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The "Key" To Your Wealth

Fighting The Four Financial Forces

Like many investors, you want to make sure that your money is working hard for you. The question is, what are you doing to make sure this happens? More often than not, when I discuss money with people their main focus is the rate of return. Now don't get me wrong, this is a very important concept to be concerned about, however it's not the only part of investing that one needs to focus on. Let's discuss what I call '*The Financial Fight.*' In order for your money to be working optimally, it needs to be fighting *'The Four Financial Forces':*

- *Risk vs. Return*
- *Inflation*
- *Taxes*
- *Fee Awareness*

Force One: Risk vs. Return
I'm sure, like other investors, when you receive your quarterly investment statements you immediately look to the box that highlights your rate of return. If it's a positive number, good—you're making money! If it's a negative number, pray that you're in a well-balanced portfolio that can get you through tough times.

A properly balanced portfolio is the best way to keep risk and return in check. The old saying "you don't want all your eggs in one basket" is truly the best way to invest for a more consistent rate of return. This concept is called asset allocation. In fact, studies have shown that asset allocation accounts for 90% of an investors' rate of return. Simply put: minimize the chance of impairing your financial goals by implementing an asset allocation strategy.

This leads me to the risk part of the equation. If you follow sports, the following analogy will help you understand the importance of risk management concerning your portfolio. When it comes to building a successful sports team everyone knows that you must have a balance of Forwards and Defensemen. Each of these players has a specific and important role to carry out during the game. To bring it back to the investment world, let's say that the Forwards are Stocks and the Defensemen are Bonds.

Now, let's take a look at the great Canadian game of hockey to illustrate this important concept. Simply put, Forwards are there to put the puck in the net and score. Defensemen want to prevent the opposing team from scoring. Generally speaking, Forwards aren't great at defence and Defensemen aren't always that great at scoring. So, if you have a team with only Forwards you'll probably score a lot, but you will let in a lot of goals too. The same is true if you have a team of only Defensemen—you'll let in fewer goals, but you probably won't score many either. Obviously, the best and most consistent team has a mixture of both Forwards and Defensemen.

Force Two: Inflation
I often refer to inflation as the Silent Killer. It's not something that you can see everyday, but it slowly creeps up on you and every year it makes things more expensive. The real threat is that your money is losing its buying power. Buying power allows you to purchase the things you need and want, but in today's dollars—not tomorrow's dollars. Simply put, a loaf of bread 10 years ago was less expensive than it is today. Inflation is directly responsible for this price increase.

Inflation in Canada over the last 50 years has averaged 3% annually and the Canadian Government's goal is to help keep inflation between 2-3%. This means that each year your dollar loses 3% of its buying power. So, if your investments aren't earning at least 3%, you're actually losing money. As discussed earlier, the rate of return is often the sole focus of many investors. This is known as the Nominal Rate of Return. However, in order to look at actual dollars and cents, we've got to talk about the Real Rate of Return. The Real Rate of Return is your percentage growth after adjusting for inflation.

Now let me guess, you're probably thinking "yeah, but the bank is giving me a guaranteed 4% on my GIC." Well, that's great, but let's examine that rate you've fought hard for with your local banker. This is how it really works: The bank reluctantly gives you a guaranteed 4% rate on your GIC. They then take that money and lend it out via mortgages, credit cards, etc at rates much higher than your 4% to make money off of your guaranteed investment, while never using any of their own capital. Again, if we're talking real dollars and cents, inflation must be factored in. Therefore, that 4% you're getting from that GIC minus 3% inflation leaves you with 1%. Not great is it? A bit of a risk too. Granted, a different type of risk, but while you enjoy that guaranteed rate you're losing ground while others take advantage of your hesitation to truly invest. Concerned yet? You should be.

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Force Three: Taxes

Let's continue using the above 4% GIC example to illustrate the tax issue. So, what about the good old tax-man? Well, in Alberta, where the taxes are the lowest in Canada, the highest tax bracket possible is 39%. In this case, we started off with a 4% GIC, then we took off 3% for inflation, leaving us 1%. Now we shave off taxes, which means you're really only left with 0.61% all the way from that glorious 4% you "stole." Not much of an investment towards your financial freedom, is it? All kidding aside, this is happening all over Canada and it's inhibiting people's wealth.

Now, we're all aware that tax evasion is illegal, however, tax avoidance is perfectly legal. I'm not about to get into the consequence of tax evasion, but Force Three deals with the important concept of tax avoidance. There are basically three ways investment growth is taxed in Canada on an annual basis in a regular cash account (outside of your RRSP). Your money can be taxed as Interest Income, Dividends, or Capital Gains. Without getting into too much detail, these vehicles are taxed very differently. Interest Income derives from investments such as a GIC, savings account, etc. Any gain or interest made in these types of investments is fully taxable at your marginal tax rate. This means that 100% of the profit made must be included as income on your tax return.

"Don't let fear ruin your investment decisions and allow the guaranteed, low return investments, slowly bleed you of your wealth."

Dividends on the other hand are a little more tax friendly. Dividends derive from being a shareholder in a company. They are basically a company's earnings that are returned to shareholders. Most often, the dividend comes in the form of cash: a company will pay a small percentage of its profits to the owner of each share of stock. When it comes to the tax treatment of dividends, only about 60% of the dividend income is included in your taxes. This of course allows you to keep the other 40% tax-free. Congratulations, you've just legally avoided tax.

Now, let's talk about Capital Gains. Other than tax-free gains such as winning a lottery, capital gains tax is the most efficient way to be taxed in Canada. It allows you to defer taxes and pay the least amount of tax on your profits. The best way to explain this is to use the example of buying XYZ Stock at $10 and selling it at $30 a few years later. The deferral part is that for those years you held the stock, you paid no annual tax on it. However, you will pay tax on the gain once you sell it. So, if you sold XYZ Stock at $30 you now have a capital gain of $20. Since this profit is in the form of a capital gain, only 50% needs to be included in your taxes. In this example, only $10 out of the $20 gain has to be included for tax purposes. Again, you've just legally avoided tax and kept half of the profits tax-free!

Force Four: Fee Awareness

First of all, make sure that you're dealing with an advisor that has the appropriate credentials and experience to help you with your financial concerns. There are many advisors out there, but so few are truly accredited advisors. There's nothing worse than having an advisor that plays a guessing game with your financial future. In addition, far too many people fail to ask how their advisor gets paid. Don't make assumptions, and don't be shy about asking. It's your money and your financial gains are on the line. If your advisor hasn't been up front and honest about how he or she is being paid it's usually a bad sign.

Here are some questions you should be asking your advisor to ensure he or she is truly focused on your financial success:

- Does your future financial success bring them future financial success?

- What incentives are in place to ensure they will provide you with the ongoing service you deserve?

- Are there any hidden or deferred fees?

- How accessible are the funds in your account?

In conclusion, it's apparent that your money is battling formidable forces. The fact of the matter is that these forces will never go away and they will never stop affecting your wealth. It's vitally important that you keep them in mind when designing a financial strategy with your advisor.

First, make sure your portfolio is properly balanced and aligned with your risk tolerances. Second, get your money working for you. Don't let fear ruin your investment decisions and allow the guaranteed, low return investments, slowly bleed you of your wealth. Third, ensure your money is working towards tax-advantaged growth—keep more in your pocket. Fourth, ensure you are aligned with an advisor that is compensated based on your future success. Avoid advisors that aren't forthright concerning how they get paid. Stay clear of the single commission advisors that get a big up-front commission, but next to nothing for maintaining the service you deserve.

There's a lot to consider when it comes to your money. The Financial Fight takes time and willpower, but if you are well equipped, the battle against The Four Financial Forces can be won.

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