NORTHWOOD FAMILY OFFICE

ALSO IN THIS ISSUE:

THE NORTHWOOD PERSPECTIVE

President's Message

Tom McCullough

How many New Year's resolutions have we all made over the years and then not kept? It can be frustrating and discouraging. On the other hand, goals can be good for us, and giving up on the whole idea seems…well… like giving up. In a recent blog post, Charles Green (trustedadvisor.com) suggests another approach. Replace the New Year's resolution list with the New Year's **gratitude list**.

Being grateful for what you already have can be a better starting place for self-improvement than personal dissatisfaction. "It turns your aspirations from negative (fixing a bad situation) to positive (making a fine situation even better)." And gratitude usually focuses our attention outwards, and not just on our own issues. Grateful people are usually more optimistic, and optimistic people do better in life.

Why not try making a list of the things you are grateful for as you move into 2011 and what you'd like to see more of.

We hope you enjoy this issue (our 19th!) of the Northwood *Perspective*. There are a number of interesting articles focused on a range of issues that wealthy families are facing.

I wanted to draw your attention to one item in particular. Since the founding of Northwood Family Office in 2003, we have had so many people ask if they could be allowed access to our exclusive investment management program, even if they didn't have the $10 million family net worth required to be eligible for our full family office service. Unfortunately we have had to say no.

Happily, we have now made some changes that allow us to offer our investment management program to clients with portfolios starting at just $3 million, through our investment management affiliate, Northwood Private Counsel. Interested clients will receive:

- An initial investment and cash flow planning report;
- Access to our successful investment management program and our top-tier investment managers; and
- Quarterly consolidated investment statements.

They will also benefit from the pricing advantages that come from the buying power of one of Canada's leading family office groups.

If you are interested, please give me a call. All the best in 2011.

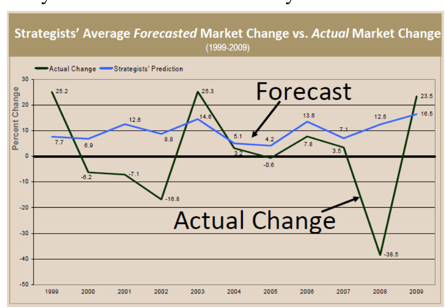
Tom

Don't Miss the Low-Hanging Fruit

Scott Hayman, CA, CFP

"Investors are hopeless at forecasting, yet it remains at the heart of the investment process." - *James Montier, GMO*

When you think about it, it really is crazy! There is an entire industry dedicated to trying to pick the best asset class, the best fund, and the best stock. And most of the evidence racked up so far proves that they can't do it consistently.



In a recent speech to the National Association of Financial Planners, Chris Davis of Davis Advisors showed a graph that clearly demonstrates how investment strategists' stock market predictions are far off the mark.

How good are they at choosing top-notch managers? In an excellent white paper, Greg Curtis at Greycourt (who actually is in the business of trying to identify top-performing managers) quotes a now-famous Vanguard study of 10 year investment fund returns. Of the 3,724 US large cap stock managers in the Morningstar mutual fund database, only 500 had a ten-year track record (i.e. the others were closed or merged), only 98 outperformed on a pre-tax basis, only 79 outperformed on a pre-tax, risk-adjusted basis, and only 40 (forty!) outperformed on an after-tax, risk-adjusted basis. Greg rightly suggests that finding these 'needles in the proverbial haystack' is a difficult task. Greg's firm believes it *can* be done. Vanguard *doesn't* (and sells index funds).

We also employ active managers in our clients' portfolios and work hard to find managers that do better than their benchmark (mostly by protecting capital in downturns). And I'm happy to say we have been successful in finding outperforming managers. But the gains relative to the index are hard-won and no one can ever guarantee that they will persist at the same level of success.

Given that forecasting is so difficult and yields such uneven success, why do investment firms spend so much time on it and why do the media spend so much time reporting on it?

Good question. Money managers can be convincing. And behavioural scientists say that investors tend toward overconfidence and believe they can beat the averages, despite the evidence.

CONTINUED FROM PAGE ONE…DON'T MISS THE LOW-HANGING FRUIT

There is a better way. I believe the whole issue needs to be turned on its head. The investment industry (and investors) should spend less time forecasting and reaching for higher returns (-- the stock market is a fair-weather friend). Instead, we should reallocate some of our time and resources to identifying and capturing the 'low-hanging fruit' that offers a more certain result. Let me explain.

low–hang ing fruit / ˈlō ˌhaNGiNG ˈfroōt /
n. **easily obtained gains; what can be obtained by readily available means**

We have to start with a fundamental definition of success which, in my view, it is quite simple – meeting investor objectives. These objectives include funding lifestyle expenses, purchasing a vacation home, and leaving a substantial legacy. Outperforming a benchmark in a particular year, then, becomes a 'nice to have' whereas meeting objectives is a 'need to have'.

Don't get me wrong. I actually believe in the ability to find above-average managers. We've done it. And it matters. But I believe it is also worthwhile to focus on things that are easier to control and more certain.

Here are five examples of the kind of low-hanging fruit I am referring to and why it merits the attention of wealth holders, in addition to enhancing investment returns:

1. **Setting realistic goals.** Investors who know their specific financial objectives are less inclined to overreach beyond their risk capacity and more inclined to protect capital, which is the most important factor in meeting investment objectives.
2. **Matching assets to liabilities.** If you match your 'must-have' objectives to low-risk assets, and longer-term 'wish-list' objectives to higher-return (higher-risk) assets, you increase your odds of success.
3. **Compounding and dividend reinvestment.** Albert Einstein famously posited that "the most powerful force in the universe is compound interest". This simple technique, along with its cousin 'dividend reinvestment', is a powerful and fully-controllable way wealth holders can boost the probability of growing their wealth over the long term.
4. **Tax management.** A tax dollar saved is a dollar in your pocket. Prudent tax management, including income splitting and tax-aware investing, can create additional 'return' in a portfolio, with no additional risk. In a low return environment, this can help a lot.
5. **Expense management.** Just like tax savings, expense savings also drop right to your bottom line. Finding ways to reduce your costs, through pooled purchasing power and segregated management (vs. most funds), can also provide tangible benefits.

It is worthwhile to find the things that *matter* in meeting family financial objectives. That way we can control and focus on them. It makes sense to start with the low-hanging fruit before pulling out the ladder to go for the potentially juicy investment returns at the top of the tree.

An Update on the U.S. Income and Estate Tax Legislation

Barrett Lyons, CA

On December 17, 2010, after much debate and drama in U.S. Congress and with only 14 days until the expiration of the current tax rate regime, President Obama signed legislation to extend the 'Bush-Era' income tax rates and boost the estate tax exemption until December 31, 2012.

Income Tax Highlights

The highest marginal tax rates on employment income will continue to be 35% at the federal level. Capital gains and qualified dividends will continue to be taxed at a maximum rate of 15%. Additional measures were passed into legislation including dozens of temporary business and individual tax incentives.

Estate Tax Highlights

There were significant changes to the estate tax rules, the major one being an increase of the estate tax exemption to $5 million per spouse (up from $3.5 million in 2009) and a maximum rate of 35% for the 2010-2012 period (down from 45% in 2009). Also, the new rules make it easier for couples to employ the full use of the exemption as it can now be transferred to a surviving spouse if a deceased spouse does not employ his or her exemption.

NEW: Northwood Private Counsel

Investment Management-Only option, starting at $3 million

Northwood Family Office was founded eight years ago to provide family office services to a select number of Canadian families with $10 million or more in investable assets. Since the inception of the firm, we have had many requests from people with smaller asset levels about the opportunity to access our proven investment management program, without the family offices services. And up until this point, we haven't been able to offer such an investment-only service. But that's about to change.

Starting in January 2011, investors with $3 million or more in investable assets will be able to access our unique family office-style investment approach. Most firms offer one manager and one strategy. At Northwood, you can access a custom investment strategy, based on your goals, with access to multiple managers.

Specifically, Northwood investment-only clients will gain access to our exclusive group of managers and quarterly family office-style consolidated reporting on all of their investments and managers, no matter where the investments are held. They will also get the benefits of the institutional pricing of investment management made possible by the buying power of the family office group.

In addition, clients will receive a personalized cash flow plan that will ensure that your investment strategy is aligned with your personal objectives and that you have the confidence to know your financial future is on track. Please contact us if you would like more information on this new service.

Dividend Investing

Still attractive despite its growing popularity

Eric Weir, CFA, CFP

Dividend investing and a focus on yield became one of the hottest investing themes in the market during 2010. It's no surprise since dividends have proven to be one of the best sources of long term returns in the stock market. At Northwood, dividend portfolios have always featured prominently in our clients' portfolios. A few of the reasons are outlined below:

- Dividends can offer up to half of the expected return on a security, with higher predictability than capital gains (i.e. if you earn a 4% dividend yield on equity investments that are expected to average 8% over the long term, 50% of the return has typically come from income versus capital appreciation);
- Studies show that companies which pay a regular and increasing dividend outperform the market over time;
- Dividend-paying companies offer downside protection. These companies are typically stable, and tend not lose as much capital value during periods of market declines; and
- In Canada, dividend income is taxed more favourably that interest income, normally giving dividends an attractive advantage on an after-tax basis.

We have subscribed to a dividend style for the entire life of our firm, using specific investment managers to run specialized dividend portfolios. But like any good contrarian, we get nervous when an approach we favour becomes a popular topic in the market. So we took some time to re-evaluate the market fundamentals to make sure that a 'dividend bubble' wasn't forming and the strategy was still the right one. We looked at three different potential areas of concern, and we'll give you a highlight of our thoughts on each one:

What is the risk of dividend cuts?

Our first check takes the pulse of the dividend-paying companies and whether they will be able to continue paying their dividends. While each one must be reviewed individually, in general, we find that their health is very good: cash on balance sheets is at an all time record high level, net debt per share remains at a very low level, and total debt vs. total assets shows companies have lots of flexibility on their balance sheets.

Another interesting fact comes from a review of dividend payout ratios (i.e. the ratio of how much companies pay in dividends as a percent of their total earnings). This ratio remains at a historically low level of approximately 30% for the S&P 500 (vs. a range for 40-50% in the past 50 years), leaving companies with ample room to maintain and in some cases increase dividends. We've already seen evidence of this with a number of notable dividend raises in Canada. In December, BCE increased their dividend by 8%, while Enbridge increased their dividend by 15%. Last quarter National Bank was the first of the big six banks to raise its dividend - it's expected that others will follow.

In general, corporate financial health is very good, and this will eventually translate into benefits for shareholders through increased dividends. We expect to see a number of dividend increases in 2011 that will push yields higher.

What is the risk to capital?

When thinking of investing in the equity markets with an income focus, it's important to remember that capital losses can potentially wipe out years' worth of income. By way of an extreme example, in less than a month in Sept./Oct. 2008, the S&P TSX dropped almost 30%. At a yield of 3.5%, it would take over seven years of dividends to earn back that lost amount of capital, assuming no share price recovery. For this reason, investors must take a long term view and be prepared for the ups and downs of the market.

Although predicting stock market returns in the short term is virtually impossible, a look at P/E ratios is a helpful check to ensure that stocks aren't trading at extreme valuations as compared to where they have traded historically (a P/E ratio represents the price a stock is trading at divided by the earnings of the company). Over the past 25 years, the TSX as a whole has traded in a forward-looking P/E range of 10 to 25 (during the mania of the dot com bubble). The average ratio over this period was 14.4. Based on recent profit expectations, the index is currently trading at a ratio of 14.8 [1]. On this basis, the market appears relatively neutrally-valued. As mentioned, it's impossible to predict where equity markets will head in the short term, but it doesn't appear that stocks are in a period of mania and significant overvaluation.

What are the alternatives?

Fixed income is the typical alternative to dividend yield for investors seeking income and stability. Fixed income investing has become one of the most difficult tasks facing any investment manager today. Extremely low yields, a limited number of bonds and investment options fraught with tax problems present an extremely challenging environment. A diversified mix of corporate and government laddered bonds currently yields 2.5-3.5% depending on the average term and credit quality. Assuming an investor is in the top marginal tax bracket (46% in Ontario), it's fair to expect an after-tax yield of approximately 1.6% (or 3% before tax) from fixed income assets.

We contrast this with dividend investing. Our clients' dividend portfolios are well-diversified in Canadian large cap equities that pay good dividends. In addition, we restrict our portfolios to investing only in companies that have not reduced their dividends in the past five years. These portfolios currently yield over 3.5%, depending on the market price of the equities when they were purchased. As mentioned, Canada also provides a very favourable dividend treatment for investors, who will typically pay only 28% tax on this income. Therefore, on an after-tax basis the portfolio will yield 2.5% or approximately 1% higher than a fixed income portfolio. Fixed income yields would need to rise to 4.5-5% to match the current yield that dividend portfolios are earning on an after-tax basis. And keep in mind that dividends can also grow over time.

We continue to believe that strong dividend-paying companies should be a key component of private investors' portfolios.

(1) Source: CIBC World Markets: Oct 2010 – The Earnings Beat Goes On, But Not as Loudly.

Property and Casualty Insurance: Protecting your Family's Assets

Barrett Lyons interviews Kevin Solomon, Managing Director of Leipsic Private Risk Management

Barrett Lyons, CA

It is not uncommon for high net worth families to have mass-marketed insurance programs in place that may meet the needs of an average family but not those of a wealthy family. With greater assets comes greater financial risk and it is imperative that any property and casualty policies serve its purpose – to protect a family's assets. If assets are not adequately covered or a family is exposed to liability and a significant claim or loss occurs, it can have a negative and enduring financial impact on a family, not to mention the emotional impact. To borrow from philosopher Blaise Pascal – "never confuse the *probability* of a negative event with the *consequences* of that event." Below is a brief Q&A on the topic of property and casualty insurance based on the needs of high net worth families with the Kevin Solomon of Leipsic Private Risk Management:

Northwood (NW): What are the most common areas of weakness in the insurance coverages of wealthy families? What are the top three risk areas that you find?

Kevin Solomon (KS): The top three weaknesses we find are: (1) low and inconsistent liability limits as well as outright gaps in liability protection that do not adequately address the family's true exposure to financial loss; (2) insured values that do not match the replacement cost of their assets; and (3) the financial stability and claim-paying ability of their insurance company. Wealthy families are most interested in protecting their personal balance sheet from a major loss, yet we'll often find significant gaps when it comes to all three of these risk areas.

NW: How are the property and casualty insurance needs of wealthy families different than others?

KS: With more wealth comes greater exposure. It's a catch 22. If you don't have the wealth then you don't need the added protection. However, if you have more to lose, then you need greater protection. The insurance needs of the wealthy are derived from the top three risk areas mentioned above and the lifestyle differences that are common to the affluent - global travel, domestic employees, board activities, frequent changes to assets. This ultimately leads to service and coverage expectations that most insurers can't deliver - ease of claim settlement, cash settlements, choice of architects/contractors, worldwide coverage including rental car coverage, high value personal belongings coverage, high liability limits – to name just a few.

NW: What can wealthy families do to ensure that all premiums spent on home, auto, and liability policies are achieving the most value?

KS: Consolidate policies with one A-rated insurer, insure one liability limit across all exposures, carry higher deductibles, put loss prevention measures in place (alarms, safes, water detection systems, sprinklers and hydrants, back-up generators), and don't insure small exposures. Also, since value is often determined at claim time, make sure your insurance advisor has put a plan in place that will enable you (along with their help and advocacy) to maximize your settlement. Most insurers are quick to take your premium, but how will they react when you're faced with a serious loss?

"Never confuse the probability of a negative event with the consequences of that event." – *Blaise Pascal*

NW: What is the difference between personal liability and excess liability or 'umbrella' insurance? What do these policies cover and when can they be employed?

KS: Personal liability insurance provides protection against a covered third party property or bodily injury claim. It's the primary liability that comes with a homeowner's, automobile, or watercraft insurance policy. Excess liability or umbrella liability provides coverage once the primary/underlying liability policy limits have been exhausted. Excess policies will also include additional coverages that aren't included on a primary liability policy - libel, slander, defamation of character, or directors' and officers' not-for-profit liability are some examples of liability coverages that aren't included with most primary personal liability policies. For the wealthy, an excess liability policy can and should be employed to protect them from incurring a devastating financial loss in the event of a major legal settlement against them. The amount of coverage needed should be based on your exposures, the legal environment, your physical assets and your net worth.

NW: How often should a client be reviewing their property and casualty policies and what should they be looking for?

KS: Assets and liability exposures change frequently so good ongoing communication with a service team that knows your assets and overall exposure is key. As well, an annual review should be conducted to make sure all assets and liabilities match the policies, that the insurer(s) remain financially stable and committed to paying claims, and that the premiums being charged are competitive in the marketplace. You should always look for ways to reduce premium while maintaining maximum coverage in the event of a significant loss.

In summary, it is important that your property and casualty insurance policies adequately cover your family's needs. If your policies have been sitting at the bottom of your filing cabinet collecting dust for some time, or your family has experienced significant recent changes to assets or net worth, it is worth the effort to have your policies reviewed.

NORTHWOOD FAMILY OFFICE

For more information or to set up an appointment, please call Tom McCullough or Scott Hayman at

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