

## The Winds of Change

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## The Winds of Change

Most of us are told at a young age that things are not the same as they used to be. They are either changing for the worse or the better, but are never quite as they were. “Back in my day” is a typical lead-in to a lesson we are compelled to listen to. Many of these instances prove to be about short-term aberrations rather than longer-term trends. Though many may have their rewards, the really big money is made in foreseeing a significant change in direction and in riding the winds of pending change. Only fools would suggest that standing pat is the better way.

### **MAJOR TRENDS TAKE TIME TO UNFOLD**

Major trends in the stock market typically last for fifteen years on the upside, twelve to fifteen years on the downside. The period 1985 to 2000 marks the most recent uptrend, a time when scads of money flowed into mutual funds, pension and insurance portfolios increased weightings in equities, and individual investors took the plunge, many for the very first time. As time passed, more and more pressure was applied to encourage CEOs to go for growth or get left in the dust. Mergers and acquisitions became the order of the day, as against growing the payouts to investors, and stock options gained bragging points at every social function. The earnings of the Bay and Wall street mandarins exploded, CEOs and their executive compensation gurus flourished. Everyone, or so it seemed, could not have cared less about us investors, who ultimately had to foot all these exorbitant takes.

The madness lasted until some time during the year 2000, when all of the major North American stock market benchmarks topped out and a severe correction ensued. Times like these require sober second thought. A rush to introduce and pass more regulation is not what is called for. After all, we have more rules on the books these days than ever before, and more corruption and crime than at any time in our history. The new game in town is governance, and nearly everyone claims to be an expert! Many have their hands out looking for fees, but few, very few, are successful investors in their own right. Just because a director is “an independent” by definition, is not proof that he or she is capable or honest. Time will prove my point!

### **BAY STREET WILL BE SLOW TO GET THE MESSAGE**

Not a single stockbroking firm foresaw the topping out of the stock market. There are just as many recommending that Nortel Networks Corp. is a buy at \$4.50 as there were back in March 2000 at \$124.50 per share. Why should they care providing they get their fair share

of the orders to either buy or sell the most traded stock in Canadian history. After all, they never have been – and are never likely to be – shareholders for their own account. In case you have not noticed, they would much prefer to own the biggest house on the block, drive the fastest car in the neighbourhood, and send their children to the best schools. The good news is that their share of our money is going to drop precipitously in the next while as trading volumes subside, underwritings dry up, and the pace of mergers and acquisitions slows to a trickle. At long last CEOs will be focusing on what their companies can do best, rather than trying to be all things to all people.

#### **THE MUTUAL FUND INDUSTRY WILL CONSOLIDATE**

For the record, about 55 percent of all stocks are owned directly by investors like you and me; 45 percent by the mutual funds and other institutional types. We have, in the past, accounted for one third of all the trading, they two thirds. In other words, the so-called professionals trade our money more than twice as fast as we do. It is no wonder the investment dealers have paid more attention to them than to us. It is hardly surprising that they have encouraged the mutual fund companies to introduce new funds to suit every investor's fancy, and that the most recent flock of stockbrokers is trained to sell "managed" products that charge a fee that is substantially greater than a discounted commission. Notwithstanding, we are about to regain the upper hand!

Given the dramatic increase in administrative costs brought on by new regulations, the mutual fund industry has no choice but to consolidate its funds and likely the management companies as well. It is also faced with having to cope with reduced fees as more and more money flows out of the underperforming managed funds into those that are more, rather than less, indexed to the TSX Composite. The recent announcement that Fidelity Investments has decided to do so in its quest to go toe to toe with The Vanguard Group, which has the lowest expense ratio of all the major U.S. indexed fund companies, is just the tip of the iceberg. For Vanguard also has the lowest portfolio turnover rate. This means that Fidelity's propensity to buy and sell stocks must drop measurably if it ever hopes to get and stay in step. Which implies that it will take even more time to research the stocks it chooses to buy or sell in order to keep its transaction costs to an absolute minimum. As it does, more and more of its competitors are likely to follow its cost-cutting example.

#### **RETAIL INVESTORS WILL PLAY A MORE IMPORTANT ROLE**

Although retail investors have been frowned upon for many years, unwilling to trade in and out as often as fund managers do, they were the first to understand the merits of investing in royalty and income trusts. Institutional investors, in the main, missed the boat, tied up as they persisted in chasing after the higher growth companies to their bitter demise. Now that this \$100-plus billion trust game has more or less run its course, portfolio managers are just beginning to get their feet wet. If only they were to grab on to the next stock market trend before it too has run its course, their overall performance would be far more robust!

Nonetheless, if nothing else, the evolution of the trusts has once again caused investors of all stripes to realize the importance of payouts, be they distributions or dividends. Warren Buffett has never lost sight of such, and today he is one of the very richest men in the world. Not only did he buy shares in dividend paying companies with strong balance

sheets, he favoured those that could grow the payout and increase the payout ratio over time. He reinvested the dividends in like companies. His initial U.S.\$100 investment is now worth something like U.S.\$41 billion. If only we could all have been so astute!

#### **LOOKING TO THE FUTURE**

The good news is that we can all become as rich as Croesus. There are a host of Buffett-type stocks to choose from these days. Furthermore, I believe that many of the dividend payers also have impressive prospects for growth which, in the end, should leave the trusts in the dust when we look back at 2004 unit prices come 2010! So if you are ten to thirty years from retirement and want to build a sizable nest egg, do not bet your future well-being on a flock of new, yet unproven companies. Instead, build a portfolio of stocks in companies where the CEO and directors want to include you in their plans, rather than bet the ranch on a risky diversification strategy.

Never lose sight of the fact that institutional investors, faced with having to reduce portfolio turnover rates, are likely to follow suit in time, giving these sorts of stocks an added boost in price. It is also comforting to know that while you are away, or just taking an afternoon snooze, the next dividend and possible increase in the payout ratio is getting closer and closer. There is no need to trade in and out to make ends meet.

Now if only the Canadian federal government would come to its senses and reduce the applicable dividend tax rate down to 15 percent, as it now is in the U.S., all the retired people in Canada would be much better off. The rest of us would have still more money to reinvest, our decisions far more astute than having some horn-rimmed bureaucrat or politician do it for us! A case in point is what has happened to Pengrowth Energy Trust. The A units that the Americans and other foreigners can buy are now trading at better than a 10 percent premium to the Canadian investor owned B units. It is a perfect example of why lower tax rates are a real plus. The saver has more money to spend or reinvest, and the cost of capital is substantially reduced, allowing Canadian companies to remain competitive with their counterparts in the U.S. and elsewhere. This would encourage companies to expand and hire additional people. As they do, more better-paying jobs are created, more taxes are generated, and everybody stands to gain. It is a no-brainer to anyone of a right mind. Those whose leaning is left of centre, I will admit, are still not sold on the idea, for fear of becoming redundant, I suppose!

The good news is that the winds of change are blowing, their might not likely to slacken for another decade or two. In the ensuing time frame, much needs to be done to right the sins of the past. As the process proceeds it is quite conceivable that the major stock market measure will make little headway. Indexing will get you nowhere. As a result, the flow of money into mutual funds will abate as more and more individuals take matters into their own hands. Stock picking based on sound fundamental research will come back to the fore, as will the lowly commission-driven retail investor stockbroker, a much maligned yet vital link in the funding of both businesses and governments.

In the final analysis, most of the wrongs will be made right, and we will all stand to gain if we keep our wits about us. Hanging on to the past, when the winds of change are blowing, will never get you to the promised land.