LEARNING MADE EASY

4th Edition

# Investing For Canadians

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A Wiley Brand

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Get home-buying and real estate investing advice


Eric Tyson, MBA

Tony Martin, B.Comm

# Investing For Canadians

4th Edition

by Eric Tyson, MBA and
Tony Martin, B.Comm

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# Introduction

With each new edition of this investing guide, we find that the core investment philosophy we discuss within it has stood the tests of time and changing market forces. During the financial crisis of 2008, things got scary. Large brokerage firms were going under, stock prices were plummeting, and layoffs and unemployment rates were soaring. Talk of another Great Depression was in the air. In fact, some polls showed a majority of people feared that another depression was actually happening. Housing prices were dropping sharply in some communities, and in the United States, more and more properties were ending up in foreclosure.

Investing didn't seem so fun anymore. However, even though the downturn was the worst in decades, it had similarities to prior downturns, and people who kept their sense of perspective and followed our advice have enjoyed tremendous returns since the market bottom.

We know from working with people of modest and immodest economic means that they increase their wealth by doing the following:

- Living within their means and systematically saving and investing money, ideally in a tax-favoured manner
- Buying and holding a globally diversified portfolio of stocks
- Building their own small business
- Investing in real estate

This book explains each of these wealth boosters in detail. Equally, if not more important, however, is the information we provide to help you understand and choose investments compatible with your personal and financial goals.

## About This Book

The best investment vehicles for building wealth — stocks, real estate, and small business — haven't changed. But you still need money to enter the investment world. Like the first edition of *Investing For Canadians For Dummies,* the fourth edition of this national bestseller includes complete coverage of these wealth-building investments as well as other common investments, such as bonds. Here are the biggest changes in this edition:

- **We've freshened up the data and examples in this book to provide you the latest insights and analyses.** Having trouble comprehending whether the Bank of Canada's raising interest rates will upset the stock market? Curious about how tax law changes might impact your investment strategies? Seeking a way to invest in stocks without exposing yourself to the tremendous risks experienced during the 2008 financial crisis? Curious about what an exchange-traded fund (ETF) or hedge fund is and whether you should invest in one? Considering using an online/robo-advisor to manage your money? Weighing whether and where to invest in real estate given current market conditions? Wondering what the best ways are to invest globally? Having trouble making sense of various economic indicators and what they mean to your investment strategy? You can find the answers to all these questions — and many more! — in this edition.
- **We offer more information on investing resources.** With the tremendous growth in websites, software, apps, publications, media outlets, and other sources of investing advice and information, you're probably overwhelmed in choosing among the numerous investing research tools and resources. Equally problematic is figuring out who you can trust — and who you need to ignore. So many pundits and prognosticators claim excellent track records for their past predictions, but who, really, can you believe? We explain how to evaluate the quality of current investment tools and resources, and we provide tips on deciding who to listen to and who to tune out.

To build wealth, you don't need a fancy university or graduate-school degree, and you certainly don't need a rich dad (or mom), biological or adopted! What you do need, however, is a desire to read and practice the many simple yet powerful lessons and strategies in this book.

Seriously, investing intelligently is *not* rocket science. By all means, if you're dealing with a complicated, atypical issue, get quality professional help. But educate yourself first. Hiring someone is dangerous if you're not financially literate. If you do decide to hire someone, you'll be much better prepared if you educate yourself. Doing so can also help you focus your questions and assess that person's competence.

# Foolish Assumptions

Every book is written with a certain reader in mind, and this book is no different. Here are some assumptions we made about you:

- You may have some investments, but you're looking to develop a full-scale investment plan.
- You'd like to strengthen your portfolio.
- You want to evaluate your investment advisor's advice.
- You may have a company-sponsored investment plan (a Registered Pension Plan, or RPP), and you're looking to make some decisions or roll it over into a new plan.
- You have — or want to start — a Registered Retirement Savings Plan (RRSP) and want to know how to best set it up, whom with, and in what to invest your savings.

If one or more of these descriptions sound familiar, you've come to the right place.

# Icons Used in This Book

Throughout this book, icons help guide you through the maze of suggestions, solutions, and cautions. We hope the following images make your journey through investment strategies smoother.

TIP

This icon denotes strategies that can enable you to build wealth faster . . . and leap over tall obstacles in a single bound! We also use this icon to point out companies, products, services, and resources that have proved to be exceptional over the years and think worth your time to check them out.

WARNING

This icon indicates treacherous territory that has made mincemeat out of lesser mortals who have come before you. Skip over these alerts at your own peril.

REMEMBER

We think the name says it all, but this icon indicates something really, really important — don't you forget it!

TECHNICAL STUFF

Skip it or read it; the choice is yours. You'll fill your head with more stuff that may prove valuable as you expand your investing know-how, but you risk overdosing on stuff that you may not need right away.

## Beyond the Book

In addition to the material in the print or e-book you're reading right now, this product comes with a free access-anywhere Cheat Sheet that can set you on the path to successful investing. To get this Cheat Sheet, simply go to `www.dummies.com` and search for "Investing For Canadians For Dummies Cheat Sheet" in the Search box.

## Where to Go from Here

If you have the time and desire, we encourage you to read this book in its entirety. It provides you with a detailed picture of how to maximize your returns while minimizing your risks through wealth-building investments. But you don't have to read this book cover to cover. If you have a specific question or two that you want to focus on today, or if you want to find some additional information tomorrow, that's not a problem. *Investing For Canadians For Dummies, 4th Edition,* makes it easy to find answers to specific questions. Just turn to the table of contents to locate the information you need. You can get in and get out, just like that.

# 1 Getting Started with Investing

**IN THIS PART . . .**

Get familiar with different types of investments, including stocks, bonds, real estate, small business, and funds.

Deepen your understanding of risks and returns so you can make informed investing decisions and react to changes in the market.

Make wise investing decisions that fit with your overall financial situation and goals.

IN THIS CHAPTER

» Defining investing

» Seeing how stocks, real estate, and small business ownership build long-term wealth

» Understanding the role of lending and other investments

» Knowing where not to invest your money

# Chapter 1

# Exploring Your Investment Choices

In many parts of the world, life's basic necessities — food, clothing, shelter, and taxes — consume the entirety of people's meager earnings. Although some Canadians do truly struggle for basic necessities, the bigger problem for other Canadians is that they consider just about *everything* — eating out, driving new cars, hopping on airplanes for vacation — to be a necessity. We've taken it upon ourselves (using this book as our tool) to help you recognize that investing — that is, putting your money to work for you — is a necessity. If you want to accomplish important personal and financial goals, such as owning a home, starting your own business, helping your kids through university or college (and spending more time with them when they're young), retiring comfortably, and so on, you must know how to invest well.

It's been said, and too often quoted, that the only certainties in life are death and taxes. To these two certainties we add one more: being confused by and ignorant about investing. Because investing is a confounding activity, you may be tempted to look with envious eyes at those people in the world who appear to be savvy with money and investing. Remember that everyone starts with the same level of financial knowledge: none! *No one* was born knowing this stuff! The only difference between those who know and those who don't is that those who know have devoted their time and energy to acquiring useful knowledge about the investment world.

## Getting Started with Investing

Before we discuss the major investing alternatives in the rest of this chapter, we want to start with something that's quite basic yet important. What exactly do we mean when we say "investing"? Simply stated, *investing* means you have money put away for future use.

You can choose from tens of thousands of stocks, bonds, mutual funds, exchange-traded funds, and other investments. Unfortunately for the novice, and even for the experts who are honest with you, knowing the name of the investment is just the tip of the iceberg. Underneath each of these investments lurks a veritable mountain of details.

REMEMBER

If you wanted to and had the ability to quit your day job, you could make a full-time endeavour out of analyzing economic trends and financial statements and talking to business employees, customers, suppliers, and so on. However, we don't want to scare you away from investing just because some people do it on a full-time basis. Making wise investments need not take a lot of your time. If you know where to get high-quality information and you purchase well-managed investments, you can leave the investment management to the best experts. Then you can do the work that you're best at and have more free time for the things you really enjoy doing.

An important part of making wise investments is knowing when you have enough information to do things well on your own versus when you should hire others. For example, foreign stock markets are generally more difficult to research and understand than domestic markets. Thus, when investing overseas, hiring a good money manager, such as through a mutual or exchange-traded fund, makes more sense than going to all the time, trouble, and expense of picking your own individual stocks.

We're here to give you the information you need to make your way through the complex investment world. In the rest of this chapter, we clear a path so you can identify the major investments and understand the strengths and weaknesses of each.

## Building Wealth with Ownership Investments

TIP

If you want your money to grow faster than the rate of inflation over the long term and you don't mind a bit of a roller-coaster ride from time to time in the value of your investments, ownership investments are for you. *Ownership investments* are those investments where you own an interest in some company or other types of assets (such as stocks, real estate, or a small business) that have the ability to generate revenue and profits.

Observing how the world's richest people have built their wealth is enlightening. Not surprisingly, many of the champions of wealth around the globe gained their fortunes largely through owning a piece (or all) of a successful company that they (or others) built.

In addition to owning their own businesses, many well-to-do people have built their nest eggs by investing in real estate and the stock market. With softening housing prices in many regions in the late 2000s, some folks newer to the real estate world incorrectly believe that real estate is a loser, not a long-term winner. Likewise, the stock market goes through down periods but does well over the long term. (See Chapter 2 for the scoop on investment risks and returns.)

And of course, some people come into wealth through an inheritance. Even if your parents are among the rare wealthy ones and you expect them to pass on big bucks to you, you need to know how to invest that money intelligently.

REMEMBER

If you understand and are comfortable with the risks, and take sensible steps to *diversify* (you don't put all your investment eggs in the same basket), ownership investments are the key to building wealth. For most folks to accomplish typical longer-term financial goals, such as retiring, the money that they save and invest needs to grow at a healthy clip. If you dump all your money in bank accounts that pay little if any interest, you're likely to fall short of your goals.

Not everyone needs to make his or her money grow, of course. Suppose you inherit a significant sum and/or maintain a restrained standard of living and work well into your old age simply because you enjoy doing so. In this situation, you may not need to take the risks involved with a potentially faster-growth investment. You may be more comfortable with *safer* investments, such as paying off your mortgage faster than necessary. Chapter 3 helps you think through such issues.

## Entering the stock market

*Stocks*, which are shares of ownership in a company, are an example of an ownership investment. If you want to share in the growth and profits of companies like Skechers (footwear), you can! You simply buy shares of their stock through a brokerage firm. However, even if Skechers makes money in the future, you can't guarantee that the value of its stock will increase.

Some companies today sell their stock directly to investors, allowing you to bypass brokers. You can also invest in stocks via a stock mutual fund (or an exchange-traded fund), where a fund manager decides which individual stocks to include in the fund. We discuss the various methods for buying stock in Chapter 6.

REMEMBER

You don't need an MBA or a PhD to make money in the stock market. If you can practice some simple lessons, such as making regular and systematic investments, and investing in proven companies and funds while minimizing your investment expenses and taxes, you should make decent returns in the long term.

However, we don't think you should expect that you can "beat the markets," and you certainly can't beat the best professional money managers at their own full-time game. This book shows you time-proven, non-gimmicky methods to make your money grow in the stock market as well as in other financial markets. We explain more about stocks and mutual funds in Part 2.

## Owning real estate

People of varying economic means build wealth by investing in real estate. Owning and managing real estate is like running a small business. You need to satisfy customers (tenants), manage your costs, keep an eye on the competition, and so on. Some methods of real estate investing require more time than others, but many are proven ways to build wealth.

John, who works for a city government, and his wife, Linda, a computer analyst, have built several million dollars in investment real estate *equity* (the difference between the property's market value and debts secured by that property) over the past three decades. "Our parents owned rental property, and we could see what it could do for you by providing income and building wealth," says John. Investing in real estate also appealed to John and Linda because they didn't know anything about the stock market, so they wanted to stay away from it. The idea of *leverage* — making money with borrowed money — on real estate also appealed to them.

John and Linda bought their first property, a duplex, when their combined income was just $35,000 per year. Every time they moved to a new home, they kept the prior one and converted it to a rental. Now in their 50s, John and Linda own seven pieces of investment real estate and are multimillionaires. “It’s like a second retirement, having thousands in monthly income from the real estate,” says John.

John readily admits that rental real estate has its hassles. “We haven’t enjoyed getting calls in the middle of the night, but now we have a property manager who can help with this when we’re not available. It’s also sometimes a pain finding new tenants,” he says.

Overall, John and Linda figure that they’ve been well rewarded for the time they spent and the money they invested. The income from John and Linda’s rental properties also allows them to live in a nicer home.

TIP

Ultimately, to make your money grow much faster than inflation and taxes, you must take some risk. Any investment that has real growth potential also has shrinkage potential! You may not want to take the risk or may not have the stomach for it. In that case, don’t despair: We discuss lower-risk investments in this book as well. You can find out about risks and returns in Chapter 2.

## WHO WANTS TO INVEST LIKE A MILLIONAIRE?

Having a million dollars isn’t nearly as rare as it used to be. In fact, according to a Boston Consulting Group report, more than 485,000 Canadian households now have at least $1 million in wealth (excluding the value of real estate). Interestingly, wealthy households rarely let financial advisors direct their investments. According to the Spectrum Group, a firm that conducts research on wealth, only 10 per cent of households in the United States or Canada with wealth of at least $1 million allows advisors to call the shots and make the moves, whereas 30 per cent don’t use any advisors at all. The remaining 60 per cent may or may not consult an advisor on an as-needed basis and then make their own moves.

As in past surveys, recent wealth surveys show that affluent investors achieved and built on their wealth with ownership investments, such as their own small businesses, real estate, and stocks.

## Running a small business

We know people who have hit investing home runs by owning or buying businesses. Unlike the part-time nature of investing in the stock market, most people work full time at running their businesses, increasing their chances of doing something big financially with them.

REMEMBER

If you try to invest in individual stocks, by contrast, you're likely to work at it part time, competing against professionals who invest practically around the clock. Even if you devote almost all your time to managing your stock portfolio, you're still a passive bystander in businesses run by others. When you invest in your own small business, you're the boss, for better or worse.

For example, a decade ago, Calvin set out to develop a corporate publishing firm. Because he took the risk of starting his business and has been successful in slowly building it, today, in his 50s, he enjoys a net worth of more than $10 million and can retire if he wants. Even more important to many business owners — and the reason that financially successful entrepreneurs such as Calvin don't call it quits after they've amassed a lot of cash — are the non-financial rewards of investing, including the challenge and fulfillment of operating a successful business.

Similarly, Sandra has worked on her own as an interior designer for more than two decades. She previously worked in fashion as a model, and then she worked as a retail store manager. Her first taste of interior design was redesigning rooms at a condominium project. "I knew when I did that first building and turned it into something wonderful and profitable that I loved doing this kind of work," says Sandra. Today, Sandra's firm specializes in the restoration of landmark hotels, and her work has been written up in numerous magazines. "The money is not of primary importance to me," she says. "My work is driven by a passion . . . but obviously it has to be profitable." Sandra has also experienced the fun and enjoyment of designing hotels in many parts of Canada and overseas.

Most small-business owners (ourselves included) know that the entrepreneurial life isn't a smooth walk through the rose garden — it has its share of thorns. Emotionally and financially, entrepreneurship is sometimes a roller coaster. In addition to receiving financial rewards, however, small-business owners can enjoy seeing the impact of their work and knowing that it makes a difference. Combined, Calvin's and Sandra's firms created dozens of new jobs.

TIP

Not everyone needs to be sparked by the desire to start his or her own company to profit from small business. You can share in the economic rewards of the entrepreneurial world through buying an existing business or investing in someone else's budding enterprise. We talk more about evaluating and buying a business in Part 4.

# Generating Income from Lending Investments

Besides ownership investments (which we discuss in the earlier section "Building Wealth with Ownership Investments"), the other major types of investments include those in which you lend your money. Suppose that, like most people, you keep some money in your local bank — most likely in a chequing account but perhaps also in a savings account or guaranteed investment certificate (GIC). No matter what type of bank account you place your money in, you're lending your money to the bank.

TECHNICAL STUFF

How long and under what conditions you lend money to your bank depends on the specific bank and the account you use. With a GIC, you commit to lend your money for a specific length of time — perhaps six months, a year, or more. In return, the bank probably pays you a higher rate of interest than if you put your money in a bank account offering you immediate access to the money. (You may demand termination of the GIC early; however, you'll be penalized.)

As we discuss in more detail in Chapter 7, you can also invest your money in bonds, another type of lending investment. When you purchase a bond that's been issued by the government or a company, you agree to lend your money for a predetermined period of time and receive a particular rate of interest. A bond may pay you 4 per cent interest over the next ten years, for example.

An investor's return from lending investments is typically limited to the original investment plus interest payments. If you lend your money to Skechers through one of its bonds that matures in, say, ten years, and Skechers triples in size over the next decade, you won't share in its growth. Skechers' stockholders and employees reap the rewards of the company's success, but as a bondholder, you don't; you simply get interest and the face value of the bond back at maturity.

REMEMBER

Many people keep too much of their money in lending investments, thus allowing others to reap the rewards of economic growth. Although lending investments appear safer because you know in advance what return you'll receive, they aren't that safe. The long-term risk of these seemingly safe money investments is that your money will grow too slowly to enable you to accomplish your personal financial goals. In the worst cases, the company or other institution to which you're lending money can go under and stiff you for your loan.

### THE DOUBLE WHAMMY OF INFLATION AND TAXES

WARNING

Bank accounts and bonds that pay a decent return are reassuring to many investors. Earning a small amount of interest sure beats losing some or all of your money in a risky investment.

The problem is that money in a savings account that pays 3 per cent, for example, isn't actually yielding you 3 per cent. It's not that the bank is lying; it's just that your investment bucket contains some not-so-obvious holes.

The first hole is taxes. When you earn interest, you must pay taxes on it (unless you invest the money in tax-deferred plan, in which case you generally pay the taxes later when you withdraw the money). If you're a moderate-income earner, you end up losing about a third of your interest to taxes. Your 3 per cent return is now down to 2 per cent.

But the second hole in your investment bucket can be even bigger than taxes: inflation. Although a few products become cheaper over time (computers, for example), most goods and services increase in price. Inflation in Canada has been running about 3 per cent per year over the long term. Inflation depresses the purchasing power of your investments' returns. If you subtract the 3 per cent "cost" of inflation from the remaining 2 per cent after payment of taxes, we're sorry to say that you've lost 1 per cent on your investment.

To recap: For every dollar you invested in the bank a year ago, despite the fact that the bank paid you your 3 pennies of interest, you're left with only 99 cents in real purchasing power for every dollar you had a year ago. In other words, thanks to the inflation and tax holes in your investment bucket, you can buy less with your money now than you could have a year ago, even though you've invested your money for a year.

## Considering Cash Equivalents

*Cash equivalents* are any investments that you can quickly convert to cash without cost to you. With most chequing accounts, for example, you can write a cheque or withdraw cash by visiting a teller — either the live or the automated type.

Money market mutual funds are another type of cash equivalent. Investors, both large and small, invest hundreds of billions of dollars in money market mutual funds because the best money market funds historically have produced higher yields than bank savings accounts. (Some online banks offer higher yields, but you must be careful to understand ancillary service fees that can wipe away any yield advantage — see Chapter 7 for information.) The yield advantage of a money market fund over a savings account almost always widens when interest rates increase because banks move to raise savings account rates about as fast as molasses on a cold winter day.

Why shouldn't you take advantage of a higher yield? Many bank savers sacrifice this yield because they think that money market funds are risky — but they're not. Money market mutual funds generally invest in safe things such as GICs, short-term bank certificates of deposit, Canadian and provincial government-issued Treasury bills, and commercial paper (short-term bonds) that the most creditworthy corporations issue.

Another reason people keep too much money in traditional bank accounts is that the local bank branch office makes the cash seem more accessible. Money market mutual funds, however, offer many quick ways to get your cash. Sometimes you can write a cheque (most funds stipulate the cheque must be for at least a few hundred dollars), or you can call the fund and request that it mail or electronically transfer your money.

TIP

Move extra money that's dozing away in your bank savings account into a higher-yielding money market mutual fund. Even if you have just a few thousand dollars, the extra yield more than pays for the cost of this book. (See Chapter 8 to find out about money market funds.)

# Steering Clear of Futures and Options

Suppose you think that IBM's stock is a good investment. The direction that the management team is taking impresses you, and you like the products and services that the company offers. Profits seem to be on a positive trend. Things are looking up.

You can go out and buy the stock. Suppose it's currently trading at around $100 per share. If the price rises to $150 in the next six months, you've made yourself a 50 per cent profit ($150 − $100 = $50) on your original $100 investment. (Of course, you have to pay some brokerage fees to buy and then sell the stock.)

But instead of buying the stock outright, you can buy what are known as *call options* on IBM. A call option gives you the right to buy shares of IBM under specified terms from the person who sells you the call option. You may be able to purchase a call option that allows you to exercise your right to buy IBM stock at, say, $120 per share in the next six months. For this privilege, you may pay $6 per share to the seller of that option (and you'll also pay trading commissions).

If IBM's stock price skyrockets to, say, $150 in the next few months, the value of your options that allow you to buy the stock at $120 will be worth a lot — at least $30. You can then simply sell your options, which you bought for $6 in the example, at a huge profit — you've multiplied your money five-fold!

WARNING

Although this talk of fat profits sounds much more exciting than simply buying the stock directly and making far less money from a stock price increase, call options have two big problems:

- **You could easily lose your entire investment.** If a company's stock price goes nowhere or rises only a little during the six-month period when you hold the call option, the option expires as worthless, and you lose all — that is, 100 per cent — of your investment. In fact, in our example, if IBM's stock trades at $120 or less at the time the option expires, the option is worthless.
- **A call option represents a short-term gamble on a company's stock price, not an investment in the company itself.** In our example, IBM could expand its business and profits greatly in the years and decades ahead, but the value of the call option hinges on the ups and downs of IBM's stock price over a relatively short period of time (the next six months). If the stock market happens to dip in the next six months, IBM may get pulled down as well, despite the company's improving financial health.

*Futures* are similar to options in that both can be used as gambling instruments. Futures, for example, can deal with the value of commodities such as oil, corn, wheat, gold, silver, and pork bellies. Futures have a delivery date that's in the not-too-distant future. (Do you really want bushels of wheat delivered to your home? Or worse yet, pork bellies?) You can place a small down payment — around 10 per cent — toward the purchase of futures, thereby greatly leveraging your "investment." If prices fall, you need to put up more money to keep from having your position sold. (*Note:* Futures on financial instruments like stock market indices and interest rates are generally cash settlements rather than physical delivery, and they're an increasingly large part of the market.) Our advice: Don't gamble with futures and options.

TECHNICAL STUFF

The only real use that you may (if ever) have for these *derivatives* (so called because their value is "derived" from the price of other securities) is to hedge. Suppose you hold a lot of a stock that has greatly appreciated, and you don't want to sell now because of the taxes you would owe on the profit. Perhaps you want to postpone selling the stock until next year because you plan on not working or because you can then benefit from a lower tax rate. You can buy what's called a *put option,* which increases in value when a stock's price falls (because the put option grants its seller the right to sell his stock to the purchaser of the put option at a preset stock price). Thus, if the stock price does fall, the rising put option value offsets some of your losses on the stock you still hold less the cost of what you paid for your put option. Using put options allows you to postpone selling your stock without exposing yourself to the risk of a falling stock price.

## Passing Up Precious Metals

Over the millennia, gold and silver have served as mediums of exchange or currency because they have some intrinsic value and can't be debased the way paper currencies can (by printing more money). These precious metals are used in jewelry and manufacturing.

As investments, gold and silver perform well during bouts of inflation. For example, from 1972 to 1980, when inflation zoomed into the double-digit range in Canada and the United States, and stocks and bonds went into the tank, gold and silver prices skyrocketed more than 500 per cent. With precious metals pricing zooming upward in the decade that began in 2000, some feared the return of inflation.

WARNING

Over the long term, precious metals are lousy investments. They don't pay any dividends, and their price increases may, at best, just keep up with (not keep ahead of) increases in the cost of living. Although investing in precious metals is better than keeping cash in a piggy bank or stuffing it in a mattress, the long-term investment returns aren't nearly as good as bonds, stocks, and real estate. (We discuss bonds, stocks, and real estate in detail in Parts 2 and 3.) One way to earn better long-term returns is to invest in a mutual fund containing the stocks of gold and precious metals companies (see Chapter 8 for information).

## GET RICH WITH GOLD AND OIL?

During the global economic expansion of the mid-2000s, precious metals (such as gold), oil, and other commodities increased significantly in value. The surge in oil prices certainly garnered plenty of headlines when it surged past US$100 per barrel. So, too, did the price of gold as it passed US$1,000 per ounce in 2008, setting a new all-time high. These prices represented tremendous increases over the past decade, with the price of oil having increased more than 600 per cent (from less than US$20 per barrel) and gold more than tripling in value (from less than US$300 per ounce).

However, despite these seemingly major moves, when you consider increases in the cost of living, oil prices at US$100-plus per barrel were just reaching the levels attained in late 1979! And even with gold hitting about US$1,920 per ounce in 2011, it was still far from the inflation-adjusted levels it reached nearly three decades earlier (it has since declined substantially). To reach those levels, gold would have to rise to more than US$2,450 an ounce!

Although the price increases in gold and oil (as well as some other commodities) were dramatic during the first decade of the 2000s, over the past 35 years, oil and gold increased in value far, far less than the overall low rate of inflation. So, one would hardly have gotten rich investing in oil and gold over the long term — rather, it would have been more like treading water.

We'd like to make one final and important point here: Over the long term, investing in a stock mutual fund that focuses on companies involved with precious metals (see Chapter 8) has provided far superior returns compared with investing in gold, silver, or other commodities directly.

# Counting Out Collectibles

The term *collectibles* is a catchall category for antiques, art, autographs, hockey and baseball cards, clocks, coins, comic books, dolls, gems, photographs, rare books, rugs, stamps, vintage wine, writing utensils, and a whole host of other items.

Although connoisseurs of fine art, antiques, and vintage wine wouldn't like to compare their pastime with buying old playing cards or chamber pots, the bottom line is that collectibles are all objects with little intrinsic value. Wine is just a bunch of old mushed-up grapes. A painting is simply a canvas and some paint that at retail would set you back a few bucks. Stamps are small pieces of paper, usually less than an inch square. What about hockey and baseball cards? Heck, we used to stick these between our bike spokes!

We're not trying to diminish contributions that artists and others make to the world's culture. And we know that some people place a high value on some of these collectibles. But true investments that can make your money grow, such as stocks, real estate, or a small business, are assets that can produce income and profits. Collectibles have little intrinsic value and are thus fully exposed to the whims and speculations of buyers and sellers. (Of course, as history has shown, and as we discuss elsewhere in this book, the prices of particular stocks, real estate, and businesses can be subject to the whims and speculations of buyers and sellers, especially in the short term. Over the longer term, however, market prices return to reality and sensible valuations.)

WARNING

Here are some other major problems with collectibles:

- **Markups are huge.** The spread between the price that a dealer pays for an object and the price he then sells the same object for is often around 100 percent. Sometimes the difference is even greater, particularly if a dealer is the second or third middleman in the chain of purchase. So, at a minimum, your purchase must typically double in value just to get you back to even. And a value may not double for 10 to 20 years or more!
- **Lots of other costs add up.** If the markups aren't bad enough, some collectibles incur all sorts of other costs. If you buy more-expensive pieces, for example, you may need to have them appraised. You may have to pay storage and insurance costs as well. And unlike the markup, you pay some of these fees year after year of ownership.
- **You can get stuck with a pig in a poke.** Sometimes you may overpay even more for a collectible because you don't realize some imperfection or inferiority of an item. Worse, you may buy a forgery. Even reputable dealers have been duped by forgeries.
- **Your pride and joy can deteriorate over time.** Damage from sunlight, humidity, temperatures that are too high or too low, and a whole host of vagaries can ruin the quality of your collectible. Insurance doesn't cover this type of damage or negligence on your part.
- **The returns stink.** Even if you ignore the substantial costs of buying, holding, and selling, the average returns that investors earn from collectibles rarely keep ahead of inflation, and they're generally inferior to stock market, real estate, and small-business investing. Objective collectible return data are hard to come by. Never, ever trust "data" that dealers or the many collectible trade publications provide.

The best returns that collectible investors reap come from the ability to identify, years in advance, items that will *become* popular. Do you think you can do that? You may be the smartest person in the world, but you should know that most dealers can't tell what's going to rocket to popularity in the coming decades. Dealers make their profits the same way other retailers do: from the spread or markup on the merchandise that they sell. The public and collectors have fickle, quirky tastes that no one can predict. Did you know that Beanie Babies, Furbies, Pet Rocks, or Cabbage Patch Kids were going to be such hits (for however long they lasted)?

REMEMBER

You can find out enough about a specific type of collectible to become a better investor than the average person, but you're going to have to be among the best — perhaps among the top 10 per cent of such collectors — to have a shot at earning decent returns. To get to this level of expertise, you need to invest hundreds if not thousands of hours reading, researching, and educating yourself about your specific type of collectible.

Nothing is wrong with spending money on collectibles. Just don't fool yourself into thinking that they're investments. You can sink lots of your money into these non-income-producing, poor-return "investments." At their best as investments, collectibles give the wealthy a way to buy quality stuff that doesn't depreciate.

TIP

If you buy collectibles, here are some tips to keep in mind:

- **Collect for your love of the collectible, your desire to enjoy it, or your interest in finding out about or mastering a subject.** In other words, don't collect these items because you expect high investment returns, because you probably won't get them.
- **Keep quality items that you and your family have purchased and hope will be worth something someday.** Keeping these quality items is the simplest way to break into the collectible business. The complete sets of baseball cards Eric gathered as a youngster are now (30-plus years later) worth hundreds of dollars to, in one case, $1,000!
- **Buy from the source and cut out the middlemen whenever possible.** In some cases, you may be able to buy directly from the artist. Some of our relatives, for example, purchase pottery and art directly from the artists.
- **Check collectibles that are comparable to the one you have your eye on, shop around, and don't be afraid to negotiate.** An effective way to negotiate, after you decide what you like, is to make your offer to the dealer or artist by phone. Because the seller isn't standing right next to you, you don't feel pressure to decide immediately.
- **Get a buyback guarantee.** Ask the dealer (who thinks that the item is such a great investment) for a written guarantee to buy back the item from you, if you opt to sell, for at least the same price you paid or higher within five years.
- **Do your homework.** Use a comprehensive resource, such as the books by Ralph and Terry Kovel or their website at `www.kovels.com`, to research, buy, sell, maintain, and improve your collectible.

IN THIS CHAPTER

- » Surveying different types of risks
- » Reducing risk while earning decent returns
- » Figuring out expected returns for different investments
- » Determining how much you need your investments to return

# Chapter 2

# Weighing Risks and Returns

A woman passes up eating a hamburger at a picnic because she heard that she could contract a deadly *E. coli* infection from eating improperly cooked meat. The next week, that same woman hops in the passenger seat of her friend's old model car that lacks airbags.

We're not trying to depress or frighten anyone. However, we are trying to make an important point about risk — something everyone deals with on a daily basis. Risk is in the eye of the beholder. Many people base their perception of risk, in large part, on their experiences and what they've been exposed to. In doing so, they often fret about relatively small risks while overlooking much larger risks.

Sure, a risk of an *E. coli* infection from eating poorly cooked meat exists, so the woman who was leery of eating the hamburger at the picnic had a legitimate concern. However, that same woman got into the friend's car without an airbag and placed herself at far greater risk of dying in that situation than if she had eaten the hamburger. In North America, some 37,000 people die in automobile accidents each year.

In the world of investing, most folks worry about certain risks — some of which may make sense and some of which may not — but at the same time they completely overlook or disregard other, more significant risks. In this chapter, we discuss a range of investments and their risks and expected returns.

## Evaluating Risks

Everywhere you turn, risks exist; some are just more apparent than others. Many people misunderstand risks. With increased knowledge, you may be able to reduce or conquer some of your fears and make more sensible decisions about reducing risks. For example, some people who fear flying don't understand that statistically, flying is much safer than driving a car. You're approximately 110 times more likely to die in a motor vehicle than in an airplane. But when a plane goes down, it's big news because dozens and sometimes hundreds of people, who weren't engaging in reckless behaviour, perish. Meanwhile, the national media seem to pay less attention to the 100 people, on average, who die on the road every day.

Then there's the issue of control. Flying seems more dangerous to some folks because the pilots are in control of the plane, whereas in your car, you can at least be at the steering wheel. Of course, you can't control what happens around you or mechanical problems with the mode of transportation you're using.

This doesn't mean that you shouldn't drive or fly or that you shouldn't drive to the airport. However, you may consider steps you can take to reduce the significant risks you expose yourself to in a car. For example, you can get a car with more safety features, or you can bypass riding with reckless taxi drivers.

Although some people like to live life to its fullest and take "fun" risks (how else can you explain mountain climbers, parachutists, and bungee jumpers?), most people seek to minimize risk and maximize enjoyment in their lives. The vast majority of people also understand that they'd be a lot less happy living a life in which they sought to eliminate all risks, and they likely wouldn't be able to do so anyway.

REMEMBER

Likewise, if you attempt to avoid all the risks involved in investing, you likely won't succeed, and you likely won't be happy with your investment results and lifestyle. In the investment world, some people don't go near stocks or any investment that they perceive to be volatile. As a result, such investors often end up with lousy long-term returns and expose themselves to some high risks that they overlooked, such as the risk of having inflation and taxes erode the purchasing power of their money.

You can't live without taking risks. Risk-free activities or ways of living don't exist. You can minimize but never eliminate risks. Some methods of risk reduction aren't palatable because they reduce your quality of life. Risks are also composed of several factors. In the sections that follow, we discuss the various types of investment risks and go over proven methods you can use to sensibly reduce these risks while not missing out on the upside that growth investments offer.

## Market-value risk

Although the stock market can help you build wealth, most people recognize that it can also drop substantially — by 10, 20, or 30 per cent (or more) in a relatively short period of time. After peaking in 2000, Canadian and U.S. stocks, as measured by the major indexes representing the value of large companies (for Canada, the S&P/TSX Composite Index, and for the United States, the S&P 500 index), dropped about 50 per cent by 2002. Stocks on the NASDAQ, which is heavily weighted toward technology stocks, plunged more than 76 per cent from 2000 through 2002!

After a multi-year rebound, stocks peaked in 2007 and then dropped sharply during the "financial crisis" of 2008. From peak to bottom, Canadian, U.S., and global stocks dropped by some 50 — or more — per cent.

In a mere six weeks (from mid-July 1998 to early September 1998), large-company Canadian and U.S. stocks fell about 20 per cent. An index of smaller-company U.S. stocks dropped 33 per cent over a slightly longer period of two and a half months.

If you think that the stock market crash that occurred in the fall of 1987 was a big one (the market plunged by about a third in a matter of weeks), take a look at Tables 2-1 and 2-2, which list major declines over the past 100-plus years that were all *worse* than the 1987 crash. Note that two of these major declines happened in the 2000s: 2000 to 2002 and 2007 to 2009.

**TABLE 2-1** **Most Depressing Canadian Stock Market Declines***

| Period | Size of Fall |
|---|---|
| 1929–1932 | 80% (ouch!) |
| 1937–1942 | 56% |
| 2000–2002 | 50% |
| 2007–2009 | 48% |
| 1980–1982 | 44% |
| 1973–1974 | 38% |
| 1987–1987 | 31% |
| 1956–1957 | 30% |
| 1969–1970 | 28% |

**As measured by changes in the TSE/TSX composite index*

**TABLE 2-2** Largest U.S. Stock Market Declines*

| Period | Size of Fall |
|---|---|
| 1929–1932 | 89% (ouch!) |
| 2007–2009 | 55% |
| 1937–1942 | 52% |
| 1906–1907 | 49% |
| 1890–1896 | 47% |
| 1919–1921 | 47% |
| 1901–1903 | 46% |
| 1973–1974 | 45% |
| 1916–1917 | 40% |
| 2000–2002 | 39% |

**As measured by changes in the Dow Jones Industrial Average*

Real estate exhibits similar unruly, annoying tendencies. Although real estate (like stocks) has been a terrific long-term investment, various real estate markets get clobbered from time to time.

When the oil industry collapsed in Alberta in the early 1980s, real estate prices in the province dropped by 25 per cent. And after a massive run-up in prices in the mid-1980s, house prices in the Toronto area plummeted by nearly 28 per cent over the next few years. Across Canada, after a whopping 50 per cent rise from 1978 to 1981, house prices dropped by 35 per cent in just over a year. Then, after hitting a new high in 1990, the market fell by 15 per cent in just 12 months, and by 1996 was down 22 per cent.

In the United States, housing prices took a 25 per cent tumble from the late 1920s to the mid-1930s. Later, in the 1980s and early 1990s, the northeastern United States became mired in a severe recession, and real estate prices fell by 20-plus per cent in many areas. After peaking near 1990, many of the West Coast housing markets, especially those in California, experienced falling prices — dropping 20 per cent or more in most areas by the mid-1990s.

Declining U.S. housing prices in the mid- to late 2000s garnered unprecedented attention. Some folks and pundits acted like it was the worst housing market ever. Foreclosures increased in part because of buyers who financed their home purchases with risky mortgages (which we recommend against in our books, including this one — see Chapter 12). But, as we've noted, remember that housing market conditions also vary tremendously by area. For example, housing prices in

Toronto and Vancouver have often shown double-digit increases while smaller cities and towns were experiencing down-markets. In the United States, some portions of the Pacific Northwest and South actually appreciated during the mid- to late 2000s, while other U.S. markets experienced substantial declines.

After reading this section, you may want to keep all your money in the bank — after all, you know you won't lose your money, and you won't have to be a non-stop worrier. Since the Canadian Deposit Insurance Corporation (CDIC) came into existence, which protects deposits at banks and trust companies up to $100,000, people don't lose 20, 40, 60, or 80 per cent of their bank-held savings vehicles within a few years, but major losses prior to then did happen. Just remember, though, that just letting your money sit around would be a mistake.

REMEMBER

If you pass up the stock and real estate markets simply because of the potential market-value risk, you miss out on a historic, time-tested method of building substantial wealth. Instead of seeing declines and market corrections as horrible things, view them as potential opportunities or "sales." Try not to give in to the human emotions that often scare people away from buying something that others seem to be shunning.

Later in this chapter, we show you the generous returns that stocks and real estate as well as other investments have historically provided. The following sections suggest some simple things you can do to lower your investing risk and help prevent your portfolio from suffering a huge fall.

## Diversify for a gentler ride

If you worry about the health of the economy, the government, and the dollar, you can reduce your investment risk by investing outside of Canada. Most large Canadian companies do business in the United States and overseas, so when you invest in larger Canadian company stocks, you get some international investment exposure. You can also invest in international company stocks, ideally via mutual funds and exchange-traded funds (see Chapter 8).

Of course, investing overseas can't totally protect you in the event of a global economic catastrophe. If you worry about the risk of such a calamity, you should probably also worry about a huge meteor crashing into Earth. Maybe there's a way to colonize outer space . . .

TIP

Diversifying your investments can involve more than just your stock portfolio. You can also hold some real estate investments to diversify your investment portfolio. Many real estate markets appreciated in the early 2000s while North American stock markets were in the doghouse. Conversely, when real estate in many regions entered a multi-year slump in the mid-2000s, stocks performed well during that period. In the late 2000s, stock prices fell sharply while real estate prices in many major centres rose, but then stocks came roaring back.

## Consider your time horizon

Investors who worry that the stock market may take a dive and take their money down with it need to consider the length of time that they plan to invest. In a one-year period in the stock and bond markets, a wide range of outcomes can occur (as shown in Figure 2-1). History shows that you lose money about once in every three years that you invest in the stock and bond markets. However, stock market investors have made money (sometimes substantial amounts) approximately two-thirds of the time over a one-year period. (Bond investors made money about two-thirds of the time, too, although they made a good deal less on average.)

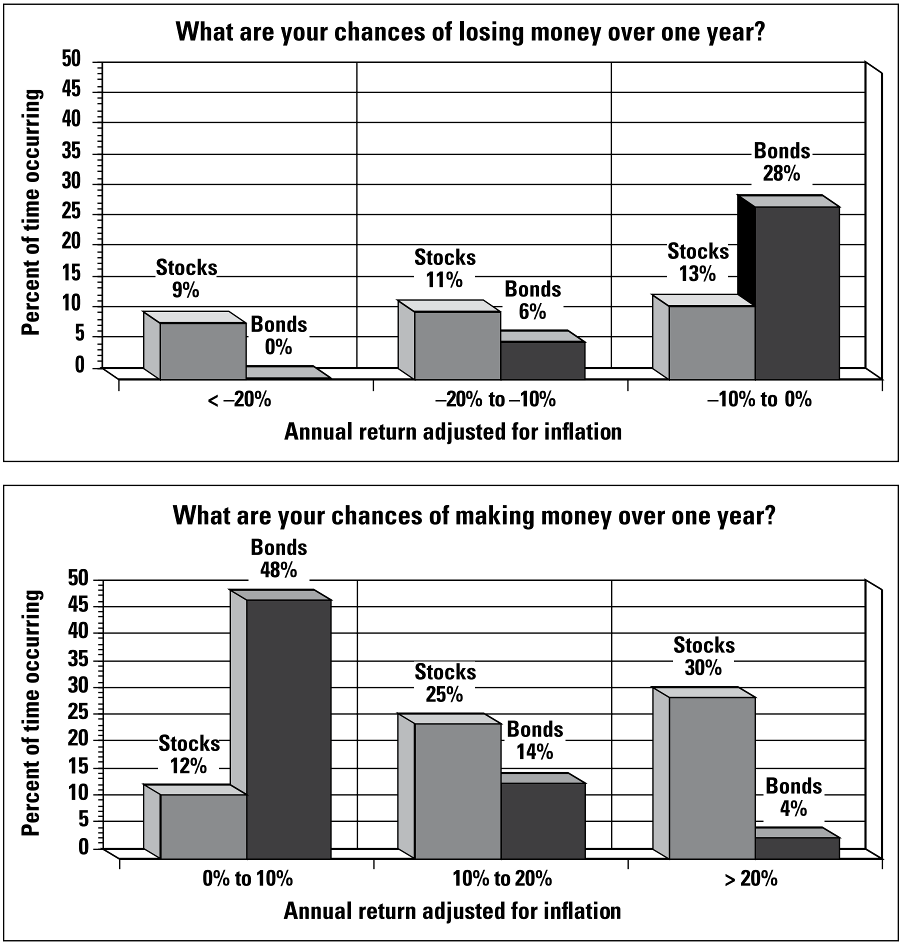


**FIGURE 2-1:** What are the odds of making or losing money in the Canadian markets? In a single year, you win far more often (and bigger) with stocks than with bonds.

Although the stock market is more volatile than the bond market in the short term, stock market investors have earned far better long-term returns than bond investors have. (See the "Stock returns" section later in this chapter for details.) Why? Because stock investors bear risks that bond investors don't bear, and they can reasonably expect to be compensated for those risks. Remember, however, that bonds generally outperform a boring old bank account.

REMEMBER

History has shown that the risk of a stock or bond market fall becomes less of a concern the longer that you plan to invest. Figure 2-2 shows that as the holding period for owning stocks increases from 1 year to 3 years to 5 years to 10 years and then to 20 years, there's a greater likelihood of seeing stocks increase in value. In fact, over any 20-year time span, the U.S. stock market, as measured by the S&P 500 index of larger company stocks, has *never* lost money, even after you subtract the effects of inflation.

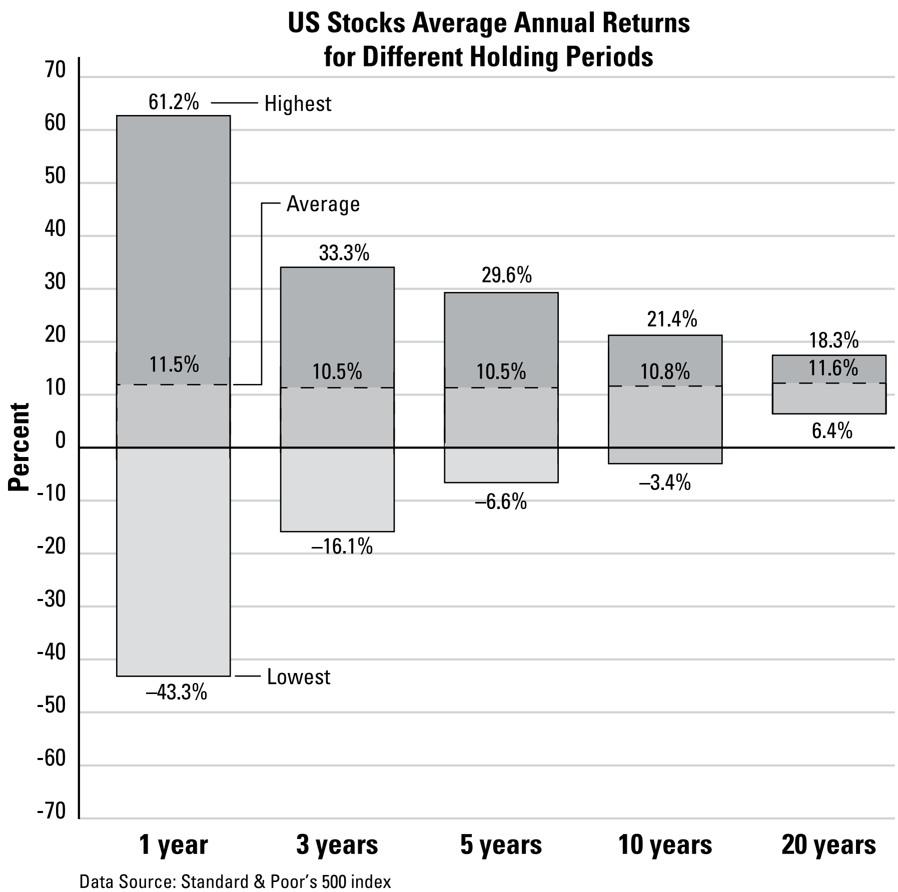


**FIGURE 2-2:** The longer you hold stocks, the more likely you are to make money.

We've used U.S. data in Figure 2-2 simply because several more decades of market data are available, giving a better sense of the long-term behaviour of the stock market. However, the same basic point is true for Canada. Since 1957, only one five-year period has had a negative return. In other words, if you had invested in the broad market (meaning your returns were similar to the composite index) and held on for five years, in only one period would you have had less after five years than you started with. If you had invested and *stayed* invested for ten years, you would always have come out ahead. To put it another way, starting in 1957, if you had invested in any year and held those investments for a minimum of ten years, you would always have ended up with a profit, assuming your returns matched those of the index.

Most stock market investors we know are concerned about the risk of losing money. Figure 2-2 clearly shows that the key to minimizing the probability that you'll lose money in stocks is to hold them for the longer term. Don't invest in stocks unless you plan to hold them for at least five years — and preferably a decade or longer. Check out Part 2 for more on using stocks as a long-term investment.

## Pare down holdings in bloated markets

Perhaps you've heard the expression "buy low, sell high." Although we don't believe that you can *time the markets* (that is, predict the most profitable time to buy and sell), spotting a greatly over-priced or under-priced market isn't too difficult. For example, in the first edition of this book, published in 2000, we warned readers about the grossly inflated prices of many Internet and technology stocks (see Chapter 5). Throughout this book, we explain some simple yet powerful methods you can use to measure whether a particular investment market is of fair value, of good value, or overpriced. You should avoid overpriced investments for two important reasons:

- If — and when — these over-priced investments fall, they usually fall farther and faster than more fairly priced investments.
- You should be able to find other investments that offer higher potential returns.

TIP

Ideally, you want to avoid having a lot of your money in markets that appear over-priced (see Chapter 5 for how to spot pricey markets). Practically speaking, avoiding over-priced markets doesn't mean that you should try to sell all your holdings in such markets with the vain hope of buying them back at a much lower price. However, you may benefit from the following strategies:

- **Invest new money elsewhere.** Focus your investment of new money somewhere other than the over-priced market; put it into investments that offer you better values. As a result, without selling any of your seemingly expensive investments, you make them a smaller portion of your total holdings. If you hold investments outside of tax-sheltered plans, focusing your money elsewhere also allows you to avoid incurring taxes from selling appreciated investments.

- **If you have to sell, sell the expensive stuff.** If you need to raise money to live on, such as for retirement or for a major purchase, sell the pricier holdings. As long as the taxes aren't too troublesome, it's better to sell high and lock in your profits. Chapter 21 discusses issues to weigh when you contemplate selling an investment.

## Individual-investment risk

A down-draft can put an entire investment market on a roller-coaster ride, but healthy markets also have their share of individual losers. For example, from the early 1980s through the late 1990s, Canadian and U.S. stock markets had one of the greatest appreciating markets in history. You'd never know it, though, if you held one of the great losers of that period.

Consider a company now called Navistar, which has undergone enormous transformations in recent decades. This company used to be called International Harvester and manufactured farm equipment, trucks, and construction and other industrial equipment. Today, Navistar makes mostly trucks.

In late 1983, this company's stock traded at more than US$140 per share. It then plunged more than 90 per cent over the ensuing decade (as shown in Figure 2-3). Even with a rally in recent years, Navistar stock still trades at less than US$20 per share (after dipping below US$10 per share). Lest you think that's a big drop, this company's stock traded as high as US$455 per share in the late 1970s! If a worker retired from this company in the late 1970s with $200,000 invested in the company stock, the retiree's investment would be worth about $6,000 today! On the other hand, if the retiree had simply swapped his stock at retirement for a diversified portfolio of stocks, which we explain how to build in Part 2, his $200,000 nest egg would've instead grown to more than $5 million!

Like most other markets, the Canadian stock market paled by comparison with the US juggernaut in the 1990s, but this country has had its share of stocks that have plummeted in value. How about Dylex, which through its many brand-name outlets, such as Suzy Shier, at one time took in one out of every ten dollars consumers spent in retail clothing outlets? The stock, which began the 1990s at $24, ended the decade languishing beneath the $10 mark, dwindling lower and lower until the company eventually went under in 2001.