WINTER 2010

NORTHWOOD FAMILY OFFICE

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The Northwood PERSPECTIVE

President's Message

Tom McCullough

Happy New Year to all our clients, colleagues, and friends.

A few months ago, I heard Michael Porter speak. He is a leading authority on competitive strategy and the author of 17 books. At this stage in his career, he spends a lot of time helping to solve some of the world's seemingly intractable issues, including poverty, the environment and health care delivery, by bringing new approaches to old problems. I thought his lecture on Value-Based Health Care Delivery was particularly interesting, and it reminded me of why family offices were created and how we serve families here at Northwood.

His thesis is "today, 21st century medical technology is delivered with 19th century organization structures, management practices, and pricing models" and to achieve any significant improvement, the system will require fundamental restructuring.

Porter suggests that health care delivery today is based primarily on the specialties of the medical staff and not on the patient medical circumstances, as should be the case. For instance, a chronic headache sufferer may have to check out a number of separate specialists/ providers to try to find a diagnosis (and hopefully a solution) to their problem. The list might include the primary care physician, imaging centers, physical therapists, detox centers, psychologists, and neurologists, each of whom may only see a chronic headache sufferer once or twice a week within their broad caseload of diverse diseases and conditions. On top of that, the patient often needs to integrate the disparate information and advice they receive, and to advocate for themselves along the way.

That sounds a lot like the financial services industry. A high net worth family has to go to many different specialists (investment, tax, insurance, legal) in an attempt to get all their financial issues properly addressed.

Porter points to the West German Headache Center as an example of a better way to deliver health care. It specializes in the specific condition the patient is facing and starts from the perspective of the sufferer. It involves multiple specialties and services all working together and all focused on the issue of headaches. It also addresses the most common co-occurring conditions and works to solve them in a holistic, patient-oriented manner.

In the same way, a family office focuses *only* on serving wealthy families and the unique issues they face, and it draws on multiple specialists to solve problems and accomplish objectives in an integrated, sensible, client-oriented way. An interesting similarity, I thought.

We wish you both wealth and health in the New Year and beyond.

A Decade of Extremes:

A look back at the 2000s and the lessons to be learned

Tom McCullough

The new millennium started with great promise. The world was mostly at peace, the economy was strong, the stock market was on a roll and the novel internet phenomenon pointed to a 'New Economy' with unlimited possibilities. Even the worrisome cloud of Y2K cleared quickly when, a few days into the year 2000, almost no serious computer crashes were reported.

Has it really been ten years since Y2K?

Given that auspicious beginning, few would have predicted the events that have now labeled the first ten years of the 2000s as 'The Lost Decade', 'The Naughty Aughties' or 'The Bubble Decade'.

While every era has its problems, the 00s had some doozies. Remember these?

- Dot com bubble (2000)
- Bear market (2001)
- Bush/Gore cliffhanger election (2000)
- Enron (2001)
- 9/11 (2001)
- War on terror (2001)
- Al Qaeda
- War in Afghanistan (2001)
- Worldcom (2002)
- Dafur (2003)
- SARS (2003)
- War in Iraq (2003)
- Thailand tsunami (2004)
- Hurricane Katrina (2005)
- Widening global income and consumption gap (2005)
- Global warming
- UBS tax fraud charges (2007)
- Oil spike/plunge (2008)
- Madoff (2008)
- Housing bubble (2008)
- Credit crisis (2008)
- Global financial meltdown (2008)
- Banking crisis (2008)
- TARP/ U.S. government deficits (2008)
- H1N1 (2009)
- Worst decade ever in stocks (2009)

Of course there have also been positives over the past ten years, including the election of Barack Obama, the first black U.S. President, the rise of mega-philanthropists like Gates and Buffett, the reduction of global poverty, mapping of the human genome, and the huge advances in technology, including the spread of internet access to much of the world. It was also the decade that brought us social networking, reality TV and (the popularization of) hedge funds. I'll leave it to you to decide into which category (positive or negative) they fall!

In my reflection on the past ten years, the moniker of the decade past that most resonates with me is the 'Decade of Extremes' as the world lurched from triumph to disaster and back, several times over. For instance, we witnessed the extraordinary overnight wealth creation of the dot com entrepreneurs in the boom (and then bust) of the internet bubble, only to be followed seven years later by another bubble. The

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frenzied housing, credit and financial engineering boom caused a tidal wave, which then, inevitably, swamped (and drowned) some of the biggest and most prestigious banks and financial institutions in its path, not to mention putting a quarter of all mortgages in the U.S. underwater!

At the turn of a decade, it seems like a reasonable time to ask ourselves what lessons investors, families and advisors might draw from the past ten years.

The extremes of the decade can also be seen from a global equality standpoint. The world (until the financial crisis) had never been so prosperous and the philanthropic dollars never so large, and yet 80% of humanity still lives on less than $10 a day. And we can't forget the extreme reversal of national fortunes that left the U.S. limping out of the end of the decade and the BRIC countries (particularly China) on a torrid growth track. We also saw extreme reversals in confidence. Before news of his $50 billion Ponzi scheme broke, Bernie Madoff had been the chair of NASDAQ, a respected industry pioneer, and a trusted advisor to the world's wealthiest investors.

Even the new terrorist style of war against the West appears bent on finding the most extreme ways of getting attention and furthering their aims, as perhaps does the entertainment industry, along with its consumers! And to top it all off, the decade managed to produce two dramatic new peaks in stocks, yet the worst total return in the equities markets in almost 200 years of American stock market history (-0.8% average p.a.).

Of course the obvious question is what is ahead for us in the next decade? While I agree with Danish Nobel prize-winner Niels Bohr that "prediction is very difficult, especially if it is about the future", there are four big themes that seem likely to play a significant role in shaping our future. They include the economic and fiscal fallout of the global credit crisis, the shift of North American baby boomers into the retirement phase of their lives, the continuing trend toward globalization, and the massive reshuffling of global politics, including the decline of America and the rise of China. (More about this in our white paper 'Lessons from the Lost Decade'.)

However, at the turn of a decade, it seems like a reasonable time to ask ourselves what lessons investors, families and advisors might draw from the past ten years. Here are three that resonate with me.

1. There is no free lunch

In today's world, especially with the free flow of information, there is no free lunch, no hidden idea available for the plucking, no hot investment that will make our dreams come true. Yet somehow, people still want to believe there is and that they can find it.

The average return from the stock market over the past 100 or so years has been about 9-10% -- about half from capital gains and half from dividends. This makes sense based on the drivers or the stock market -- growth of the economy and corporate profits, productivity gains, and inflation.

And after the strong returns from the 1980s and then the 1990s (which was the *best* calendar decade in history at a 17.6% per annum

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Perpetual Guaranteed Return

Scott Hayman, CA, CFP

There are at least two ways to grow your net worth. The first is to increase the asset value and/ or income from your investments. The other is to shrink the outflow (eg. spending, taxes, fees etc.) that would otherwise reduce your overall wealth. Of course both methods can be good, and, in a certain way, both tactics can be expressed as a 'rate of return' on your baseline amount of wealth.

If you choose the former (*increasing the return/ inflow* from your investments), you typically have to take on additional risk. For instance, stocks can return more than bonds over a long period of time, but they are more volatile and you are not guaranteed to get your principal back at the maturity date.

On the other hand, if you choose to increase your rate of return by reducing *outflows*, it does not necessarily require the same boost in risk. In fact, it can carry no risk at all. If you are able to trim your personal expenses or reduce your tax burden, the money you save all drops to the bottom line and can be thought of as 'additional' return, without any attendant increase in volatility. And, in the case of tax rate reductions, the benefits repeat every single year. As such, we like to describe this method as a 'perpetual, guaranteed, risk-free return'.

So, for many families, it is possible (and beneficial) to develop appropriate (and legal) 'asset structuring' strategies to reduce tax payable, in conjunction with a well thought-out investment policy. When properly conceived, implemented and managed, these tax strategies can save thousands of dollars.

Here is an example. Let's assume that an investor has $3,000,000 of liquid investments in his own name and is taxable at the top marginal rate. His wife stays at home with their three young children and has no income. Let's assume the total return he could expect from his overall portfolio is 6% ($180,000 on $3,000,000). Let's assume tax is paid every year, for ease of calculation.

By simply setting up a trust, with his wife and children (and possibly even himself) as beneficiaries, and then loaning the funds into the trust at the 'prescribed rate' of interest (currently the lowest it has ever been at 1%), the investor can split income among his family members. The result would be a tax savings of approximately $45,000 and translates into the equivalent of a 7.3% pre-tax return vs. the 6.0% he would have achieved prior to initiating this basic planning. That is the equivalent of an extra 1.3% pre-tax 'return' on his portfolio – not just this year, but every year – with no additional risk taken in the investments to achieve that extra return. Any money manager would be happy to get a 1.3% extra perpetual, guaranteed, no-risk return.

This strategy may be applicable for many families, particularly in this low interest rate environment. Make sure you work with a tax advisor to ensure the trust is properly set up and administered.

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return), it is not surprising that returns would revert to below-average in the decade that followed. In our Summer 2008 newsletter (available on our website www.northwoodfamilyoffice.com/re_perspectivenewsletter.asp), we published a segment from Warren Buffet's annual report that provides an excellent perspective on long term returns. He found it difficult to expect much more than a 7% p.a. return from the broad equity markets over the long term.

No matter how the market is performing, it is also important to remember that any promise of extraordinary returns, significantly above the general market, often entails much higher risk. Unfortunately, because the investment/brokerage industry is still basically a sales-driven industry and because investors are ever-hopeful, those risks are commonly downplayed and/or discounted, leading to inevitable disappointment, frustration and mistrust.

I remember seeing an ad in the Globe & Mail (in the Spring of 2008) by a well-known investment firm quoting a (historical) return of over 100% on one of their funds and, I assume, inferring that new investors would be similarly well-served. Not surprisingly, as markets fell later that year, that particular fund fell 60-70% in value. The manager no longer publishes investment performance ads for that fund in the Globe & Mail.

Just to be clear, we do believe that thoughtful, proactive management can add value to investment portfolios (-- we have experienced that first-hand with investment managers who manage our clients' funds). But it is not a good idea to trust someone who promises a consistently above-average return without stressing the (potentially significant) additional risk or reduced liquidity. And it is an even worse idea to count on those above-average returns in calculating how you plan to fund your income needs or future objectives.

And with the modest contribution to portfolio returns from bonds in the current environment (and the virtual certainty that they will generate lower capital gains that they did in the last 30 years as interests rates fell), it is doubly important that investors use all the tools at their disposal to get the most out of their portfolio. This includes a focus on proper diversification (see below), careful selection of complementary tax-aware investment managers, saving on taxes and fees, where possible, and a reasonably accurate estimate (perhaps even adjustment) of spending plans, as needed.

2. *Diversification* does *work*

It has been frustrating to read the financial press over the past year as they have dissected and analyzed the entrails of the 2008 crash. Most have argued that 'diversification didn't work' as they watched domestic and international stock markets fall almost in unison and many 'absolute return' funds, designed to produce consistent, modest positive returns, actually produce large losses.

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A Lasting Legacy: The Importance of Updating Your Estate Plan

Eric Weir, CFA, CFP

In our busy lives, it's easy to put off updating and reviewing our estate plans. But the time we take to make sure our wishes are properly documented could be one of the best gifts we leave to our family and friends. There are many parts to a well-developed estate plan, but regularly reviewing and updating the two main components—your will and beneficiary designations—can protect your net worth and create a lasting legacy.

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Many of our clients come to us with wills that are out of date and don't properly reflect their wishes. It is generally recommended that you review your will:

- at least every two years,
- any time a significant event has taken place in your life, and/or
- when there have been changes to applicable laws and tax regulations.

Examples of significant events in your life that could impact your will can range from the sale of a business, a marriage in the family, the birth of children or grandchildren, or the death of a current beneficiary of your estate.

When it comes to updating your will, there are two basic choices, and professional assistance is recommended for both: (i) you can prepare and properly execute a new will that revokes the earlier will, or (ii) you can prepare and properly execute a codicil to the will. A codicil is a separate document that adds to and/or replaces one or more provisions in an existing will. Although your intentions may be good, writing in the margins, or crossing out words, lines, or sections of the original will invites confusion, potential ambiguity, and the possibility of unpleasant and protracted will contests.

Ensuring your wishes are properly reflected in your will is often only one part of your estate strategy. Large portions of your estate may also be held in assets such as life insurance policies, RRSP's or RRIF's which can be distributed outside of your will. Canadian tax laws allow some assets to flow directly through to beneficiaries named in the policies and accounts, thus avoiding probate and deferring taxes. If instead, the estate is named as the beneficiary of such assets, your estate might be faced with an otherwise avoidable tax and/or probate payment. When updating your estate plan, it is important to review the beneficiaries of all of your assets that will be distributed outside your will.

As you start the New Year, it is worth taking the time to ensure your wishes and desires are captured in your will and asset beneficiary designations. These are two important pieces of an up-to-date estate plan, but there are also a variety of other factors to consider to ensure you have a comprehensive and effective plan in place. These will be discussed in future newsletters.

Leaving an up-to-date and well-documented estate can ensure a lasting legacy for generations to come while ensuring your wishes are carried out in the manner you desire.

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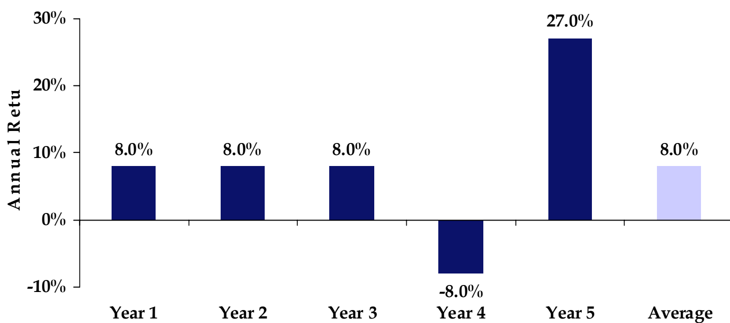
But asset diversification, faithfully applied, did work. High quality bonds in 2008 and early 2009 actually went up in price, while stocks fell. And over the last decade, a portfolio comprised of all equities[1] returned 0.76% per year while a portfolio of half bonds and half equities[2] produced a return of 3.71% per year – not exciting, but not a disaster either. The addition of a downside protection-oriented equity manager, some appropriate international, private equity and real estate diversification, and a tax-saving strategy or two, can help make a difficult period positively bearable.

And as Warren Buffet is fond of saying "There are two rules of investing. Rule #1: Don't lose money. Rule #2: Never forget Rule #1." For instance, in the graph below, an investor has an 8% p.a. five-year objective and achieves it in each of the first three years, but loses 8% in year four. Unfortunately, she has to earn a whopping 27% in year five to meet her plan. Knowing that can cause her to take inappropriately high risk to try to get back on plan, or alternatively she will have to reduce her objectives (eg. spending) to match her



(lower) ending capital amount.

3. You need to know where you are headed

While it sounds simple, I think it is fair to say that 90% of private investors invest without knowing specifically what their objectives are. And to quote the New York Yankees catcher and accidental philosopher Yogi Berra: "You've got to be very careful if you don't know where you're going, because you might not get there."

Most investors can not accurately answer the question 'What rate of return do you need on your investments to be sure that all your objectives will be met?' Instead they succumb to the urgings of the financial press and investment industry to chase 'the best return' and to 'beat the market'– which can work for a while but, rarely does long term.

It can seem daunting to figure out and quantify your objectives and then build a portfolio to achieve them. Here's the way we think about it.

When it comes right down to it, there are only two things you can do with money. You can spend it or you can give it away.

When it comes right down to it, there are only two things you can do with money. You can *spend it* or you can *give it away*. (Of course you can save it too, but that is just deferring the ultimate decision to spend it yourself or give it away.) All of our client families have more assets than they plan to spend in their lifetime, as do many readers of this publication.

Once you understand your two sets of self-imposed 'liabilities' or commitments – *lifetime* spending and *legacy* funding – you then set up your assets (eg. investment portfolio) to match or meet these liabilities.

The *lifetime* liability is, for the most part, fixed, in the sense that you don't want to have to worry about the money being available each month/ year when you need it or being enough to meet all of your spending needs over your lifetime. So that particular liability should be matched with assets that are safe (or perhaps even guaranteed) and that provide some level of income. This could include bonds (including inflation-protected real return bonds) and possibly some high-quality dividend paying shares.

The *legacy* liability – the money you plan to leave to your spouse, children, charities etc. – is only needed when you die. This liability is likely to occur a number of years into the future and you may not need all of the ultimate bequest/ inheritance to be a fixed amount. So there is time available, both for investments to compound, and for any investment mispricing and missteps to be corrected. This liability could be funded with public or private equities, real estate and insurance, for instance.

In this way, a portfolio can be well-diversified overall, but each asset class is used to meet a specific liability category. And it also allows you to live your life without worrying about short term market movements (even big ones) and their effect on your lifestyle.

The beauty of this approach is that it can serve you well in *any* decade!

1 For a portfolio comprised of 50% S&P/TSX Index and 50% S&P500 Index (Canadian dollar adjusted) for the period January 1, 2000 to December 31, 2009
2 For a portfolio comprised of 25% S&P/TSX Index, 25% S&P500 Index (Canadian dollar adjusted), and 50% overall DEX Universe Bond Index for the period January 1, 2000 to December 31, 2009

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