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WEALTH MANAGEMENT review

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The China proxy

By Jim Allworth

Let's play a guessing game. What do these two numbers represent – plus 14% and minus 14%? Give up? Well the plus 14% is how much the TSX was up last year and the minus 14% is the drop experienced over the same year by the Chinese stock market.

Or we could look at where each market is today compared to the all-time peak readings both registered in the months before the financial crisis entered its most destructive phase: The TSX is 8% below its high-water mark set in the spring of 2008 while the Shanghai Composite is off a whopping 52% from the top tick posted in the fall of 2007.

Now imagine for a moment we're back in 2008 just before the financial crisis begins to blow hot. We meet a genie (more probably, we consult a genie website) who is willing to reveal to us exactly what will happen in the economy over the next couple of years but can't (or won't) tell us what will happen in the stock market over the same period.

A "global recession" that wasn't global

The Canadian economy, says the genie, is about to be blindsided by one of the worst global financial system meltdowns on record and plunged into a recession that shrinks GDP by more than 5% in just a few months, throwing a half million people out of work in the process. The important auto industry will lurch toward bankruptcy only to be saved at the eleventh hour by a massive cross-border rescue operation spearheaded by the U.S. and Ontario governments.

The U.S. economy – Canada's biggest customer, taking over 80% of this country's exports – fares much worse, losing almost nine million jobs as well as several venerable financial institutions along the way. American house prices plunge and millions lose their homes to foreclosure. Two years on, fewer than 15% of the lost American jobs have been regained and fully a quarter of all homes having mortgages are worth less than the debt against them.

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China also feels the global slump as exports fall sharply. The government responds quickly with a US $700 billion stimulus program (proportionally much larger than the two American spending packages put together), easily funded from a strong national balance sheet. The Chinese economy slows but never even flirts with recession. Chinese growth bottoms at around +7% and the economy is back running at a 10%+ pace in no time.

Armed with this knowledge in advance, what would a rational investor have done back in early 2008? It's tempting to say "invest in China" (meaning invest in the Chinese stock market). A more useful conclusion might have been to invest in businesses that benefitted from Chinese prosperity. But most Chinese manufacturers, for many the emblem of the successful rise of the Chinese economy, depend on exports to drive sales and profits. Through much of 2008 and 2009 their principal customers, notably the U.S., were in recession. The growth in China was coming from infrastructure spending, housing, and autos for domestic consumption – all highly commodity intensive.

Canada's hot commodities

As RBC Capital Markets strategist Myles Zyblock points out, it's hard to find an index geared more to commodities than Canada's TSX. Fully 50% of the value of the shares making up the index resides in energy and materials stocks. It's important to distinguish between the make-up of the index and the composition of the Canadian economy where commodities account for only 15-20% of GDP. Gold mining for example is 11% of the index weight but certainly less than 3% of GDP. Healthcare, on the other hand, is 7-8% of GDP but only 1% of index weight.

When Myles refers to the TSX as a "resource-heavy, global index" he makes a further distinction: 45% of the revenues of TSX companies come from outside Canada, including more than 80% of the revenues of the heavy-weight materials sector. Asia accounts for disproportionately more of the growth of resource sector revenues because fast-growing economies like China and India are so highly commodity intensive. Most of the growth in physical demand is coming from that region and because supply is having a difficult time consistently keeping pace, prices for commodities have also been rising.

Perking up

So Canada's economy is faring pretty well on most fronts. In addition to the happy set of circumstances driving the commodity sector, the larger manufacturing sector is benefitting because its biggest customer, the American consumer, is once again growing its spending and has a pent-up demand for new automobiles. And the resurgence of both these sectors has accounted for a dramatic rebound in employment in this country which means the domestic economy – i.e., spending by Canadian households, government and business – is perking along at a respectable pace.

Meanwhile the composition of Canada's stock market is very highly skewed in weight toward the sector enjoying by far the fastest rate of growth in sales and earnings – commodities – and away from the slowest-growing component – domestic spending. That largely explains why even though the Canadian economy is expected to grow at only something less than 3% in each of the next two years, RBC Capital Markets forecasts TSX index earnings to grow by 18% in 2011 (to $814 per index share) and by 19% (to $972) in 2012.

Some of that is undoubtedly already priced in to the market but at 17X this year's earnings, the TSX is reasonably valued and, if earnings perform as advertised, then the stock market is likely to go on gaining ground – we're looking for all-in returns (i.e., dividends included) of about 10% for each year.

Positioning portfolios

But in order to earn the returns the market has on offer, a portfolio has to bear some resemblance to the market. Many Canadian investors find it hard to get sufficiently invested in the materials sector for a variety of understandable reasons. Dividends are low and often erratic. Many of the old, comfortable large-cap names have been taken over by foreign concerns and are no longer in the index. (Imagine how big the sector would be if Alcan, Inco, Falconbridge, Noranda and Dofasco were still listed Canadian companies.)

But as difficult as getting invested in this sector may be, the fact remains that until the arrival of some global economic downturn that dramatically slows down the major emerging economies as well as the developed ones, the dynamic laid out above is likely to persist. And so far the things that would cause such a downturn have not appeared on our radar screen.

For a fuller discussion of the outlook for the economy and financial markets please ask for a copy of the most recent *Portfolio Strategy Quarterly*.

Jim Allworth is a member of the RBC Investment Strategy Committee.

Using segregated funds to protect, convert and transfer your wealth

By Liz Horn

In the wealth planning process, there are four key life stages:

1. Accumulating wealth to build your retirement savings or legacy.
2. Protecting wealth from various risks, which normally becomes a greater concern as you approach retirement age.
3. Converting wealth into a tax-efficient income source.
4. Transferring wealth to your beneficiaries in an organized manner, while reducing the impact of taxes.

In this article, we will focus on how segregated funds can assist you in the wealth planning process, particularly during the second, third and fourth stages.

What is a segregated fund?

A segregated fund combines two products: a professionally managed fund and an insurance contract. All segregated funds offer principal protection to specified limits at maturity or death, while a newer breed of segregated fund also offers guaranteed income, typically for life.

You can choose from a select group of underlying funds, including conservative, balanced and growth-oriented funds. If the underlying fund goes up or down, so does the segregated fund, minus insurance (guarantee fees) costs. At maturity or death, you or your designated beneficiaries will receive whichever is greater – the segregated fund's market value or its guaranteed amount.

Protecting wealth from risk

Segregated funds have garnered much public attention, particularly for their ability to protect wealth through principle guarantees and the ability to lock-in any growth. They can also offer creditor protection.

› Principle protection

Segregated funds guarantee between 75% and 100% of your "guaranteed amount" at maturity or death. The guaranteed amount represents your initial investment, subsequent deposits and locked-in growth, minus any withdrawals. Traditional segregated funds with fixed terms (e.g. 10 or 15 years) typically offer at least 75% principle protection at maturity. If the fund's value is higher than the guaranteed amount, you (or your estate) receive that higher amount instead.

› Locking in growth

The "optional reset" feature enables you to lock-in any growth at regular intervals, which can increase your guaranteed amounts. Note that for segregated funds with fixed terms, this may also reset the maturity date.

› Creditor protection

Segregated funds are also a useful wealth protection strategy for anyone exposed to the risks of lawsuits or bankruptcy, such as professionals, business owners or self-employed individuals. Assets held in a segregated fund are generally protected from creditor claims.

Converting wealth into income

Segregated funds may also be useful if you want to preserve your wealth, while receiving a steady income stream, as certain types of segregated funds offer guaranteed income.

› Guaranteed income

Certain segregated funds offer "guaranteed minimum withdrawal benefits", which can assist in the wealth conversion process. This type of segregated fund offers guaranteed annual income, normally 5% of the deposit(s),

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typically at age 65. Investors looking for early income can start at age 50, typically at a lower rate of 4%. The income is guaranteed for life – even if the segregated fund's value goes to zero due to withdrawals and/or poor performance. You can also elect to delay making withdrawals, which can boost your income payments higher than 5%. Usually you receive a 5% "bonus" which increases your guaranteed withdrawal amount every year you don't make a withdrawal.

Because segregated funds pay guaranteed income, but offer some upside potential, they can augment tried-and-true GICs and bonds. One strategy to consider with your Investment Advisor is to diversify your retirement income stream, so it includes some segregated fund income in addition to GIC/bond income.

Transferring wealth to your beneficiaries

So a segregated fund, as we've seen, can be a useful strategy to protect and convert wealth. It can also help with wealth transfer. A segregated fund typically pays a death benefit of 75% to 100% of the guaranteed amount (or the fund's market value if that's higher) to the fund's designated beneficiaries.

› Probate-free death benefit

The death benefit also bypasses probate, so your estate pays no probate fees and your beneficiaries receive the benefit in weeks rather than months as with a probated Will. Furthermore, the assets pass to your beneficiaries privately (while assets passing through a probated Will are a matter of public record).

› Solution for uninsurable individuals

In addition, you don't have to qualify for insurance to receive the probate-free death benefit, and the insurance costs don't vary based on age or health. As a result, for individuals who may find it expensive or impossible to get normal life insurance coverage, segregated funds provide an interesting solution to assist with wealth transfer.

Depending on your situation, segregated funds may be a cost-effective solution to help you protect, convert and transfer wealth. If you would like to learn more, please speak with your insurance-licensed Investment Advisor, who can help you weigh both the pros and cons of segregated funds based on your individual circumstances.

Liz Horn is a Program Manager with RBC DS Financial Services Inc.

INTEREST RATES APPLIED TO ACCOUNT BALANCES*

As of March 22, 2011 our interest rates are as follows:

Credit balances	Canadian dollar accounts	US dollar accounts
Under $10,000	0.10%	0.10%
$10,000 – $24,999	0.10%	0.10%
$25,000 – $49,999	0.10%	0.10%
$50,000 – $59,999	0.10%	0.10%
$60,000 – $99,999	0.10%	0.10%
$100,000 and over	0.10%	0.10%
Debit balances	**Canadian dollar accounts**	**US dollar accounts**
Under $10,000	5.00%	5.50%
$10,000 – $24,999	4.75%	5.25%
$25,000 – $49,999	4.50%	5.00%
$50,000 – $99,999	4.25%	4.75%
$100,000 and over	4.00%	4.50%

Registered accounts	Canadian dollar accounts	US dollar accounts
All credit balances	0.10%	0.10%
All debit balances	5.00%	5.50%

The interest rates that will be in effect for debit balances in cash and margin accounts fluctuate with Royal Bank prime rate as follows:

Debit balances	Canadian dollar rates†	US dollar rates†
Under $10,000	$CDN Prime + 2.00%	$USD Prime + 2.25%
$10,000 – $24,999	$CDN Prime + 1.75%	$USD Prime + 2.00%
$25,000 – $49,999	$CDN Prime + 1.50%	$USD Prime + 1.75%
$50,000 – $99,999	$CDN Prime + 1.25%	$USD Prime + 1.50%
$100,000 and over	$CDN Prime + 1.00%	$USD Prime + 1.25%

†Based on Royal Bank prime rates as of March 22, 2011.
$CDN Prime = 3.00% and $USD Prime = 3.25%. Rates are subject to change.

* RBC retains the right to change interest rates on a discretionary basis. A committee comprised of individuals representing various authorities within RBC Dominion Securities administers these interest rates. These rates are adjusted from time to time based on various factors, including, but not limited to, competitive analysis, Bank of Canada and other bellwether rates, and/or cash rates. Interest amounts less than $5 are neither charged nor paid on regular accounts and interest amounts less than $1 are neither charged nor paid on special product accounts. Rate changes of less than 1% will be processed on the 22nd of the month. The average daily cash balance for the month determines the tier that will be used to establish the rate.

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