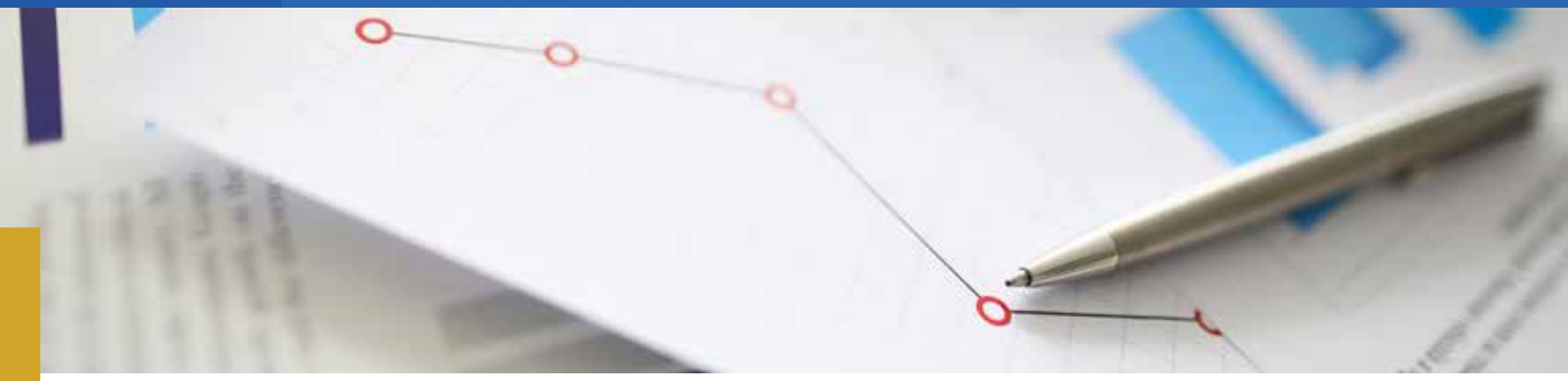
INVESTOR EDUCATION

FUNDAMENTALS OF LONG-TERM INVESTING



EQUITY Associates Inc.

MING & ASSOCIATES

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INTRODUCTION

The term Investing is so broadly referenced in today's society that it can be an intimidating subject to handle alone. There are many different types of investments you could make; essentially to invest means to commit money today with the expectation of earning a future return.

The first step in any investment is to determine your goal for the money. Is it for retirement? Children? Legacy? Just like any purchase you make; it is important to **know why you are doing it**. It is this goal that will be at the forefront of your account and investment selection. In the long-run it is your performance against your goal that truly matters, not how you stack up to the multitude of various investment benchmarks out there.

Today, news and financial media place importance and urgency on short-term events and returns, most of which are forgotten weeks or months later. However, It is well proven that to be successful, investors need to think beyond these distractions and focus on what is important to them.

We have put this guide together as an educational piece for investors of all levels. This guide will look at:

- **Risk vs Volatility and the misconceptions commonly associated with these terms.**
- **Investor behaviour and why many investors fail to achieve their goals.**
- **Why appropriate asset allocation and diversification are critical to achieving your goals.**

Before we delve further into these points, let's look at a quick overview of financial markets, account types, and asset classes.

The stock market is a system where public companies issue stocks for individual investors to buy and sell. There are millions of investors (with widely different views) who get matched up together… a buyer for every seller. There are many, many reasons why a stock price may rise or fall in any single day, week or month. These may include simple supply and demand issues, investor sentiment, public opinion, mergers, lawsuits, politics, or natural disaster (or a pandemic) as well as computer programs and short-term arbitrage. Simply put, there is no easy way for media to report why the stock market moves the way it does each day, and for the majority of the time, this has very little impact on the true long-term value of the companies that are being traded.

OVERVIEW – THE BASICS

Determining your investment goals is a significant factor in deciding which plan or plans you should choose to invest in. You are permitted to hold a wide range of securities in both your registered and non-registered accounts, including Mutual Funds, Exchange Traded Funds (ETF), Guaranteed Investment Certificates (GICs), Stocks, Bonds, and Cash.

Remember, the first decision is to determine which type of plan(s) you will invest in. Only then do you look at the type of asset to hold in the plan.

ACCOUNT TYPES

Investments are made in registered or non-registered plans. A non-registered plan has no contribution limits; however, you will be taxed on any growth generated in the account. The three main types of investment growth are interest (100% Taxable), dividends (68% taxable), and capital gains (50% taxable).

A registered plan is a plan that is registered with the Canadian Revenue Agency (CRA) and each offers some types of savings and tax benefits. There are four main types of registered plans:

- Registered Retirement Savings Plan (RRSP/RRIF, LIRA)
- Tax Free Savings Account (TFSA)
- Registered Education Savings Plan (RESP)
- Registered Disability Savings Plans (RDSP)

Your eligibility, allowable contribution room, and tax consequences differ by plan type. Integrating the advantages of the different plans into your long-term goals is primarily about saving tax and maximizing the amount of money in your plan after tax. If you would like more information on the details of any of these plans, we'd be pleased to provide that for you.

**See Equity Associates Inc. disclaimer.*

ASSET CLASSES

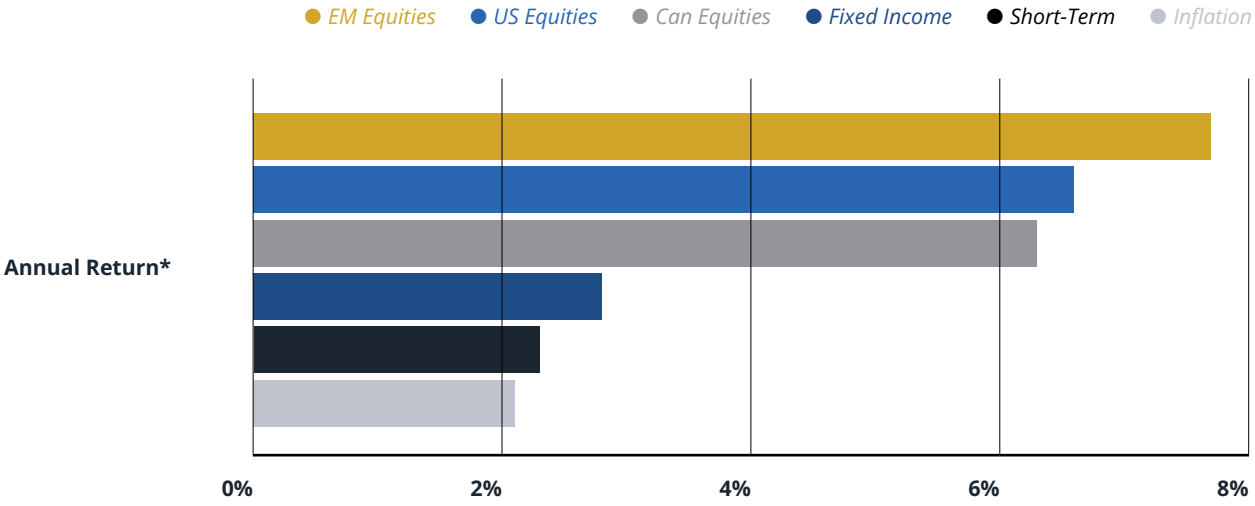
In investing, there are three asset classes you will most commonly see referenced; Equities, Fixed Income, and Cash.

Fixed Income represents the **lending of money** to a government or business/entity for the future repayment of an agreed amount of interest, followed at the end of the period by repayment of the invested amount. Examples of Fixed Income investments are GIC's, Bond Funds, Corporate and Government Bonds and Mortgages.

Equities (stocks) represent the **ownership of a business**. When you invest in equities, you are becoming a part owner of those businesses you have invested in, and you therefore get to share in the profits (or losses) of that business until the day you sell your stock to another buyer (for a profit or loss).

Throughout history, equities have provided the highest return to investors. Think of these superior returns as the premium for withstanding the volatility/risk associated with Equities. No one likes volatility … but it's the price you must pay to earn potentially higher returns.

Table 1: FP Canada 2022 Return Assumptions for long-term planning



**Returns reported before taxes and any investment fees for the use of long-term financial planning.*

**See Equity Associates Inc. disclaimer.*

RISK & **VOLATILITY**

A key reason many investors fail is that they misunderstand the concepts of risk and volatility.

Let's look at a definition of each:

Risk
Measured as the probability that you will fail to achieve your goals.

Volatility
Price swings of an asset that occur both higher and lower than the long-term value or trendline.

A portfolio of equities (stocks) is often perceived as "risky" while a portfolio of cash/fixed income is often deemed as "safe". This is accurate if you need your investment in the short term(say 1 year) as there is a reasonable probability that you could end up with less money (or a loss in equities) over a short period of time due to the volatility involved. However, it is important to note that the price declines of the equity markets have always been temporary in nature and should not be of concerned unless you sell your investment. Because of these temporary declines the volatility of equity markets means the shorter your investment time horizon the more risk there is that you won't meet your goal of growing your money. In general, history has shown (and we believe) that you need to have a time frame of at least 5 years to be able to invest in equity markets and the longer the better.

Historically, on average equity market returns have been positive 3 of every 4 years or 75% of the time. As a simple example of how volatility is reported; if the equity market had positive returns of 15% for three years followed by a negative 15% in year four, the fourth year wasn't the only 'volatile' year although the media might have you thinking otherwise. All of the years were 'volatile' in the sense that they were all unpredictable and moved higher or lower than their growth over the long term (but the year getting the most attention of course is the negative year.)

Understanding this expected market price movement, and determining your time horizon and investment goals before making an investment is critical if you want to ensure success. To plan properly you truly need to understand how "risk" applies to you and your goals.

There is no such thing as risk free. Although you may be able to protect your investment from falling there are other types of risk that are important when planning one's future. Risks that reduce the value of your money over time (ie. what our money can buy) such as inflation and taxes are also real threats to understand when evaluating a suitable investment plan.

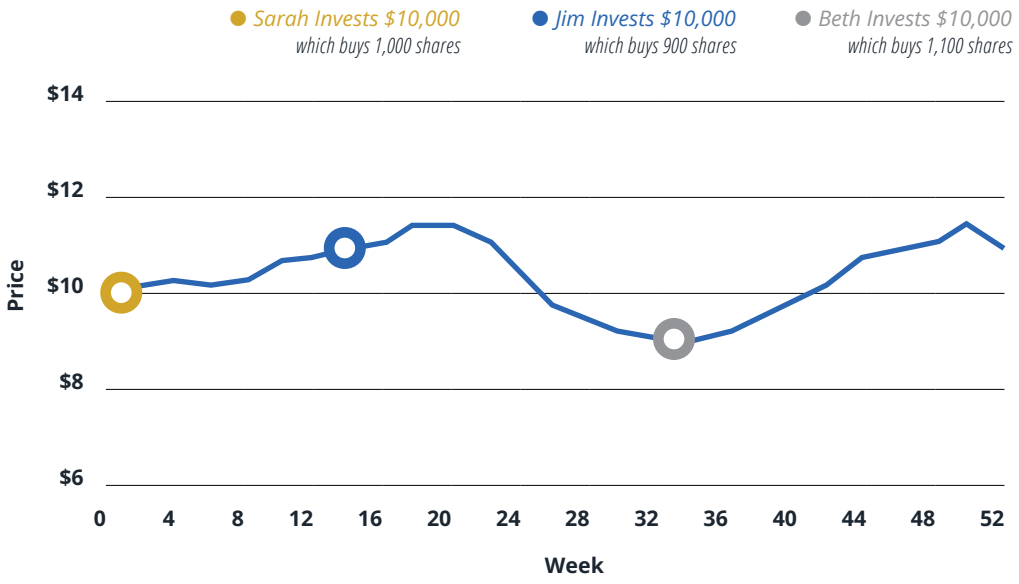
RISK OF "SAFE" INVESTMENTS

For a longer investing horizon, short term volatility is a risk that should not be of concern to an investor. With any investment goal, you always need to factor in inflation. Traditional 'safe' investments like GICs offer low interest rates in return. Often, once taxes and inflation are accounted for, the low returns of 'safe' investments can actually eat away at your savings true value and erode your purchasing power over time. Said another way, **your money will be worth less every year if you do not generate after-tax returns that outpace inflation.** Consider diversifying your portfolio with equities to offset the impact of inflation and preserve or preferably increase your purchasing power.

EMBRACING VOLATILITY

In the accumulation stage of an investment plan you could argue that investors should crave market volatility. The more there are both higher highs and lower lows around the long-term upward trendline of markets, the better this can be for disciplined long-term investors as volatility creates opportunity.

Assume you're investing the same amount every month into your portfolio. When the market tumbles, your regular monthly investment runs into the midst of chaos and buys you more shares at lower prices that you may never see again. Conversely, as markets peak, your same dollar investment can only buy a fraction of very expensive shares.



The figure illustrates a hypothetical price of an investment over a calendar year, and three investments of $10,000 at different times. One of the best ways to reduce this effect on your portfolio is "Dollar Cost Averaging" which means making smaller deposits on a consistent basis throughout the year, to get the "average" price. This visual and returns are for illustration purposes only.

Make sense? Well, it is important to note that this is exactly the opposite of how the mass of investors behave.

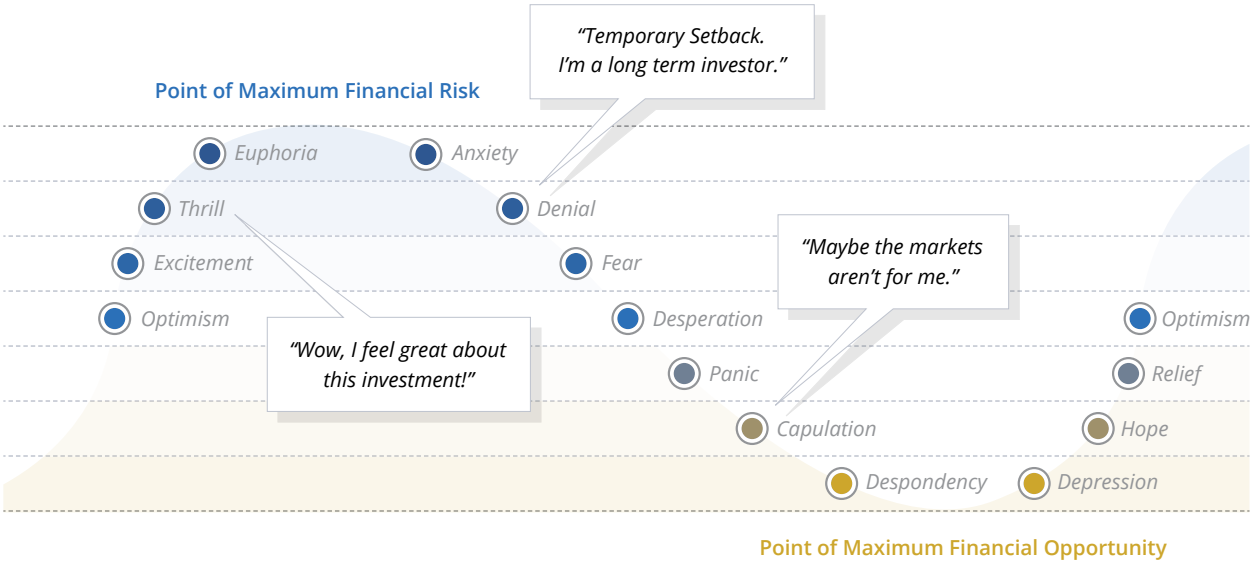
When you abandon any effort of trying to time the market, and just invest the same amount monthly (or whenever) into your own diversified portfolio of quality companies, your 'timing' becomes perfect. This leads us to investor behavior which is not only critical for investment success but also one of the only things you can truly control.

INVESTOR **BEHAVIOR**

When it comes to investing and finances, individuals are not always as rational as you think. Numerous studies have been completed on behavioral finance, which attempts to understand how human emotions influence investors decision-making process. The studies consistently conclude that the average investor considerably fails to achieve average market returns. The reason for this is that investors feel obligated to react to short term volatility and performance, and **lose sight of their long-term goals.**

THE CYCLE TO SUCESS

THE CYCLICAL NATURE OF INVESTING & EMOTIONS



A study completed by Dalbar Canada looked at a 15 year period (2000-2015) where it found that the average equity investor underperformed the S&P 500 Index (USA) by 8.19%. What that means is that if an investor bought and held similar funds for this 15 year period, and did nothing through all of its volatility (remained calm through all the cycles above), they had returns that were double that of those who tried to time the market and made irrational short-term decisions.

WHY DOES THIS HAPPEN?

Behavioral biases arise when individuals begin the process of investing. Some of the most commonly discussed biases are:

1. Overconfidence: you think you're better at something than you actually are, and that you think you know what the market will do next.
2. Chasing Performance & Trends – buy the 'hot' stock of the year, regardless of how much it costs.
3. Loss aversion – investors believe that today's losers may very well be tomorrow's winners and tend to hold on to stocks longer than they should to avoid locking in a loss.
4. Narrow framing – making decisions on part of a portfolio and not taking into consideration the overall effect to their goal.

Two of our favourite quotes regarding investor behavior are by Benjamin Graham and Warren Buffet (who is arguable the best investor in the past 70+ years).

"The investor's chief problem — and even his worst enemy — is likely to be himself."
-Benjamin Graham

"The stock market is a device to transfer money from the impatient to the patient."
–Warren Buffet

STICKING WITH SOLID STRATEGIES

As history has shown, investors can be their own worst enemies. Trying to time or beat the market has never paid off over the long term. In fact, it often results in inconsistent behavior which more often than not will impact your wealth negatively.

In 1907, famed U.S. Banker JP Morgan helped avert a financial collapse in the U.S. by preaching calmness. Years later, someone asked him his best guess on the future direction of markets. His answer: "They will fluctuate."

Over one hundred years later, that's still the best answer to someone looking for a short-term market forecast. No one can predict market movements in the short to immediate period ahead – primarily because they will be impacted by unknowable 'events" that won't matter years later. All we can do is understand clearly how much short-term volatility we can live with, work with our advisors to adjust our portfolios accordingly, and stay focused on the horizon as we deal with the rough waters.

As esteemed financial planner Nick Murray says, "Invest when you have the money. Sell when you need the money. Anything else is market timing, which is another term for madness".

ASSET ALLOCATION

The decision of what mix of assets to hold is the most important one most investor will make, and deserves to be fully understood. The volatility and return of any mix of investments depends on how the portfolio is put together and what it is trying to achieve. As such, it is necessary to determine your investment objectives and time horizon before determining which asset allocation mix fits your needs.

Asset allocation attempts to mitigate the risk versus reward by adjusting the percentage of each asset class within an investor's portfolio. This strategy is based on the fact that different types of investment assets perform differently in various market and economic conditions.

We should all be aware that diversifying our assets across different classes (stocks, bonds, cash) and different regions (domestic and international) will help lower our risk through a principle called negative correlation. What does this all mean? Basically, when one thing is going up something else may be going down...and vice versa.

Looking at diversification through the lens of Modern Portfolio Theory, diversification is more about admitting to yourself that you have no idea which asset class and country will do the best in the time period ahead. If we all knew, it would be obvious where to invest. Could you get lucky and just invest in one country/industry that performs the best over and over again (continually "time" the market)? Sure, but history tells us that very few people are that lucky... and absolutely nobody possesses that skill that is repeatable year after year.

Proper diversification allows you to avoid extreme outcomes and consistently balance risk/return to stay on track to reaching your goals. It is an integral part of long-term investing success. As the chart below shows, Canada, US, Foreign and Emerging market asset classes tend to move in opposite directions in relation to each other so it is important to have a balance;

○ *Can. Bonds* ◆ *Can Small Cap* ✱ *Emerging Markets* ● *US Small Cap* ◘ *US Equity* ✚ *Foreign Equity*

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Best Returning Asset Class	○ 6.4%	◆ 68.9%	◆ 35.2%	○ 9.7%	✚ 16.4%	● 48.1%	◘ 23.9%	◘ 21.6%	◆ 31.9%	✚ 28.7%	◘ 4.2%	◘ 31.5%
Best Returning Asset Class	◆ -48.6%	○ 5.4%	✚ 2.6%	✱ -16.2%	◆ -0.5%	○ -1.2%	◆ -2.8%	◆ -16.3%	✚ -2.0%	○ 2.5%	◆ -20.3%	○ 1.4%

Asset class performance represented by: foreign equity: MCSI EAFE Index, global equities: MSCI world index; emerging markets equity: MSCI emerging markets index: US Equity: S&P 500 Index; US Small Cap: Russell 2000 Index; Can. Equities: S&P/TSX Composite Index; Canadian Small Cap: BMO Small Cap blended weight index; Canadian Bonds: FTSE Canada Universe Bond Index.

ASSET ALLOCATION AND YOUR PORTFOLIO

There are several different asset allocation strategies based on investment goals, time horizon, risk tolerance and diversification. When it comes to asset allocation planning, the decision on the amount of bonds vs stocks in an investor's portfolio is a very important decision as each asset class has different levels of risk and return which will behave differently over time.

So, how much in fixed income? How much in Equities? Global or domestic? There is no simple formula to find the correct asset allocation for every investor. Depending on what the underlying objective is, the asset mix amongst an individual's portfolio will change based on their individual goals.

Having the right mix of assets is a critical part of reducing the volatility and risk you have to put up with to get the returns your plan needs. Diversification is so crucial in helping investors remain invested and avoid those costly knee jerk reactions caused by short-term volatility.

COSTS & **FEES**

All investments and financial products carry costs. Many investments have the costs embedded within the investment product such as a GIC, Mutual Fund, ETF (Exchange Traded Fund) or the purchase and sale of a Bond. Other costs you pay directly such as trustee fees, trading fees or fees to money managers for portfolio management.

The first step is understanding that different types of investments have different costs. Let's look at some of the common ones you'll see.

MUTUAL FUNDS

All Mutual Funds --one of the most common investment instruments—contain an embedded fee that's called a management expense ratio (MER). It is a measure of what it costs to manage the investments including auditing, reporting and taxes. It can also include the costs of advice and distribution of the fund.

It is expressed as a percentage and commonly in the range of 1% to 2% depending if advice and distribution is included or not (and the size of the account). The MER is based on the total assets invested in the fund and is calculated annually and is paid within the fund. Returns of the fund that are reported to investors are calculated after the MER is paid.

There are additional costs that can be added on when you purchase or sell a fund, although these are becoming less common than in the past. Not all mutual funds fees are the same, so it is important to understand your fee structure.

GUARANTEED INVESTMENT CERTIFICATES (GIC'S)

While a GIC doesn't charge the investor directly, they make money by lending your money out for a higher rate than they are paying you. Generally, the money the bank earns on your deposit is the difference between what a GIC pays and the corresponding loan rate for the same term. This is typically in the range of 2%.

STOCKS AND BONDS - HELD IN BROKERAGE ACCOUNTS

Most Brokerage or Investment accounts that hold stocks and bonds will charge an annual account or trustee fee. There will also be charges to buy or sell various securities and the fees will vary widely depending on if the account is undertaken on a do-it-yourself basis or if financial advice is involved.

Many full-service brokers are moving to a fee as a percentage of assets (ie. 1% to 2%) that includes all costs rather than charging transactional and account costs as mentioned above.

SEPARATELY MANAGED OR PRIVATE CLIENT ACCOUNT

A number of money managers can be accessed directly by a client if their portfolio is large enough. These managers buy and sell investments on a discretionary basis and customize the portfolio to the client's unique situation. Their fee is generally a percentage of assets and again will vary from 0.75% to 2% depending on the manager and size of assets.

CONSIDER TAX COSTS

Lastly, likely the most ignored aspect of investing costs (and very important to consider) are taxes paid on earnings and/or gains. It can also be the most complicated. Even seasoned investors find it beneficial to get help from a professional when it comes to taxes and how to organize their plan or portfolio in the most optimal way. The savings generated are often significant when compared to the cost of advice. Most people can benefit from a well thought out plan that incorporates all the various types of taxable and non-taxable accounts. In doing so, together with the different rates of tax paid on interest income, capital gains and dividends, you will be in line to maximize your after-tax returns.

THE BOTTOM LINE

Understand that there are fees involved with virtually every type of investment. While some types of fees can be charged directly, others are included in the cost and performance of the product. The range of fees varies depending on the services provided. For instance, is asset allocation, investment recommendation, advice, and planning incorporated or not? Like all things in life - when comparing fees - make sure to use an apples to apples comparison and look at value received from each source.

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