your wealth

TO WIN, FIRST DO NOT LOSE

by J. Peter Hodgson CFA

The recent good fortune in Canadian financial stocks and poor fortune in income trusts reminded me of a great book, "The Millionaire Next Door" written by Thomas J. Stanley, Ph.D and William Danko. One of the key points of the book was that true wealth is built over time, principally by not losing it in the first place. While people do worry about losing money, most focus on the minutiae, what stocks, which funds, and the rates of return and fees? While these are important things to consider, the major risks to wealth lie elsewhere. The book provided great insight by pointing out that the largest predictor of the accumulation of wealth for a family over time was having one marriage (or no divorce). I will avoid expanding on that point further as it is clearly beyond my professional expertise but I think the message is clear. What we will try to do is point out where to look for the obstacles that can compromise wealth accumulation and provide an example where relevant. This will provide a good starting point for discussions with your advisors and family members.

With the goal in mind of avoiding major losses of wealth we should then ask ourselves what are the major risks to our wealth? While this topic may not light up the cocktail circuit quite like the current hot investment, this lack of appeal affects many investors and professionals alike. Preventative wealth management just isn't all that sexy. In our practice we use the concept of strategic wealth management. We consider how we can help our clients best shelter their net worth from the major destroyers of wealth.

So while it may be appealing to debate investments the discussion is not all that relevant if you have not identified your key risks effectively first.

So what are some of the major risks that could negatively impact accumulation of Wealth? This list below is just an indication of some factors that may affect wealth accumulation there may be others that are more relevant to you than others. **The big ones are Consumerism, Unemployment, Health, Death, Law Suits, Poor or no Planning/plan, and emotions (perhaps the most significant).**

Consumerism, this may be the toughest of all as we are under constant siege from advertisers. I recall a conference on wealth management organized by the CFA Institute some years back. In an open session there was a question from the floor as to where the largest competition to investment managers was coming from. The response was not what I expected, the speaker replied, "The Car Companies, they have massive advertising budgets and spend gobs of money to find out what triggers the impulse to buy". Of course this is true of many companies and products. No wonder North America for the most part has a negative savings rate. To build wealth we must first spend less than we earn. The first defense is a household budget, the second are written goals and time frames for things that are important for the family.

Unemployment, we are all aware of the implications but few of us stress test our skills, contacts, education, job and industry situation. Many are happy to spend $20,000 or more on a vehicle every five years. What if we did that for our own skills? What would our business and employment choices look like if we invested that amount in our continued development? A great resource to help with process would be Harvey Mackay's book "Dig Your Well before you are Thirsty". He stresses putting pen to paper, building a skill, resource and relationship inventory. Consider these with the goals you have in mind and think about the skills and contacts required to help make them happen. It is very hard to build wealth without cash flow.

Then there is retirement, a kind word used in place of "unemployment" which more accurately reflects the financial reality. To help prepare for this period of your life, you should have a complete forecast of income each year from all sources and estimated tax obligations during retirement. These should be mapped against the asset pools available to fund them. Only from there can you make informed decisions about the choices available to you. Your advisor should be able to help with this. ☛

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Health is often overlooked. It is a blessing often taken for granted until we lose it. What would happen to you and your family if anyone was injured or ill for say 6 months? How about 2 years? The implications are more complicated than you may think. Here is an example of a small business owner. She had a successful company with 15 employees in it. She ran the company and drove the sales. She was wallpapering one weekend and fell from the ladder injuring her spine severely. She had a two year recovery. While many have short term disability coverage very few have business interruption insurance. In this case she had her wages covered but not the lost revenue from the business. As she was the principal rainmaker the business failed in her absence. This resulted in lost jobs and the evaporation of the value of the business. Independent businesspeople face many such risks. Losses like this may be mitigated with the proper risk management.

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Death is a more obvious risk and most people do have some form of life insurance where few have stress tested the health risks. However the economic contributions of stay at home partners are often overlooked and this becomes acute when children are involved. Estate taxes, income and capital gains tax are just s few issues to consider. Business ownership will add further elements. This is worth spending some time on.

A great way to injure an estate is to have a legal fight over its distribution. Interestingly we all, notionally, have a Will. It was written for us by the provincial government. If you are comfortable that the government understands your estate wishes then carry on. Old wills and poorly written ones are high risks for family disruption and wealth erosion. They should be reviewed regularly and amended with changes in family circumstances. There are ways to protect estates from failed marriages of children. There are also strategies to mitigate tax impact. There is no replacement for a well prepared Will done by a qualified lawyer specializing in estate planning. The broader and more complicated your affairs are, the more this is essential. If you are appointed to be an executor for an estate it is wise to get independent legal advice. There are significant risks for executors if things go badly.

A law suit can result in bankruptcy. Comprehensive home and auto insurance policies are a good first step to protecting yourself. Shopping around for the cheapest coverage may not be the best option as it may leave out important provisions that may not be obvious to you at the time. Discuss your situation with a qualified insurance professional. A review of other exposures you may face may save your net worth down the road. You can do this on your own or help with your lawyer. Consider any volunteering activities, any directorships you hold and other obligations you face or undertake (executorships for example). You should ask and understand the risks and insurance coverage the organization may provide, if any. Business investment and real estate assets and how they are held/registered can have a huge impact on how exposed they are to legal attack. Seeking out professional advice may save you much grief down the road.

Having no plan or even worse, a bad plan, can lead to heavy losses in wealth. There are many simple options offered as part of an investment program. They may be suitable for very simple and straight forward situations. However they fall short where assets involve real estate, businesses and estates. A good plan prepared by an experienced professional or team can help address much of the above. A good plan should cover more than just investments. For example we often see situations where, through real estate or investments, people are exposed to US estate tax. It would surprise many of you how little in the way of US assets one needs to hold to be exposed. US estate tax covers world wide assets and is not limited to US citizens or residents. The US tax authorities consider real estate and securities as US property. It can lead to significant US tax exposure. Fortunately the remedies are usually straight forward and not all that expensive. A good plan should be able to identify issues such as this and potentially others.

Emotions, fear and greed often dominate investment decisions. Recent experiences blind investors to long term rules of thumb. Investors often chase short-term returns and run from great long-term opportunities. There are a number of investment strategies that can help the investor manage their own emotions and potentially benefit from the emotions of others. Constant mix asset allocation approaches come to mind. For individual investments, a useful rule of thumb is to ask if a security or fund's recent return is twice that of its long term average (10 years is best) what are the reasons and probabilities that this return will continue.

It may be fun to debate financial stocks versus income trusts. The importance of this discussion pales in comparison to addressing the above but a solid plan will help you understand the risks you and your family may face and help provide you with a starting point to involve professionals to help immunize against many of the risks.

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