



# CastleMoore News

Buy, Hold... and Know When to Sell™

## SIMPLE LOGIC



**By Ken Norquay,  
CMT, Partner**

Why is the United States so low on the list of life expectancy of its citizens? Everyone knows the USA ranks very high on the lists of wealth per capita, income per capita and other standard of living statistics. Why are they ranked fiftieth on the list life expectancy. (There are a number of different life expectancy lists on the internet: the USA consistently ranks fortieth to fiftieth.) Canada consistently ranks in the top 9 to 12. Those of political persuasion may argue it's about the comparative healthcare systems. Health and fitness enthusiasts will site statistics on how over-weight the average American is. But, whatever type of person you are, America's low ranking is a logic-defying bell ringer. It just doesn't make sense.

It does make sense that the poorest African countries are at the bottom of these lists. We can imagine the triple ravages of poverty, crime and AIDS shortening people's lives. But how do we explain the fact that an African country is also at the top of the list? Morocco is far and away the leader: the average Moroccan will out live the average Canadian by eight years!

Logic is strange stuff. Because of these life expectancy statistics, it makes sense for Americans to move to Canada when they retire. But the opposite is what usually happens. And the reason retiring Canadians move south is something to do with winter weather. Sometimes logic makes us weigh one set of logical reasoning against another. Weather or longevity: which is more important?

In the investment business we are used to quirky logic. Investors have been trained to think blue chip is better than small. But it's not true. The giant General Motors kept getting less and less effective as the once smaller Toyota kept growing. The price of the giant Microsoft's stock is about the same today as it was ten years ago: the smaller Apple Computer has gone up a multiple of 35X. Big and Blue Chip is not a good rule of thumb: it's faulty logic.

If we tried to construct a logical investment plan without falling back on faulty assumptions, what would our plan look like? Logically, our investment focus would be on using a variety of financial instruments to make money for us. Logically, we should own investments that are going up in price and not own investments in down trends. Our investments should serve our needs: and if they don't, we should not own them. The best reason to own an investment is to sell it in the future at a higher price. A secondary reason to own it is that it might pay interest or dividend income. Capital gain and income give us a rate of return. Simple logic.

Would diversification be important? Surely we would want a diversified portfolio of solid investments. What about value and what about earnings? Surely we would want to own companies that have solid earnings and are conservatively valued. Would a logical plan include these concepts?

Or would the focus be on the rewards reaped by the investor instead of the features and characteristics of the investments?

Somehow we get distracted. Somehow we lose track of simple logic. Someone else's investment ideas might involve diversification or value; and we sometimes come to think they should be important to us too.

### Here are some logical rules for investors.

1. Own securities in up trends and hold them until they stop going up.
2. Some day you will want to sell the investment you are buying today: make sure there is sufficient trading volume so you can sell when you want to sell. Make sure you have a way out.
3. Never hold investments in down trends.
4. When you make a mistake and buy a security that goes down instead of up, sell it right away. Smart investors have small losses.

If your financial planner told you to diversify, maybe you should own a portfolio of diversified investments that are all in up trends. If you want value stocks, maybe you should own a portfolio of value stocks that are in up trends. If your stock broker tells you to buy high yielding securities, buy high yielding securities that are in up trends. Owning investments that are going down in price is never logical, whether they are part of a diversified portfolio, whether they represent value or whether they have a high yield.

By insisting on simple logic in your investing, your portfolio will live a lot longer.

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## THE CAPTAIN GETS THE SEAS HE'S GIVEN: MONETARY AND FISCAL POLICY AND ELECTION CAMPAIGNING



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

During election cycles, like a good bureaucrat, I try to publically avoid taking any strong positions, saving my political banter for my closest pals over beers. For disclosure purposes, I am a fiscally conservative centrist Canadian. I don't like to tell others how to live, appreciate we have some environmental and social responsibilities, and like the government books and spending to be tight. I have been a Director in the old Progressive Conservative party's Vancouver Centre riding, worked on an Ontario mayoral race, helped out in an NDP campaign during university, and several years back I was a regional polling supervisor for Elections Canada. While I have some broad political experience, to me talking about it is still a rather private affair. As with religious discussions, I was raised to not talk about politics in public – you'll tee off someone for sure and you just might change your mind on things down the road.

But now that the election is over I have to get something that's been stuck in my craw for many, many years out: politicians taking credit (or conversely getting blamed) for economic conditions for which they had little or no affect upon. Why today? It's because this false attribution rises up and is strongest around election time. It's freshest in our minds now and timely to set the record straight.

After the writ was dropped we saw Conservative ads showing Prime Minister Harper in his office late at night. He is working, papers neatly organised on his deep dark wood desk. The voice over talks about the sensible Conservative stewardship of the economy, and how no other party should be trusted in these uncertain times. This attribution of economic success to a government or individual within one would be as misguided as the British government's in its recent hiring of Paul Martin, Canada's finance minister during the troubling days of our stand alone budget crisis in 1994, and later Prime Minister, solely because of what he did back then.

In examining economic attribution, or rather impact, we can make it simple. There are only two things (policy) that can be done to create optimal conditions for economic stability and growth: fiscal and monetary actions. Fiscal policy relates to actions by governments or elected officials and the other to actions of The Bank of Canada. But neither works all neat and tidy like in the movies and each has a different time frame of efficacy.

Monetary policy is non-political and is executed by bureaucrats. It is implemented through its raising and lowering of interest rates. This in turn affects the money supply in circulation. To avoid being seen as favouring one party or another The Bank has a quiet period pre and post election where little action if ever is undertaken. If The Bank wants to stimulate the economy rates are lowered to entice borrowing, thereby fuelling subsequent economic expansion. The reason for stimulation as we have seen in the last two years is to prevent deflation or a downward spiral in prices. Once deflation takes hold it's rather hard to stop. During the Great Depression the authorities in the 1930's cranked up rates too quickly and did other things to constrict the money supply. It was for these reasons that we saw the final bottom in stock markets later in 1932, not in 1929 as conventional memory would place it.

Fiscal policy relates to the consequences of the governing party of the day's decision on taxation and spending. If we use the Liberal government's rule during those challenging days in the early 1990's history shows that it was forced by the bond market to make some changes. As we see today with Greece, Ireland, Portugal and Spain the bond market through the machinations of buying and selling determines at what rate a country will refinance its political agenda and budget. If investors are concerned about a country's financial situation they will demand a higher rate to be compensated for the

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increased risk. And the greater you rely on foreign bondholders the more susceptible you are to market rates.

In 1994 with the country on the precipice of default Paul Martin did what he was forced to do by cutting spending and adjusting tax rates. It was the Liberal government's actions at that time – that long ago - that put Canada out in front during the financial crisis of 2008-2009 as an economically strong and stable nation. It was not the actions of Stephen Harper's minority government. Fiscal policy takes much time for the effect of whatever policy is enacted to wind its way through the economy.

For example, lowering corporate or personal tax rates have a lag time wherein recipients do not necessarily spend the savings immediately. Some may go to debt repayment or savings before it shows up in corporate or personal spending. We will bare witness to the impact of the Conservative's decisions several more years down the road.

In this particular global crisis what did save things was mostly attributable to monetary policy. All central banks reduced interest rates at the same time and in dramatic fashion. The response had to be swift in order to prevent a ceasing of financial markets – had that occurred who knows what things would look like now. Today, many central banks have started to sop up that extraordinary liquidity including Canada, Australia, China and the EU to name the major ones, through the raising of national interest rates. This in turn prevents the opposite effect of deflation, namely, inflation, from getting a foothold. The US has maintained its "accommodative" stance and sees no need to begin increasing rates partly because the US Fed Chairman, Bernanke, remembers the mistake made in the 1930's by reducing the money supply too quickly. Some argue higher energy and food prices are only topical and temporary, that down in the deep there is still the shadows of deflation.

Governments, through fiscal policy, enact visions based on their political preferences to achieve an increase in disposable income, full employment and longer term economic growth. The trade offs for attaining these may be a reduction of services, particularly social services. Historically, in Canada, we have tended to seek a balance between income growth, potential economic prosperity and services.

National economic data has bounced back up across the globe to varying degrees. This is in line with the ranges of the pace of interest rate increases that we've seen amongst countries. Some have been quicker to raise rates and others, less so. But in no region has the economic output surpassed those heady peaks of 2007-2008. Monetary policy is far more short term in its efficacy, linking several smaller periods or economic snapshots together without a longer term vision for economic growth. As mentioned, that is the task of governments not appointed bureaucrats.

Monetary policy cannot fix the structural economic problems that caused the crisis. That's the job of fiscal policy. And the leaders of the day must sail the seas he's given. The rest of us must understand the task at hand and be sparing with our protest or praise.



## CHINESE INVESTORS HELPED PROPEL COPPER HIGHER IN AVOIDING TIGHTENING BANK REGULATIONS

Readers and clients know how we are fond of reviewing the price of copper to gauge the larger equity and economic picture. Copper goes into everything from electronics to autos to construction. Historically it can lead broader markets, both on the upside and downside. For example, it bottomed in November 2008 well ahead of the bottom for global stocks which occurred 4 month later in March 2009.

Commodities have been on a tear in the last year based on improving economic data and a drop in the USD, the currency copper is priced in. But now we learn that there may have been a third column - tightening money policy in China.

According to a recent investigation by Michel Pettis of the Carnegie Endowment for International Peace's Asia Program, and a professor of finance at Peking University's Guanghua School of Management (also a former member of the faculty at Columbia University's Business School) and breached at CBNC.com, Chinese investors who required loans would purchase copper with a very cheap line of credit, then use the copper as collateral with the banks to avoid the onerous unfunded loan rates of 10 – 20%. Apparently the authorities caught wind of this scheme in April and halted the practise.

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# THE CHART PAGES

## GOLD BULLION



The move from the lows in January saw gold travel from \$1300 to \$1575/oz. At present, it has pulled back from the peak, with many indicators at high or extreme readings. Gold bullish sentiment has dropped (not shown) faster than the price. The asset class, which is in a long term secular bull market, is in the midst of another correction. Considering bearish sentiment has risen so quickly, the odds are favourable that it may correct by going sideways or find solid price support if any larger downside were to occur. We own bullion in both Canadian and US dollars.

## CHINESE STOCKS



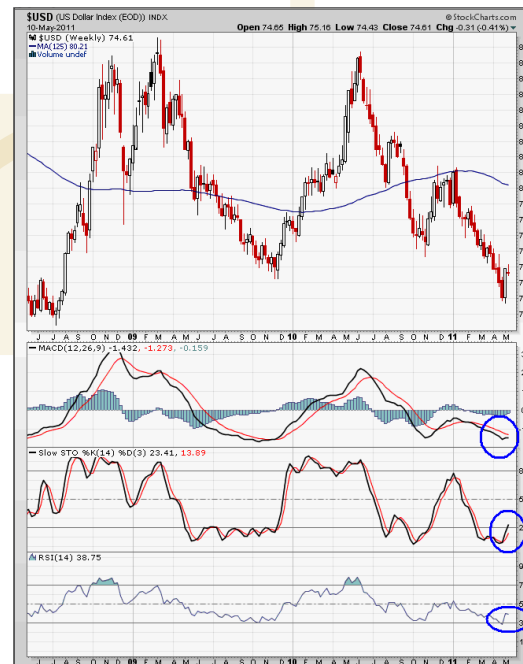
Since we wrote last month about the efforts of the Shanghai to break out above the 3025 level, the march up has been repelled at resistance. We use this market to get a true read on the domestic China situation as it is only available to nationals. Regulatory authorities have raised bank reserve requirements 5 times this year to try to tamp down inflation. Once the market is comfortable the campaign is over, this market may play catch up with and provide a tail wind to other global markets.

## LOONIE



The Loonie has pulled back from a near term peak of approximately \$1.06/USD. Price support is found at \$1.02 and \$1.00/USD. 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.

## 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 has found resistance at 75 (a measurement against a global basket of major currencies).

# THE CHART PAGES

## CANADIAN EQUITIES



The recent correction has been swift and volatile – more so than in most markets due to our high concentration towards commodities, especially gold and oil. As the chart shows the longer term 125 week moving average has only recently turned up, suggesting that we are at the early stages of a longer term market move. There will be further volatility expected, but as with our comments on gold, the market should find support quickly.

## US EQUITIES



Compared with the Canadian market the US S&P has performed better. Though it too is in a corrective phase its lack of commodity exposure has produced far less volatility. Healthcare and Consumer staples have actually provided positive returns during this short period (weekly). We currently hold Johnson and Johnson and Pfizer in our Two-Way portfolios. Often during corrections new front-runners emerge that will lead the next general market move higher. The strong monthly sectors still remain energy, technology, materials and industrials. We are watching to see if this longer term leadership is changing from these higher risk sectors to the more prosaic ones, including the two mentioned formerly as well as the utility and telecom sectors. A move towards these would indicate a "risk off" environment and a stronger US dollar.

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## UP, DOWN OR JUST SIDWAYS?



By Thomas Kleinschmidt

You are familiar with the S&P/TSX 60 and the DOW JONES 30 indexes as charts as displayed on BigCharts.com or Stockcharts.com but are you familiar with an SVA® (Structural Valuation Analysis®) graphic from Strategic Analysis Corp? This is the stuff of balance sheets and what the market is trying to tell us if we can decipher the message.

News can be quite the distraction and can simply be tantamount to little gusts of wind within the Trade Winds. Below are 5 year semi-log SVA® charts which simply overlay factors of book value onto the price charts. The secret symbology of these charts is "N" equals 1 times adjusted book value and "G" equals 2 times "N". These are called "structural" lines and are based on the "structure" of the balance sheet and their message should be well heeded.

For example, in late 2008 when the TSX 60's prices dipped below the SVA® Growth line the market was telling us that the TSX60's growth was severely in question and prices were revalued all the way back down to book value...a 50% fall. Today, what is the market saying about the TSX60 and DOW30 – up, down or sideways from here?

See how the TSX 60 is below the red "G" or growth line of 2 times book value and that the DOW 30 is above its Growth valuation line. The market values the DOW30 above the TSX60 in terms of growth... the market now expects that growth. When the market doesn't get that growth what happens? Look at the charts in late 2008 – a massive valuation crash occurred – not only did the TSX 60 fail to stay above its Growth line the DOW 30 failed to hold its higher "MG" line. Support and resistance in terms of factors of book value are evident. For those that care, arithmetically, the TSX 60 shows up 26% /down 8% and the DOW 30 shows up 5% /down 15%.

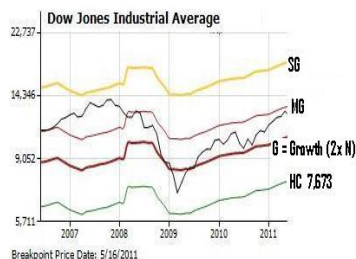
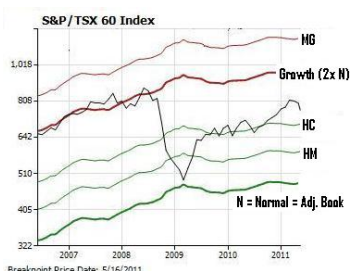
**For investors like you, the above new knowledge means one of 3 things:**

- UP – I'm decidedly bullish for such-and-such index ETF or stock
- DOWN – I'm decidedly bearish for such-and-such index ETF or stock
- SIDEWAYS – I'm hoping like mad that my investments won't take a plunge like they did in '08

**For everyone I recommend at this juncture in the markets that you take a few hours and do 3 things:**

- review the audio tracks on our website and identify what Level of investor you are
- review your January portfolio statements from 2008 through to 2011 to determine how your money is being actually managed (hint: your money needs to be managed according to your Level, that is your risk tolerance)
- determine if you need to take some urgent action to balance how your money is being managed

For those of you who have read this far I offer you my next article two months ahead of schedule. With SVA® charts I discuss the key sectors of both indexes. You will be able to see how "structurally" sound the supporting sectors are, which is important for the equity-based allocation of your portfolio. Give me a call (905) 847-2713 or email me [thomas@castlemoore.com](mailto:thomas@castlemoore.com) and I'll send it to you early. I can also do a "structural review" of your current holdings should you wish.



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## GUEST COLUMNIST

# OUR HOME, OUR COTTAGE, OUR FARM, OUR WINTER CONDO! TAX PLANNING = MEGA TAX SAVINGS

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

So many choices – so little time! That is often the dilemma for families when they decide to move on in life and sell their home, their cottage or their weekend farm. A place where they have spent so much time and with such fond memories.

An emotional roller coaster for sure but life is taking the family in a new direction. Maybe it's retirement, maybe it's just time for change or maybe someone is in poor health. Whatever the reason, there can be significant opportunities for tax savings if families properly plan the reporting of the sale of their homes.

It is indeed unfortunate that tax planning is such a root canal. Many people just want to get it done as cheaply as possible. E-filing is the mission and saving the cost of tax return preparation is the bonus. Drat! But what if you paid a little money to get your return done – maybe a nice refund would happen. Would it be worthwhile? Certainly, planning the sale of your home or the family retreat is a good place to put in some serious effort.

Everyone probably knows that the gain on your home (CRA calls it your principal residence) is not taxable. And a recreational property qualifies as a principal residence. The trick is deciding which one gives you the best tax advantage because you can only choose either one of them in any year. There is such a myriad of rules surrounding this exemption that it is mind boggling. The following questions might occur to you.

- What if we own two homes at the same time?
- What if our farm retreat is not just a couple of acres but has fifty acres of bush and some farmland? Does all the property qualify as a principal residence?

- What happens if our Shangri-la is in Portugal?
- What's the situation if we move away for a few years, rent out our home and then come back to live in it again?

What if? Every one of these situations is fraught with rules and rules to interpret the rules but the tax savings we are talking about here can be huge. In some cases the gain (depending on your choice of principal residence) could be say \$250,000 – in another case maybe a million. Remember that about 25% of your gain could come back as tax savings. Still planning on tackling this problem yourself? I wouldn't think so!

A single newsletter can't possibly deal with all of the nuances of the principal residence rules. Therefore, this one will only review the scope for tax planning when you have more than one qualifying residence. In future, we can talk about other issues and some solutions.

Let's look at an example. Don't try to follow the math too closely because the Income Tax Act throws in some curves you will not understand.

Bob and Sandy own two residences. They paid \$150,000 for their home in 1972 and spent another \$160,000 on renovations over the years bringing the total cost up to \$310,000. The property is worth \$630,000 today so they have a handsome gain of \$320,000.

In 2005 they bought a cottage for \$90,000. Cottage property has done well and it is now worth \$300,000 giving them a nice gain of \$210,000.

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It is their intention to sell both properties this year and use some of the proceeds to buy a condo in Port Hope, Ontario. They plan to spend about \$350,000 on the condo and invest the balance of \$580,000 (less any tax on capital gains) for their retirement so they want to minimize income taxes.

Which property should they choose as their principal residence for the most tax savings or should they select both of them in some combination. Although they can only designate one of the properties as their principal residence in a particular year, they can pick and choose which one is the principal residence in each year over the total period of ownership.

It seemed to Bob and Sandy that they should select their home as their principal residence for the entire period since their home shows a gain of \$320,000 compared to a gain of only \$210,000 on the cottage – hence a bigger capital gains exemption.

The peculiarities of the tax calculation (as mentioned above) will still allow them to designate one year to the cottage in the principal residence exemption calculation. In the end, this will mean that \$60,000 of the cottage gain and all of the gain on their home will be exempt from tax. Therefore, they will only pay tax on a cottage gain of \$150,000 and the remaining \$380,000 of gains will be completely tax free. Tax of about \$35,000 on the combined gains of \$530,000 seems like a pretty good deal to Bob and Sandy.

Bob decides to do a little more work because he starts to think that maybe they should select the cottage as their principal residence for some of the years. After all, the gain on the cottage on a per year basis is larger than the per year gain on their home. Maybe this allocation will work out better.

Bob reverses the calculation so the cottage becomes their principal residence from 2006 to 2011 (not 2005 due to a plus 1 factor in the calculation) and their home for all other years. Now the entire gain on the cottage is tax exempt. Their home becomes the principal residence from 1972 to 2005 and \$280,000 of that gain is tax free based on 35 years out of 40 being exempt. When the house and cottage exemptions are added together, the total exemption is \$490,000 and only \$40,000 is taxable. The tax bill just went under \$10,000 or a savings of \$25,000.

Hold on a minute – \$490,000 is a larger exemption than the \$380,000 when their home was designated for the longer period. How can that be since there was a larger gain on their home? Well the answer lies in the fact that their home had an annual gain of \$8,000 while the cottage had a gain of \$30,000 a year so a larger election in favour of the cottage gives a larger overall exemption for that year. What do you know!

One thing I have learned in this business is never trust final conclusions without checking things out. Put everything down on paper and test it. More often than not that the result is different than what you may have originally thought. Of course it helps to know the rules of the game and that is where professional advice comes in.

This is just one simple example of how the principal residence exemption rules can work to your advantage. There are many more and they need to be road tested if you are about to sell a property that qualifies as your principal residence. It is really the only legitimate tax shelter left.



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