LEITH WHEELER INVESTMENT OUTLOOK

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Living With Low Interest Rates

Those that are either in or near retirement remember the days of paying interest charges of close to 20% per year on their mortgages, whereas now as investors they are receiving closer to 2% on their term deposits or t-bills. This dramatic decline in interest rates has coincided with a decline in inflation since the early eighties, which peaked at over 12% per year in 1982 and now sits at around 1.6%. Having seemingly won the fight against inflation, central banks have been content to reduce interest rates to lower and lower levels, and rates in the bond market have followed the same path, falling from 17% on a long term bond in 1982 to 4.3% today. Who would have thought that investors would be quite content to lend money to the government for 30 years at such low interest rates. Line up, they're paying 4% until 2035!

This dramatic fall in interest rates has had an equally dramatic, positive impact on the values of most major asset classes. Let's delve a little into the theory behind this: the going price of any asset is simply the value of the income stream that it generates in the future, looked at in today's dollars by "discounting" at the going interest rate. This provides the link between interest rates and the value of assets…a lower interest rate increases the current value of investment assets, and vice versa. In basic terms, we need to pay a ***higher*** price for an asset today, since it is invested at ***lower*** interest rates in the future, to produce the same income stream. Whether the income stream is rental income from property, dividends from shares or interest payments from a bond – prices generally go up if interest rates go down, all other things being equal. So in the last several decades, owners of stocks, bonds and real estate have generally prospered, via capital gains on their investments. Today however, those gains have to be reinvested at lower rates.

Before we consider the future let's look even further back in history. The environment of the ***prior*** twenty years (i.e. between 1962 and 1982) presented almost a reverse image of the last twenty years, as inflation and interest rates moved up steadily over that time period. Bonds delivered ***negative*** real returns (when taking inflation into consideration) and US stocks weren't much better, providing a measly 2.3% per year real return!

Are we in the 60's again? There are some similarities…price to earnings multiples are roughly where they were 45 years ago, and inflation and interest rates are not that dramatically different. But before you dust off your Woodstock gear, consider the differences. This time around, central banks are vigilant about taming inflation by using interest rates as a lever, while the globalization of trade has had the effect of "exporting low inflation" and keeping costs down for consumers. As well, pension plans are maturing along with the population and their demand for bonds is increasing (this keeps bond prices up and bond rates low). The ageing population and relatively low birth rates will also result in slowing economic growth, with low pressures on inflation and hence little pressure on rising interest rates. In a nutshell, get used to low interest rates.

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What Should An Investor Do In This Environment?

Set Realistic Goals

The large capital gains that have been achieved in the markets over the last twenty years are not likely to be repeated in the next decade. Inflation is low, so inflation adjusted returns in the foreseeable future won't be dramatically out of line with the past, however the nominal amount of return generated by a portfolio will be lower. Plan on reinvesting those historical capital gains at lower levels of return going forward. Recognize that some of the wealth that has been created with those capital gains is not all true wealth, since it is a reflection of lower interest rates and a lower income-producing potential. In other words, a 10% price appreciation on a property you own is only as good as the income it produces in the future.

Control Fees

The investing public still seems content to have mutual funds sold to them with high management fees taken out of their returns each year. With fees averaging in excess of 2.5% per annum for a Canadian Balanced fund, investors are going to be giving up an increasing proportion of their return to fees when faced with the prospects of single-digit returns in the future. Consumers should be more vigilant and should consider the true costs of their investments relative to their returns. Lower fee mutual funds without sales commissions or "loads" are the way of the future. The obvious advantage is saving 1% a year on fees which can translate into a 20% or 30% higher retirement account over time.

Focus on Absolute Returns

Many investment managers are content to run portfolios that look very similar to the overall market. Historically this has been a successful practice because the falling interest rate environment has generally been very good to both the equity and bond markets. However, in a market that will be extremely challenged to deliver the large gains of the past, a manager must have skill as a stock or bond picker, not simply as an index tracker. Actively managed portfolios won't beat the market every quarter or every year, but over longer-term periods the good active managers have added significant value. Studies* have shown that the most successful managers are those that, among other things, build portfolios that are concentrated on a small number of companies rather than simply a large basket of the biggest stocks in the index. This allows the manager to focus on their best investment ideas for delivering **absolute** returns for their clients, with less regard to the gyrations of the market.

Be Open Minded to Alternatives…

Income Trusts are investments that trade like common stocks, but pay out cash at a higher level like preferred shares or bonds. Additionally, they enjoy a corporate structure that allows them to side-step traditional corporate taxes, thereby effectively reducing the tax paid on these distributions. With investors' increasing appetite for income in this era of low interest rates, income trusts have enjoyed explosive growth in the last five years. However, these securities are not all of the same quality, and it is essential that strong fundamental research be applied in selecting appropriate Income Trusts.

…But Be Wary As Well

There are always new products being developed, promoted and sold to capitalize on the current themes in the market. Hedge Funds have enjoyed a surge in popularity due to their common marketing message of delivering positive returns regardless of the direction of the overall market. From our point of view, this strategy is not without risk, as these funds typically use leverage, can be unclear in their investment thesis, and charge high ongoing management fees. As is the case with Income Trusts, not all Hedge Funds are created equal…caveat emptor.

Most Important - Don't Speculate

Low interest rates encourage speculation…investors are more willing to use margin in their brokerage accounts or tap into the equity in their house when borrowing costs are low. This is extremely dangerous when combined with investors' pursuit of high yielding and lower quality investments in the hopes of increasing returns. Resist the urge to play this game.

*D. Finstad, Canadian Investment Review, Spring 2005

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