InSite

News and views for the online investor

FALL 2006

Financial Markets in for More Volatility

by Dr. Sherry Cooper

It is a time of transition for the North American economy. The U.S. will continue to lead growth in the G7, but its economy is cooling. In Canada, the economy has gone for well over a decade without a recession but there is a Western tilt to the overall gains. Meanwhile, Europe and Japan are rebounding from sluggish growth.

The Bank of Canada left its policy rate unchanged on July 11, for the first time in a year, signalling a pause in its 225-basis-point tightening campaign. Then, on August 8, the U.S. Federal Reserve paused as well, after 17 consecutive hikes. Although North American monetary policies are now in a holding pattern, financial markets are unlikely to fly turbulence-free in the months ahead.

On both sides of the Canada-U.S. border, the combination of high energy prices along with high rates of resource utilization is applying upward pressure on inflation. Meanwhile, economic momentum is ebbing, potentially dampening inflation pressure. The reason why these central banks have paused is that they believe they have lifted rates enough to ensure that economic growth slows sufficiently to drive out inflation while steering clear of recession.

"Meanwhile, economic momentum is ebbing, potentially dampening inflation pressure."

Unfortunately, the data during the months ahead are likely to show growth and inflation veering from this planned path. At times, the indicators will exhibit signs of stronger growth and faster inflation, prodding speculation of more central bank tightening, which will be a drag for stock and bond markets. At other times, the data will display signs of weaker growth and slower inflation, stoking expectations of central bank easing, which will be a boost for stocks and bonds. Despite the monetary policy pauses, Canadian and U.S. financial markets are still likely to be at the mercy of the whims of economic data in the months ahead. In addition, we are in a period of extreme geopolitical turbulence, which will inevitably rock markets from time to time. But, the silver lining is that the volatility is likely to be less than in prior economic cycles.

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The Dollars Are in the Details

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Watch for further research enhancements and new tools, coming later this fall.

>FUELLING UP YOUR INVESTMENT BARREL

by Mahesh Kumar

Here's good news for wine lovers and teetotallers alike: Investing in a diversified portfolio of investment grade wine, either on its own or as part of a diversified portfolio, delivers superior double-digit returns, significantly lowers volatility and provides diversification benefits. As a result, buying and selling bottled wine from and onto secondary markets, such as trade, retail and auctions, has grown into a multi-billion dollar industry over the last 25 years.

The two-tier global wine market is made up of early consumption and investment grade wines. Over 90% of the wine market is early consumption, that is, wine consumed within three years from release. As it is sold immediately to the final consumer, it has no resale value and never finds its way back to the secondary market.

However, investment grade wines—the "blue chips"—possess impeccable quality, longevity and history, a price performance track record and a highly liquid secondary market following (annual volumes $2.1 billion CDN).

"...buying and selling bottled wine from and onto secondary markets, such as trade, retail and auctions, has grown into a multi-billion dollar industry over the last 25 years."

The blue chips—including wines from Bordeaux, Burgundy, Rhone Valley, Tuscany, Piedmont and Champagne—produce significant resale values and are actively traded in the global secondary market. Over the 21-year period from 1982 to 2003, the Fine Wine 50 Index (a portfolio of 50 investment grade wines) averaged an approximately 12% return per annum. The risk, measured in RiskGrade™ (RG), of a portfolio of investment grade wine held on its own (RG = 55) or held as part of a diversified portfolio of equities and bonds (RG = 70) is significantly lower compared to a portfolio of equities and bonds only (RG = 80).

Interestingly, the investment grade wine market is not correlated with financial and economic markets. Rather, investment grade wine prices are supported by a global demand/supply imbalance. The global demand for superior wine is increasing as there is only a finite supply of wine due to non-expandable acreages. When a wine is released for consumption globally, the supply of wine is reduced and the demand increases, inevitably causing prices to increase. Since investment grade wine prices are unaffected by the movement of equity and bond prices, the zero correlation with the financial and economic markets leads to significantly lower volatility, and provides diversification to a portfolio of traditional investments.

However, like traditional investing, there are many strategies you can use to buy wine. Like equities, you can invest in "neglected value". This simply means buying below an asset's fair market value and selling either at or above its fair market value.

You can also engage in arbitrage in the wine market. For example, if a case of investment grade wine is being auctioned at Sotheby's in New York for $5,000 and the same case of wine is being auctioned at Sotheby's in Paris for $4,500, arbitrageurs will buy in one market and sell into another, profiting from the price differentials.

Some investors identify sleepers both in terms of wine and vintage, buying lesser-classed wines in great years and great ones in lesser years. Others "talent-spot", for instance, buying wines that are either underrated or less known, but which are likely to win wider acclaim in the future. Alternatively, some trade down to "pale blue chip" wines, which can show significant investment potential in the future once these pale blue chip wines become more popular, and the demand for these wines increases.

"En primeur" buying involves securing allocations of wine before it is bottled and physically available (i.e. buying "wine futures"). En primeur buying is used selectively, only in highly sought after, fairly priced vintages. Buying wine en primeur has the potential to produce substantial short-term profits as the growth in wine prices in the first few years of a wine's life can be significant. Buying bottled wine from primary markets, for example, directly from the producers, eliminates intermediaries' mark-ups.

Investing in a wine fund involves fund managers, including pension fund managers, buying investment grade wine and/or shares in blue chip wine companies. Fund managers actively switch out of overvalued wines and lesser vintages into undervalued wines and greater vintages, so that portfolio returns are maximized.

Buying the right wines for your portfolio is the same as buying the right wines for your table: To maximize portfolio returns, lower volatility and enhance diversification, wine should only be bought from sources with strict quality and provenance guidelines and stored in a controlled optimum environment.

Mahesh Kumar BA (Honors), MBA, DipIC Mgmnt., ACMA, ATT, CMC, is the Founder, President and CEO of Roman-Boston Consulting Corporation ***(www.roman-bostonconsulting.com)****. Mahesh Kumar is the author of Wine Investment for Portfolio Diversification – How Collecting Fine Wines Can Yield Greater Returns Than Stocks & Bonds, winner of the 2006 Gourmand Global Media Award for the "Best Wine Education Book in the World." He is also an associate faculty member at the Faculty of Management at Royal Roads University, Victoria, BC.*

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Year-End Tax Tips
From The Experts

Given the significant tax changes for 2006 and onward, your investment strategy could benefit from some expert tax tips on year-end tax planning. The Knowledge Bureau is Canada's leading educator in the tax and financial services industry. Here, some of The Knowledge Bureau's experts give you their favourite tax tips.

For more tax-saving strategies, go to **bmoinvestorline.com** and read *Year-End Tax Planning 2006 - Full of Surprises* by Evelyn Jacks.

EVELYN JACKS *is the bestselling author of the 2007 editions of Essential Tax Facts and Make Sure It's Deductible. Her next book to be released later this fall, Get Your People to Work Like They Mean It, is co-authored with Jean Blacklock, COO of BMO Trust Company.*

You don't have to wait until year-end to put your tax-saving strategies in place—these next three tips will help you reduce your quarterly tax installments for 2007: 1) maximize tax-loss selling opportunities to offset capital gains in your non-registered accounts; 2) hold over disposition of assets with large gains to January 1 to defer taxes owing to April 2008; and 3) review income-splitting opportunities, perhaps by drawing up a bona fide investment loan to transfer capital to your lower-earning spouse at the quarter's prescribed interest rates.

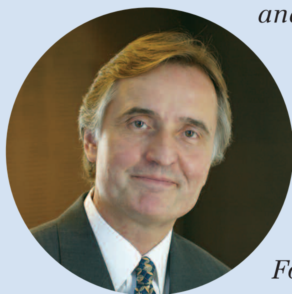
By reducing your quarterly installments as well as your year-end tax liability, you can invest your tax savings dollars that much sooner.

> "...stocks or mutual fund units that have built up gains over the years should be your donation vehicle of choice, as opposed to giving cash."

DAVID CHRISTIANSON *is a planner with Wellington West Total Wealth Management.*

The recent federal budget eliminated tax on capital gains resulting when publicly traded (listed) securities are donated directly to a registered charity. Therefore, stocks or mutual fund units that have built up gains over the years should be your donation vehicle of choice, as opposed to giving cash.

An even greater benefit comes from donating matured flow-through shares, which usually become liquid through a tax-free rollover into an eligible mutual fund after a two-year holding period. The fund will typically have a cost base near zero after the flow-through entity converts exploration tax deductions into capital gains. A sale would result in a capital gain, the tax on which negates some of the tax benefits from purchase. Donating the fund to charity instead of selling eliminates the tax liability on the gain, multiplying the net benefit of the tax-advantaged investment in flow-through shares.



DARYL DIAMOND *is President of Diamond Retirement Services and author of Buying Time: Trading Your Savings For Income and Lifestyle.*

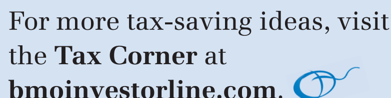
Consider loaning money to your lower-earning spouse to split income earned on non-registered assets and reduce taxes on that income. The Canada Revenue Agency (CRA) permits this type of inter-spousal loan as long as certain conditions are met:

Interest – Interest on the loan must be charged to the borrower by the lender. The interest rate can be set by the lender, but cannot be less than the prescribed rate established by CRA; this rate of interest is set quarterly. The rate or interest applies for the duration of the loan regardless of future changes to the prescribed rate.

Payment of Interest – Payment of loan interest must be actually made by the borrower and documented. It is due at the end of the calendar year and must be paid by January 30 following the calendar year end.

For example, assume a wife loans her husband $20,000 for investment purposes. He immediately invests the money so any investment income is now taxed in his hands. Assuming a 4% prescribed interest rate, he will pay her $800 per year in interest by January 30, which she must declare as income. This same amount serves as a deduction from income for him since he used the money to acquire income-producing investments. In this case, the family unit pays less combined tax by arranging this legitimate income-splitting transaction and taking advantage of his lower marginal tax rate.

For more tax-saving ideas, visit the **Tax Corner** at **bmoinvestorline.com**.



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FINANCIAL MARKETS IN FOR MORE VOLATILITY

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Both the Bank of Canada and the Fed have not needed to raise rates to back-breaking levels, as in previous episodes of rising inflation, minimizing the risk of outright recession. This risk is also reduced because businesses on both sides of the border boast the healthiest balance sheets in generations, and firms are now much better at managing their payrolls and inventories. Meantime, globalization and competition continue to crimp the ability of firms to pass on their higher costs, minimizing the risk of an inflation outbreak. There will be financial market turbulence ahead, but it's going to be a bit easier to navigate than in the past.

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