

T H E L O N G V I E W

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Building Family Wealth

In the tug of war between the investor and society, society almost always wins. Over time, most family fortunes are dissipated.

Governments use their taxing power to wrest wealth from investors. Of greater importance is the all-too-human propensity to spend rather than save, and to speculate rather than invest.

But family wealth need not be destroyed. In this edition of *The Long View* we discuss how a family can, over more than one generation, build a substantial amount of capital through intelligent long-term planning.

Why Leave It to the Kids?

At this point you may well be asking yourself – Why would I want to leave my money to my children or grandchildren? Why not enjoy it while I am alive – or leave it to charity? Will inheriting wealth not rob my children of the sense of accomplishment that would come from building their own wealth?

To these difficult questions we can only answer that the decision is highly personal. We would, however, suggest that everyone should decide what they wish to have happen to their capital on their death – and plan accordingly.

We hope that those who like the idea of building family wealth will find this to be a helpful guide.

Taxable Investors Are Different

Those who wish to accumulate wealth should begin by understanding how assets are continually eroded by a combination of inflation and taxes. Only then

does it become clear that, to win at this game, an individual or family must behave quite differently from a pension fund or any other organization that doesn't have to pay taxes.

To illustrate, let's compare the after-tax return from investing in bonds and stocks.

Bonds Don't Build Wealth

Over the past 75 years the highest quality long-term bonds have produced an annual return averaging about 6%. During this period inflation has averaged about 3%.

If you're not taxable, a nominal return of 6% – or a real return of 3% – may be quite acceptable. For a taxpayer, however, the results are not as happy. The top marginal tax rate in Canada is just under 50%. And this rate is applied to the *nominal* return. A taxpayer who owns bonds yielding 6% gets about 3% after tax. With inflation averaging 3%, the real return is zero – and that's *before* any trading or investment management costs.

How, in a free-market economy, can bonds yield a zero return? The answer is that the prices of financial assets – stocks and bonds – are set by non-taxable entities, which are by far the biggest buyers and sellers of securities.

The taxable investor is sleeping between two elephants. One elephant, the government, expropriates wealth through inflation and taxes. The other elephant, the large pension funds and other non-taxable entities, sets the market price for financial assets. Little wonder the taxable investor has restless nights.

Stocks Outpace Bonds and Inflation

Fortunately, the erosion from tax and inflation is less if an individual or family buys stocks. Over the past 100 years, North American equities have provided a nominal annual return of about 9% and a real (i.e. after inflation is taken into account) annual return of about 6%.

To simplify our calculations we'll assume that all of the return consists of capital gains – i.e. that the stocks do not pay a dividend. A taxable investor who buys all his equities on the first day of the year and sells them on the last day of the year can be expected to earn, on average, a return of 9% before tax.

As only half the capital gain is taxable, the top tax rate on capital gains is in effect about 23%. So our investor will earn about 7% after tax, or a real return of about 4% after accounting for both the tax and the 3% inflation rate. Now 4% per year may not sound like a great return, but it sure beats the zero percent real return earned on bonds.

A key concept then, for anyone wishing to build wealth is to recognize that even when taxed annually, the after-tax value of stocks will, over time, grow at a much higher rate than both bonds and inflation.

The Advantage of a Buy and Hold Strategy

Better still, the equity investor is not obliged to sell stocks every year. And the longer the investor holds the stocks, the higher the after-tax return.

Let's look at an example.

Two equity investors achieve before tax capital gains of 10% annually over a 30-year period. Mr. Action enjoys playing the market and replaces his portfolio of stocks with new stocks once each year. The lethargic Ms. Boring holds all her stocks for the full period. At the end of 30 years both investors sell their shares and pay any capital gains tax owing. The results are as follows:

<u>Investor</u>	<u>Starting Capital</u>	<u>Compound Annual Return Before Tax</u>	<u>Compound Annual Return After Tax</u>	<u>Capital After 30 Years After Tax</u>
Mr. Action	\$100,000	10%	7.50%	\$875,496
Ms. Boring	\$100,000	10%	9.02%	\$1,333,705

Although both investors earned exactly the same 10% return before tax, Ms. Boring winds up with more than half again as much money as Mr. Action. This is because, by postponing her payment of capital gains tax, she has, in effect, obtained an interest free loan from the government.

Towards the end of the period, Ms. Boring has almost twice as much capital compounding for her benefit. So, even after Ms. Boring pays a big whack of capital gains tax at the end of 30 years, she finishes way ahead.

Intelligent Concentration

Of course, if Ms. Boring or any other investor is planning to hold investments for the long run, they must choose those investments extremely carefully.

Benjamin Graham used to say that, in investing, the first rule is Don't Lose Money, and the second rule is Don't Forget the First Rule. Investing with patience and discipline not only reduces risk. It also significantly improves returns.

To achieve an exceptionally good return, investors should look only at businesses having a strong balance sheet, a high return on invested capital and reasonably predictable prospects for continued profitable growth. Honest and effective management is essential. So is an attractive purchase price.

Because these opportunities are rare, the most successful investors buy a relatively small number of companies. An investor who knows he will buy only a few companies will set his standards high and exercise patience. Warren Buffett, who enjoys baseball analogies, has observed that in investing there is no such thing as a called strike. The astute investor is willing to wait a long time for a fat pitch.

We have always believed that risk is most effectively reduced by buying only the highest quality companies and insisting on a purchase price that is below the economic value of the company. As many investors in widely diversified stock portfolios learned in 2000, 2001 and 2002, when it comes to reducing risk, intelligent concentration beats diversification hands down.

Reducing Taxes Payable on Death

The Mr. Action and Ms. Boring example assumes that Ms. Boring lives for at least 30 years after her initial investment. If she dies before the 30 years are up the government will tax her capital gain up to the date of her death. So buy and hold doesn't necessarily do it. To achieve a major deferral of tax, an individual investor has to buy and hold – and live to be as old as Methuselah.

Fortunately, companies don't suffer from mortality. And so some families choose to hold their investments in a holding company. Often these companies are structured to produce for the older generation what is known as an "estate freeze". This leaves control of the assets with the older generation but allows

the growth in value to accrue to the younger generation. The result is significantly less capital gains tax payable on the death of the older generation.

Investors can, by utilizing estate freezes, extend their family's investment horizon well beyond their lives. Consequently, looking out 50 years or longer is not unreasonable. And compounding over longer periods produces extraordinary results. A ten percent annual return will, over 50 years, multiply an initial investment by more than 100 times.

Theory and Reality

Now let's check our theory against the real world. If our analysis is correct, families who follow this approach – using holding companies to buy shares of a few good companies which they hold for the very long run – should be the most successful in building wealth.

How have Canada's very wealthiest families gotten that way? None of them have become rich by investing in bonds or mutual funds, or by playing the stock market. Virtually all have followed the tax-efficient approach of investing through holding companies in good businesses that they have held for 30 years or more.

But, you may say, families like the Thomsons or Westons have an advantage over the rest of society – the current generation inherited large and well established family businesses. However, in each case, more than 90% of these fortunes have been accumulated over the past 30 years.

Any one of us could have, 30 years ago, bought a stake in Thomson Corporation or George Weston. And, assuming we had the wisdom and discipline to hang on to this investment, our gain, in percentage terms, would have equalled that of the principal owners.

Hindsight is, of course, always 20/20 and not all public companies have done as well as these two. On the other hand, there are many other large public companies – including the principal Canadian chartered banks, Investors Group, General Electric, Coca Cola, and most of the larger pharmaceutical companies – that have been public for many decades and have well above average track records. More important, looking forward, companies such as Investors Group and The Toronto-Dominion Bank, as well as some well capitalized, smaller, rapidly growing companies that we follow closely, appear likely to produce superior returns for many years to come.

The Human Side

Building up a family fortune through disciplined investing is one thing. Ensuring that the money will truly benefit future generations is a greater challenge.

Capital brings with it responsibilities – not the least of which is passing on values and knowledge – including worldly wisdom – to the younger generation. We believe this should include discussing money matters with children from an early age and, by the time they are in their 20's, involving them in decisions.

An approach which has proved successful for some families is to put the capital in a company, and view that company as a growing enterprise, for which the best is yet to come. All family members over a certain age are treated as shareholders. They elect a board of directors made up of both family members and trusted advisors. The board in turn elects a chief executive.

To make this work, the older generation must be willing to share at least some control over the family fortune and the younger generation must be willing to learn about money and participate actively.

Having outside advisors on the board helps for at least two reasons. It enables lawyers, accountants and investment managers – who, if they haven't met, are often suspicious of one another – to meet and exchange views openly. Also, the presence of outside directors tends to cause family members to behave in a more businesslike manner, rather than falling back into their traditional family roles.

It's All About Long Term Planning

The expression “from shirtsleeves to shirtsleeves in three generations” apparently exists in one form or another in all developed cultures. While the three stage process of growth, maintenance and decay may be inevitable, it is far from inevitable that this will take place over three generations. A family should, in fact, be able to maintain real growth in its fortunes for well over a hundred years. All that is required is intelligent long-term planning.