Farm, family and finances

Don’t overlook the importance of non-farm assets while building wealth

DAVID DERWIN Hedging your bets

For many farmers, their business, land and other real estate are the largest part of their asset base. So it’s easy to overlook financial assets like stocks and bonds when you’re busy running the day-to-day aspects of the farm.

However, investment tools like registered retirement savings plans (RRSPs), tax-free savings accounts (TFSAs) and corporate cash accounts can be important components of a properly diversified long-term business plan. They can also be a great way to generate a valuable source of future income and a helpful succession planning tool. This month we’ll move away from commodity markets to address equity and interest rate market risks and opportunities.

The two main components of a financial asset portfolio are equities and bonds. Even a standard balanced investment portfolio could have a mix of 50 per cent stocks and 50 per cent interest rate-based investments.

Since we’ve already seen increased stock market volatility, U.S. equities in a multi-year bull market and rising interest rates, it’s important to reassess valuations and what the future could bring for investors.

Stocks have indeed had an exceptional increase in the past decade; this recent 10-year run is in the top 10 per cent, based on a 150-year chart.

Since the long-term total annualized return from North American equities, including reinvesting dividends, is around nine per cent, history suggests that the next 10 years won’t be as good as the last 10.

This leads us to current market valuations as it affects those prices going forward. Are stocks expensive or still fairly priced? The price-earnings ratio, or P/E ratio, measures the price an investor pays for $1 of a company’s earnings or profit and can help determine if a stock is cheap or expensive. If a stock is trading at $20 and produce $1 of profit per share, the P/E ratio is 20. For all U.S. S&P 500 stocks combined over the past 150 years, the P/E ratio has averaged about 16. It’s currently around 22.5. This is in the top 10 percentile, meaning that stocks have been cheaper 90 per cent of the time since 1871.

By this measure, U.S. stocks are expensive. This doesn’t mean that stocks have to drop; it’s just saying they aren’t cheap.

But, it will be harder for them to continue going up as much as they have in the past since they are already near high historical valuations. It’s kind of like a marathoner trying to sprint through the whole marathon, it’s just not sustainable.

Next, how will the American political situation affect stocks going forward? The U.S. just had its midterm congressional elections and history has shown that the year after these elections is the strongest for U.S. stocks of any of the four years in the presidential cycle.

Perhaps it’s because some of the uncertainty is out of the way, or because the president can now implement his policies or maybe it’s because it creates gridlock in the White House so no one can mess anything up.

Either way, in the six-month period following these midterm elections, U.S. S&P 500 stocks have been up on average over 15 per cent in the past 70 years. This historical midterm election tendency should help stocks for the next six to 12 months. However, with a couple of 10 per cent corrections already in the books for 2018, we'll see if stocks stay in their sideways consolidation pattern they've been in for the past year, or if they move to new highs.

Finally, we have to look at interest rates since they can influence all other asset prices. In the past three years, the U.S. Federal Reserve Bank has raised interest rates from 0.25 per cent to 2.25 per cent. Meanwhile, the Bank of Canada has increased from 0.50 per cent to 1.75 per cent. Historically, though, the correlation or connection between interest rates and stocks is close to zero.

This means that in the past, the direction of interest has not had the impact on stocks you might think. Rising interests are a headwind but not a showstopper.

So then, what about bonds and interest rate-based investments? Interest rates are still low, but moving higher. As we already saw above, U.S. rates have risen two per cent and are still moving higher, with Canada following close behind.

This isn't good for long-term bond holders because when interest rates go up, the value of these long-term bonds, as well as the balanced mutual funds that hold them, tend to go down.

Fortunately, there are alternatives to two per cent or three per cent GICs or government bonds such as high-yielding corporate bonds, preferred shares and floating-rate investments paying six per cent, seven per cent or even eight per cent. And if stocks are likely to give us less than the nine per cent long-term average, these can be a good addition to your investment portfolio; steady cash flow returns with reduced volatility and less stock market risk.

Bottom line, trees don't grow to the sky and the sun doesn't always shine — so while stocks aren't cheap, it doesn't mean stock markets have to crash.

They may just grind out modest returns or be flat or slightly negative over the next several years. Nor does it mean you have to sell all your stocks and bonds and just move to cash or short-term GICs. There are lateral moves and adjustments you can make to your portfolio to generate cash flow, hedge investment risks and still capture some capital gains from the market.

Just like business decisions on the farm, it's all about balancing risk with reward.

Financial assets can be part of your long-term strategy to diversify assets, increase your income and develop investment plans for tomorrow.

David Derwin is a commodity portfolio manager and futures/investment adviser with PI Financial Corp. (dderwin@pifinancial.com / www.commodityoptions.ca), a member of the Canadian Investor Protection Fund. The risk of loss in trading commodity interests can be substantial. Past performance is not necessarily indicative of future results.

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