Manulife Securities

MANULIFE SECURITIES INCORPORATED
MANULIFE SECURITIES INSURANCE INC.

FINANCIAL STRATEGIES FROM

KURT ROSENTRETER & BRANDON WHITBY

CHARTERED ACCOUNTANT • INVESTMENT ADVISORS • INSURANCE AGENTS • ALL IN ONE

kurt.rosentreter@manulifesecurities.ca 416 628 5770 ext 230 brandon.whitby@manulifesecurities.ca

What Kind of Stock Market Investor Are You?

Written By Kurt Rosentreter, CA, CFP, CLU, TEP, FMA, CIMA, FCSI, CIM

It is Autumn 2008 and the world's stock markets have not dropped this much since the tech stock meltdown of 2001. World stock markets are down 30% or more. A continuing banking crisis, rising unemployment and slowing economies worldwide seems to indicate fiscal recession on the short term horizon – How will you react? How will you react to adapt your investment portfolio for this volatility and similar volatility that will likely occur every five to ten years during your life?

So with the stock market looking bleak and a recovery a ways off, now is the ideal time to revisit your stock market personality.

Your stock market personality can be defined as several key aspects of your investor profile: i) how much you are prepared to let your portfolio drop in value before you start to worry; ii) how much you are prepared to let your portfolio drop before you are upset enough to sell securities; iii) how your preference for certain types of investments will influence results; iv) what rate of return you expect to get on investments and over what time period; v) your knowledge about how stock markets work and your previous experience with it; vi) your buy and sell criteria preferences for trading securities; vii) whether you are a buy and hold investor of value stocks or an active momentum trader of growth stocks; viii) your time horizon for holding the investment portfolio and your judgment period for evaluating results regularly; ix) how often you look at your investment account balances; and x) your attention to fundamental analysis vs. macro economic forecasting.

With stock market investing you have to be honest with yourself. It is human nature for all of us to want as much return as possible. Stock market investing should not be based on how much you want to earn, but rather how much you are prepared to lose. That fact is often lost in a rising market where everyone is making money. But this fact hits home hard when perhaps you got in over your head, bought too much and now are facing sharp declines.

In the spirit of not wanting to make that mistake, let's review several ways you can invest in the stock market. Of course the goal is to make money – more money than you could in bonds. But let's examine several types of products for their broader investment characteristics in an effort to help you understand the differences and more importantly, help you to find out what is really the best stock market products for your investor personality. In other words, what kind of stock market investor are you?

Six Different Options
Let's use the Canadian stock market throughout this article as our example. Note however that similar products exist for the global stock markets as well.

There are six different ways to buy into the stock market in Canada, and share in the upside of potential future big returns:
- You can buy the shares of individual companies.
- You can purchase equity mutual funds that own the shares of individual companies.
- You can purchase an exchange traded fund (ETF) holding shares of the 60 biggest companies in Canada.
- You can purchase a principal protected note that tracks the Canadian stock market.
- You can purchase a segregated fund that owns the shares of individual companies.
- You can purchase a performance annuity.

Let's now examine each one of these options so you can better determine what kind of stock market investment is most suitable for you:

Individual Shares
You can open a brokerage account or an RRSP and purchase shares of any stock market listed company in Canada. Stocks like Royal Bank, Imperial Oil, BCE and Research in Motion are some of the largest companies in Canada and are popular stocks held by investors.

The advantages of purchasing stocks are:
- Easy to understand – if you buy shares in companies you know, the familiarity creates a comfort level for novice investors. As well, the stock can easily be followed in newspapers and will appear as a single line item on your monthly investment statement.
- Low cost – to purchase shares of a company you would normally pay a trade commission of 1% to 3% of the trade value. This fee is paid once and can be considered relatively tiny if you plan to hold the stock for five years or more.
- Dividend payments – some stocks pay dividends every year. Dividends are cash payments that you receive on a per share basis for owning the stock. Dividends can rise over time and they can be used to buy even more shares. Dividend reinvestment plans or "DRIP"s are a popular way to grow your stock holdings. Dividends are taxed at lower rates in Canada than other forms of investment income (e.g. interest from bonds) and can be a desirable form of cash flow for retirees.

The disadvantages of purchasing stocks are:
- Risk – This disadvantage is a big one – big enough to override the advantages above in some investor's minds. When you invest money in a single stock, or a few stocks, you place a lot of emphasis on one business. If this business runs into financial trouble in six months, six years or thirty years, it could result in a significant drop in stock price that erodes your return and unwinds years of successful growth. If this happens right before you need the money, the financial impact on your finances could be catastrophic. The year 2007 was a good example to see the scary implications of buying a blue chip stock only to find out that blue chip stocks can get in trouble too. Canadians have long been in love with their bank stocks, feeling they are money makers with big dividends that only go up in value. But in mid 2007, as the US mortgage crisis broke, several Canadian banks started to outline their exposures to the subprime mess and their stock prices started to fall sharply. Supposedly blue chip lower risk bank stocks now showed double digit declines for the first time in many years. This fall in price has continued into 2008 and may continue into 2009 as we prepare for the banks to announce their full year earnings in a few weeks.

  So let's be clear on the risk of buying individual stocks – there are no safe stocks to buy. You can hold a stock for a decade only to have the entire return wiped out by some company bad news released yesterday. There is rarely a way to avoid the drop in price before it hits. Yes, the stocks may recover, some fast, some slow but this comes back to your patience and tolerance as a stock market investor. Would you wait it out?

  The traditional logic of buying stocks is to purchase no fewer than 18 to 30 stocks in order to create a diversified mix such that one or two disasters won't bring down the bunch. This logic holds true in my opinion, but requires a certain amount of money ($1 Million or more) in order to execute. Yes, you can purchase stocks for smaller accounts but the costs of maintaining may become uncompetitive.
- Another disadvantage of buying stocks is that you cannot cost effectively make small purchases off of a pay cheque. For investors trying to save on a monthly basis, buying individual stocks for $50 a month is not feasible.

Equity Mutual Funds
Canadians seem to have a love / hate relationship with mutual funds as both the pros and cons garner a lot of press on a regular basis. An equity mutual fund is a trust or corporation structure that holds a portfolio of stocks – sometimes as few as 20 or as many as several hundred. The fund is managed by a Portfolio Manager and a team of expert researchers at the fund company who buy and sells shares of businesses on a regular basis to generate returns for investors. Your share of ownership in a fund

is called a "unit" and it has a unit price when you purchase. The value of the units rise and fall according to the collective value of all the stocks together inside the fund. All the money in the fund is a pooling of your savings and that of every other investor who wishes to own the same fund – by pooling the money together you gain the benefits of size and clout in the financial market place. Mutual funds charge embedded fees called management expenses to pay the fund managers. Management expense along with operating costs of the fund form the management expense ratio or "MER" which is the total cost of operating and managing the fund measured on a yearly basis. Mutual fund policies and investing guidelines are summarized in a prospectus, which is a legal document outlining what you are buying, what they will do with your money, fees, risks and other key facts.

The advantages of mutual funds are:

- Access to expert money managers – some of the greatest financial minds in the world can purchased as part of your portfolio. Their teams of researchers, research and global strength provides a formidable team managing your money. Surely they can out perform an amateur.
- Risk management – by pooling your money with thousands of other investors in the same fund, the money manager has enough money to buy dozens of stocks at the same time. Owning many securities together is called diversification because it reduces the likelihood of a major drop in your account should only one of one hundred stocks fall apart. Theoretically this should be a lot less risky than just buying a few stocks.
- Defense and offense – you can purchase mutual funds where the money manager will actively trade the portfolio. During a stock market correction the money manager may choose to sit in cash, protecting you against the drop. In a hot rising market the money manager may buy into the fastest rising stocks, maximizing your return. This kind of expert trading and timing may be hard to match on your own or through a stock broker.
- Purchases of mutual funds can be made for as little as $25. Purchases can be automated through a payroll savings plan. Vice versa, for retirees needing monthly cash flow, automatic payments can be made from mutual funds to offer a simple and streamlined income payment regularly. Basically mutual funds have been desired to be extremely flexible to all the practical needs of our financial lives.
- Liquidity – Mutual funds take care of the administration of the stocks for you. This means they will deal with trading of thinly traded stocks, handle foreign currency issues, reinvest dividends, manage stock reorganizations and buyouts and oversee all other other complexities of stock ownership that you would have to do on your own if you owned the stock directly.
- Simplicity – By purchasing mutual funds you have purchased a professional money manager to manage your money on your behalf. There is no regular administration for you to take care of. They are watching all the stocks for you and trading as needed.
- Global markets – when you want to invest in the stock markets of Europe and Asia, mutual funds present easy entry and exit because of their structure.
- Tax efficiency – mutual fund mechanics present the potential to pay less income tax annually on returns compared to any other kind of products. For non-RRSP / RRIF money, this is an important factor to consider.

The disadvantages of mutual funds are:

- High cost – the MER fee of a Canadian equity mutual fund averages more than 2.5% per year. That means if the fund returns 10% gross, you actually make 7.5% in your pocket pre-tax. If you buy stocks directly, you save almost this entire fee every year.
- Poor performance – this is a bit of a crapshoot as every product type will have good and bad performers and mutual funds are no different. With more than 10,000 mutual funds in Canada there are many under performers to be wary of. The stronger argument about performance relates to mutual fund performance compared to stock market indexes, where the high fee of mutual funds puts them at a direct disadvantage to the indexes, leaving many more funds underperforming on a multi-year basis. This argument is in the eye of the beholder as a mutual fund may underperform an index by 1% in a good stock market year but only lose 4% when the index loses 24% in a bad stock market year. There is no doubt that the high cost of mutual funds is a hindrance - but it must be judged alongside your stomach for risk and loss since a mutual fund is more likely to protect your downside than investing in stocks or indexes.
- They only trade at the close of the market at the end of every business day. While this is rarely an issue for the casual investor, for an active trader it means you can not sell the mutual fund at 11am in the morning if you want to. You can do exactly that with stocks.
- Lack of transparency – mutual fund managers sometimes only disclose their most current fund stock holding one to three months after the fact. On your monthly statement you only see the name of the fund, not the stocks you own. For some investors who are hands-on with their investments this is fine. But for others who want to know just what the money manager is buying, this lack of information is unacceptable.

Exchange Traded Funds (ETFs)
A relatively new product, ETFs have exploded onto the investment scene in Canada as a hybrid between owning stocks and owning mutual funds.

They are not mutual funds. They are structured investments that trade as stocks on the stock exchange. So they are like stocks in that way. They also pay dividends the way stocks do on a regular basis. And they can be traded throughout the day the way a stock can.

But they are also like mutual funds in several ways: first, they are baskets of many stocks bundled as one – for example, the Ishares S&P TSX 60 Index ETF is a basket of the sixty largest company stocks in Canada. This product trades as one stock (ticker XIU) on the TSX every day. They also have an embedded MER fee like a mutual fund, but the ETF MER is often less than 0.50% a year. So the fee is much, much less.

The fee is less because an ETF is not actively traded. Unlike a mutual fund where a professional money manager is at the helm and actively trading stocks regularly, with an ETF there is no trading – the 60 stocks in the TSX 60 ETF will not change – they are passively held forever. The only way a stock may change in an ETF is if the index itself changes due to a company bankruptcy, takeover or a smaller company grows to replace a previously larger company in the index.

The Advantages of ETFs
- Low cost - more than owing a stock but far less than owning a mutual fund.
- Tax efficiency – since there is no trading in the product the turnover rate is low and so are your taxes.
- Performance – looking back over the last ten years, performance of indexed products has been superior to many / most mutual funds (ETFs are referred to as indexed products because many of them choose to track common worldwide indexes like the TSX 60 in Canada, S&P500 in the U.S or EAFE index in Europe and Asia)
- Diversification for risk management – since the ETF owns 10, 20 or far more stocks as one bundle, you benefit from the diversification of owning many securities at once. Should one stock fall, your performance suffers less.
- Trading all day long – ETFs trade all day long so if you want to buy or sell at 11am you can execute the trade immediately.

The Disadvantages of ETFs
- You cannot cost effectively make small purchases off of a pay cheque. For investors trying to save on a monthly basis, buying ETFs for $50 a month is not feasible.
- The nature of index investing means there is no professional money manager the helm looking out for your best interests. You are merely buying a block of stocks. In good markets, they may do better than mutual funds. In falling markets, because they don't sell to cash or hold a cash cushion, they may fall much deeper than a mutual fund will. So ETFs can prove to be a wilder ride both up and down over time. If you are looking for a smooth, less volatile way through the stock market, an ETF would not be what you should purchase.

  But if you are looking to maximize returns, and you can stomach the downsize, ETFs may be your preferred product of choice compared to mutual funds and individual stocks. They are a combination of the best characteristics of both.

Principal Protected Notes
Principal protected notes or PPNs, previously called index linked GICs are a product that has been invested to comfort the nervous stock market investor.

They are a combination of a bond investment offering guaranteed return of your original capital attached to a return promise that tracks the stock market in some fashion. For example, if you invest $10,000 in a PPN that tracks the TSX 60 stock index, if the stock market falls over the three year period you will only get your $10,000 back. This is comforting to some investors to know you will never lose your original investment. However if the stock market rises 10% over the same three year period, your return may be 8% out of the 10%.

A product like this gives the appearance of no downside – you either get a good stock market return or you get your money back – but there will never be a negative return.

Advantages of PPNs
- They provide a guaranteed minimum investment value that is no lower than zero yet offer an upside of big stock market returns if they occur.
- They are easy to buy and hold.
- You will not lose your original capital if the product is held to maturity.

Disadvantages of PPNs
- The return you earn on the upside is limited – if the stock market rises 12% you may only earn a portion of the total return. The rest is effectively a fee.
- You are locked into the product for several years.
- The return is not an actual stock market return – only a proxy return that is manually tracked and paid to you. This means you don't get dividends from stocks nor do you get the capital gains treatment of the return at the end of the term. This is not a good tax result. However

if you buy this product inside a registered account (RRSP or RRIF) this tax disadvantage is irrelevant.

- The fees inside of the PPN may be significant. These fees are embedded and netted against your return.

PPN's have been very popular the last few years. Investors feel these products have no downside but great upside even despite the few disadvantages. They are definitely a softer, gentler way to buy into the stock market and you don't have to fear a loss when holding to maturity.

Segregated Funds
Segregated funds are often called mutual funds from insurance companies but are really variable annuities in which you can invest your money with brand name money managers. Under the insurance umbrella, they offer unique characteristics that you cannot get with regular mutual funds.

The Advantages of Seg Funds

- Seg funds, when compared to mutual funds offer all the same advantages of mutual funds (professional expert money managers, risk management, liquidity, simplicity, global markets access, small purchases, etc.) but also offer some potentially huge extra advantages compared to mutual funds:
  - Creditor proofing – in some circumstances, seg funds can offer some protection against loss due to individual bankruptcy.
  - Guaranteed returns – the insurance company guarantees that you will at least get your original investment back assuming you had purchased a 100% guarantee option and held to maturity. Other options may only guarantee 75% of the original investment.
  - Resets – better still, some seg funds will reset your starting cost to capture stock market gains over the ten year period. This means you can lock in gains as they happen and still avoid losses entirely. It really is a case of getting all the upside with no downside.
  - Estate benefits – Seg funds are the only product discussed so far where you can designate beneficiaries for your estate. This means that on your death the seg funds will be paid directly to the named heir, bypassing your estate and avoiding probate fees.
  - Cash payments – some new seg funds now offer guaranteed cash payments of 5% of the market value of your investment for life. This means that regardless of whether the stock market rises or falls anytime, you will receive 5% of your portfolio paid to you each year. Even if your portfolio theoretically went to zero, the 5% would continue. This is the ultimate peace of mind for a retiree who needs more cash flow than GICs and bonds can offer but can't stand the stress of the stock market.

The Disadvantages of Seg Funds

- Seg funds have similar disadvantages to mutual funds such as poorer long term performance, poor transparancy inside the product, they only trade end of day and have a high cost - higher than regular mutual funds.
- Seg fund annual embedded fees are 3% to 5% a year. This amounts to one third to as high as one half of the annual long term average return of the product. Many consider this a huge price to pay for the guarantee of never losing any money. But it clearly must not rattle too many Canadians given the billions invested in seg funds nationally.
- The guarantee of your original investment only applies if you hold the product for ten years and if you had purchased a 100% guarantee option. The guarantee may also apply on death.

Performance Annuity
Annuities have been around for decades, but you don't hear much about them anymore for a few reasons. First, they aren't sexy, explosive products that garnish headlines when stock markets rise. Second, they force investors to commit to one product for life and third their returns are average only.

An annuity is a life insurance product whereby you give the insurance company a lump sum of money initially in exchange for receiving a fixed stream of payments over a set period of time, often your lifetime. The payments are guaranteed to arrive forever (or as long as the insurance company exists).

A performance annuity takes a regular annuity and provides you with some stock market upside as well. It guarantees the minimum payments you will receive each month to ensure you continue to get a stable cash flow, but also provides the potential for more cash flow if the stock market rises. Some or all of the annuity payment is linked to the rising performance of the stock market – offering you bigger payments. However if the stock market falls, you continue to get the minimum payments.

Other features of an annuity are: there are no investments to manage – you just get a cheque in the mail for the monthly guaranteed return payment forever; if you die long before the annuity has paid you much money you can set a guarantee period of up to fifteen years to have payments continue to your estate; and you can make payments rise over time to offset the cost of inflation.

The Advantages of a Performance Annuity

- This product is best suited to investors who hate the stock market, don't want to get involved with investing and prefer a guaranteed payment for life that you can never outlive.
- Annuities are often compared to pensions that police officers and teachers get – the peace of mind of a guaranteed cash flow stream in retirement.
- Performance annuities offer a guaranteed minimum payment to you with the potential for more if the stock market goes up. Like seg funds, these are the only two types of products that offer you the upside of the stock market with limited downside risk if held to death or maturity.
- There is no need to maintain a relationship with an Investment Advisor, saving you thousands of dollars in fees over your lifetime and hundreds of hours of meetings.
- The payments you receive are a blend of capital and interest providing an income stream that attracts less income tax.
- For investors scared they will run out of money in retirement, an annuity guarantees it won't happen.

The Disadvantages of a Performance Annuity

- Annuities are lifetime commitments. Once you buy one you can't get your money back if you change your mind. Never put all of your savings into a product like this.
- If you are confident that you can earn 10% in the stock market, an annuity is not for you. The payment stream on a regular annuity may only reflect an embedded 3% to 5% return – forever. Payment rates are set at the time you purchase the regular annuity and are based on long term interest rates and other factors. The performance annuity is the only annuity option that provides you with a potential return and cash flow payment closer to the traditional stock market.
- When you die there is no estate value to most annuities. They will pay out the guaranteed payment period that you selected, but that's it. If you have a spouse, they will continue the payments until the death of the second spouse. But if your goal is to leave your heirs a large inheritance, an annuity likely will not provide this.

One Word about Bonds and GICs

After reading this article, I don't want you to think that I have forgotten about fixed income products. This article is merely to highlight the different types of stock market products only.

Long before getting to this point in your planning, an overall financial plan and investment plan must be crafted. Within the investment plan you will set financial goals, evaluate your investor profile, create a Statement of Investment Policy & Guidelines and structure a strategic asset allocation for all of your investment accounts together.

Long term investing should not be stressful. Investors may be well served to consider some of these guaranteed products (seg funds and annuities) to provide a reliable base of income in retirement that will cover fixed costs. A portfolio that consists partially of bonds, partially of stock market products and partially of guaranteed return products may enhance your returns and also make stock market investing more tolerable.

I look forward to discussing all aspects of your investment plan together as we create a sound investment framework for your financial plan!

Contact us to answer your questions, schedule a meeting, get a second opinion, refer a friend, order a book, receive a brochure on services and fees, create a financial plan and more. *MEMBER CIPF.

Kurt Rosentreter, CA, CFP, CLU, TEP, FMA, CIMA, FCSI, CIM
Senior Financial Advisor & Branch Manager
Certified Financial Planner
Telephone: 416.628.5770, ext. 238
Email: kurt.rosentreter@manulifesecurities.ca

Brandon Whitby, CFP, FMA, FCSI
Senior Financial Advisor & Branch Manager
Certified Financial Planner
Telephone: 416 628 5770, ext. 230
Email: brandon.whitby@manulifesecurities.ca