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Weighing Risks and Returns

A couple pass up eating hamburgers at a picnic because they heard that they could contract a deadly *E. coli* infection from eating improperly cooked meat. The next week, that same couple hops in the backseat of their friend's old model car that lacks airbags.

This story isn't meant to depress or frighten anyone. Instead, the goal is to make an important point about risk — something everyone deals with on a daily basis. Risk is in the eye of the beholder. Many people base their perception of risk, in large part, on their experiences and what they've been exposed to. In doing so, they often fret about relatively small risks while overlooking much larger risks.

In the world of investing, most folks worry about certain risks — some of which may make sense and some of which may not — but at the same time they overlook or disregard other, more significant risks. This chapter discusses a range of investments and their risks and expected returns.

Understanding Different Types of Risks

Everywhere you turn, risks exist; some are just more apparent than others. Many people misunderstand risks. With increased knowledge, you may be able to reduce or conquer some of your fears and make more sensible decisions about reducing risks.

For example, some people who fear flying don't understand that, statistically, flying is much safer than driving a car. You're approximately 110 times more likely to die in a motor vehicle than in an airplane. But when a plane goes down, it's big news because dozens and sometimes hundreds of people who weren't engaging in reckless behaviour perish. Meanwhile, the national media seem to pay less attention to the five people, on average, who die on the road every day.

Then there's the issue of control. Flying seems more dangerous to some folks because the pilots are in control of the

plane, whereas in your car, you can at least be at the steering wheel. Of course, you can't control what happens around you or mechanical problems with the mode of transportation you're using.

This doesn't mean that you shouldn't drive or fly. However, you might consider steps you can take to reduce the significant risks you expose yourself to in a car. For example, you can get a car with more safety features, and you can bypass riding with reckless taxi drivers.

Although some people like to live life to its fullest and take "fun" risks (how else can you explain mountain climbers, parachutists, and bungee jumpers?), most people seek to minimize risk and maximize enjoyment in their lives. The vast majority of people also understand that they'd be a lot less happy living a life in which they sought to eliminate all risks, and they likely wouldn't be able to do so anyway.

Likewise, if you try to avoid all the risks involved in investing, you likely won't succeed and won't be happy with your investment results and lifestyle. In the investment world, some people don't go near stocks or any investment that they perceive to be volatile. As a result, such investors often end up with lousy long-term returns and expose themselves to some high risks that they overlooked, such as the risk of having inflation and taxes erode the purchasing power of their money.



You can easily — and smartly — minimize most risks, But eliminating them entirely typically just isn't palatable because they significantly reduce your quality of life. The only way to ensure that you're never in a highway collision, for example, is to never set foot in any type of motorized vehicle.

Risks are composed of several factors. The following sections discuss the various types of investment risks, and go over proven methods you can use to sensibly reduce these risks while not missing out on the upside that growth investments offer.

Market value risk

Although the stock market can help you build wealth, most people recognize that the market can also drop substantially — by 10 percent, 20 percent, or 30 percent (or more) in a relatively short period of time. After peaking in 2000, Canadian and U.S. stocks, as measured by the major indexes representing the value of large companies (for Canada, the S&P/TSX Composite Index, and for the United States, the S&P 500 index), dropped about 50 percent by 2002. Stocks on the NASDAQ, which is heavily weighted toward technology stocks, plunged more than 76 percent from 2000 through 2002!

After a multiyear rebound, stocks peaked in 2007 and then dropped sharply during the financial crisis of 2008. From peak

to bottom, Canadian, U.S., and global stocks dropped by some 50 percent or more.

In a mere six weeks (from mid-July 1998 to early September 1998), large-company Canadian and U.S. stocks fell about 20 percent. An index of smaller-company U.S. stocks dropped 33 percent over a slightly longer period of two and a half months.

If you think that the stock market crash that occurred in the fall of 1987 was a big one (the market plunged by about a third in a matter of weeks), take a look at Tables 1-1 and 1-2, which list major declines over the past 100-plus years that were all *worse* than the 1987 crash. Note that two of these major declines happened in the 2000s: 2000 to 2002 and 2007 to 2009.

Period	Size of Fall
1929–1932	80% (ouch!)
1937–1942	56%
2000–2002	50%
2007–2009	48%
1980–1982	44%
1973–1974	38%
1987–1987	31%
1956–1957	30%
1969–1970	28%

Table 1-1: Most Depressing Canadian Stock Market Declines*

*As measured by changes in the TSE/TSX composite index

Period	Size of Fall
1929–1932	89% (ouch!)
2007–2009	55%
1937–1942	52%
1906–1907	49%
1890–1896	47%
1919–1921	47%
1901–1903	46%
1973–1974	45%
1916–1917	40%
2000–2002	39%

Table 1-2: Largest U.S. Stock Market Declines*

**As measured by changes in the Dow Jones Industrial Average*

Real estate exhibits similar unruly, annoying tendencies. Although real estate (like stocks) has been a terrific long-term investment, various real estate markets get clobbered from time to time.

When the oil industry collapsed in Alberta in the early 1980s, real estate prices in the province dropped by 25 percent. And after a massive run-up in prices in the mid-1980s, house prices in the Toronto area plummeted by nearly 28 percent over the next few years. Across Canada, after a whopping 50 percent rise from 1978 to 1981, house prices dropped by 35 percent in just over a year. Then, after hitting a new high in 1990, the market fell by 15 percent in just 12 months, and by 1996 it was down 22 percent.

In the United States, housing prices took a 25 percent tumble from the late 1920s to the mid-1930s. Later, in the 1980s and early 1990s, the northeastern United States became mired in a severe recession, and real estate prices fell by 20-plus percent in many areas. After peaking near 1990, many West Coast housing markets, especially those in California, experienced falling prices — dropping 20 percent or more in most areas by the mid-1990s.

Declining U.S. housing prices in the mid- to late 2000s garnered unprecedented attention. Some folks and pundits acted like it was the worst housing market ever. Foreclosures increased in part because of buyers who financed their home purchases with risky mortgages. But note that housing market conditions also vary tremendously by area. For example, housing prices in Toronto and Vancouver have often shown double-digit increases while smaller cities and towns were experiencing down markets. In the United States, some portions of the Pacific Northwest and South appreciated during the mid- to late 2000s while other U.S. markets experienced substantial declines.

After reading this section, you may want to keep all your money in the bank — after all, you know you won't lose your money, and you won't have to be a nonstop worrier. Since the existence of the Canadian Deposit Insurance Corporation (CDIC), which protects deposits at banks and trust companies up to \$100,000, people don't lose 20 percent, 40 percent, 60 percent, or 80 percent of their bank-held savings vehicles

within a few years, but major losses prior to then did happen. Just keep in mind, though, that just letting your money sit around would be a mistake.



If you pass up the stock and real estate markets simply because of the potential market value risk, you miss out on a historic, time-tested method of building substantial wealth. Instead of seeing declines and market corrections as horrible things, view them as potential opportunities or “sales.” Try not to give in to the human emotions that often scare people away from buying something that others seem to be shunning.

Later in this chapter, you see the generous returns that stocks and real estate, as well as other investments, have historically provided. The following sections suggest some simple things you can do to lower your investing risk and help prevent your portfolio from suffering a huge fall.

Diversify for a gentler ride

If you worry about the health of the economy, the government, and the dollar, you can reduce your investment risk by investing outside Canada. Most large Canadian companies do business in the United States and overseas, so when you invest in larger Canadian company stocks, you get some international investment exposure. You can also invest in international company stocks, ideally via mutual funds and exchange-traded funds (see Chapter 5).

Of course, investing overseas can't totally protect you in the event of a global economic catastrophe. If you worry about the risk of such a calamity, you should probably also worry about a huge meteor crashing into Earth.



Diversifying your investments can involve more than just your stock portfolio. You can also hold some real estate investments to diversify your investment portfolio. Many real estate markets appreciated in the early 2000s while North American stock markets were in the doghouse. Conversely, when real estate in many regions entered a multiyear slump in the mid-2000s, stocks performed well during that period. In the late 2000s, stock prices fell sharply while real estate prices in many major centres rose, but then stocks came roaring back.

Consider your time horizon

Investors who worry that the stock market may take a dive and take their money down with it need to consider the length of time that they plan to invest. In a one-year period in the stock and bond markets, a wide range of outcomes can occur. History shows that you lose money about once in every three years that you invest in the stock and bond markets. However, stock market investors have made money (sometimes substantial amounts) approximately two-thirds of the time over a one-year period. (Bond investors made money about

two-thirds of the time, too, although they made a good deal less on average.)

Although the stock market is more volatile than the bond market in the short term, stock market investors have earned far better long-term returns than bond investors have. (See the later section “Stock returns” for details.) Why? Because stock investors bear risks that bond investors don’t bear, and they can reasonably expect to be compensated for those risks. Keep in mind, however, that bonds generally outperform a boring old bank account.



History has shown that the risk of a stock or bond market fall becomes less of a concern the longer you plan to invest. As the holding period for owning stocks increases from 1 year to 3 years to 5 years to 10 years and then to 20 years, there’s a greater likelihood of seeing stocks increase in value. In fact, over any 20-year time span, the U.S. stock market, as measured by the S&P 500 Index of larger company stocks, has *never* lost money, even after you subtract the effects of inflation.

Since 1957, only one five-year period in Canada has had a negative return. In other words, if you had invested in the broad market (meaning your returns were similar to the composite index, which represents the market’s overall performance) and held on for five years, in only one period would

you have had less after five years than you started with. If you had invested and *stayed* invested for ten years, you would have always come out ahead. To put it another way, starting in 1957, if you had invested in any year and held those investments for a minimum of ten years, you would have ended up with a profit every single time, assuming your returns matched those of the index.



Most stock market investors are concerned about the risk of losing money. The key to minimizing the probability that you'll lose money in stocks is to hold them for the long term. Don't invest in stocks unless you plan to hold them for at least five years — and preferably a decade or longer. Check out Chapters 3 and 5 for more on using stocks as a long-term investment.

Pare down holdings in bloated markets

Perhaps you've heard the expression "buy low, sell high." Although you can't *time the markets* (that is, predict the most profitable time to buy and sell), spotting a greatly overpriced or underpriced market isn't too difficult. This book explains some simple yet powerful methods you can use to measure whether a particular investment market is of fair value, of good value,

or overpriced. You should avoid overpriced investments for two important reasons:

- If — and when — these overpriced investments fall, they usually fall further and faster than more fairly priced investments.
- You should be able to find other investments that offer higher potential returns.



Ideally, you want to avoid having a lot of your money in markets that appear overpriced (see Chapter 3 for how to spot pricey markets). Practically speaking, avoiding overpriced markets doesn't mean that you should try to sell all your holdings in such markets with the vain hope of buying them back at a much lower price. However, you may benefit from the following strategies:

- **Invest new money elsewhere.** Focus your investment of new money somewhere other than the overpriced market; put it into investments that offer you better values. As a result, without selling any of your seemingly expensive investments, you make them a smaller portion of your total holdings. If you hold investments outside of tax-sheltered plans, such as an RRSP (registered retirement savings plan), focusing your money elsewhere also allows you to avoid incurring taxes from selling appreciated investments.

- **If you have to sell, sell the expensive stuff.** If you need to raise money to live on, such as for retirement or for a major purchase, sell the pricier holdings. As long as the taxes aren't too troublesome, it's better to sell high and lock in your profits.

Individual investment risk

A downdraft can put an entire investment market on a roller-coaster ride, but healthy markets also have their share of individual losers. For example, from the early 1980s through the late 1990s, Canadian and U.S. stock markets had one of the greatest appreciating markets in history. You'd never know it, though, if you held one of the great losers of that period.

Consider a company now called Navistar, which has undergone enormous transformations in recent decades. This company used to be called International Harvester, and it manufactured farm equipment, trucks, and construction and other industrial equipment. Today, Navistar makes mostly trucks and buses.

In late 1983, the company's stock traded at more than \$140 per share (all amounts in U.S. dollars). It then plunged more than 90 percent over the ensuing decade. Navistar dipped under \$5 in early 2016 and, even with a rally in later years, never got above \$48 before merging with the Traton Group, which saw Navistar's investors bought out at \$44.50 a share. Lest you think that's a big drop, the company's stock traded

as high as \$455 per share in the late 1970s. If a worker retired from the company in the late 1970s with \$200,000 invested in the company stock, the retiree's investment would have been worth only about \$15,000 when the shares stopped trading. On the other hand, if the retiree had simply swapped the stock at retirement for a diversified portfolio of stocks (see Chapters 3 and 5), that \$200,000 nest egg would've instead grown to more than \$5 million.

Like most other markets, the Canadian stock market's gains paled by comparison with the U.S. juggernaut in the 1990s, but this country has had its share of stocks that have plummeted in value. How about Dylex, which through its many brand-name outlets, such as Suzy Shier, at one time took in \$1 out of every \$10 consumers spent in retail clothing outlets? The stock, which began the 1990s at \$24, ended the decade languishing beneath the \$10 mark, dwindling lower and lower until the company eventually went under in 2001.

Just as individual stock prices can plummet, so can individual real estate property prices. In California during the 1990s, for example, earthquakes rocked the prices of properties built on landfills. The quakes highlighted the dangers of building on poor soil. In the prior decade, real estate values in the communities of Times Beach, Missouri and Love Canal, New York plunged because of carcinogenic toxic waste contamination. (Ultimately, many property owners in these areas received compensation for their losses from the federal

government, as well as from some real estate agencies that hadn't disclose these known contaminants.)



Here are some simple steps you can take to lower the risk of individual investments that can upset your goals:

- **Do your homework.** When you purchase real estate, a host of inspections can save you from buying a money pit. With stocks, you can examine some measures of value and the company's financial condition and business strategy to reduce your chances of buying into an overpriced company or one on the verge of major problems.
- **Diversify.** Investors who seek growth invest in securities such as stocks. Placing significant amounts of your capital in one or a handful of securities is risky, particularly if the stocks are in the same industry or closely related industries. To reduce this risk, purchase stocks in a variety of industries and companies in each industry.
- **Hire someone to invest for you.** The best funds (see Chapter 5) offer low-cost, professional management and oversight as well as diversification. Stock funds typically own 25 or more securities in a variety of companies in different industries. You can invest in real estate in a similar way (that is, by leaving the driving to someone else).

Purchasing power risk (also known as inflation risk)

Inflation (increases in the cost of living) can erode the value of your retirement resources and what you can buy with that money — also known as its *purchasing power*. Here's an example: When Teri and Mike retired at the age of 60, they were pleased with their retirement income. They were each set to receive an \$800-per-month pension, along with \$1,200 per month from money they had invested in long-term bonds. Their total monthly expenditures amounted to about \$3,000, so they were able to save a little money for an occasional trip.

Fast-forward 15 years. Both Teri and Mike still only receive \$800 per month from their pensions, but now they each only get \$900 per month of investment income, which comes from some GICs (guaranteed investment certificates). They bailed out of bonds after they lost sleep over the sometimes roller-coaster-like price movements in the bond market. In contrast, their total monthly expenditures now amount to approximately \$4,800, thanks to inflation, and they've been forced to use some of their investment principal (original investment) to cover their bills. The risk they're now preoccupied with is the terrifying thought of outliving their money.

Teri and Mike have reason to worry. They have 100 percent of their money invested without protection against the inevitable increases in the cost of living. Although their income felt comfortable in the beginning of their retirement, it doesn't at

age 75, and Teri and Mike could easily live another 15 or more years.

The erosion of the purchasing power of your investment dollar can, over longer time periods, be as bad as or worse than the effect of a major market crash. Table 1-3 shows the effective loss in the purchasing power of your money at various rates of inflation, and over differing time periods.

Inflation Rate	10 Years	15 Years	25 Years	40 Years
2%	-18%	-26%	-39%	-55%
4%	-32%	-44%	-62%	-81%
6%	-44%	-58%	-77%	-90%
8%	-54%	-68%	-85%	-95%
10%	-61%	-76%	-91%	-98%

Table 1-3: *Inflation's Corrosive Effect on Your Money's Purchasing Power*

Skittish investors have tried to keep their money in bonds and money-market accounts, thinking they were playing it safe. The risk of this strategy is that your money won't grow enough over the years for you to accomplish your financial goals. In other words, the lower the return you earn, the more you need to save to reach a particular financial goal.



A 40-year-old wanting to accumulate \$500,000 by age 65 needs to save \$722 per month if earning a 6 percent average annual return but needs to save just over half that — \$377 — per month if earning a 10 percent average return per year. Younger investors need to

pay the most attention to the risk of generating low returns, but so should younger senior citizens. Even by the age of 65, many seniors need to recognize that they may not need to use a portion of their assets for a decade or more from the present. This means inflation could seriously erode that money's buying power. But it also means they have a longer timeframe to invest that money in stocks and ride out any market downturns.

Career risk

Your ability to earn money is most likely your single biggest asset, or at least one of your biggest assets. Most people achieve what they do in the working world through education and hard work. Education doesn't simply mean what one learns in formal schooling. Education is a lifelong process. People have learned far more about business from their own frontline experiences and those of others, as well as training others, than they've learned in educational settings. Reading a lot also helps.

If you don't continually invest in your education, you risk losing your competitive edge. Your skills and perspectives can become dated and obsolete. Although that doesn't mean you should work 80 hours a week and never do anything fun, it does mean that part of your "work" time should involve upgrading your skills.



The best organizations are those that recognize the need for continual knowledge and invest in their workforce through training and career development. Just be sure to look at your own career objectives, which may not be the same as your company's.

Analyzing Returns

When you make investments, you have the potential to make money in a variety of ways. Each type of investment has its own mix of associated risks that you take when you part with your investment dollar and, likewise, offers a different potential rate of return. The following sections cover the returns you can expect with each common investing avenue. But first, you look at the different components that make up the total return on an investment.

The components of total return

To figure out exactly how much money you've made (or lost) on your investment, you need to calculate the *total return*. To come up with this figure, you need to determine how much money you originally invested and then factor in other components, such as interest, dividends, and appreciation (or depreciation).

If you've ever had money in a bank account that pays interest, you know that the bank pays you a small amount of interest when you allow it to keep your money. The bank then turns around and lends your money to some other person or organization at a much higher rate of interest. The rate of interest is also known as the *yield*. So, if a bank tells you that its savings account pays 2 percent interest, the bank may also say that the account yields 2 percent. Banks usually quote interest rates or yields on an annual basis. Interest that you receive is one component of the return you receive on your investment.

If a bank pays monthly interest, the bank also likely quotes a *compounded effective annual yield*. After the first month's interest is credited to your account, that interest starts earning interest as well. So, the bank may say that the account pays 2 percent, which then compounds to an effective annual yield of 2.04 percent.

When you lend your money directly to a company — which is what you do when you invest in a bond that a corporation or a government issues — you also receive interest. Bonds, as well as stocks (which are shares of ownership in a company), fluctuate in value after they're issued.



When you invest in a company's stock, you hope that the stock *appreciates* (increases) in value. Of course, a stock can also *depreciate* (decrease) in value. This change in market value is part of your return from a stock or bond investment:

$(\text{current investment value} - \text{original investment}) \div \text{original investment} = \text{appreciation or depreciation}$

For example, if one year ago you invested \$10,000 in a stock (you bought 1,000 shares at \$10 per share) and the investment is now worth \$11,000 (each share is worth \$11), your investment's appreciation looks like this:

$$(\$11,000 - \$10,000) \div \$10,000 = 10$$

Stocks can also pay *dividends*, which are the company's sharing of some of its profits with you as a shareholder. Some companies, particularly those that are small or growing rapidly, choose to reinvest all their profits back into the company. (Of course, some companies don't turn a profit, so they don't have anything to pay out.) You need to factor any dividends into your return as well.



Suppose that in the preceding example, in addition to your stock appreciating from \$10,000 to \$11,000, it paid you a dividend of \$100 (\$1 per share). Here's how you calculate your total return:

$([\text{current investment value} - \text{original investment}] + \text{dividends}) \div \text{original investment} = \text{total return}$

You can apply this formula to the example like so:

$$([\$11,000 - \$10,000] + \$100) \div \$10,000 = 11$$

After-tax returns

Although you may be happy that your stock has given you an 11 percent return on your invested dollars, note that unless you held your investment in a tax-deferred registered retirement savings plan (RRSP), registered retirement plan, registered education savings plan (RESP), or tax-free savings account (TFSA), you owe taxes on your return. Specifically, the dividends and investment appreciation that you realize when you sell are taxed, although often at relatively low rates. The tax rates on capital gains and stock dividends are lower than the tax rates on other income. Chapter 2 discusses the different tax rates that affect your investments and explains how to make tax-wise investment decisions that fit with your overall personal financial situation and goals.

If you've invested in savings accounts, money-market accounts, or bonds outside a tax-deferred registered retirement plan or a TFSA, you owe the Canada Revenue Agency (CRA) taxes on the interest.

Often, people make investing decisions without considering the tax consequences of their moves. This is a big mistake. What good is making money if the government takes away a substantial portion of it?



If you're in a moderate tax bracket, taxes on your investment probably run in the neighborhood of 30 percent (federal and provincial taxes combined). So, if your investment returned 6 percent before taxes,

you're left with a net return of about 4.2 percent after taxes.

Psychological returns

Profits and tax avoidance can powerfully motivate your investment selections. However, as with other life decisions, you need to consider more than the bottom line. Some people want to have fun with their investments. Of course, they don't want to lose money or sacrifice a lot of potential returns. Fortunately, less expensive ways to have fun do exist.

Psychological rewards compel some investors to choose particular investment vehicles such as individual stocks, real estate, or a small business. Why? Because compared with other investments, such as managed mutual funds and exchange-traded funds (ETFs), they see these investments as more tangible and, well, more fun.



Be honest with yourself about why you choose the investments you do. Allowing your ego to get in the way can be dangerous. Do you want to invest in individual stocks because you believe that you can do better than the best full-time professional money managers? Chances are, you won't. Such questions are worth considering as you contemplate which investments you want to make.

Savings, high-interest, and money-market account returns

You need to keep your extra cash that awaits investment (or an emergency) in a safe place, preferably one that doesn't get hammered by the sea of changes in the financial markets. By default and for convenience, many people keep their extra cash in a bank savings account. Although the bank offers the backing of the Canadian Deposit Insurance Corporation (CDIC), it comes at a price. Most banks pay a relatively low interest rate on their savings accounts.



A far better place to keep your liquid savings is a high-interest savings account, offered by the big banks and most mutual fund companies, as well as by many new and smaller companies, such as Alterna Bank, DUCA Credit Union, EQ Bank, Saven Financial, and Wyeth. These accounts typically offer rates anywhere from 4 to 40 — yes, 40 — times the rate on savings accounts.

Another good place to keep your liquid savings is in a money-market mutual fund. These are the safest types of mutual funds and, for all intents and purposes, equal a bank savings account's safety. The best money-market funds generally pay higher yields than most bank savings accounts. Unlike a bank, money-market mutual funds tell you how much they deduct for the service of managing your money.

If you don't need immediate access to your money, consider using Treasury bills (T-bills) or Guaranteed Investment Certificates (GICs), which are usually issued for terms of three months to five years. Your money will generally earn more in one of these vehicles than in a bank savings account. (Often, the yields on T-bills have been so low that the best CDIC-insured bank savings accounts have higher yields.) Rates vary by institution, so it's essential to shop around. The drawback to T-bills and GICs is that you incur a penalty (with GICs) or a transaction fee (with T-bills) if you withdraw your investment before the term expires (see Chapter 4).



You may be wondering, "What does the phrase *liquid savings* mean?" The term *liquidity* refers to how long and at what cost it takes to convert an investment into cash:



- The money in your wallet is considered perfectly liquid — it's already cash.
- Suppose that you invested money in a handful of stocks. Although you can't easily sell these stocks on a Saturday night, you can sell most stocks quickly through a broker for a nominal fee any day that the financial markets are open (normal working days). You

pay a higher percentage to sell your stocks if you use a high-cost broker or if you have a small amount of stock to sell.

- Real estate is generally much less liquid than stock. Preparing your property for sale takes time, and if you want to get fair market value for your property, finding a buyer may take weeks or months. Selling costs (agent commissions, fix-up expenses, and closing costs) can approach 8 percent to 10 percent of the home's value.
- A privately run small business is among the least liquid of the better growth investments that you can make. Selling such a business typically takes longer than selling most real estate.

Bond returns

When you buy a bond, you lend your money to the issuer of that bond (borrower), which is generally the federal government, a provincial government, or a corporation, for a specific period of time. When you buy a bond, you expect to earn a higher yield than you can with a money-market or savings account. You're taking more risk, after all. Companies can and do go bankrupt, in which case you may lose some or all of your investment.

Generally, you can expect to earn a higher yield when you buy bonds that

- **Are issued for a longer term:** The bond issuer is tying up your money at a fixed rate for a longer period of time.
- **Have lower credit quality:** The bond issuer may not be able to repay the principal.

Wharton School of Business professor Jeremy Siegel has tracked the performance of bonds and stocks back to 1802. Although you may say that what happened in the 19th century has little relevance to the financial markets and economy of today, the decades since the Great Depression of the 1930s — the timespan usually tracked — are a relatively small slice of time.



Note that although the rate of inflation has increased since the Great Depression, bond returns haven't increased over the decades, according to the data. Long-term bonds maintained slightly higher returns in recent years than short-term bonds. The bottom line: Bond investors typically earn about 4 percent to 5 percent per year.

Stock returns

Investors expect a fair return on their investments. If one investment doesn't offer a seemingly high enough potential

rate of return, investors can choose to move their money into other investments that they believe will perform better. Instead of buying and holding a diversified basket of stocks, some investors frequently buy and sell, hoping to cash in on the latest hot investment. This tactic seldom works in the long run.

Unfortunately, some of these investors use a rearview mirror when they purchase their stocks, chasing after investments that have recently performed strongly on the assumption (and the hope) that those investments will continue to earn good returns. But chasing after the strongest-performing investments can be dangerous if you catch the stock at its peak, ready to begin a downward spiral. You may have heard that the goal of investing is to buy low and sell high. Chasing high-flying investments can lead you to buy high, with the prospect of having to sell low if the stock runs out of steam. Even though stocks as a whole have proved to be a good long-term investment, picking individual stocks is a risky endeavour. See Chapter 3 for advice on making sound stock investment decisions.

A tremendous amount of data exists regarding stock market returns. In fact, in the U.S. markets, data going back more than two *centuries* document the fact that stocks have been a terrific long-term investment. The long-term returns from stocks that investors have enjoyed, and continue to enjoy, have been remarkably constant from one generation to the next.

Going all the way back to 1802, the U.S. stock market has produced an annual return of 8.3 percent, while inflation has grown at 1.4 percent per year. Thus, after subtracting for inflation, stocks have appreciated about 6.9 percent faster annually than the rate

of inflation. The U.S. stock market returns have consistently and substantially beaten the rate of inflation over the years.

Stocks don't exist only in Canada and the United States, of course. More than a few investors seem to forget this fact, as they did during the sizzling performance of the Canadian and U.S. stock markets during the late 1990s. As discussed in the earlier section "Diversify for a gentler ride," one advantage of buying and holding overseas stocks is that they don't always move in tandem with North American stocks. As a result, overseas stocks help diversify your portfolio.

In addition to enabling Canadian investors to diversify, investing overseas has proved to be profitable. The investment banking firm Morgan Stanley tracks the performance of stocks in both economically established countries and emerging economies. As the name suggests, countries with *emerging economies* (for example, Brazil, China, India, Malaysia, Mexico, Russia, and Taiwan) are "behind" economically but often show high rates of growth and progress.



Stocks are the best long-term performers, but they have more volatility than bonds and T-bills. A balanced portfolio gets you most of the long-term returns of stocks without much of the volatility.

Real estate returns

Over the years, real estate has proven to be about as lucrative as investing in the stock market. Whenever there's a real estate

downturn, folks question this historic fact. However, just as stock prices have down periods, so, too, do real estate markets.

The fact that real estate offers solid long-term returns makes sense because growth in the economy, in jobs, and in population ultimately fuels the demand for real estate.

Consider what has happened to the Canadian population over the past two centuries. In 1867, a mere 3.5 million people lived within our borders. In 1900, that figure grew to over 5 million, and by 1929, it had doubled to over 10 million. At the time of writing, it's about 38 million. All these people need places to live, and as long as jobs exist, the income from jobs largely fuels the demand for housing.

Businesses and people have an understandable tendency to cluster in major cities and suburban towns. Although some people commute, most people and businesses locate near major highways, airports, and so on. Thus, real estate prices in and near major metropolises and suburbs generally appreciate the most. Consider the areas of the world that have the most expensive real estate prices: Hong Kong, Singapore, London, San Francisco, New York, and Boston. Here at home, our most expensive cities are Vancouver and Toronto. What these areas have in common are lots of businesses and people and limited land.

Contrast these areas with the many rural parts of Canada where the price of real estate is relatively low because of the abundant supply of buildable land and the relatively lower demand for housing.

Small business returns



You have several choices for tapping into the exciting potential of the small-business world (see Chapter 7). If you have the drive and determination, you can start your own small business. Or perhaps you have what it takes to buy an existing small business. If you obtain the necessary capital and skills to assess opportunities and risk, you can invest in someone else's small business.

What potential returns can you get from small business? Small-business owners who do something they enjoy will tell you that the non-financial returns can be major. But the financial rewards can be attractive as well.

Every year, *Forbes* magazine publishes a list of the world's wealthiest individuals. Perusing this list shows that most of these people built their wealth by taking a significant ownership stake and starting a small business that became large. These individuals achieved extraordinarily high returns (often in excess of hundreds of percent per year) on the amounts they originally invested to get their companies off the ground.

You may also achieve potentially high returns from buying and improving an existing small business. Such small-business investment returns may be a good deal lower than the returns you may gain from starting a business from scratch.

Unlike the stock market, where plenty of historic rate-of-return data exists, data on the success — or lack thereof — that investors have had with investing in small private companies is harder to come by. Smart venture capitalist firms operate a fun and lucrative business: They identify and invest money in smaller start-up companies that they hope will grow rapidly and eventually go public. Venture capitalists allow outsiders to invest with them via limited partnerships. To gain entry, you generally need \$1 million to invest, although there are some exceptions from time to time. (No one ever said this was an equal-opportunity investment club!)

Venture capitalists, also known as *general partners*, typically skim off 20 percent of the profits and also charge limited partnership investors a hefty 2 percent to 3 percent annual fee on the amount that they've invested. The return that's left over for the limited partnership investors isn't always stupendous. According to Venture Economics, a U.S. firm that tracks limited partners' returns, venture funds have averaged comparable annual returns to what stock market investors have earned on average over this same period. The general partners that run venture capital funds make more than the limited partners do.

You can attempt to do what the general partners do in venture capital firms and invest directly in small private companies. But you're likely to be investing in much smaller and simpler companies. Earning venture capitalist returns isn't easy to do. If you think you're up to the challenge, find out more about how to invest in small business in Chapter 7.