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Why Should We Buy Stocks?

This is a very interesting question that I have been asked on several occasions. After all, isn't the stock market risky? Yes, it's true. Whether it is directly, through a selection of individual stocks, or indirectly, through mutual funds or exchange traded funds (ETF), buying stocks in the market is risky. However, buying bonds or guaranteed investment certificates (GIC) also involve risks. In fact, **there is no such thing as a riskless investment!** You take a risk if you choose to keep your money at home under your mattress (possibility of theft or fire), and even if you keep your money in your bank account. Why? Because of inflation. Precisely, inflation is a risk that consequently results in a gradual loss of purchasing power. It's a silent killer! You might think you are becoming richer because your GIC brought you a couple more dollars, but in reality you are becoming poorer! **To become rich, you have to obtain an after-tax rate of return that is higher than the inflation rate.**

Are you lucky enough to have savings? If so, you will need to make some decisions that will have a big impact on your future quality of life. Welcome to the life of the rich and famous! Risk is omnipresent and every investment decision you take should bring you closer to your short and long term goals.

Lender or Owner?

When the time comes to invest your money, there are only two things you can do with it: lend it or become an owner. Let's take a closer look at these options.

Source : etrouve.com

Source : Michel Gauthier

We become an **owner** by buying a building (residential or commercial) or a part of a company. The easiest way to buy a company is to buy shares of companies listed on the stock market. Being a shareholder means owning a part of the company, whether 100% of it or less than 1% of it. Private companies that are not offered on the stock market aren't always accessible to investors because they have a limited amount of shareholders. Also, they are usually start-up enterprises that are new to the business world and contain far more risks.

We become a **lender** when we lend to a country, province, city or company. This type of lending is called a bond. Governments need money from people to finance their enormous expenses in infrastructures, public services and many more. Companies, on the other hand, borrow money for their operational needs, opening or renovating stores, making acquisitions, etc. We also become a lender when we leave our savings in our bank account or when we buy a term deposit or a GIC. This way, we, «lend» our money to the bank who then will lend it to a house buyer, an entrepreneur, etc. averaging a higher interest rate than the one they give you. Money never sleeps!

Both of these choices carry risks with their advantages and disadvantages. **Generally, being an owner is significantly more rewarding than being a lender.** The return is usually proportional to the risk that is taken.

The risks of investing

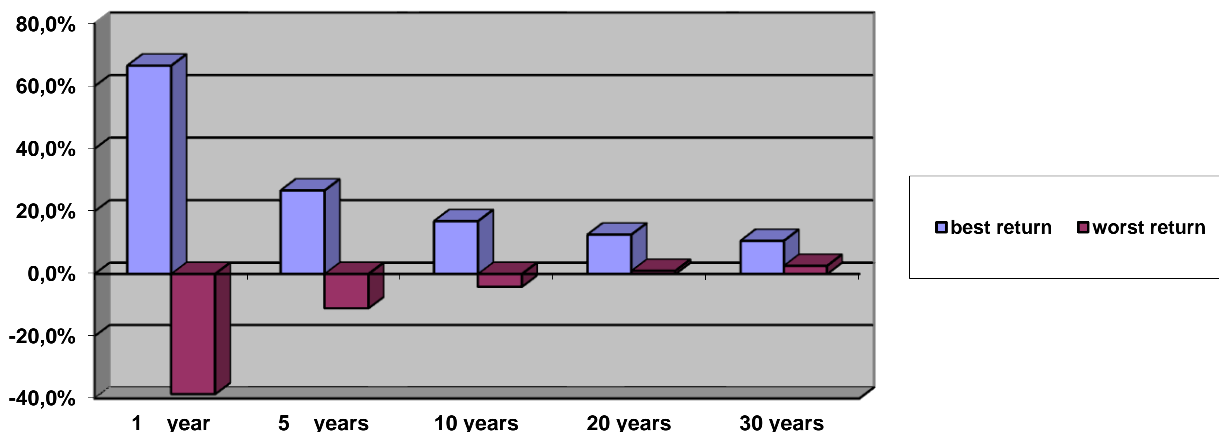
Even if they are considered safe, fixed income investments, such as bonds, can be risky. If you lend money to your irresponsible brother in-law, an in-debt government like Greece or Argentina or if you lend to a badly run company with financial difficulty, you still risk not seeing your money again. You are taking huge risks! This is usually why, when a bond has a lower credit rating, a higher interest rate is also required to compensate for the extra risk. Time is equally important. It is riskier to lend your money over a long period of time. Who knows what will happen 30 years from now? What will the inflation rate be in 10 or 15 years?

An increase in interest rates proportionally decreases the market value of a bond. The opposite is also true; a decrease in interest rates increases the bond's market value. Also, since interest rates are at an all-time low, there are good chances that they will increase over the next couple of years. Of course, if you hold onto your bond until its maturity date, you will not lose any capital. However, receiving a tiny 3% interest coupon for the next 20 years until maturity is not a great idea if inflation is at 6% and the market rates for a bond is also 6%!

Being an owner has its risks. The owner of an apartment building must offer a good service while limiting his expenses and maximizing his revenues. Meanwhile he must deal with bad tenants, urgent repairs, municipal and scholar tax increases, tax increases on mortgage renewal, vacancy (difficulty filling up apartments), etc. Many owners have lost a lot of money! Also, real estate is cyclical, and with the long ascending cycle we have just seen, many people have forgotten that.

As for stocks, there is also a lot of risk. **Buying stocks is like getting your feet off the solid ground of guaranteed revenue to sail out onto the ocean.** Their price constantly fluctuates; it rises when people get optimistic and falls when they get worried. In the short term, price movements can be enormous! As such, volatility creates a risk to the one that wishes to trade his stocks in a short period of time. This is why we should never invest the money we need for food in the upcoming week, or our rent, in the stock market. Therefore, the stock market is very risky in the short term. However, in the long term, fluctuations shrink considerably, to the point where there has not been a 20 year period in the stock market that has been negative within the last 2 centuries, with the exception of the financial crisis of October 1929 in which it took 25 years to recover the losses incurred during this euphoric period.

Stock Market: Best and worst holding period, 1802 to 2001



Source: AIC Funds

For someone who invests in the long term, the true risk is not fluctuations, which are just temporary losses, but the risk of permanent losses following a bad investment decision. This is why serious investors pay close attention to the quality of the companies in which they invest in. In fact, **volatility is a friend to an investor who knows what he is doing.**

From time to time it lets him buy shares of excellent companies at discount prices. Without this volatility, which is caused by emotions, the buyer would be condemned to always pay the full price. For the long term investor, the biggest risk is not reaching his/her objectives.

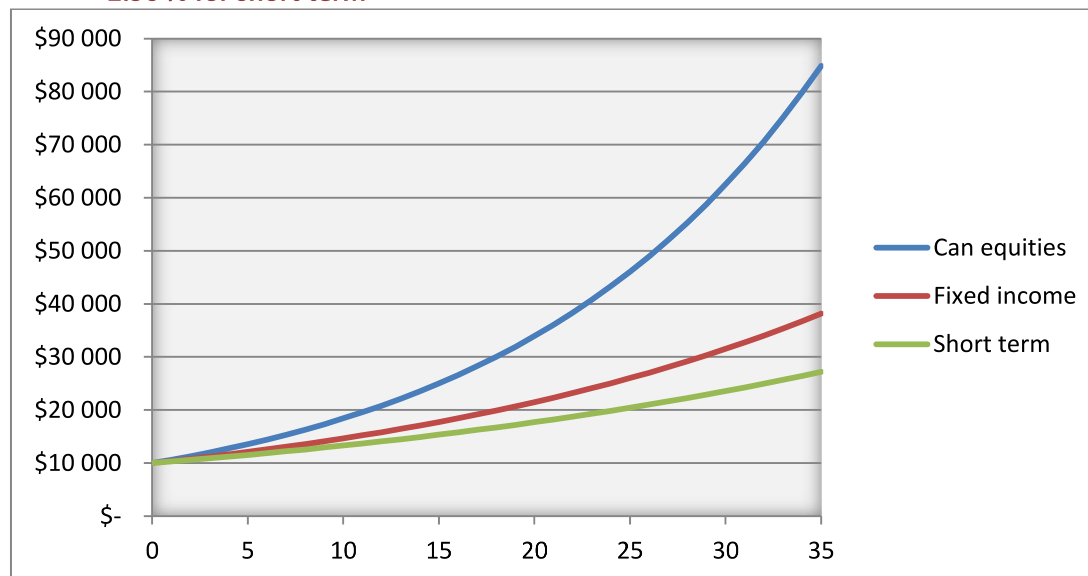
Why should we buy stocks?

In order to decide whether or not buying stocks is suitable for you, you must first clearly define your objectives and your tolerance to volatility. **Over 90% of your future yield will be determined by your asset category[1].** After witnessing pitiful returns offered by fixed income assets, the risks of an increase in interest rates and the expensive Canadian real estate sector, there aren`t too many interesting alternatives for someone who wishes to get richer in the long term. By being too conservative, you risk not being able to attain your retirement objectives. You would be forced to work a lot longer or would have to put yourself on a very strict budget**. If you're looking to invest for the long term, 10 years or more, the stock market remains the best place to put your money and have good chances to receive satisfying results.** Keep in mind that I am referring to investing in the stock market, not speculating in the stock market. A person who tries to win with the market by trading frequently, significantly reduces his/her chances of success.

In the long term, stocks allow you to protect yourself against damaging inflation rates. Companies are usually able to increase their prices towards their consumers, when dealing with inflation. **Stocks are fiscally advantageous.** It's true, as long as you don't sell, you do not have to pay any taxes on your capital gain. And while you realize a capital gain after selling stocks, only half of the gain is taxable in an un-registered account. There are mathematical advantages to postpone your taxes as long as possible.

Investment of a unique amount of 10 000$ for 35 years with a compounded rate of:

- **6.30 % for Canadian equities**
- **3.90 % for fixed income**
- **2.90 % for short term**



According to 2015 Projection Assumption Guidelines from l'Institut québécoise de planification financière

The above projections from the IQPF represent very conservative rate of returns for stocks. On a historical base for the long term, stocks have been giving far better returns. Between 1946 and 2012, the average compound return for Canadian stocks has been 9.8% per year[2].

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[1] Brinson, Singer, Beebowery, Financial Analysts Journal, February 1991
[2] Desjardins études économiques, September 2013

Stocks with less risk

Is it possible to reduce the risks of your stocks? Of course it is! First, you will need a **healthy diversification.** You do not need to be over-diversified! Second, by the choice of companies we decide to have in our portfolio and paying attention to **quality.** Finally, you have to let time run its course by maintaining a **long term** perspective.

By choosing only companies that are very profitable, are well managed, have little to no debt, having lasting competitive advantages and have an exceptional management team, you put the chances on your side and lessen the risk of permanent capital loss. If, additionally, you favor companies that are growing and are active in sectors that are not sensitive to economic cycles, you increase your probabilities for long term success. One last important criterion is, of course, the price you pay for those companies. You have to avoid paying too much for a company, while keeping in mind that a Mercedes will always be worth more than a Chrysler!

If we can't eliminate the volatility of stocks, it is possible to reduce it significantly with a well-constructed portfolio holding **uniquely excellent companies.** Usually, when the stock goes down, the best companies decrease less than the others and recover as quickly when the market goes up. Punctured boats cannot resist the waves of the sea!

To succeed in the stock market, you need the right approach and the right attitude. Once we get our hands on some of the rare excellent companies, we cannot let our emotions affect our investment decisions. We must avoid getting distracted by external «noises», but we should witness the progress that our companies are accomplishing. We should ideally think like an entrepreneur and focus on our long term objectives. It takes serious convictions and nerves of steel. This is where a good investment advisor can be very useful!

« Risk comes from not knowing what you're doing. »

Warren Buffett

My disciplined and proven approach consists of buying only elite companies, each the best of their sector. I hold them for a very long time in order to minimize taxes and other additional fees. **From the quality of enterprises acquired, I aim for the protection of capital and a great long term return.** I keep a very close eye on the companies I hold and that I recommend to my clients. I also continually read on this subject because it is a passion to me. I regularly attend shareholders annual meetings in order to further my understanding on my companies and get the answers to my questions. It's my competitive advantage!

If, after all, stocks keep you awake at night, it is possible to be a lender and a buyer simultaneously. Your return will decrease a bit but so will your risk.

It would be my pleasure to receive your comments and answer your questions!

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"I have prepared this commentary to give you my thoughts on various investment alternatives and considerations which may be relevant to your portfolio. ***This commentary reflects my opinions alone, and may not reflect the views of National Bank Financial Group.*** In expressing these opinions, I bring my best judgment and professional experience from the perspective of someone who surveys a broad range of investments. Therefore, this report should be viewed as a reflection of my informed opinions rather than analyses produced by the Research Department of National Bank Financial."

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