

JULY 2010 NEWSLETTER



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U.S. Housing Starts

Privately owned housing starts in May were at a seasonally adjusted annual rate of 593,000. This is 10% below the revised April estimate of 659,000, but 7.8% above the May 09 rate of 550,000.

This is less than half the rate of household formation of 1.5 million per year, and it is only a matter of time before excess supply caused by 3 years of housing starts of 2 million per year is absorbed.

Second Quarter – Not a Lot of Fun

World markets have had a tough go this quarter, with Greek budget problems, a potential slowdown in China, and slow North American growth causing investors to avoid risk.

	<u>March 31/10</u>	<u>June 30/10</u>	<u>% Loss</u>
S&P 500	1,169	1,030	-12.0%
TSX 300	12,037	11,294	-6.0%

The market has been so bad in the U.S. for so long that a recent financial industry publication has an article on “Disarming 8 hostile remarks advisors hear at social gatherings.” This is a long way from 1999 when investors were keen to hear tips during the technology boom. Hopefully this type of report is an indication that the worst is behind us.

Canadian T-Bills and Bonds

	<u>Dec 30/09</u>	<u>March 31/10</u>	<u>June 30/10</u>
90 day	0.18%	0.26%	0.46%
180 day	0.28%	0.47%	0.75%
1 year	0.66%	0.96%	1.03%
2 year	1.38%	1.73%	1.27%
5 year	2.70%	2.90%	2.32%
10 year	3.56%	3.56%	3.00%
30 year	4.08%	4.07%	3.64%

U.S. T-Bills and Bonds

	<u>Dec 30/09</u>	<u>March 31/10</u>	<u>June 30/10</u>
90 Day	0.07%	0.15%	0.17%
180 Day	0.15%	0.23%	0.22%
1 year	0.37%	0.37%	0.30%
2 year	1.02%	1.02%	0.61%
5 year	2.57%	2.56%	1.78%
10 year	3.76%	3.83%	2.94%
30 year	4.61%	4.71%	3.89%

There has been a rally in bonds as the world adjusts to signs that we may have a pause or slowdown in our recovery. There is also a “flight to quality” as investors sell distressed European government bonds.

Opportunities in Fixed Income

Most investors want some of their funds in bonds, debentures and preferred shares. These can provide a more secure income than income trusts and common shares, where the distributions can be reduced more readily when business conditions are poor.

British Columbia (BC) combined federal & provincial tax rates				
2010 Taxable Income	2010 Marginal Tax Rates			
	Other Income	Capital Gains	Canadian Dividends	
			Eligible Dividends	Small Business Dividends
First \$35,859	20.06%	10.03%	-12.59%	4.16%
Over \$35,859 up to \$40,970	22.70%	11.35%	-8.79%	7.46%
Over \$40,970 up to \$71,719	29.70%	14.85%	1.29%	16.21%
Over \$71,719 up to \$81,941	32.50%	16.25%	5.32%	19.71%
Over \$81,941 up to \$82,342	36.50%	18.25%	11.08%	24.71%
Over \$82,342 up to \$99,987	38.29%	19.15%	13.66%	26.95%
Over \$99,987 up to \$127,021	40.70%	20.35%	17.13%	29.96%
Over \$127,021	43.70%	21.85%	21.45%	33.71%
Marginal tax rate for dividends is a % of actual dividends received (not grossed-up amount).				
BC Basic Personal Amount				
2010 \$11,000	Tax Rate 5.06%			
Federal Basic Personal Amount				
2010 \$10,382	Tax Rate 15.00%			

Source: <http://www.taxtips.ca>

As the chart above indicates, investors with taxable incomes less than \$40,970 pay negative tax on Canadian dividends, and investors with taxable incomes less than \$71,719 pay only 1.29% tax on Canadian dividends. There have been a number of high-quality preferred shares issued recently that provide decent income and great tax treatment.

TransCanada Pipelines Cumulative 4.4% 5.5 Year Reset Preferreds

P2 S&P Credit Rating

This preferred share pays a 4.4% dividend until January 30, 2016. After that time it will either be called (highly likely) or be rolled over for another 5 years at the Government of Canada 5-year rate at that time, plus 1.54%. For most taxable investors the 4.4% is the same after tax as a bond or a GIC paying over 6%.

Power Financial Non-Cumulative 4.4% 5.5 Year Reset Preferreds

P1 (low) S&P Credit Rating

This preferred share is very similar to the previous one except if it is not called on January 31, 2016 it will be rolled over at the 5-year Canada bond rate at that time plus 1.6%.

For exact details on these preferred shares give me a call. I feel that they are good value for your “safe” money when compared to a 5-year Canada bond @ 2.34%, or a 5-year locked-in GIC @ 3.6%, both of which are fully taxable.

Corporate Bonds That Look Good Now

Baytex Energy 9.15% August 26, 2016 – callable @ 104.58 August 26, 2012
S&P Rating ‘B’ @ 109.50 yield to maturity 7.20%
yield to first call 6.36%

Fairfax Financial 7.5% August 19, 2019
S&P Rating ‘BBB-low’ @ 105.00 yield to maturity 6.76%

Both of these bonds are “high yield” bonds so in a balanced medium risk portfolio we should limit our positions to 5% of the total portfolio.

Equity Investing

As the TSX is down 8.3% and the S&P 500 is down 15.5% since the April 2010 highs and we are still down 25% and 35% respectively from the all time highs in 2008 & 2007 it is hard to be exuberant about the markets.

Fortunately the vast majority of our holdings pay a distribution or a dividend, so we are paid to wait. To the right are the largest equity positions my clients hold.

<u>Equity</u>	<u>Yield</u> <u>As of June 30</u>
H & R REIT	4.94%
Royal Bank	3.94%
TD Bank	3.53%
Innergex Renewable Energy	6.92%
Riocan REIT	7.24%
CML Healthcare	10.78%
Canadian Oil Sands	7.41%
Power Financial Corporation	5.13%
Bank of Montreal	4.84%
Bank of Nova Scotia	4.00%

While these shares will fluctuate with the markets and individual corporate challenges at least we get paid while we wait. In addition, the dividends we receive attract very little tax when compared with bond or GIC interest.

Diversification

We all have the temptation to “bet the farm” on our best idea, rather than allocating 5% of our portfolio to our best 20 ideas. 90 days ago a large oil company with an AA credit rating was trading around 10 times earnings with a dividend close to 5%. It was in the process of drilling what would become the fastest flowing well in the western hemisphere. It would have been easy to “bet the farm” on the stock. The company is BP, and has dropped from over \$60 per share to less than \$30. Stay diversified!

Summary

We are in an era where consumers have to repair their balance sheets, Countries have to get their fiscal houses in order, and confidence has to return to world markets. In the meantime every investor has some combination of cash equivalents, fixed income and equities to balance the conflicting goals of safeguarding their capital while providing income and growth. If you are not sure that you have the right combination, please call.

All the best and have a great summer.

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Note: For those of you who would like to receive future newsletters electronically, please email Barbara at barbara.holmes@raymondjames.ca and she will put you on our email list.

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