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This is a special edition of the weekly Internet Wealth Builder e-letter, published by BuildingWealth.ca. This special issue is being made available FREE to every interested Canadian. Please pass this copy along. This issue of the IWB includes several promotions and special offers not available to regular subscribers. Regular editions contain no advertising.

INCOME TRUSTS WON'T GO AWAY

Income trusts just won't go away, will they? Just when it appeared the battle was over, the Liberals have resurrected the debate with a promise to keep the sector alive if they are returned to power, albeit with some tight restrictions. It's all starting to be reminiscent of *The Terminator* and Arnold Schwarzenegger's famous line: "I'll be back."

What's going on here, anyway? It was the former Liberal government of Paul Martin that originally set out to bring down the trust sector. In fact, they tried not once but twice, before backing away. The charge was led by former Finance Minister Ralph Goodale, who has now done a 180-degree turn and recast himself as a trust defender. Odd, to say the least!

Clearly, the Liberals believe there's gold in them thar trusts – electoral gold, that is. The thinking may be that disaffected seniors, angry oil patch workers, and unhappy Bay Street underwriters might swing enough votes towards Stéphane Dion's crew to make a difference in the next election.

Maybe, maybe not. By the time that election rolls around – and it won't be any sooner than 2008 – many of the voters who gave a hoot about the tax announced last Halloween by Finance Minister Jim Flaherty (a small percentage of the population if the polls are to be believed) will likely have moved on to new concerns.

For the record, the Liberal proposal – which builds on a policy statement issued several months ago – is to replace the 31.5% Conservative tax on income trusts with a 10% tax, which would be refundable to Canadian residents. An additional twist, unveiled last week, is that the party would also allow the creation of new trusts in certain sectors. The exact sectors have not been defined but Liberal finance critic John McCallum said in Calgary last week that the oil and gas industry would be a likely candidate.

The Liberal attempt to restart the trust debate seems to have fallen flat, at least so far. A search of the website of the *Calgary Herald*, the newspaper that would logically be most interested in McCallum's remarks, turned up only a passing reference to them. The *Toronto Star* did run an editorial on the subject on Thursday, headed "Liberals wrong on income trusts" but that was the only editorial comment I could find. (If any members know of others, please send me the reference.)

Despite this muted reaction, we shouldn't dismiss the Liberal position out of hand. There will certainly be a federal election between now and

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MEMBERS' CORNER

Stelco takeover

Member comment: I am an IWB member now teaching in Shanghai but who still has investments in Canada and I appreciate the IWB greatly. I wish I could say that I am insulated from all the turmoil over here, but we live in a global society and there does not seem to be any appreciable difference where I live now when there is online investing (except, of course, differing tax rates).

I was surprised that you did not comment on the recent buy-out of Stelco and its significance. Maybe you could mention that next week? – Geoff P.

Response: We did not mention Stelco because we never recommended the stock or discussed the company in the past. We felt the subject was well covered in the Canadian media and that we did not have any new insights to add. As for the bigger picture – yet another foreign takeover – we have dealt with the topic several times and I expect we will continue to do so.

However, there was one side effect of the announcement that we should note. One of beneficiaries of the Stelco takeover by U.S. Steel will be Brookfield Asset Management, one of my recommended stocks (TSX: BAM.A, NYSE: BAM). RBC Capital Markets reports that the Tricap I Restructuring Fund, which Brookfield manages and in which it has a 48% stake, owns 9.9 million Stelco shares as well as some warrants. RBC estimates that Brookfield should realize a net gain of more than \$200 million on its position when the deal closes. U.S. Steel is paying \$38.50 a share for Stelco. – G.P.

Recommended ETF book

Member comment: There is an excellent Canadian book on ETFs written by Howard

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Income Trusts – continued from page 1...

Jan. 1, 2011, when the trust tax is due to kick in (legislation creating it was passed by Parliament in June). Based on the opinion polls, Stephen Harper's Conservatives are not a sure bet to win that vote. Despite Dion's failure thus far to capture the imagination of voters, the Conservatives seem to be stuck in neutral, which is why Harper decided to prorogue Parliament and come back in October with a new Throne speech. A fresh start, and all that.

Given the fragile nature of the current government and the seeming inability of Canadians to warm to Prime Minister Harper, anything is possible over the next few years, including the return to power of the Liberals. Should that happen, they would have to follow through on their income trusts plan or lose a huge chunk of credibility right out of the starting gate.

So stay tuned. The trusts saga may not be over just yet. – G.P.

WARNING SIGNALS

There were more signals last week that investors should adopt a more defensive strategy with their portfolios for the next few months. Among them:

A terrible U.S. job report. The loss of 4,000 non-farm jobs in August may not seem like a lot at first glance. But when you put it in the context of an expected increase of 110,000 jobs during the month, it was a shocker! It was the first time in four years that U.S. employment declined and Wall Street stocks immediately responded with the Dow plunging 250 points. (It should be noted that in contrast to the U.S. results, Canadian job creation in August was better than expected.)

The Bank of Canada holds the line. Until a few weeks ago, almost everyone had expected the Bank of Canada to keep raising interest rates through the rest of 2007 to battle growing inflationary trends in the economy. Then came the subprime mortgage mess and more blows to Ontario's manufacturing sector with the announcement of mass lay-offs at a General Motors truck plant in Oshawa. Suddenly the Bank decided that other matters were more pressing than the CPI.

In a statement accompanying the announcement, the Bank said that "near-term economic prospects for the United States are weaker than expected. It now seems likely that the adjustment in the U.S. residential housing sector will be more pronounced and protracted, exacerbated by recent developments in financial markets. On balance, this implies weaker demand for Canadian exports..."

The statement went on to say that while there is a possibility that household demand in Canada could exceed expectations, thus fuelling inflation, there is also the possibility that "the ongoing adjustment in the U.S. housing sector could be more severe and spill

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TOM SLEE: BEWARE OF HEDGE FUNDS!

Tom Slee is with us this week with some thoughts about hedge funds. I don't like them and have said so on several occasions. It turns out, neither does he. Tom is a former professional money manager and holds CGA and CFA designations. Over to him.

Tom Slee writes:

Somebody should make hedge funds change their name. It's misleading. One commentator called it downright fraudulent. To start with, very few of these funds actually hedge their positions. On the contrary, they leverage their portfolios and increase the risk accordingly. Second, small investors often mistake them for mutual funds and think they are regulated, defensive investments. Nothing could be further from the truth. Hedge funds these days are highly speculative loose cannons. Arguably they should be labeled "Extremely Dangerous"

In fairness, hedge funds did live up to their billing at the outset. The first one, a general partnership, was established in 1949 by Alfred Jones who methodically offset long positions by short selling other stocks, thus hedging his bets and reducing the risk of poor market timing. He was extremely successful, probably because he was a good money manager, and other people jumped on the bandwagon. Hedge funds boomed but then crashed in the early 1970s when the market contracted.

Fifteen years later investors rediscovered them. They blossomed once more only to collapse again in the early 1990s when bond prices turned down. Obviously there was no magic formula. You still had to know which securities to buy and which ones to short. Yet in the last couple of years, hedge funds have become all the rage again. Only this time around they are a different animal and carry far more risk.

What are present-day hedge funds? There is no real definition for them but they have evolved into pools of money handled by managers who have almost total discretion and receive substantial performance based fees (20% plus). There is little transparency and no guarantees. In other words, they are tailor-made for investment gunslingers who want results and are willing to pay for them. True, the hedge funds usually provide a cursory description of their investment policies. A few claim to be "Event Driven" while others deal in "Distressed Securities". You even see an occasional nod towards the original concept with "Long/Short Equity". However, the understanding is that the managers have a

free hand and, more alarmingly, are often not required to report their performance or holdings on a regular basis. In effect, investors are asked to roll the dice, to sign what amounts to a blank cheque. We have come a long way from Alred Jones and his plan to reduce risk.

Of course, none of this would really matter if hedge funds were a small fringe market for informed, wealthy people who want to speculate. Indeed, that is how the U.S. Securities and Exchange Commission (SEC) and Ontario Securities Commission (OSC) view these investments and why they have done little to regulate them. In Canada, hedge funds are exempt from most prospectus requirements and not subject to the restrictions that have been placed on mutual funds. South of the border, the rules only require that hedge funds be sold mostly to Accredited Investors (those with a net worth of US\$1 million or more).

For once, I'm on the side of the regulators. If wealthy people wish to invest aggressively, they should have an opportunity to do so. That is, of course, as long as they are getting a fair shake. The trouble is that, perhaps inevitably, some hedge funds are less than candid about the risks involved and people have been hurt by some serious, unexpected failures recently. Moreover, small Canadian investors are now being solicited to join in the speculation. They are also being hurt because their pension funds have taken substantial positions in hedge funds.

Here in Canada, hedge funds are a \$30 billion business and growing. This is not only an American phenomenon! True, nearly all of the Canadian investors meet the "Accredited" requirements but a lot of others are exposed through Principal Protected Notes (PPNs). Of course, not all PPNs are tied to hedge funds but enough of them are so as to cause concern. Here is how they work:

You invest, say, \$1,000 in a PPN at a financial institution for a set term with the principal amount guaranteed and possibly a handsome return by exposure to a hedge fund. The issuer then invests \$700 at a fixed-interest rate that assures \$1,000 is available when the note comes due. The other \$300 is used to buy a hedge fund. This is where you earn the return, if any. Sounds good? It's not! In fact, you are gambling with 30% of your capital. These notes can lock in your money for extended periods, 10 years in some cases, and if the hedge fund fails to perform there is zero return. Some people have the mistaken impression that having your money locked in for a long period with no profit but a return of capital

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Hedge Funds – continued from page 3...

produces a net break-even. Not so! It actually translates into a substantial loss. Moreover, the fees, sometimes hidden, can be staggering. In addition, because PPNs are essentially unregulated, the principal guarantee could be suspect.

Yet small investors like PPNs linked to hedge funds. As one wag pointed out, they sell faster than umbrellas in Vancouver. People are attracted by the huge profits that some hedge funds have provided. They also like the fact that these funds usually deal in, and base their performance fees on, absolute rather than relative returns. For example, if the market is down 10% or more in a year, a mutual fund manager whose fund is up 1% would claim an above-average performance. A hedge fund manager, on the other hand, has to answer for the dismal 1%. There are no excuses.

Fair enough! My concern is that because of increased competition and relentless pressure to perform, hedge funds are assuming much more risk without investors realizing it. For one thing, the managers are making esoteric and illiquid investments. We see them trading in things such as complex derivatives based on natural gas futures contracts. There is no real market for this sort of commitment or even meaningful quotes for that matter. So the funds, which sometimes only publish their portfolios once a quarter, perhaps once a year, resort to calculating returns and values using subjective mathematical formulae. This is extremely dangerous because hedge funds are often highly leveraged. Once their assets are locked in, they become vulnerable to

margin calls from nervous lenders as well as investor withdrawals. As a matter of fact, energy futures brought down hedge fund giant Amaranth Advisors last September. The managers found that their positions were too large to liquidate and lost US\$6 billion.

Another problem is that hedge funds are starting to chase the same products. A recent study at Northeastern University showed an increasing pattern in their performances. There are just too many hedge funds and they inevitably pile up in the few unusual opportunities that come along. They cannot afford to diversify. That is why we have seen such a ripple effect from the collapse in subprime mortgages. Investors are still being unpleasantly surprised to find that their funds, supposedly focused on other markets, have been badly hurt by the downturn in U.S. housing. Keep in mind that these managers have unlimited discretion.

Finally, and a further reason to avoid hedge funds right now, the pension funds are likely to start redeeming their holdings. The amounts involved are enormous. The California Public Employees Fund alone has US\$5 billion at stake and any pullback would be a severe blow to the sector. The hedge funds have become accustomed to and now depend on a flow of new pension money to provide liquidity while they invest long term. If institutions turn off the tap, let alone withdraw money, the market could collapse. I doubt very much whether there would be any rescue operation.

TOM SLEE'S UPDATES

MANITOBA TELECOM (TSX: MBT)

Originally recommended on Nov. 17/04 (IWB #2441) at \$46.68. Closed Friday at \$48.86.

Manitoba Telecom turned in a surprisingly good second quarter. Admittedly, revenue of \$475 million was down slightly year-over-year but operating profit of \$170 million, equal to 79c a share, was up 16% from 68c in 2006. Analysts had been looking for about 69c. Especially encouraging was the fact that most of that improvement resulted from better controls and growth in higher margin wireless and high-speed Internet services. The improvement was generated internally and management celebrated by raising this year's earnings guidance from \$2.50 to \$2.75 a share.

As we all know, MBT has been through a very difficult period. In 2004 the company bought high-tech Allstream to

complement its traditional telephone business but there was very little synergy. Then management was severely criticized for not converting the company into an income trust. Disappointed investors bailed out and drove the stock down. More recently, following the BCE takeover, there was speculation that MBT would be the target of a leveraged buyout. Once more the stock fluctuated. Meanwhile, management still struggled to digest Allstream. Now, finally, the company has settled down once more and is generating solid earnings growth.

Looking ahead, MBT continues to cut costs and hopes to achieve savings in the \$50 million range this year while promoting more profitable products. Digital television and Internet solutions should make increasing contributions. There is also good news on the pension

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Slee's Updates – continued from page 4...

front. Longer term funding is now expected to be in the \$22 million per annum range, down sharply from previous estimates of \$40 - \$45 million.

The real prize here, though, is the \$2.60 dividend that analysts once thought was in jeopardy. Now it's safe. There was a net cash flow of \$85.6 million in the second quarter alone and the company is actually building liquidity.

Action now: Manitoba Tel remains a Hold at \$48.86 for investors seeking income. Based on our original recommended price of \$46.48, the shares yield 5.6%. That is equal to almost 8% from a bond for high income investors after the dividend tax credit.

PEPSICO INC. (NYSE: PEP)

Originally recommended on Dec. 18/06 (IWB #2644) at \$62.89. Closed Friday at \$67.98. (All figures in U.S. dollars.)

Things are going well at PepsiCo, in fact very well indeed. Second-quarter earnings jumped an impressive 17%, to 94c a share, up from 80c in 2006. Analysts were looking for 89c at most. There was progress across the board. All the operating divisions beat expectations and as a result Pepsi has increased 2007 earnings guidance to at least \$3.35 a share. We should see \$3.80 or more in 2008.

This is an excellent stock to own in these volatile markets. Everything points to continued earnings and cash flow growth in the U.S. soft drinks industry. History shows that people keep buying these beverages even during economic downturns. So companies such as Pepsi and Coke are likely to be unaffected by any fallout from the housing slump. At the same time, the industry is benefiting from a growing demand for non-alcoholic products and bottled water. The only concern is that prices of some raw materials, corn syrup and citrus juices in particular, could spike over the next 12 months and squeeze margins. However, Pepsi has some leeway on the pricing side to compensate for these.

It's also interesting to note that Pepsi's campaign for healthier snacks, once derided as a poor joke by some skeptics, is paying dividends. Consumers still like their snacks but are now turning to Pepsi products, such as Baked Lay's potato chips, Diet Pepsi, and Tropicana orange juice, that are labeled as meeting the company's limits on sodium and other additives.

Another thing worth noting is that the rumoured merger with Nestlé, the giant Swiss food conglomerate, will not go away. It would make a lot of sense. Pepsi still relies on the U.S. for 37% of its revenues while the future lies with emerging markets where Nestlé is well positioned. One report suggested that the Swiss company is on a health food kick and therefore reluctant to make a deal

with Pepsi because of its carbonated drinks image. That may explain all this new focus on Diet Pepsi and bottled water. In any event, Pepsi is not wasting time waiting for an offer. The company plans to invest \$1.3 billion in China over the next few years. Another \$1 billion is earmarked for Eastern Europe.

Action now: Buy PepsiCo at \$67.98 with an increased target of \$75. I have set a \$62 revisit level.

MCDONALD'S CORP (NYSE: MCD)

Originally recommended on Jan. 12/04 (IWB #2402) at \$25.15. Closed Friday at \$49.24. (All figures in U.S. dollars.)

McDonald's is another company on a health kick, and it goes from strength to strength. Fueled by a 12% increase in revenues (8% after adjustment for foreign exchange), operating earnings in the second quarter were 71c a share. That compares to 56c a share a year earlier and met expectations, which goes to show how impressive MCD has become. Company-operated and franchise restaurant margins improved for the sixth consecutive quarter.

McDonald's, having emerged from a turn-around situation, is now operating on all cylinders. The last major restructuring, a sale of Latin American operations to a licensee that resulted in a one time loss of \$1.31 a share in the second quarter, is now complete. This should result in more consistent earnings and cash flow from the region. We should also see on-going benefits from extended operating hours and upgraded meals, with an emphasis on salads. At the same time, results are being improved by a pragmatic culling of outlets. For example, approximately 800 restaurant openings, mostly in Asia, planned for this year are being offset by 350 closures.

Operating profits of \$2.80 or more a share are expected in 2007, followed by about \$3.30 a share in 2008.

Action now: Buy McDonald's at \$49.24 with an increased target of \$60. I will revisit the stock if it dips to \$43.

ALCAN SERIES C PREFERRED SHARES (TSX: AL.PR.E)

Originally recommended on June 3/03 (IWB #2321) at \$25.20.

These floating rate preferred shares were redeemed by Alcan on Sept. 3 at a price of \$25. The move may be tied to the pending purchase of the company by Rio Tinto. If you did not receive notice of the redemption or did not tender your shares, contact your broker right away because dividends ceased as of that date.

With the supply of good preferred shares already low, it's a shame to lose another high-quality issue such as this. I will be on the lookout for an alternative to replace it in the future.

Action now: Redeemed. - end Tom Slee

GORDON PAPE'S UPDATES

RBC GLOBAL PRECIOUS METALS FUND

Originally recommended on Dec. 12/05 (IWB #2544) at \$24.17. Closed Thursday at \$38.24.

The one bright spot in the recent market volatility has been gold. The price of bullion moved back over US\$700 last week, finishing on Friday at US\$709.70. Gold is recovering from a mid-summer slump, in part because of concerns in the credit markets and in part, some bullion-watchers believe, because of the upcoming fall wedding season in India as well as the Diwali festival, a joyous Hindu celebration which includes the giving and receiving of gifts. The theory is that demand for bullion rises in September as Indian jewelers craft gold pieces for wedding and Diwali gifts, thus driving up the price.

This fund has been a major beneficiary of the recent jump in the bullion price. In the week ending Sept. 6, the fund's NAV increased by more than 9% and I believe there are more profits on the way. If you don't have a position, this is a good time to commit some money. It's a no-load fund and the minimum initial investment is \$1,000.

One other important point – although it is technically a global fund, almost 80% of the assets are invested in Canada so currency risk is minimal.

Action now: Buy.

GOLDCORP (TSX: G, NYSE: GG)

Originally recommended on Jan. 9/06 (IWB #2602) at C\$28.73, US\$24.69. Closed Friday at C\$27.42, US\$25.99.

This has been a frustrating stock for us. After reaching a 52-week high of \$35.89 last December, it went into a stop-and-start retreat that culminated in a low of \$22.40 in mid-August. Now it's on the rise again. Last week, the share price broke through its 50-day moving average (MA), which is significant. However, it is still well below its 200-day MA.

Second-quarter financial results, released in early August, contributed to investor disenchantment with the stock. Goldcorp reported adjusted net earnings of \$95.3 million (14c per share) compared to \$136.9 million (36c per share) in the second quarter of 2006. The 2007 adjusted earnings excluded a \$104.4 million non-cash loss on the revaluation of future income tax liabilities due to the strengthening Canadian dollar. The company said that, excluding all adjustments, net earnings were only \$2.9 million compared to \$190.4 million in the year-before period – and this despite an increase in both

production and sales. (Note: Goldcorp reports its results in U.S. dollars.)

CEO Kevin McArthur said the company was experiencing "short-term challenges" at some of its mines, including the Los Filos and San Dimas mines in Mexico and the Marigold mine in Nevada. As a result, 2007 production estimates were reduced to the range of 2.2 million to 2.3 million ounces.

Despite this, Goldcorp shares are on the rebound as the bullion price moves higher. As well, it appears investors have decided that the August sell-off was overdone. On Friday, the price bucked the market trend, rising 21c.

As I said at the outset, the performance of this stock has been disappointing so far. But it is still one of the lowest-cost producers in the industry and owns several first-class properties.

Action now: Buy.

SUNCOR ENERGY (TSX, NYSE: SU)

Originally recommended on June 12/06 (IWB #2622) at C\$83.25, US\$75.14. Closed Friday at C\$95.90, US\$90.98.

Suncor has also had its share of ups and downs in recent months. The stock briefly broke through the \$100 level in July but then seemed to decide it couldn't take the rarified atmosphere and retreated, falling to as low as \$88.72 in intra-day trading on Aug. 16.

As with Goldcorp, although obviously for different reasons, Suncor reported disappointing second-quarter results. Net earnings were \$641 million (\$1.39 per share) compared to \$1.22 billion (\$2.65 per share) in the second quarter of 2006. Cash flow from operations was \$884 million compared to \$1.32 billion in 2006.

In a statement, the company said: "The decrease in net earnings was primarily due to lower oil sands production and higher operating expenses, as well as lower income tax rate reductions compared to the second quarter of 2006. A shutdown of one of the company's two oil sands upgraders impacted production volumes while increased maintenance costs were the main reason for the increase in operating expenses."

However, assuming no unexpected developments, the

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Pape's Updates – continued from page 6...

next two quarters should be better. The company said it expects production to average 280,000 barrels per day, compared to 225,100 in the first half of the year. That projection held true for August, with the company reporting daily production of 280,000 barrels for the month. And the price of oil continues to rise, closing on Friday in New York at US\$76.70, up 40c on the day.

In another development, Suncor released its latest report on climate change – the company was one of the early oil patch pioneers in this field and has had a climate action plan in place for a decade. In the latest report,

Members' Corner – continued from page 2...

Atkinson with Donna Green called: *The New Investment Frontier III: A Guide to Exchange Traded Funds for Canadians*. I find that is a well researched and well written textbook (paperback: \$21.95). It is available at Chapters. Atkinson wrote this book when he was senior VP at Barclays and was responsible for the development of iShares. It also discusses American and international ETFs. He believes in a well balanced and diversified approach. Please note that I do surgery and that I have nothing to gain by recommending this book. – Paul K.

Response: This e-mail was sent in response to my comment last week about a book on ETFs that was written for the U.S. market. Although I have talked to Howard Atkinson on occasion, I was not aware of his book and I appreciate that our member took the time to alert me to it.

Through our connection with Amazon.ca, we have made Atkinson's book available on our Best Books page, where you'll find more details about the contents and some reviews. Our price is \$16.02 plus tax, which I believe is the lowest you'll find anywhere this side of a flea market. The Best Books page is located at <http://astore.amazon.ca/buildicaquizm-20>

Other new additions to our Best Books page include Benjamin Graham's classic *The Intelligent Investor* (\$19.77) and Peter Lynch's lively and perceptive guide to stock picking, *One Up on Wall Street* (\$14.59). The latter is one of the most entertaining books about investing I have ever come across – a sheer joy to read and packed with terrific insights. – G.P.

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Warning Signals – continued from page 2...

over to the U.S. economy more broadly. In addition, there is uncertainty about the extent and duration of the tightening of credit conditions in Canada and, hence, about the tempering effect this will have on growth in domestic demand."

European banks also back off increases. The Bank of England and the European Central Bank also backed off from expected rate increases last week, citing economic concerns. The European Bank made a small cut in its growth projection for 2007, from 2.6% to 2.5%. It also continued to inject cash into the financial system in an effort to ease credit tightening in Europe.

Alan Greenspan makes a troubling comparison. On Friday, former Fed chairman Alan Greenspan raised eyebrows by comparing the subprime mortgage turmoil with conditions that existed during the run-up to the stock market crashes that took place under his watch. "What we are observing in the last seven weeks is identical in many respects to what we saw in 1998, what we saw in the stock market crash of 1987," he was quoted as saying by the *Wall Street Journal*. The 1987 crash of Oct. 19 was the worst in history with the Dow falling 508 points, a loss of about 20% of its market capitalization.

Fed governors are nervous. The next rate setting of the U.S. Federal Reserve Board doesn't take place until Sept. 18 but there were indications last week that a cut in the federal funds rate is unlikely. Nonetheless, some of the statements from Fed governors were disquieting. Reuters quoted Atlanta Federal Reserve Bank President Dennis Lockhart as saying: "The balance of risk to the economy seems to have shifted. We're facing greater uncertainty in the economic outlook." Even more ominous was the statement made in London by St. Louis Federal Reserve Bank President William Poole: "I think the probability of recession is higher than it used to be."

Taken individually, none of these developments are serious enough to set off alarm bells. But put them all together and to my mind they confirm that there is more trouble ahead for the markets, and the economy. – G.P.

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