CastleMoore News
Buy, Hold... *and* Know When to Sell™

# THEY CHOSE THE ROCK

**By Ken Norquay, CMT, Partner**

In previous letters I have been empathetic toward our American friends because they are between a financial rock and an economic hard place. Greece, Ireland, Italy, Portugal, Spain and now France all occupy the same rocky ground. They all owe too much money.

They hope to muddle through this problem by (a) stimulating their economies so they can continue to make their loan payments, and (b) introduce austerity programs to cut back expenses so they will have extra money to make their loan payments. Of course, these two policies are exactly opposite: how can a country do both? Hence, they are all between a rock and a hard place.

In August 2011, the Americans, with grandiose flair and pizzazz, chose austerity. When President Obama was first inaugurated, he inherited the exact opposite; a stimulus package started by the George Bush Republicans in response to the global banking crisis of 2008/9. The stimulus didn't work, and the President got the blame for continuing economic weakness. Earlier this summer, the Republicans did an about turn and pushed for cut-backs. As a Canadian, I am fascinated by how skilfully the Republicans are instituting their agendas – stimulus in 2008/9 and austerity now. The politics is fascinating, but the economics is inevitable. The debt expansion game is over. Countries can no longer borrow their way to prosperity. It's pay-back time.

It's always fun for commentators like me to sit back and pretend we know all about the problems of state and of economics. But wise words aren't going to help those who owe too much – or those who loaned them the money. Now that pay-back time has arrived, we don't need knowledge or words; we need money. And, ironically, in modern economies, money is created by bank lending. The very process that caused the problem is the solution.

So, you see, there is no easy way out.

During my whole career in the financial sector, there has been a consistent theme in the world of money. There were long economic good times interrupted by short periods of economic bad times. In fact, ever since my father and his buddies won the Second World War, this theme of long periods of prosperity followed by short down turns has been the way of the world. Now I see that the whole post-war period was a time of gradual debt expansion. Whenever the economy cooled down, the central bank would heat it up again by easing credit. Whenever it got too hot, the central bank would cool the economy down by tightening credit: long periods of expansion interrupted by short periods of contraction. But somehow, this time, it's not working. Central banks around the world took dramatic coordinated measures to ease credit. The Americans unleashed their "Quantitative Easing 1" and QE2 programs. Yet somehow, it didn't work. Economies are not responding to the stimulus.

And the reason it didn't work is because collectively, the western nations have "maxed out" on debt creation. Collectively, we owe so much money that we can barely make the payments.

Those of us who live in these mature western economies will have to adapt. Perhaps the new economic era will feature long periods of contraction interrupted by short periods of expansion. Can we adapt?

How will you adapt? What can you do to influence the Fantasy Land of World Finance? Not a thing! Most of us don't live in the Never Never Land of billions and trillions of Dollars and Euros. We live in the reality of our own personal savings and investment accounts. We are our own central bank. We make our own fiscal and monetary policy. We are in charge of ourselves and our own finances.

At CastleMoore, we have made a business of dealing in the real world of our clients' personal savings and investments accounts. We realize we are not financial genius's who somehow know more than the world's economic leaders. It's not our job to save the world. It's our job to work in the real world of our clients' investment accounts and decide what investments they should own and when to buy and sell them. In the real world, some investments are going up and others are going down. Our clients should have the ones going up – not the ones going down. That's our guiding principle. It's how we live in the cloudy world of international economics.

As our American and European friends make headlines with their valiant attempts to spin economic chaos into economic stability, we pursue a less glamorous occupation: sorting through the lists of different investments to find those that are in an uptrend. And not getting dashed on the rocks.

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# NO INVESTMENT RELIGION FOR US, WE'RE AGNOSTIC

**By Robert 'Hap' Sneddon, FCSI, President**

At CastleMoore we having working hypotheses on the investing world – What keeps central bankers up at night? What is the true rate of inflation? What is the long term outlook for housing? Where are equities in terms of the secular or generational picture? – but all these large and complex topics should never get in the way of investment decisions. If anyone can tell you how the Greek drama is going to play out I would have to say there's a whole lot of guess work and hope involved. Sure, it would seem to make sense that they will eventually default on their debt obligations and maybe leave the Euro and return to the drachma so that they will be able to repay their loans using a devalued currency. It all seems logical doesn't it? We know from history that events take their own twists and turns, and often surprise us when the final chapter unfolds.

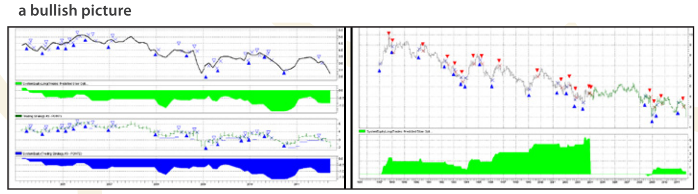
All we have to navigate investment decisions is methodology. Now when I say "all we have" it's not as if I am describing what happens when you look in the freezer and see that all you have for dinner is some funky pizza with weird, non-tomato sauce or some frozen meat that you think should still be okay. Methodology is all you need.

Two recent decisions we've made, one to do something, and the other to do nothing, amidst all these global challenges shows how we let our methodology guide us and not our ability to interpret the world.

We have held long dated Canadian bonds for quite some time now. (As at September 19, 2011 total returns on our 10 and 20yr Canadian bonds, net of costs, run from +9.7% to 18.4% and have been held for approximately two years. In the US our 20 year bond ETF is up +20.95%, net of costs, and has been held for 3.5 months). We've heard many times over the last few years, and particularly over the last 8 months, about the impending inflation coming. It's true, at some point, we will get inflation from rising wages (primary driver) and increasing house values (secondary), the two most significant inputs. Granted, by the time these factors are forcing the hand of central bankers to act, it will have already started to show up in the methodology or the model. The models will reflect investors' future view of inflation at that time, whenever it comes, by a drop in prices and rise in yields. Central bankers are always behind the curve as it were.

Our bond models, run and created by Associate Portfolio Manager, Thomas Kleinschmidt, have three components to them. If the model is like an engine there is one master cylinder which looks at the long term trend (large chart) and two smaller cylinders which produce shorter term signals.

Out longer term bond model chart shows yields falling, meaning bond prices are rising: a bullish picture



These shorter term models, including our buy and sell signals, helps to see changes in the longer picture before they show up in the longer term model.

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Our bond model allows us the freedom from having to correctly distil the larger global economic picture. While our working assumption arise from analysing tangible data points to continuing deflationary forces, we do not have to rely on such an analysis alone. A few years back, in the fall of 2008, another model started to reveal cracks in the banking sector well before the crash. Sure we could handicap the situation at the time in general terms by looking south into the US and wonder how people could afford such homes on average salaries, but taking action based on this assessment is another matter. Our models allow us the confidence to be decisive and act based on pre-conditions without knowing the whole picture which we all know too well now.

Similarly, we recently sold our gold bullion positions across all our portfolio types. (As of September 19, 2011, net of cost, our Canadian gold bullion position returned 26.1% and our US gold position 25.8%). One type of account, The Two Way Portfolio, even went modestly short. Now the conventional wisdom is that gold is in a long term up trend and you must own it today. Pick a reason to be bullish - inflation (a misplaced reason at that), currency swings, industrial use, price trend – and you can justify it. On the other hand, this week I heard a rumour that central banks may sell some gold to pay for their country's bills. And, the US dollar now appears to be strengthening. These are some bearish arguments. How do you not have your head snapped around everyday?


**This long term chart of gold bullion shows the recent parabolic blow off move.**

A quick look at the chart shows how parabolic the move has recently become. Again, we cannot factor in all the fundamental inputs into decision-making.

We can use a model to help us make the final decision against the longer term thesis. In this case, we state that gold is in a long term up trend but is over extended now. Because we also pay very close attention to the risk-to-reward ratios we do not like to give up profits when a security reverts to its trend. In this case, gold could come back to the 1500 range without harming the trend. Sometimes, you can pay a higher price when you repurchase or so close to your sale price that in hindsight you should have just stuck with it. But that said, what models in conjunction with a working thesis (or the fundamental analysis) provide you are probabilities.

Over time, when you start with the odds in your favour by using models, have a working thesis based on experience and incoming economic data, pay attention to the risk-to-reward before and during your holding period, and last, have tight risk management levels (loss tolerance) you increase your odds of profit. You do not have to rely on faith that things will return to the way they used to be or will continue as they are today, whatever that is. Getting away from the fervour of the doctrine of the investment industry and becoming a little more agnostic about outcomes when it comes to your investments will not only reduce time spent figuring how things will unfold but it will also reduce stress and increase success.


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# THE CHART PAGES

## GOLD BULLION


We no longer own gold. Yes, we sold client bullion, beginning several weeks back, and in the last two weeks became modestly short (sold it to profit from it falling in value) and added to that short position this week. The first trigger was the parabolic move in the price. Other indicators such as bullish sentiment on gold, futures contracts (mostly by hedge funds), stochastics and RSI reached extreme readings.

## CHINESE STOCKS


We watch the Shanghai market carefully to gauge a true read on the domestic China situation as it is only available to nationals. A break above the 3000 level or a test and bounce from support at 2300 would provide bullish confirmation to other global markets. We would consider foreign markets so long as we can mitigate any currency impact or hedge a portion of it.

## LOONIE

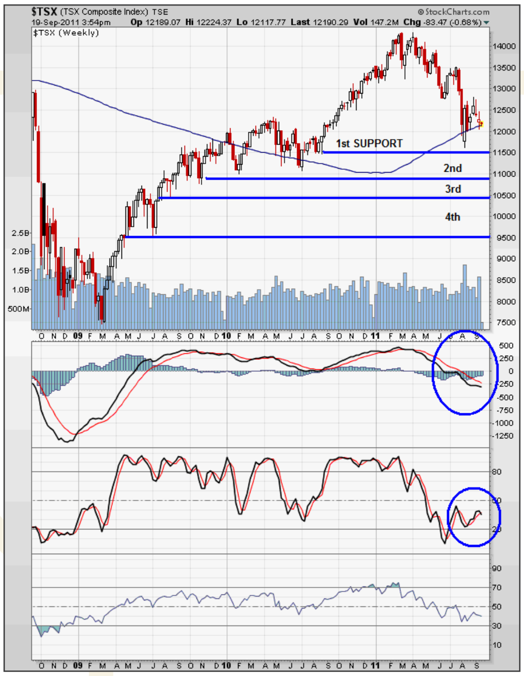

The Loonie has pulled back from a near term peak of approximately $1.06/USD. Price support is found at $1.02 and $1.00USD. The Loonie, S&P stock market and oil all have a very high positive correlation. A break down in the Loonie or WTI would raise a red flag for stocks and raise a green one for bonds, particularly US & Canadian government bonds. We currently hold a significant position in AAA government of Canada bonds (40-70%) and a smaller one in US Treasuries.

## US DOLLAR


On the flipside of the implications of the movements in the Loonie are the implications of the movements in the US greenback. At present the currency is moving higher. It has become a "risk trade" barometer for stocks. A move down in the dollar implies investors are feeling risky and are buying stocks; a move up implies they are feeling cautious and are selling them. The move up will find resistance at 80 on the dollar index.

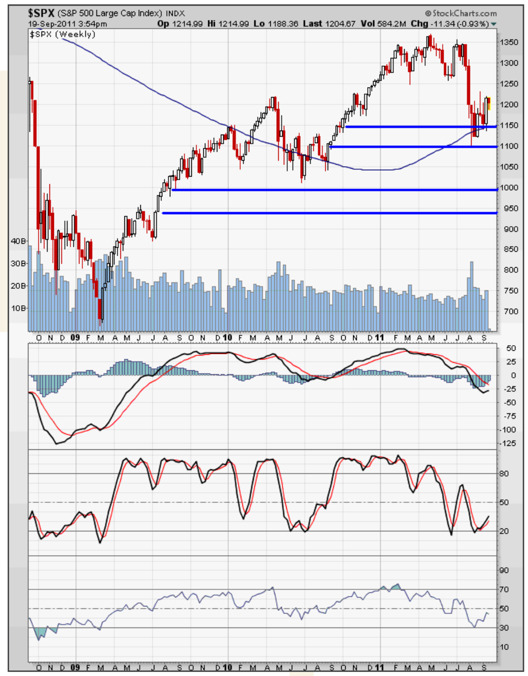
# THE CHART PAGES

## CANADIAN EQUITIES




In the middle to late September, equities are under duress, and Canadian equities have a little more froth to them because the stimulus funds (The Quantitative Easings I&II) went straight to commodities. The chart shows the various support levels, with the most critical being the near term support found at the August 8th lows around 11,600 for the TSX. At present CastleMoore clients have very little stock exposure (25% approximately) and of this, most is in defensive, positive sectors such as utilities, pipelines and telecomm.

## US EQUITIES




The US market is providing no near term buy signals though any washouts may present buying opportunities in specifically strong sectors. Like the TSX, the US stock market has various layers of support. At the beginning of September, our Investment Committee set out parameters – if this…then that – to purchase equities on finding support, providing excellent risk to reward ratios for profit potential. Handicapping the puzzle that is global economics these days does not lend itself to make rational investment decisions. Having a methodology and game plan ahead of time, before volatility sets in does.

## WHAT MAKES CASTLEMOORE UNIQUE AND VALUABLE?

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- Effective Portfolio Management – Plain & Simple
- Broad & Deep Industry Experience
- Managed Asset Classes – cash, maturities, ETFs/stocks, precious metals


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# DÉJÀ VU, ANOTHER SHOE?

**By Thomas Kleinschmidt**

Sadly, many investors were paralyzed when the First Fed Shoe dropped in 2008.

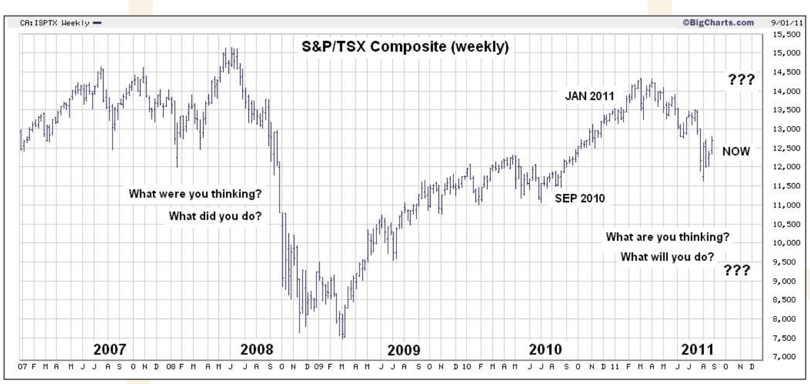
In the SEP-OCT 2010 issue I discussed a few key behavioral finance biases that most individual investors have. In the JAN-FEB 2011 issue I began with "Don't think that since the TSX is almost back at where it was 2 years ago your retirement is 'back on track' as now is the time to worry about losses and put an action plan in place to deal with the next slumping. This might entail switching managers, advisors, or taking the plunge to self-management." The next shoe would fall…it was just a matter of when.

So, is the Second Fed Shoe dropping now? My question to you is "what's going on for you this time?" Are you concerned or confident? In cash or fully invested or something in between? If the equity markets are strong what will happen in your portfolio? If the equity markets are weak are you going hold 'em or fold 'em?

I am finding that many investors old and young, especially higher net worth investors close to retirement, are having gut reactions of between nervous to frozen. All are looking for answers and hoping to find something that sounds decent enough to give them the confidence that their decades of hard work, careful planning and trust in their plans is not going to be taken away from them again. Be determined that another 2008 won't happen to you.

The good news is that the study of behavioral finance can point to why you, seasoned or novice, typically make the same mistakes and beat themselves up. Worth taking another look at now, here are a few of the main investor biases that, if not addressed properly, will cause "issues" with your portfolio value, if not your retirement itself.

- Prospect Theory – fearing losses more than valuing gains; selling winners too soon, holding losers too long
- Overconfidence – overestimating news, analyst forecasts, etc. and acting to affirm the level of confidence
- Confirmation Bias – only listening to new info that supports the prior decision and ignoring opposing info
- Noise Traders – the uninformed amateur investors who are often late to the party and stay too long
- Escalation Bias – averaging down and not cutting losses…what you hear from financial advisors as well.




Now would be a "good time" to sit for 5 minutes and consider the above investing biases and if these are causing a problem in your returns. Your advisor should not have these biases at all. If they do, fire them. If you do, fire yourself. So, the next time you are killing 5 minutes pull this out and note what biases you need to eliminate.

Enjoy the remaining days of summer, but please don't have a great fall!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## GUEST COLUMNIST

# RRSP'S - INVEST YOUR TAX SAVINGS TO STAY AHEAD

**By Ed Arbuckle,
CA, FCA, TEP**

Contributing to an RRSP for retirement has always been accepted as a financially sound proposition. Providing you follow through with all of the other necessary steps, that is true. If not, the result is not so great. The common mistake most people make is they spend their RRSP tax savings and end up being worse off than if they had not made a contribution in the first place.

To illustrate, we will go through a typical example for Pat Jones. Let's start with some basic assumptions about rates of return, time lines and tax rates so we are comparing apples and apples. We will assume a 5% interest rate on bonds 8% on stocks and tax rates of 45% and 25% respectively. Finally, let's work with an investing period of 25 years and an annual RRSP contribution of $10,000 by Pat who is in the highest tax bracket.

### ACCUMULATED RRSP FUNDS

If Pat contributes $10,000 to her RRSP every year for 25 years she will accumulate about $500,000 in the plan if RRSP funds are invested in bonds or $790,000 if invested in stocks. The after tax amount on withdrawal will be reduced to about $280,000 for bonds and $440,000 for stocks as illustrated below.

| | BONDS | STOCKS |
|---|---|---|
| RRSP deposits | $250,000 | $250,000 |
| RRSP earnings | 250,000 | 540,000 |
| **Total RRSP balance** | **$500,000** | **$790,000** |
| Income tax on future withdrawal | 220,000 | 350,000 |
| **After tax accumulation** | **$280,000** | **$440,000** |

### INVESTING OUTSIDE THE RRSP

Now let's assume that Pat invests her savings in a portfolio instead of contributing to an RRSP. In that case, accumulated after tax funds in 25 years would be about $365,000 for bonds and $590,000 for stocks.

| | BONDS | STOCKS |
|---|---|---|
| Savings | $250,000 | $250,000 |
| Earnings net of tax | 115,000 | 330,000 |
| **After tax accumulation** | **$365,000** | **$580,000** |

What happened – the accumulated after tax amount is higher by investing in a portfolio than it is by contributing to an RRSP? That seems surprising! The reason for the lower accumulated RRSP amount is because funds contributed to the RRSP are fully taxable when withdrawn – whereas taxes on portfolio capital gains and dividends are taxed at a much lower rate. You are probably starting to see the error most people make. They do not re-invest their tax savings to make up for the future tax hit on RRSP income.

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To stay even, Pat should invest at least some of her annual tax refund. Let's see what happens when she does that.

| | BONDS | STOCKS |
|---|---|---|
| RRSP after tax accumulation (above) | $280,000 | $440,000 |
| Invested accumulation | 161,000 | 260,000 |
| **After tax accumulation** | **$441,000** | **$700,000** |

So now the total accumulated funds are higher by using an RRSP and investing the annual tax savings than by investing. Our calculations indicate that you do not even have to invest the entire annual tax savings to break even but if you do not, you are not getting the full advantage from your RRSP. The object of an RRSP is not to stay even but to improve your net wealth in retirement so invest all of your tax refunds.

## PENALTIES FOR USING RRSPS

There are penalties for RRSP investing that you should consider. When you reach retirement, tax rules make it mandatory to include a certain amount of your RRSP balance in income each year. For some individuals, their tax rate in retirement could be higher than their rate during their working years. On death of the last spouse, the full RRSP balance is taxable and a whopping tax bill usually results. Another significant penalty is that the RRSP capital and income stream cannot be well managed and estate planning options are pretty much nonexistent.

## OTHER CHOICES

To be effective, RRSP investing requires a commitment to a long term saving strategies. If not, the benefit disappears or slips into negative territory. Because of the lower tax rate on capital gains and dividends, the tax advantages of RRSP contributions are diminished – especially as you get older. Perhaps you should use some of your savings to build an investment portfolio instead of contributing to an RRSP. This will also allow more flexibility to manage your finances and taxes in retirement.

At some point, individuals may actually consider reducing their RRSP balances to overcome the tax hit in retirement. They could borrow an amount equal to the tax they pay on an RRSP withdrawal to bring their total investment back to its original amount. Interest expense on the loan should be tax deductible if structured properly and families will start to build a more manageable pot of capital outside the RRSP. This is not for everyone but is an option worth looking at - certainly for high wealth individuals. The technique will also assist families with estate planning.

There is a lot to think about in RRSP planning – more than meets the eye. Contributing to an RRSP is not always the solution that it sometimes seems to be and can cost you money if not done properly.

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