The Francis Forum

Create Wealth, Achieve Freedom **Fall Edition 2013**

MANDEVILLE PRIVATE CLIENT INC.

Duane Francis, CFP, CPCA, CIM, FCSI, CSWP, Senior Financial Advisor, Life Insurance Advisor

Mandeville Private Client Inc.
1565 Carling Avenue, Suite 610
Ottawa, ON K1Z 8R1
Telephone: (613) 728-0101
Toll-free: 1-888-870-4443
Fax: (613) 728-4075
Email: dfrancis@mandevillepc.com

Janet Nunn
Executive Assistant
Telephone: (613) 728-0101 Ext.228
Email: jnunn@mandevillepc.com

INSIDE THIS ISSUE

Thoughts on Private-Equity Investment

The hard economic reality of the new millennium has pummeled many growth oriented investors. Investors in U.S. stocks, on the receiving end of a "one-two-three punch" from the tech wreck, soaring loonie and global credit crisis, are still in the red. International stocks have struggled and, while Canadian equities have delivered so-so positive returns, you can't build wealth running on one cylinder.

In contrast, private-equity funds that focus on buying out or providing financing to individual companies, typically privately owned, have achieved stellar returns.

Private-equity investment has serious merits. It allows ownership participation in a portfolio of growing, private companies without the concentration risk of a single business. It can generate attractive returns while its long-term orientation removes concerns about short-term market swings. Investors can diversify broadly or target particular industries or geographies. It is a "hands-off" investment — the burden of execution falls on the fund managers and the portfolio company executives.

However, investors should always look before they leap since private equity comes with drawbacks. First, it is illiquid. It's a lot easier to get in than out. Many endowments and pension funds found this out the hard way when they needed to raise cash in the depths of the global credit crisis.

Also, in the early years of a fund, the private-equity managers are busy evaluating and structuring acquisitions while investors are writing cheques to satisfy their original investment commitment. It's a one-way street with cash going out the door. At the same time, the initial fees and expenses of the fund as well as early write-offs of underperforming acquisitions can result in negative returns. The positive gains and cash flow occur much further down the line as the portfolio of companies matures and is sold or taken public.

In fact, the typical life of a private-equity fund runs in the order of 10 years. Many private investors accustomed to the liquidity of publicly traded markets find this disconcerting.

There is good and bad news about private-equity manager performance. Unlike the realm of publicly traded stocks where there is little evidence of persistence in manager outperformance, some private-equity managers possess unique skills, networks and experience and have been able to deliver excess returns with some consistency.

Also, an investor faces real risk in manager selection. There is considerably more dispersion in the returns achieved by private-equity managers than is the case for investment managers of stocks and bonds. One of the appeals of a fund of private-equity funds is the mediation of this risk through diversification.

As always, I'm always available to discuss the topics in my newsletter, or any other financial inquiries you may have.

Sincerely,

Duane

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Projecting Investment Returns

If you are trying to predict your cash flow in retirement, it's useful to know what investment returns you can expect.

From an actuary's perspective, this involves less guesswork than you might imagine. Just like it's easier to forecast the average climate over the next 25 years than the weather next week, you can make a reasonably good estimate of long-term returns.

Actuaries face this problem all the time since future investment returns are crucial to estimating the liabilities in defined benefit pension plans. And the magic number they seem to always come up with — 6%.

The 6% estimate may seem unrealistically low. After all, the typical pension fund manager achieved an 8.5% return over the past 50 years, so why should returns be so much lower in the future?

For the individual investor, returns can be lower than 6% depending on investment fees. If you go with mutual funds, expect to pay 1% to 3% in annual fees which would reduce the gross 6% return down to 4% or so. As a result, you might decide ETFs, alternative strategies or fee-based accounts are the better bet since management fees are so much lower.

Here's how actuaries arrive at a 6% return:

Estimate future inflation The average inflation rate since 1924 has been 2.94% though actuaries generally assume lower future inflation because (a) inflation has been low for quite a while, (b) economic growth in the developed world looks like it will remain sluggish for a long time to come and (c) the Bank of Canada is targeting inflation at 2% per annum. Taking all this into account, the typical estimate of future inflation is about 2.25%.

Forecast the *real* return Calculate the return on each asset class over and above the inflation rate. Assuming three asset classes with 40% in long-term government bonds, 30% in Canadian equities and 30% in international equities.

Expect bond yields to rise Bonds are currently at the bottom of a 60-year interest cycle so yields are expected to rise over the next 25 to 30 years. As yields rise, long-term bonds will produce capital losses that will reduce total return. This has already started as bond funds have registered a net loss in the first eight months of 2013. Indeed, there have been 25-year periods when bonds lost money in real terms. Nevertheless, we will go with the consensus that real returns on long-term bonds will average about 1.25% over the next 25 years.

Expect equities to rise less Actuaries generally expect that Canadian equities will generate real returns of 5.25% over the next quarter century; this is less than the 6.7% or so that they have generated historically but an aging population implies a slower economy. Real returns on international equities are expected to be a little higher, about 5.75%.

Factor in rebalancing Put this all together and we derive a nominal return of 6.05%. (Nominal means we added back in the inflation component.) We can then bump this up by the closest thing to a free lunch that you are apt to find in the investment world: If we assume the portfolio is going to be rebalanced regularly (to maintain the 40-30-30 mix), the actual return will be a little higher than if the asset mix is allowed to drift. We can therefore round up our estimated return to about 6.4% to reflect regular re-balancing.

Assume 6% gains Finally, we knock off about 0.5% for management fees to come up with our final estimate of 5.9%, which we will round up to 6%.

Even though this seems like a lot less than the 8.5% return that fund managers actually achieved over the past 50 years, the past and the future may not be as different as they look.

The 8.5% return cited above does not factor in management fees. If we assume the same 0.5% annual fee, past returns are now down to 8.0%. Next, the average inflation in the period 1963-2012 was 4.1% versus our forecast of 2.25% for the next 25 years. If we subtract out inflation, we get a real return of 3.9% for the past 50 years versus 3.75% for the next 25 years (6% less 2.25%). Our forecast is starting to look a lot more reasonable.

Can you do better than 6%? It will be very difficult in a low inflation environment; to have any real chance, you would have to take on more risk (meaning investing heavily in equities) and avoid high investment management fees. It also helps to stay away from long-term bonds, especially government bonds.

You would also need a little luck, and you just might get it. If you look at all the 25-year periods since 1924, the average real return on Canadian equities has ranged from a low of 3.0% to a high of 10.3%, so it is certainly possible we will beat the 5.25% estimate for real returns on equities that was used in this analysis.

http://business.financialpost.com/2013/09/21/calculating-investment-returns-actuarially-speaking-6-is-a-good-rule-of-thumb/

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5 Similarities between Real Estate and Investing

1. **It is very important to do your own research.**

Many of the published articles on local real estate trends are overly biased on the positive side, especially if a realtor is featured. Unfortunately, the same often happens regarding stock research from many of the investment banks due to inherent conflicts.

This can be very misleading and, at times, result in costly decisions being made from both a buyer and seller perspective.

2. **Understand the bid and the ask.**

Selling or buying a house, for the most part, is not unlike trading an illiquid stock. As an investor, it can be helpful to use reference points to assist in determining the bid or ask in such circumstances, which could involve the last sale price or the price of a comparable stock from a multiple perspective.

The same can apply when buying or selling a house. In the case of someone serious about selling, it's important to understand what the bids could be and price accordingly. If the bid is likely going to be well below where you believe the real value is, simply don't list unless you can benefit on the other side of the trade.

3. **Don't try to time the market.**

This maxim especially applies if you are selling and buying at the same time in the same market.

Let's say you sell your house but decide to wait because you think your target purchase is too expensive. What happens if the market rallies and you miss out on the trade?

The same can apply to the sale of a stock. Unless your intention is to go to cash, it's generally beneficial to switch into a more desirable stock within a reasonable time period following the sale.

4. **Know the difference between momentum and value.**

It's important to know what people want. A unique home will often take longer to find a buyer, while a trendier home will probably move faster. Likewise, value stocks may take time for that value to be realized, while a trendy stock will likely move faster.

That said, beware that a trend today may not be your friend tomorrow.

5. **There is value in getting professional help.**

It is worth paying for professional help in many cases. Someone with extensive experience in the market will be able to assist with the aforementioned challenges and help maximize value in the process.
It is important to note that there are good and bad realtors and financial advisors, so do your homework.

Make sure the services they provide will appropriately match their compensation levels. Look for full transparency of fees, a full description of the services being provided and a fiduciary duty to act in your best interest.

http://business.financialpost.com/2013/09/09/5-similarities-between-real-estate-and-investing/

Are You House Rich or House Poor?

According to Statistics Canada, about one-quarter of Canadians are spending too much on housing costs. "Too much" is defined by Canada Mortgage and Housing Corporation (CMHC) as 30% or more of household income. Are you house rich and cash poor?

With time winding down to get in on some of the best mortgage rates in Canadian history, consumers pulled the trigger on purchases and in the process seemed to have turned around the housing market.

Firstly, it's important to understand what CMHC's "household income" refers to in order to measure if you are over or under the suggested 30% threshold. They define household income as pre-tax household income, which is a questionable metric due to our tax code.

We have a graduated tax system in Canada where every taxpayer files their own tax return, so there can be a big difference in after-tax income between two households with identical household incomes. A household where two people are earning $50,000 each in Ontario, for example, has

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after-tax income of about $75,840. A household where one person is earning $100,000 – the same gross income as the $50,000 times 2 household – has only $69,841 of after-tax income. That's a difference of about 8%, so not immaterial.

According to CMHC, housing costs include rent and utilities. For homeowners, they add mortgage, property taxes and condo fees.

With young couples, they're often wondering if they can afford their dream home without breaking the bank. Taking on a bigger house and a bigger mortgage can limit other things which may or may not be important. Retirement savings might need to be scaled back, but what about living for today? Big mortgage payments might make a family think twice about a vacation they might otherwise enjoy (or need).

Not surprisingly, a lot of Baby Boomers consider a downsize of their home. In some cases, it's because they have more house than they once needed. In others, it's because they live in an expensive city like Vancouver and a move outside the city can help pad retirement savings.

Either way, young or old,, housing costs represent a large component of household spending and a large proportion of household net worth. It's important to evaluate the pros and cons of moving up or cashing out.

One thing to emphasize; just because a bank approves you for a mortgage, doesn't mean you're wise to take it on. And just because CMHC suggests a 30% target for your housing costs as a proportion of your household income, it doesn't necessarily constitute sound personal financial planning – especially when today's interest rates and the resulting mortgage payments are artificially low.

http://business.financialpost.com/2013/09/17/housing-canada-poor-rich/

How to Get the Biggest Bang for your Buck from your RESP

While RESPs have been around for many years, and really took off in 1998 with the introduction of the matching 20% Canada Education Savings Grants (CESGs), my experience is that parents are not using them in the most strategic or optimal manner possible.

Here's a quick overview of the basic rules and then we'll run through a couple of optimization strategies.

The RESP is a tax-deferred savings plan that helps an individual, typically a parent, save for a child's post-secondary education. Similar to other registered plans, the RESP is in essence a wrapper in which you can hold various eligible investment products. Unlike RRSPs, contributions to an RESP are not tax-deductible.

The benefit of the RESP is the ability to have all earnings (capital gains, dividends and interest) on the investments inside the RESP accumulate tax-free until withdrawn. When the funds are paid out, they are included in the student's income but presumably the child will be in a low- or zero-tax bracket, on account of the various tax credits available to them, that little, if any, tax will ever be paid on the earnings when withdrawn.

Another benefit is the CESG, equal to 20% of the annual contributions, to a maximum of $500. The maximum CESG entitlement is capped at $7,200 per child.

When funding an RESP, the first missed opportunity is that parents often only start thinking about contributing to their kids' RESPs several years after their children are born. But contributing to an RESP as soon as possible can reap significant financial rewards down the road.

Finally, for those parents who can afford to do so, consider maximizing the tax-deferred (or, most probably, tax-free) compounding by contributing beyond the annual amounts needed to maximize the CESGs. This can be done by making an additional lump sum contribution of $14,000, bringing the total amount contributed up to the lifetime maximum of $50,000 per child.

http://business.financialpost.com/2013/08/28/resps-how-to-get-the-biggest-bang-for-your-buck/

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Setting a Retirement Income Target — Maybe You Need to Save Less than you Think

Setting your savings target is one of the most important yet least understood questions in retirement planning.

Expert estimates on what percentage of your pre-retirement income you will spend in your elder years — which crucially determines how much you need to save — vary widely. Some suggest you need to save enough to give you an annual retirement income of 70% of your pre-retirement income. Maybe you need much less to get by, perhaps even half that 70%.

Before retirement you will go through a variety of expensive phases: buying a home, paying off the mortgage, going to work every day and saving for retirement itself. Consider these special expenditures as 'investments.'

What is left over we will call regular consumption — food, shelter, transportation, entertainment, home maintenance, insurance, etc.

If one has sufficient income, regular consumption should remain about the same after retirement. The 'investments,' however, tend to go away. This is a critical piece of information, often missing from financial planning exercises.

It means your retirement income target should be the percentage of your total pre-retirement pay allocated to regular consumption, not the entire pre-retirement pay as many calculate.

Obviously, the 'investments' differ from person to person. Some people don't have children. Some rent instead of buy. Still, the formula is the same in all cases and provides a useful way to approximate one's retirement income target.

We know that spending on children ramps up with each child born and further depends on whether the parents have plans for daycare, private schools and summer camps, to name but a few child-related expenditures. As another example, the income dedicated to paying off a house may fall off in the latter part of one's career but not always; many couples decide to trade up or add on a vacation property and take out a bigger mortgage to do so. Finally, for higher-income people, income tax rates can be significantly higher during their working years though how much higher depends on the level of RRSP contributions made.

If you look at a real life example of a higher-income couple with two children, retirement saving starts low, falls further with the birth of a second child, then starts rising as retirement nears. Employment costs remain a near-constant percentage of pay for the couple's entire working career. The cost to pay off a home is a similar percentage of pay in all years though the cost is broken down into three phases — saving for the down payment, paying off the mortgage on the first house, and finally trading up and paying off the mortgage on the second house.

Child costs start at age 35 in this case, rise with the birth of a second child, then fall away as the children reach adulthood.

If you calculate regular consumption as a percentage of total gross income during their working years, it averages out to just 30% of gross income over the 25-year period preceding retirement.

Assuming mortgage payments finally end by retirement, this same 30% also is a rough estimate of this couple's retirement target.

It still needs to be adjusted for income tax paid after retirement, though that number will be surprisingly small, and also for any special expenditure the couple has in mind such as more travel, eldercare or continued support for grown-up children.

For this couple, the adjusted target is estimated to be 35% of final pay. This couple's retirement cash flow is secure for a number of reasons. They began contributing to RRSPs early, they both belong to an employer-sponsored retirement savings program, and they increased their retirement savings as their income grew. Moreover, they set their expected investment return conservatively low. They will also have significant equity in their mortgage free home at retirement, which will be available in the event that they live beyond age 90.

The savings target won't be this low for everyone: Some people pay off their mortgage early and then start spending more than they did in the early part of their working life. Some couples have no children. In general, the target will be higher for households with lower income, fewer children and those who rent instead of owning their home.

Still, most people who go through this exercise of quantifying all their expenditures will find the percentage of their income dedicated to regular consumption is lower than they think, so their retirement income target will also be lower, perhaps much, much lower.

http://business.financialpost.com/2013/07/23/setting-a-new-retirement-income-target-maybe-you-need-to-save-less-than-you-think/

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Health and Wellness: Fruit for thought

If you packed someone's lunch this morning, there's a pretty good chance that you added an apple or popped in a peach to make the most of this season's best fruit fly fodder. It makes sense, yet in a nutrition world where no food is entirely safe from scrutiny, you might have heard rumours that eating fruit does us more harm than good.

Fruit, it is argued, is a sugary food that can be fattening, sending us on a blood sugar roller coaster that is both uncomfortable and unhealthy. And that's not to mention the fructose, one of the more prevalent sugars in fruit, which may play a disproportionately significant role in the development of fatty livers and elevated triglycerides, the latter of which is a risk factor for heart disease.

First, the bad news for fruit: Despite earlier studies suggesting that fruit is protective against cancers, more recent research suggests that fruit consumption offers little, if any protection. Having said that, individual fruits, such as berries, may have a significant effect, but one that gets lost when all fruits are lumped together in research studies. Overall, fruit does influence cancer risk; however, the overall effect is relatively small, especially when compared with major factors such as smoking, exercise, or weight.

So what about fruit and diabetes risk? Compiling data from both the Nurses' Health Study (I and II), and the Health Professionals Follow-up Study - which collectively followed more than 180,000 individuals for at least eight years – the research aimed to show not only the effect that total fruit consumption had on the risk of type 2 diabetes, it also cancelled out the effect of individual fruits and fruit juice on the disease risks as well.

As it turns out, fruit in general seemed to have a modest benefit when it comes to type 2 diabetes. Every three servings of whole fruit per week reducing the risk of diabetes by about 2%, compared with eating fruit less than once per month. The authors took into account various factors, including age, ethnicity, weight, smoking, activity, and family history, and total calories consumed when making these comparisons. Looking at fruit individually, however, they found some intriguing results: for every three servings of blueberries consumed per week, type 2 diabetes risk dropped by 26%. Less impressive, but still noteworthy, were the grapes and raisins (12% reduced risk), prunes (11%), and apples and pears (7%). Interestingly, bananas, which are often thought to be too sugary to be a part of some diet plans, followed next (5% reduced risk per three servings per week), coming out equal to the more health-associated grapefruit. Peaches, plums, apricots and oranges followed.

As for the reasons for the particularly protective effect of blueberries, grapes, and apples, the authors found that the glycemic index or load of the fruit, a measure of its impact on blood sugar, did not seem to be a factor. How is this possible, when previous studies have suggested that diets that trigger bigger and longer spikes in blood sugar are associated with diabetes risk?

It's difficult to say, but the authors note the possibility that as-yet poorly understood nutrients in fruit, such as anthocyanins in berries grapes, and apples, resveratrol in grapes, chlorogenic acid in apples, peaches, plums, prunes and apricots, and naringin in grapefruits somehow minimize the harm.

Perhaps the most significant finding of the study, however, was that fruit juice consumption was associated with the opposite effect of whole fruit. For every three servings of fruit juice consumed per week, type 2 diabetes risk increased by 8%. We've known for some time that sugar-sweetened drinks, like pop, iced tea, and vitamin water, are linked with weight gain and diabetes risk, although the fruit juice story has been less clear. This study provides further evidence that fruit juice may not be as healthy as we would like to believe, and at the very least, that whole fruit is a better choice.

THE BOTTOM LINE

This is a cohort study, which means that its results only suggest that fruit in general, and berries, grapes, and apples in particular, are *associated* with a lower risk of diabetes; it does not, however, tell us whether or not fruit actually *causes* diabetes risk to drop, which means that its findings are only one piece of a broader puzzle. It is intriguing, however, to imagine that the type of fruit may play a role in diabetes risk, and that blood sugar is only one of many factors to consider when choosing fruit as a snack over a granola bar or handful of crackers. At the very least, this study reaffirms the notion that packing an apple (or grapes, or kiwi or persimmon) and a bottle of water is a better choice than getting your fruit through a straw.

http://life.nationalpost.com/2013/09/03/jennifer-sygo-fruit-for-thought/

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Summer Activities

The Wedding Show
October 19th – 20th, 2013
http://www.ottawaweddingshow.com/

The Ottawa Wine & Food Festival
October 31st – November 3rd, 2013
http://www.ottawawineandfoodshow.com/

The Great Pumpkin Charity Ball
November 1st, 2013
http://greatpumpkinball.com/

The Help Santa Toy Parade
November 23rd, 2013
http://www.toyparade.org/

Bell Capital Cup
December 28th – January 1st
http://www.oihf.net/

News

A Note from Mandeville Private Client

At Mandeville we search for investment opportunities both within the public and private realm. We provide you with access to such opportunities that are usually reserved for the affluent and institutional investors.

Our goal is to democratize these private investment opportunities for wealth creation, and where appropriate, provide you the same investment techniques used by ultra high net worth and institutional investors.

We are committed to delivering the highest standard of excellence in personalized customer service.

It's your money and you want to ensure it is working for you in a manner that puts you in a customized wealth program that is aligned with the most successful private and institutional investors.

The Spooky Wagon Ride

Cannamore Orchard welcomes you to their 21st year of "The Spooky Wagon Ride".

Friday and Saturday nights are a flat rate of $20.00 per person regardless of age. There are no tickets for individual attractions.
The wagons offer a tour through the orchard and woods, narrated by a Cannamore Witch. The ghouls will thrill you as they present Halloween related scenes, involving witches, flying monsters, body snatchers and more. Rides for the brave run after dark but for the little ones there are weekend afternoon rides. The ride is definitely for those 10 and older but you are the judge!

Your admission to "The Spooky Wagon Ride" also includes the House of Terror, presented by the band students from St. Francis Xavier High School, the Kid's Spooky House, the Spooky Fog Maze and the Spooky Village. The Spooky Village, the only one of its kind in the world, presently has 8 houses and offers a chance for the visitor to interact with vampires, witches, coffin makers and more. Stick around and have your fortune told if you are brave enough to learn what is in store for you. Visit the new jail and feel what it is like to be behind bars! Again this year, Sunday afternoon is Family Day with special activities taking place in the village. These activities are especially for children and take place twice each Sunday afternoon.