatility inherent in the TSE. I see a balanced fund that continues to out-perform the TSE. When I see that I think of all the Canadian equity funds, such as the Investors Group Canadian Equity fund shown above, that regularly under-perform the TSE, and I wonder why people still invest in them?

Please accept my apologies if my review sounds a little bit like the "Coaches' Corner" of mutual funding investing, but quite frankly, I'm sure we could all benefit by applying a little "Don Cherry" wisdom here.

Am I exaggerating ? I think not. Many of us pay 2% or more for fund managers to look after our savings. What do the bulk of them do? They "manage" to consistently under-perform the market! You don't see it because your return is reported to you net of management fees, but if you have $100,000 invested you're paying somebody $2,000 to get you the best return with the least amount of risk. Ask yourself - would I willingly pay $2,000 to under-perform an index?

Okay - enough fund manager bashing - what makes this fund so good? For starters - the Fund Managers:

Manager Profile

Lead manager, asset allocation
Dick Habermann is a portfolio manager and managing director of Fidelity Investments, senior vice president of Fidelity Management and Research Company, as well as joint Chief Investment Strategist for Portfolio Advisory Services. He now manages more than $30 billion in mutual fund assets.

Manager equity portion
Alan Radlo joined Fidelity Investments in 1985. Mr. Radlo manages over $2.0 billion for Fidelity. He received his BA from Brandeis University and his MSc/MBA from the University of Massachusetts, Amherst.

Manager fixed-income portion
Ford O'Neil joined Fidelity Investments in 1990. In total, he manages more than $600 million in assets for Fidelity. Mr. O'Neil is a Harvard graduate and has an MBA from the Wharton School, University of Pennsylvania.

Managers' Investment Style
The Fund managers take a two-tiered approach to investing. The managers look at a broad range

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of market and economic variables such as relative valuation of stocks versus bonds, monetary policy, and the performance expectations for particular types of investments. Factors such as commodity prices and seasonality trends are also considered.

This information helps determine the overall asset mix within the Fund. The Fund's neutral asset mix is 70% stocks, 25% bonds, and 5% short-term instruments. As market conditions change, asset class weightings will be altered in an effort to maximize return and minimize risk.

Individual securities are selected using a "bottom-up" approach to investing. The managers employ Fidelity's vast research resources to choose individual investments that can provide the best opportunities within each asset class.

The Top Holdings Boring is beautiful when it comes to investing and nothing could be more boring than the top holdings in this fund: Bank of Montreal, Bell Canada Enterprises, Government of Canada Bonds, National Bank of Canada, Teleglobe, Power Corporation, and the Toronto Dominion Bank.

Performance: The fund has out-performed it’s peer group and it’s index (blended index) over all periods. For up-to-date performance visit http://www.globefund.com .

Useful Links

- Fund Performance http://www.globefund.com
- The Fudlibrary http://www.fundlibrary.com/home.cfm
- Financial Advisor Pages http://www.fapages.com/links.cfm
- Garth Turner’s Website http://www.garth.ca/Default.html

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