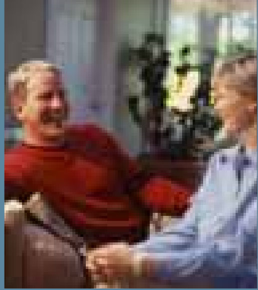


ScotiaMcLeod
exchange

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APPLYING A DISCIPLINED INVESTMENT PHILOSOPHY

To Our Clients

With this issue of *exchange*, we are pleased to present ScotiaMcLeod Investment Executive and noted author David Cork. Author of the best-selling *The Pig and the Python* and *When the Pig Goes to Market,* David's books have shown Canadians why they should invest in the stock market and how to achieve long-term investing success. In his new book, *Bulls, Bears and Pigs*, David continues his focus on the baby boomers and shares his strategy for how this generation can build and sustain wealth as they prepare for retirement.

In this feature article, using comparisons between the stock market and real estate, David illustrates why investors need to take a more passive approach to their long-term investing goals.

Sincerely,
ScotiaMcLeod

Treating our Equities like Real Estate

David Cork • *ScotiaMcLeod Investment Executive, Director*

You read it almost every day in the press: we're an aging population. As a result, there is a growing concern about a series of issues that catch our attention as we get older. What is health care going to cost? Is the public pension sustainable? How does aging affect the economy? Have I saved enough? These all really boil down to the same issue: as I get older and hit my senior years, am I going to be okay? Clearly, these are questions that are very difficult to answer with any degree of certainty. What is clear is that more and more Canadians are becoming aware of the importance of financial planning in this vacuum of uncertainty. They're aware of the importance of understanding risk tolerance and having a written investment policy statement to execute their asset mix.

The Importance of Asset Mix

In fifteenth-century Europe there lived a very wealthy man by the name of Jacob Fugger. His family is wealthy to this day, and looking back over the past five hundred years it would be fair to say that he could be described as the father of proper asset management. It seems remarkable that the modern-day 'average investor' is just now discovering an idea that was obvious to this man so many years ago. For those seeking sustainable long-term wealth, it would be wise to consider the thoughts of this man:

> "Divide your fortune into four equal parts: stocks, real estate, bonds, and gold coins. Be prepared to lose on one of them most of the time. During inflation, you will lose on bonds and win on gold and real estate; during deflation, you

continued...

lose on real estate and win on bonds, while your stocks will see you through both periods, though in a mixed fashion. Whenever performance differences cause a major imbalance, rebalance your fortunes back to the four equal parts."

Jacob Fugger the Rich
1459-1525

What is striking about his statement is how little things have changed over the centuries. Of course, we now have central banks and international exchange mechanisms so we can use cash instead of gold coins; however, the four basic asset categories still exist, i.e. two fixed return assets (cash and bonds) and two capital assets (real estate and stocks). Also, the basic tenets of asset mix laid out so many years ago still hold true today, including defining the mix, diversifying and rebalancing. However, real wealth creation occurs in the capital assets and the average investor needs to get a handle on how these work.

	TORONTO STOCK EXCHANGE		OTTAWA REAL ESTATE	
1990	-14.8%	$10,000	2.9%	$10,000
1991	12.0%	$8,520	1.4%	$10,290
1992	-1.40%	$9,542	0.4%	$10,434
1993	32.5%	$9,409	3.0%	$10,476
1994	-0.2%	$12,467	-0.4%	$10,790
1995	14.5%	$12,442	-2.9%	$10,747
1996	28.3%	$14,246	-1.9%	$10,435
1997	15.0%	$18,277	2.4%	$10,237
1998	-1.6%	$21,019	0.1%	$10,483
1999	31.70%	$20,683	4.0%	$10,493
2000	7.4%	$27,239	6.6%	$10,913
2001	-12.6%	$29,255	10.3%	$11,633
2002	-12.4%	$25,569	14.1%	$12,831
2003	26.7%	$22,398	9.0%	$14,641
2004	1.1%	$28,378	11.0%	$15,958

SOURCE: TORONTO STOCK EXCHANGE
OTTAWA REAL ESTATE BOARD

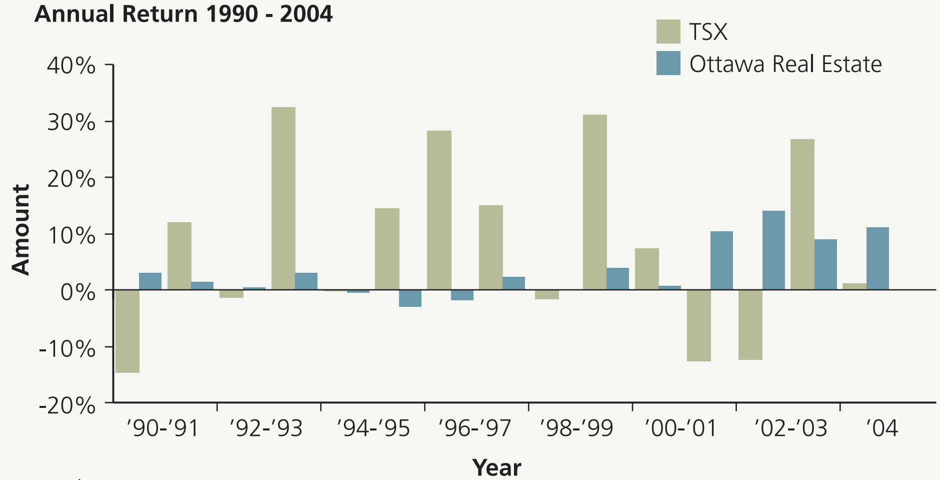
REAL ESTATE vs. STOCKS

What has changed over the years is the average person's access to capital investments. Until recently, most capital was controlled by the very rich. So, for the majority that were just scraping by, the notion of asset mix was somewhat moot. However, affluence has increased dramatically in the post-war era. The dream of home ownership years ago has today become a basic right of passage in our modern society and the boomers have changed this asset class forever. They've taken what was once basic shelter and turned it into an entertainment centre, a statement of status, and, of course, a place to store considerable wealth. So it should come as no surprise that the average house size in Canada has doubled over the past twenty-five years even though our family size has dropped significantly.

Investing typically comes after shelter as we start to put capital away for future use. What is intriguing is how society reacts to these two different capital asset classes. To illustrate this

STOCK MARKET vs. REAL ESTATE

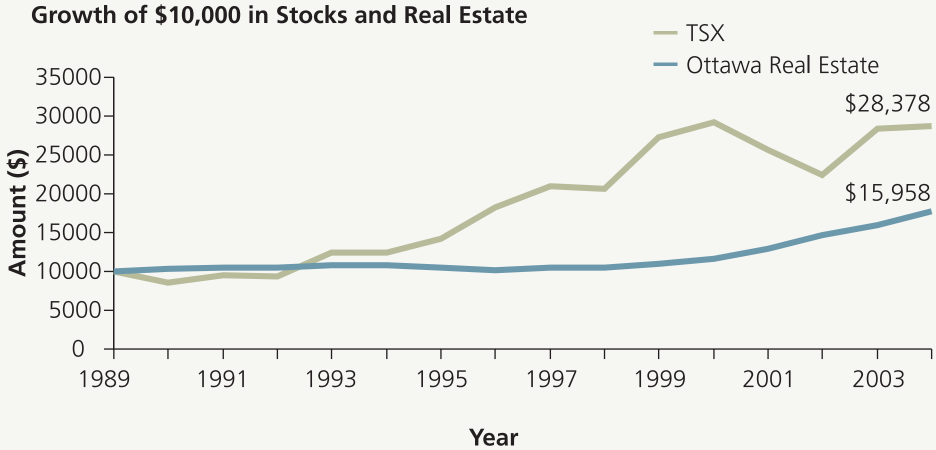
Annual Return 1990 - 2004



Graph 1

STOCK MARKET vs. REAL ESTATE

Growth of $10,000 in Stocks and Real Estate



Graph 2

comparison, I've included data showing Ottawa real estate prices and Toronto Stock Exchange prices for the past fifteen years. Clearly, the best performer of the two is equities, and yet many investors struggle with this asset class. A closer look at the numbers reveals an interesting statistic that shows that two-thirds of the time, equities showed double-digit returns (either positive or negative). Real estate rarely gave a double-digit return and never on the negative side.

Investment psychologists will point out that the average Canadian has a greater reaction to a loss than to the equivalent gain. Using the data, this can be shown in a couple of ways. Graph 1 shows the yearly fluctuations in prices, whereas Graph 2 shows the cumulative rate of return. With real estate, we tend to have a longer view – more of a Graph 2 mindset. Many equity investors tend to get caught up in the 'noise' of the markets and unfortunately have more of a Graph 1 mindset. So how can average investors adopt a more passive approach to their long-term financial goals?

Passive vs. Active Management

Owning a home is a very unobtrusive event in our day-to-day lives. We buy a place, we settle down, and we pay it off slowly. We rarely think about its value and therefore it becomes a very passive asset class. Every once in a while, a similar home in the neighbourhood sells for a good price and we're pleasantly surprised. If it happens to sell for a lower price, we justify our home's value by saying something like, "well, we just put up a new fence," or, "we've just upgraded the family room." The reality is, we take a long-term view. Again, if we view the data, you will note that Ottawa real estate prices were flat for a decade. Did anyone worry and conclude that they needed to sell and become a renter?

So why don't we give the equity markets the same long-term benefit of the doubt? They seem to have earned it. Clearly, the problem is not only volatility but the liquidity to deal with it, and unfortunately, the second factor is a major cause of the first. The markets have greater swings because we see the moves and can react. We are active in the markets, and unfortunately for many investors, this has been the problem. The passive real estate investors capture the full potential gain because they wait out swings by default. The more active equity investors try to outsmart the markets and often fare poorly. So what is the solution? Perhaps if we can treat our equities like we handle our real estate, we might have a better result.

The Importance of a Plan

Think of how we approach the process of becoming a homeowner: we have to figure out what we need, what part of town to live in, and, of course, how we finance the purchase. The bottom line is that it requires a great deal of thought and requires a plan. Even if you're not that well-organized, the lending institution isn't going to let you off the hook. They have a great deal of their capital invested in your home and, as a result, it is in their best interest to build a repayment plan for you. There is a very specific process we all have had to go through to become homeowners. As a result of our plan, we feel very secure with an asset that is highly leveraged, poorly diversified, and, when we first start out, often ties up most, if not all, of our free capital.

Now consider how we approach the investment markets: we often, at the last minute and motivated by a tax refund, throw money into an account and make a quick decision as to where this money goes. These decisions are all too often influenced by a hot sector and we tend to ignore them until some event causes us to reassess our actions. For many there is no plan, and as a result, a great deal of short-term thinking is involved.

If we look back at the data, what we have is a very specific, planned, and passive approach to real estate – a very stable, long-term passive investment.

Unfortunately, many individuals lack a plan and take an ad hoc approach to equities, a much more volatile asset class. Is it any wonder that so many investors struggle with the equity markets and are frustrated by the returns? The bottom line is that we need to handle our investment assets as we handle our real estate. It is imperative that we approach all our assets with the correct mindset, the proper asset mix, and a specific written plan. Leveraging a team of specialists, your ScotiaMcLeod advisor can help you achieve your financial goals by developing a clearly-defined, long-term plan that will establish and maintain the optimal asset mix suitable for your level of risk.

If we can achieve this, I'm sure Jacob Fugger would be proud of us.

Reflections

"We don't receive wisdom; we must discover it for ourselves after a journey that no one can take for us or spare us."
– Marcel Proust,
French Novelist

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[1] Source: Credit Suisse First Boston

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