McIVER WEALTH MANAGEMENT
CONSULTING GROUP

Five Costly Mistakes Investors Will Make in 2010

1) NOT Owning U.S. Equities

It has become fashionable for commentators 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. However, this ignores the alternatives.

There is no other economy in the world that has the economic power of the U.S. It is unmatched in terms of size as well as the proven ability to recover from recessions. No other economy compares in terms of the depth of its tax base. Sure, the U.S. has a debt burden. However, it has taxpayers that can finance it fiscally. Even though this will be difficult for U.S. taxpayers, the bottom line is that it is not only possible, but likely. It would not be possible in many of other industrialized countries of the world where the end result would be much more inflationary than what the U.S. will experience when the damage from the credit crunch is finally resolved.

It is also important to note that the U.S. is unrivalled in terms of the strength of its institutions (regulatory, social, charitable, and corporate). It is hard to put a value on this, but it is instrumental in helping to eventually recover from economic challenges. It also keeps any type of social instability to minimal levels. There may be some political reform or a change in power, but it will never be economically disruptive like it can be in other countries.

We may still be a few years away from a steadily growing U.S. economy. However, the stock market discounts the future. As a result, if we see credible economic growth on the horizon, investors will bid up the price of stocks. This may happen this year, or next year, or perhaps it has begun already following the market low in March of 2009 from which the market has rebounded by more than 60% in a little over a year. In fact, nearly all Technical Analysts (chartists) believe that the U.S is one year into a sustained multi-year advance.

It is also important to keep in mind that the primary goal of owning equity is to buy that equity in a market with the greatest capacity for and likelihood of growth, and at a time when that market is historically low and likely out of favour with investors. The U.S equity market potentially provides both these advantages.

Despite its many machinations over the past 11 years, the Dow Jones Industrial Average has not grown. The DJIA (currently in 11,000 range) has crossed 10,000 over 20 times during this time frame yet provided a near-zero rate of return. In spite of this, its long-term average rate of return remains undamaged at over 10%. The likelihood that the U.S equity market returns to its long-term historical average rate of return is high.

The bottom line is that the greatest equity growth over the next 10 years very well may be found in the U.S. Omitting U.S equities, prejudiced by the high volatility and poor returns experienced in our most recent decade, could prove to be a significant mistake.

2) NOT Owning Real Return Bonds

Real Return Bonds issued by the Canadian government adjust to the rate of inflation so that 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 various central banks in order to get economies out of recession. While it is very easy to print money and increase the money supply, economists are underestimating the difficulty of pulling all of that money out of the system once the economy has gained traction. It is publically and politically very unpopular for central

banks to reduce the money supply as this can seriously impact employment and economic growth (politicians usually like over-heated growth, more than what makes central bankers comfortable).

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 it is imperative that investors consider investments that protect the “real” yield that is earned (“real” yield is the nominal yield minus the impact of inflation). This also implies that your overall exposure to bonds needs to be reviewed and maturities shortened to reduce risk. Regular nominal return bonds, which have been a nice solution to volatility and anemic equity markets over the past 20 years (as rates fell) 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 own them immediately.

3) NOT Owning Gold

For many years, gold was shunned as investors were attracted to stocks and bonds in response to the stunning performance of these investments. This proved to be the best strategy in the 1990’s. However, since 1999, gold has been one of the best-performing asset classes and has trounced the performance of stocks and bonds over this period.

Over the last decade, gold has risen fourfold. It has been the part of the market where anxious investors sought refuge 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 of the banks and debt looked unsustainable.

Although gold has been the champion asset class of the last ten years, its advance could continue well into this decade. Volatility and frustration will continue to be features of the economic landscape (as evidenced by the difficulties in Dubai, Greece, Portugal, and others), and gold will be the destination of those who don’t want to hold sovereign debt or riskier investments at times like these.

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.

4) Rear View Mirror Investing

One of the many reasons that individual investors feel that the game is ‘fixed’ and why they underperform professional institutional money managers is that individual investors have a very strong and consistent tendency to look backward and invest into what worked over the past year, or two or ten. 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 which have the capacity to outperform in the future. Most non-professional individual investors employ strategies designed to capitalize on previous market opportunities. As a result, they miss out on new opportunities.

Currently, investors are giving too much promise to banks and insurance companies in the U.S. and internationally as well as some large technology companies that had their heyday 10 years ago.

These strategies are hoping that we return to an environment where inflation is low, credit is easy to obtain, and where corporations continue to purchase technologies that were in vogue five to ten years ago. Unfortunately, that environment is gone.

The realities are now focused on companies and investments that can adjust to a slower-growing and more inflationary environment. Companies that produce goods that are not impacted by inflation or where inflation can be passed on to the consumer will outperform in the future. Additionally, there won’t be a

build-out of more corporate technology until there are significant advancements as opposed to minor refinements.

Another strategy that had success in the past but that is unlikely to succeed in the future is over-weighting mid- to long-term bonds and preferred shares which do not protect against rising rates or inflation.

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

Now more than ever, new real opportunities are presenting themselves and it is critical to review old strategies and update your portfolio in order to take advantage of them.

5) Getting Seduced by the BRIC Countries

It has been difficult for investors to ignore the stories of run-away economic growth and wild stock market gains in countries such as Brazil, Russia, India, and China. However, this is territory for adrenaline-seeking speculators. These markets reverse suddenly and far more often than markets in mature industrialized nations. As a result, the speculator has to engage in market-timing, a strategy that almost never produces results that are better than what is achieved through conservatively investing in established markets.

The challenges in emerging markets are potentially amplified by social and political instability, suspicious economic statistics, limited or no rule of law to enforce contracts, lack of enforcement to prevent corporate and government corruption, dubious accounting standards, and a lack of domestic demand that creates excessive reliance on export markets.

A broad brush analysis of these markets, which is usually the depth that we see in the financial press, makes it look like they are similar to the markets and the economy here. However, by travelling to these countries regularly and by looking behind the scenes, analysts realize that it is very different and a whole set of other rules apply, almost never favoring foreign companies or investors.

In new markets (just as it was with North America in the 1800's) fortunes are won and lost. It is important to remember the second half of that statement.

Just as with "rear view mirror" investment strategies discussed above, aggressive financial services sales organizations will often use the promise of potential riches by weaving the seductive stories of emerging market opportunities.

Avoiding Investment Mistakes

We are portfolio managers that manage asset-allocated portfolios for high net-worth clients. Not only do we comment on the investment marketplace, but we also employ our recommendations by investing into the marketplace each day and are accountable to our clients. We are constantly vigilant with respect to changing circumstances in the investment marketplace. We look critically at our previous decisions in order to stay ahead of the herd of investors in the market. We look at trends and evaluate their potential over the medium to long-term and work to avoid the pitfalls that initially look attractive to unsuspecting investors.

The next two years will be a critical time for investors as the market shifts and economic realities change. Your portfolio needs to be structured to avoid these common mistakes and to take advantage of new opportunities as they present themselves.

As we evaluate the investment climate and compare it to our investment strategy, the list containing the Five Costly Mistakes that we identify will change over time