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OD Financial Planning

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Reasonable Market Expectations for 2005

Introduction

From the November issue of *Ontario Dentist*, readers will recall that Dr. Frank Mertz is a successful 60 year-old dentist, and he and his wife Edna are preparing for their retirement in two years. Their expectations for investment returns had been influenced by friends who up until 2000 claimed they were earning 30 percent per year on tech stocks. The Mertz's succumbed to the temptation to invest based on their friends' experience, and lost 50 percent on some of their investments in 2000. After that, they became very risk-averse, investing only in cash. As our clients, they have agreed to a balanced portfolio of cash, bonds and stocks for diversification, for sufficient long-term returns to meet their living expenses and to leave enough for an estate.

Dr. Mertz: As the new year begins, we are visiting you to review the market's performance in 2004. What can we expect for portfolio returns in 2005? What are the investment implications of these expectations?

A: We will present our market expectations to you (and to our readers), and explain why we think these expectations are reasonable.

Retirement and estate plans involve the client's portfolio today, future living expenses, and the client's expected returns. Therefore, it is important for you, Frank and Edna, to have reasonable expectations in order to plan for a secure retirement.

Dr. Mertz: You have said that the returns for Canadian investors in 2004 have been very good. Why do you say that?

A: Canadian markets in 2004 recorded "very good" returns. Cash or Government of Canada T-bills returned 2.5 percent or close to the long-term average return of three percent per year. (This was the main class of the Mertz's investments before becoming our clients.)

Canadian bonds (the Scotia McLeod Universe Bond Total Return Index) returned 7.2 percent for the year ended December 31, 2004. Falling interest rates gave bonds an extra gain of three percent as well as the expected interest yield of 4.2 percent. Steadier interest rates will likely limit bond returns to about five percent in 2005.

In 2004, Canadian equities (the S&P/TSX Equity Index) returned 14.5 percent with short-term gains from the energy and materials industrial sectors (due to temporarily high oil and commodity prices). This return is well above the long-term average for Canadian equities of about eight percent per year.

In 2004, the S&P 500 Index returned 10.9 percent in U.S. dollars but only 2.8 percent in Canadian dollars because of the temporary strengthening of the Canadian dollar. Over the long term, U.S. equity returns average about 10 percent to 12 percent per year in Canadian dollars. We expect that U.S. equity returns will recover to their traditional levels, and this offers a buying opportunity before prices recover and go higher.

Like other clients, your balanced portfolio is a blend of asset classes. The portfolio comprises two percent cash or treasury bills, 38 percent Canadian bonds, 30 percent Canadian equities, 20 percent U.S. equities, and 10 percent international equities. The blended return of these classes using indices was nine percent for 2004 excluding management fees. A reasonable long-term return is seven percent per year for this balanced portfolio.

Another measure of what is "reasonable" is the mutual fund market. If you or any investor had purchased the median performing mutual fund in each asset class and blended them in the proportions noted above, the blended return would have been 6.6 percent after management fees. That means that the return of the blended mutual fund was 2.4 percent below the market, about equal to the mutual fund management fees. Although disappointing, this performance is typical.

Dr. Mertz: Do you expect higher returns or stable equity markets?

A: We think the markets have stabilized since the tech-bubble burst in March 2000. The blue-chip Dow Jones

Index has recovered by 40 percent from its low in October 2002 and stabilized. The Canadian S&P/TSX and the U.S. S&P 500 indices have both recovered by 50 percent from their lows and stabilized. The tech-heavy NASDAQ index has recovered by 80 percent and also stabilized.

Company valuations, as measured by todayÕs market price per share divided by 2005 expected company earnings (the P/E ratio), have also stabilized. The P/E multiple for the S&P500 Composite rests at 18 times or near its 50-year average. Similarly, the Canadian S&P/TSX Composite is at its 50-year average of 17 times.

The dividend yield for both indices is about 1.8 percent. Therefore, you and other investors still must buy equities for capital gains to achieve desired retirement needs.

Dr. Mertz: What economic conditions do you expect for 2005?

A: We expect oil prices to average $35 US per barrel, moderate economic growth and limited inflation. These conditions should keep interest rates generally stable in 2005. However, U.S. interest rates may rise due to higher U.S. government borrowings, causing equity P/E multiples to reduce offsetting earnings growth. U.S. bonds should provide returns limited to the coupon yield. With a slightly contracted multiple and earnings growth, the U.S. equity markets overall may not grow significantly in 2005.

In Canada, returns for bonds can provide higher returns based on flat interest rates.

Mrs. Mertz: Based on your economic assumptions, what are your investment forecasts for 2005?

A: Based on the assumptions, we expect that market returns will be moderate in 2005. In Canada, we anticipate that the bond market index will return about five percent, and Canadian equity returns will be between seven to nine percent. US equities will return six to seven percent in U.S. dollars. The Canadian dollar will stay in the $0.80-$0.85 US range.

Risk is defined as the uncertain (and usually negative) variation of possible returns. The major downside risk factors today are a world-scale terrorist calamity, a disruption in a major energy supply, or increased global warming. These could have an immediate and unexpected market impact, and may also precipitate a recession, with higher interest rates, slower growth and a decline in consumer confidence and spending. Under these adverse conditions, a diversified portfolio with selected securities can provide reduced market exposure while giving long-term performance. You have a diversified portfolio with high-quality securities.

Mrs. Mertz: What are the implications for investors in general?

A: Other long-term investors, like you both, can invest in U.S. equities now in anticipation of the future recovery of the U.S. currency. In this way, capital gains may be controlled and risk diversified using a blend of bonds and equities to suit the clientÕs risk tolerance.

We are investing for you, Frank and Edna, using selective portfolios. This means investing in companies that reflect long-term profitable growth, low volatility and at reasonable prices. TodayÕs market conditions favour owning strong companies for buy-and-hold investors.

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