NORTHWOOD STEPHENS
PRIVATE COUNSEL INC.

Best Independent Family Office in Canada
EUROMONEY Private Banking Survey 2008

THE NORTHWOOD STEPHENS **PERSPECTIVE** SPRING 2008

President's Message

Welcome to the spring edition of the Northwood Stephens Perspective. It has been a long winter – both from the standpoint of the weather and financial markets - and I think it is fair to say that we are all more than ready for Spring!

The last six months have been particularly painful for investors in certain areas of US real estate, asset backed commercial paper and Bear Stearns shares (which dropped from over $100 to $2 before being taken out at $10, all in the space of two weeks!) While it was difficult to find any investment categories that were not affected, investors with a clear long term plan, diversified investments and discipline to 'stay the course' should not feel uncomfortable.

One of the other consequences of volatile and difficult financial markets is the perceived need for comprehensive advice as the world becomes more difficult to navigate alone. Northwood Stephens has had a significant increase in the number of calls from wealthy private clients asking about our family office services and we have added a number of successful families to our client list. Most of these new clients come to us via referrals from existing clients and professional advisors. We are grateful for the confidence and trust you continue to place in us.

A few weeks ago, we held an interesting event for our clients and a few friends of the firm called 'A Conversation about Money & Values – Across the Generations'. It was a fascinating discussion of the values that drive each of us, where they come from and how they help or hinder the communication about money (and many other things) across the generations of a family. At this meeting, our speaker introduced us to a set of 'Value Cards' that can be a great tool to get money conversations started in families.

We used them in our family a year ago and it spawned a discussion about philanthropy which ended up with our children (14 and 17) more actively involved in our family foundation. We hope to encourage many such conversations among the families of our clients and friends.

Enjoy this issue of the Perspective and enjoy the Spring weather.

Tom

Tom McCullough
President and CEO

Photograph courtesy of Frances Juriansz Photography

Expectations Management

Scott Hayman, CA, CFP, EVP and Head of Client Service
Northwood Stephens Private Counsel Inc.

In many things in life, proper expectation management helps lead to better outcomes. Your portfolio is no different. One of the questions we ask of all of our clients is "What is a reasonable rate of return to expect from your portfolio?"

Over the years, the answers have varied but even today, the most popular answer is 10%! When asked why, individuals usually point to long term time horizons and returns in the past. Very seldom do we hear any suggestion that "it depends on the risk you take". Obviously risk and return go hand in hand. Prior to constructing your own portfolio, or having your advisor do so for you, it is key that you have realistic return expectations.

At Northwood we ask a series of initial questions in an effort to understand return expectations and the level of risk an investor is willing to assume. We want to know not only the rate of return an investor expects but also how he/she arrived at this expectation. The unfortunate reality of the financial markets is that risk and return are highly correlated. In an effort to increase return from the portfolio, one must accept additional risk (volatility and chance of loss). Therefore the need for security (reduced risk of loss) in one's portfolio first requires an alignment of return expectations relative to an acceptable risk level.

So what is a reasonable rate of return to expect?

The answer is based on two primary issues:

1. Your goals and objectives
2. The level of risk you are willing to take

Looking at the two traditional asset classes of fixed income and equities in Canada, we see that the average returns over the last 15 years have been 9.7% (Canada long bonds 1992 -2006) and 11.3% respectively, however, recently those returns have changed.

Fixed Income - Over the past few years, fixed income interest rates have fallen to historic lows and are currently offering very little premium for 'going long'. For example, as we write this article, 5 and 10 year Government of Canada bonds are yielding approximately 3.2% and 3.7%. However, by adding a mix of high quality corporate bonds into portfolio, we could boost the yield to at least 4% (high quality laddered bond portfolio purchased today and held to maturity). Although some might argue that we are at a period of historical lows and rates will rebound, we haven't seen evidence of this over the past 5 years, therefore this is the conservative starting point we must use when setting expectations from this asset class.

Equities - We then turn to the equity side of the portfolio where it is much more difficult to predict returns. Over the short term, equities as an asset class can be very volatile as we've seen over the past year.

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However, over the long term equities have historically outperformed the bond markets, compensating for the additional level of risk assumed by shareholders. The historical returns of domestic equity markets over the past 50 years have tended to gravitate to an average of approximately 10%. When breaking the last 50 years into five 10 year time periods (ending in 2006), returns for these shorter 10 year time periods have ranged from 6% to 16%. Many economists predict we are heading into a period of more conservative equities returns, an 8% estimate for this asset class allows us to be a little more cautious in our assumptions.

Using the two assumptions we determined for rates of return (current 4% fixed income yield and 8% equity returns), and based on an evenly balanced portfolio of 50% fixed income and 50% equities, an investor can therefore reasonably expect a return of 6%. If you reduce the fixed income exposure (therefore increase risk) we can boost the return expectations to 7%.

So are single digit returns in line with your expectations? While good managers can often beat the market, planning should be as realistic and conservative as possible. The next time you review your financial plan, be realistic in your planning and be careful not to try and convince yourself that you will "beat the market". The key is to have realistic expectations and review your assumptions often. If your advisor does not talk about these two things, it may be time to talk to them.

Money and Values Across the Generations

Bryan O'Neill, CA
Northwood Stephens Private Counsel Inc.

The next decade is likely to see the largest intergenerational transfer of wealth in history. At the same time, many affluent families are anxious about how inheritances may affect their children and how to best prepare their children for this inevitable transfer of wealth.

On April 8th Northwood Stephens, along with the Richard Ivey School of Business, had the pleasure of hosting an intimate evening titled 'A Conversation about Money and Value – Across the Generations'. Our speaker was Sharna Goldseker, Vice-President of the Andrea and Charles Bronfman Philanthropies in New York City, where she manages the 21/64 initiative which specializes in multi-generational values discussion.

The evening was structured as an interactive discussion with the goal of providing the tools necessary to begin a family conversation about money and values. In particular, the focus of the discussion was on understanding how the events and conditions of each generation helped to shape their views of the world and how this impacted a family discussion about money.

Sharna illustrated these generational differences through an exercise that had everyone individually rank 25 motivational values (i.e. compassion, family, recognition …) that drive our own decision-making process. In the discussion that followed it became clear that early life experiences directly impact the values that an individual holds high on their list. For instance, those that had experienced the Great Depression chose family and responsibility at the top of their list, while the youngest in the crowd, that were influenced by the age of information, typically selected values such as freedom and pleasure.

The evening provided great insight into understanding why different generations hold different views and beliefs closely and how this understanding is key to any family discussion that spans across multiple generations.

We would like to thank Sharna for a very informative and eye opening evening and the Richard Ivey School of Business for co-hosting the event.

Guest Column: Volatility, Risk, and Valuation

Evans Investment Counsel

At Northwood, we read a wide range of articles on investments and markets every month. This one is a summary of comments from the quarterly letter of Evans Investment Counsel, a Toronto based investment manager used by some of our clients. We thought their comments were particularly apt for this stage in the investment cycle.

One of the general principles underlying any investment – be it in stocks, bonds, real estate, etc. – is that in exchange for taking on more risk the investor should be compensated with more reward. The two elements of risk and reward go hand-in-hand, and as investors we all start out with a general understanding of this relationship. As Warren Buffet explained, however, the difference between having an understanding of investing and actually being invested with your own money is like "reading a romance novel and doing something else." People seldom truly grasp what the risk/reward trade-off means until our portfolio takes a downturn and the risk component of the equation becomes palpable.

We would suggest that now is as good a time as any to take an honest look at your risk/reward tolerance. We are taking the opportunity in this letter to provide you with a bit more perspective on how we approach investing. Having an informed understanding of risks and rewards can often provide the necessary resilience to weather and prosper from the inevitable rough patches. Our long-term track record shows we have had success evaluating risk and reward. That is of little comfort if we cannot help you stay the course through the stressful times. If you are still tempted to throw in the towel at the first sign of a downturn in stocks then you probably have too much of your portfolio in equities and not enough in cash and bonds.

Richard Pzena, a well-respected value manager, gave a presentation titled "Surviving the Cycles of Investing" at the Columbia Investment Management Conference on February 1st. He presented the chart on the following page which highlights the drops that value stocks inevitably experience. Despite the overall positive returns over the last 40 years, investors in this strategy experienced eight periods where they were down at least 20% from their recent highs.

"So given that, what do you do? Well, my solution – because I haven't yet figured out how to avoid those -20% periods in my career – is to promise them to my clients. I tell them, 'This is going to happen. And if you don't like it, we're not the right people for you. You should try to find someone who you think might be able to predict the sentiment changes.'" – Richard Pzena

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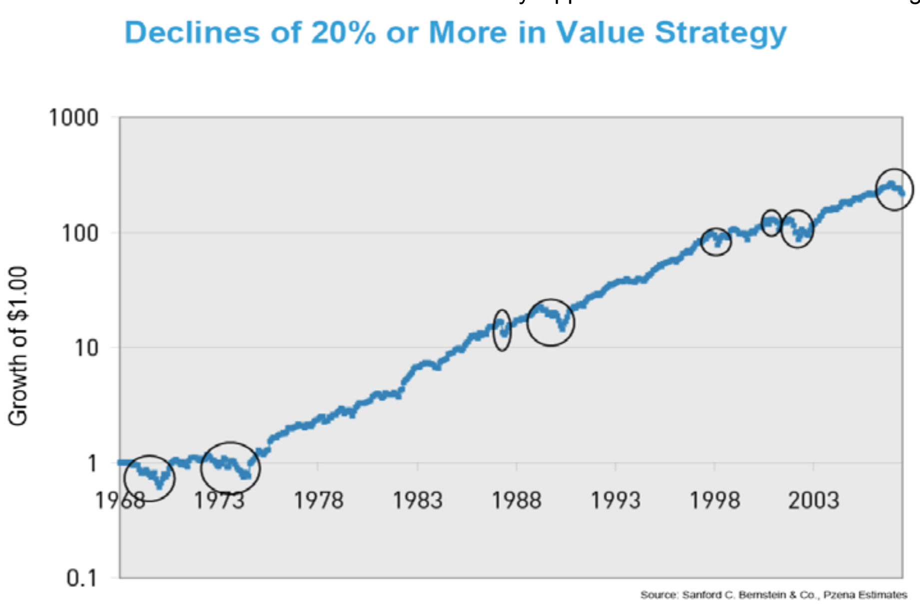
We can never tell with any certainty when conditions will change, so we cannot rely on changing the asset mix to capture the upside return while avoiding the downside risk. In this respect human nature can be cruel to investors. Rising share prices can be exciting and incite the urge to buy, while falling stocks are naturally disheartening often leading to capitulation at the worst time. The emotional strains of a volatile market lead many people to buy high and sell low, a sure recipe for poor returns. Attempting to time the market is notorious for being a loser's game. Instead we must consider how our portfolio mix will likely fair through both good times and bad.

National Bank Financial recently wrote a report titled "Equities: Time to jump back in?" The report noted the difficulty in predicting a market bottom, as well as the importance of being invested when it is finally reached:

"In seven U.S. recessions since 1960, the S&P 500 has lost an average 20.5% from onset of recession to ensuing market trough. ...The rebound, when it comes, is typically very steep – for the S&P 500, an average gain of 17.5% after three months, 28.4% after six months and 36.0% after nine months."
– NBF Vision March 2008, pg. 22



The numbers in the comment above suggest that a significant portion of missed opportunities come in the first few months after a trough. If you want to achieve the gains, you must understand and be willing to accept the volatility.

The standard definition of risk in investing has to do with the volatility of share prices, that is, the frequency and magnitude to which share prices fluctuate. When we consider the merits of investing in a particular stock we give little regard to its volatility as this tends to pose relatively little actual risk to us over our long time horizon. We are more concerned with how the business behaves than how the shares behave. Consider this:

When you are the sole owner of a private business, the monetary value of your business can generally be seen to come from two things: 1) the assets your business owns (land, machinery, inventory, patents, etc.); and 2) the "free cash flow" that can be generated from those assets over the years – that is the cash earnings of the business, after paying for the up-keep of the assets.

As the sole owner of a privately held company your biggest risks come from a permanent loss of capital, either through asset impairment (machinery wears out, inventory becomes obsolete, patents expire, etc.) or lower free cash flow (from increased competition, investments in unproductive assets, etc.).

As value investors we approach buying a fractional ownership of a publicly traded business (as is the case when you buy shares) the same way we would approach buying the entire business. Our job is to determine a reasonable valuation for a company given its assets, free cash flow, and its prospects for deriving value from these in the future. This valuation, by its very nature, contains some estimation and subjectivity. To compensate for the inherent limitations in our methodology we only buy shares of a company when the price we pay is sufficiently less than the value we expect to receive, taking into account our timeframe, the nature of the risks a company faces, and the likelihood those risks will arise. At no point thus far has volatility entered into the equation.

Once we have determined the price we are willing to pay for a company the only way we can buy shares at an attractive price is if someone else is willing to sell theirs at that price. Naturally we ask ourselves why someone would be willing to sell their shares to us at what we consider to be cheap prices. Likely reasons for selling at depressed prices could include: a different time horizon (they want the money right now); they cannot handle the volatility of the share prices (share prices tend to fluctuate much more than the value of the underlying business which can be unnerving if your shares are down); or because they estimate a different value for the shares than we do. We can never know for sure why someone is selling their shares. What we do know for sure is that the first two reasons provide us with easy opportunities. Meanwhile our long-term track record gives us some comfort that our valuation methodology is reasonably robust to handle the third. It is here that volatility is our friend.

"In the short run, the market is a voting machine, but in the long run it is a weighing machine." – Benjamin Graham

Perhaps the most difficult part of being a value investor is having the patience to see your results through. The same forces that push share prices to levels attractive enough for us to buy can push them to even more attractive levels shortly after we have bought them. That is to say we seldom, if ever, buy stocks at the very bottom – they quite frequently fall shortly after we have bought them. On the other hand, stocks that we sell at what we consider to be fair-to-overvalued levels quite often run up higher in the short term. We seldom, if ever, sell stocks at the very top. It is invariably frustrating to have the market price go against our assessment of value. The market gives us a price (whether we want it or not) but our patience is usually rewarded as time has a way of working these things out.

We hope this has provided a clearer understanding of how we view risk and reward, price and value. The framework we use for evaluating investment opportunities often presents us with a view that is different from what we read, see, and perhaps most importantly, feel. Challenging markets can often be appreciated for the attractive opportunities they may be presenting to disciplined and patient value investor.

Guest Column: Florida Real Estate Opportunities - What Canadians Need to Know

Leslie R. Kellogg, Partner
Hodgson Russ LLP

The strong Canadian dollar, coupled with the subprime mortgage crisis in the United States, has created new economic opportunities for Canadians interested in making an investment in Florida real estate. The benefits of being able to escape to a warmer climate during the winter months are certainly notable as well. But before you sign on the dotted line, there are a number of U.S. tax considerations that should be considered.

If a Canadian citizen/resident owns US real property at his or her death, that property is "US situs" property and thus potentially subject to US estate tax (on the full value of the property, and at rates up to 45% in 2008). Under the Internal Revenue Code, the estate of a non resident, non citizen (NRA) of the US is allowed a "unified credit" that exempts only $60,000 (USD) of US situs property from US estate tax. Under the Canada-US tax treaty, however, a Canadian's estate qualifies for a potentially greater exemption (the "prorated exemption"), based on the following formula:

$$\text{2008 tax exemption allowable to a US citizen (Currently \$2MM)} \times \frac{\text{Value of US situs assets}}{\text{Value of Worldwide estate}}$$

The Treaty also allows a marital exemption equal to the prorated exemption. Therefore, if a Canadian citizen dies owning U.S.-situs assets and leaves them to his or her spouse in a manner that would qualify for the US marital deduction if the surviving spouse were a US citizen, the exemption amount is effectively doubled. There also is a mechanism under the Treaty for crediting the US estate tax against the Canadian gains tax imposed at death. As in Canada, the US endeavors to defer taxation until the surviving spouse's death.

In some cases, planning for use of the Treaty prorated exemption and marital exemption can alleviate most or all of the US estate tax exposure at the owner's death. However, that usually requires drafting a new Will to create a testamentary trust for the surviving spouse that holds the property after the owner dies, to keep the property from estate tax at the second death. In other cases, however, a couple's assets are so significant that the potential exemption amounts are not sufficient to protect against US estate tax exposure.

Assume, for example, that Mr. and Mrs. Smith are both Canadian citizens and residents. Mr. Smith dies owning a house in Florida worth US$1 million, his only US-situs asset. His worldwide estate totals US$10 million. His Will leaves his assets outright to Mrs. Smith. Mr. Smith's prorated exemption under the Treaty allows $200,000 of assets to pass free of estate tax calculated as follows:

$$\underset{\text{(2008 tax exemption for a US citizen)}}{\$2{,}000{,}000} \times \frac{\$1{,}000{,}000 \text{ (Mr. Smith's US-situs assets)}}{\$10{,}000{,}000 \text{ (Mr. Smith's worldwide estate)}}$$

Even though Mr. Smith's exemption can be doubled to $400,000 by virtue of the treaty's marital exemption, $600,000 of his US property remains exposed to US estate tax. Furthermore, if Mrs. Smith owns all or a portion of the property at her death, it is likely to attract US estate tax again in her estate.

US estate tax exposure in both Mr. Smith's and Mrs. Smith's estates may be avoided through the proper use of a residence trust. A residence trust can be used in many situations, but it works most effectively for a married couple. The structure avoids the inclusion of the US real property in either spouse's estate for US estate tax purposes if specific requirements are met.

With the residence trust approach, one spouse would be the settlor/grantor of the trust and contribute all the funds towards the purchase of the property. The trust would be for the benefit of the grantor's spouse and descendants, and the trust would acquire the property. The trust agreement generally would provide that (1) the beneficiary spouse is the trustee (the grantor spouse can not be the trustee), (2) the beneficiary spouse and descendants have lifetime rent-free use of the property, and (3) distributions from the trust can be made to the beneficiaries subject to an ascertainable standard. The property needs to be purchased by the residence trust at the outset, and cannot be transferred to such a trust thereafter without raising US income, gift and (other) estate tax issues.

The residence trust also has significant US income tax advantages as it potentially allows the long term capital gains rate (applicable to property held for more than one year) to be available on a sale. This rate is presently 15% federally, whereas the ordinary income and short term capital gains rates for individuals are at a maximum rate of 35% federally. Ownership of US real property by a corporation, for example, does not permit use of a lower capital gains rate on a sale of the property - instead, the regular corporate rate (34% federal) applies. In Florida, there is also a state income tax for corporations but not individuals. Therefore, there is a significant tax rate differential on a sale of capital gain property by an individual (15%, federal only) as opposed to a corporation (about 40%, federal and state). The residence trust also has creditor protection benefits.

There are certain disadvantages with the residence trust approach in the event of divorce or if the beneficiary spouse dies before the grantor spouse. These disadvantages can be minimized with proper drafting of the trust agreement.

If the property is going to be rented to third parties, a limited partnership should be considered in conjunction with the residence trust approach to give the owners additional liability protection.

The Florida real estate market welcomes you with open arms and with appropriate planning you can keep your US tax and liability exposure to a minimum.