SEPTEMBER 2013

Global Insight – Special Report

A Canadian's guide to investing in U.S. equities

Global Portfolio Advisory Committee and the Portfolio Advisory Group

There's Wealth in Our Approach.™

Priced as of September 5th, 2013, unless otherwise stated.
For important disclosures see page 10.
All values in CAD unless otherwise stated.

RBC Wealth Management

- The U.S. equity market has always been of interest to Canadian investors. However history has shown there have been times to own U.S. equities, and other times when Canadians were better served by sticking to home grown stocks.
- The twelve years from 1999 to 2011 were one of the challenging periods. But from where we stand today and based on a confluence of factors outlined below, we believe the odds have once again shifted, this time in favour of investing in U.S. equities.
- The time is right for Canadian investors to consider an allocation to the American stock market.
- There are a number of ways to accomplish this. The solutions range from individual stocks, to exchange traded funds, mutual funds, segregated managed portfolios, and lastly, structured products that offer the ability to customize payoffs for a particular investor's preferences.
- Clients need to carefully consider their particular circumstances, as well as the potential tax implications of each investment solution.

In This Report

Introduction 3

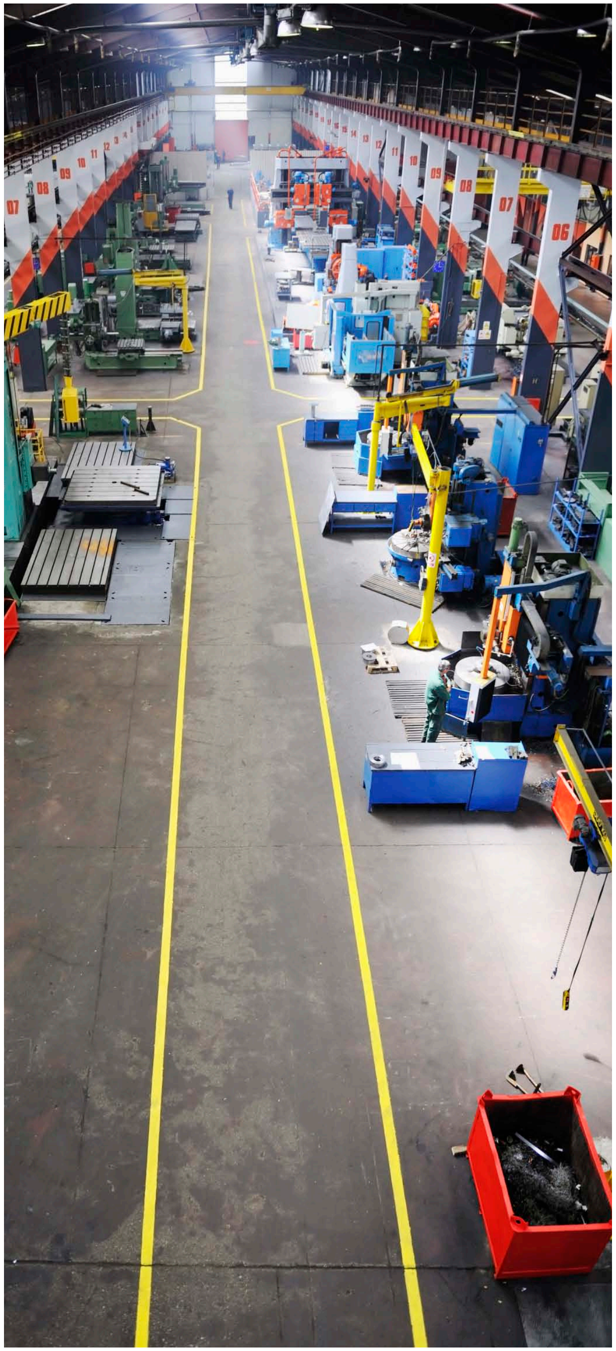
The Improving U.S. Landscape 6

Earnings Outlook Supports Higher Dividends and Share Prices 7

Investment Conclusion 7

Tax implications for Canadian investors investing in the U.S. 8

A number of investment solutions 9



Investing in U.S. Equities

A Sea Change...

Mark Bayko – Toronto, Canada mark.bayko@rbc.com; RBC Dominion Securities Inc.
Jim Allwroth– Toronto, Canada jim.allworth@rbc.com; RBC Dominion Securities Inc.
Salvatore De Cillis– Toronto, Canada salvatore.decillis@rbc.com; RBC Dominion Securities Inc.

For more than a decade, American stocks dramatically underperformed Canadian equities. However, we would argue that over the past two years, the tide has turned and that today there are compelling reasons to expect a U.S. component will add to overall portfolio performance for a Canadian investor while substantially reducing risk. There are a number of factors driving this view.

The Canadian equity market is highly vulnerable to the fortunes of just three sectors.

Today, about 38% of the market value of the Canadian TSX Composite is accounted for by Energy and Materials stocks. That's down from a high water mark of 50% in 2011 and a long way above the 15% registered in 2000. The last time resource stocks reached the 50% threshold was in the early 1980s just before the collapse of energy and metals prices and the onset of a multi-decade relative bear market for commodities. While we do not necessarily expect a repeat of that experience, there are meaningful headwinds to consider: China, the largest consumer of most industrial

One of the most compelling factors stoking interest in the U.S. equity market has always been the sheer number of large, successful, well-known businesses on offer.– businesses that very often have a significant presence in Canada's economy and which often come from industries or groups not well represented in the Canadian stock market...

EXHIBIT 1: A NEW TREND?

U.S. Equities (S&P 500) relative to Canadian Equities (TSX) (currency adjusted)
1987-2013

Source: Trend & Cycle

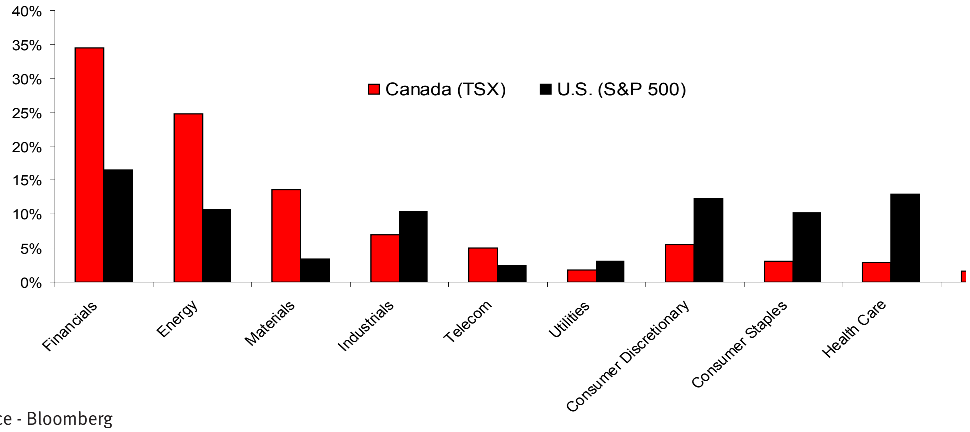
commodities, is intentionally gearing down its growth rate; the U.S., the world's largest economy, is growing at a substantially reduced rate relative to the experience of the past three decades; and Europe (the second largest consumer of industrial commodities) is in recession. Furthermore, there has been a significant source of commodity supply that has come to market in recent years given major investments growth in production by the global mining industry over the past decade. It seems likely that commodity consumption and pricing is going to have to suffer through a challenging and much less dynamic interlude.

Meanwhile, Financials – especially banks and life insurance companies –may remain vulnerable to future developments in the global credit markets. Furthermore, the sector's weighting in Canada is high and potentially leads to concentration risks. More specifically, it has twice the weight in the TSX Composite as in the U.S. S&P 500 index – 34% versus 17%.

The U.S. market offers far superior exposure to sectors we believe are most likely to thrive over the next five-to-ten years.

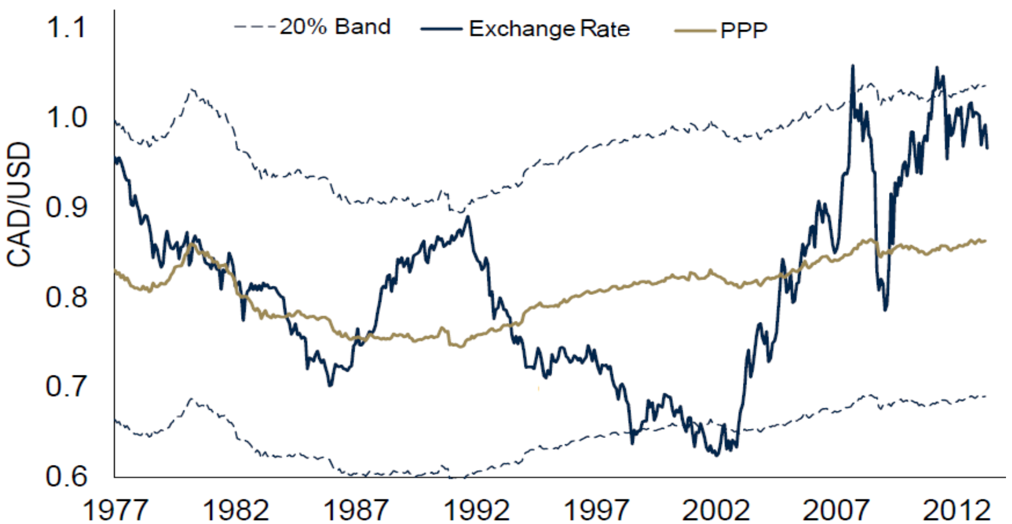
One of the most compelling factors stoking interest in the U.S. equity market has always been the sheer number of large, successful, well-known businesses on offer – businesses that very often have a significant presence in Canada's economy and which often come from industries or groups not well represented in the Canadian stock market, especially consumer related, industrials, healthcare and technology.

Exhibit 2: Sector Concentration in Canada



Source - Bloomberg

Exhibit 3: A strong Canadian dollar is less at risk of getting stronger



Source - DB FX Research, RBC Global Asset Manageemnt

U.S. Equity Market still looks reasonable for Canadians

	2000	2013
S&P 500	1,527	1,656
S&P 500 (in $CAD)	2,232	1,740
Earnings Per Share (EPS)	$53.92	$106.41
Dividends Per Share (DPS)	$16.76	$34.53
Price to Earnings	28.3x	15.6x
Earnings Yield	3.5%	6.4%
Dividend Yield	1.1%	2.1%

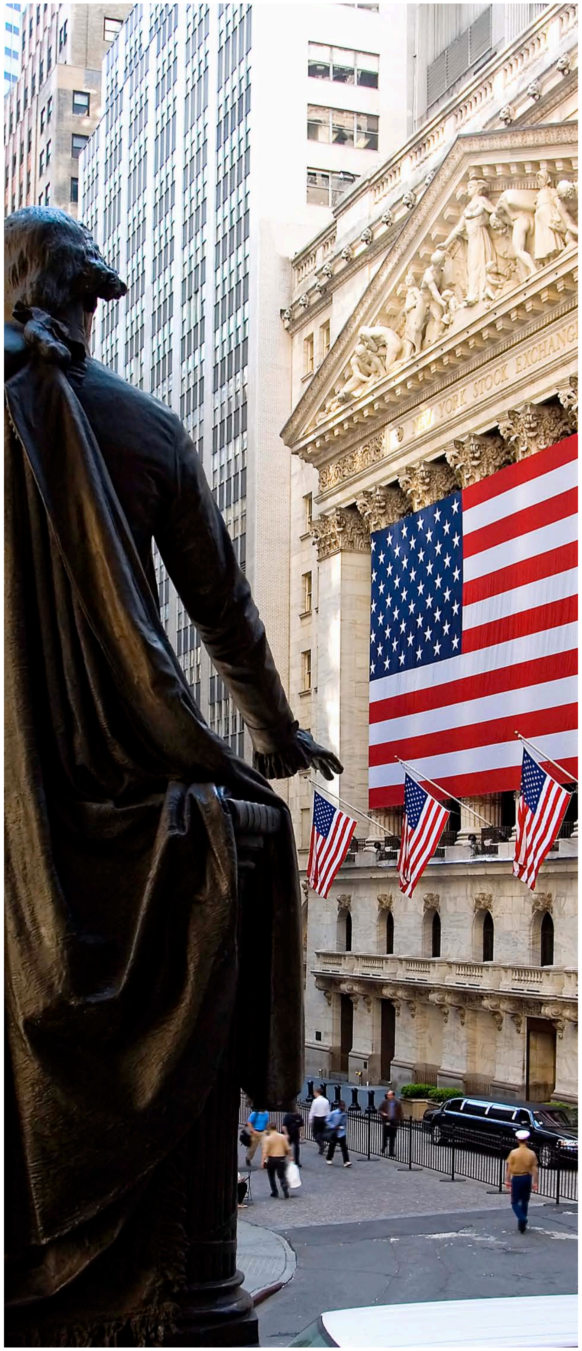
*EPS and DPS are trailing figures

Source - Bloomberg, Thomson Reuters

These sectors offer global exposure to favorable demographic trends, growing consumption, and productivity enhancing and cost saving solutions that companies are constantly looking for to remain competitive. Furthermore, some of these sectors have characteristics that we believe will reward investors over time, including strong cash flow, balance sheets, and among the fastest dividend growth.

Companies in these sectors range from large global enterprises to smaller, domestic oriented businesses. In recent years, we have preferred the large capitalization stocks that have significant exposure to international end markets, and in some cases to the emerging markets. Nevertheless, as the U.S. economy continues to show signs of moving towards self sustaining growth, our inclination is shifting towards a more balanced allocation of large-cap global and mid-cap and domestic oriented U.S. businesses.

The Canadian dollar poses a much smaller risk than it did ten years ago and might even prove to be a tailwind.



In 2002, the loonie was more than 20% undervalued versus the U.S. dollar on a purchasing power parity (PPP) basis which measures the cost of equivalent goods and services between the two countries. Currently, PPP suggests the loonie is almost 20% overvalued. History suggests it is difficult for the Canadian dollar to sustain itself for very long periods when it is more than 20% either side of its PPP with the greenback. This suggests that any gains made by a Canadian investing in U.S. stocks in the period ahead of us are unlikely to be eroded or eaten up by any adverse strengthening of the Canadian currency.

The improving U.S. landscape

Not surprisingly, many Canadian investors may approach the U.S. equity market with a certain degree of scepticism. After all, a few notable events and currency moves of the past are still fresh in investors' minds. Furthermore, most investors are well aware of the fiscal challenges facing governments around the world today, including the U.S. with its high government debt levels and deficits. Nevertheless, future portfolio returns are not based on what happened over the past decade, but rather, what could potentially happen over the next one. While headwinds exist, as they always do, we believe the backdrop continues to improve for U.S. equities.

On the economic front, the U.S. continues to be on the mend. By some metrics, the U.S. economy may be on more solid footing today than other global economies. More than half of the job losses of the most recent recession have now been recouped. Manufacturing activity has been on an upswing. Household debt levels have meaningfully declined and monthly payment obligations are at the lowest level in many years. Housing has now turned a corner, and is contributing to growth, as opposed to being the drag it was over the past few years. Importantly, the strengthening in house prices over the last year and a half has dramatically improved the mood and outlook of the American consumer. In late 2011 consumer confidence had fallen to thirty-year lows; today it sits close to a six-year high.

Meanwhile, through advancements in technology, the U.S. has been able to unlock vast resources in the form of shale oil and natural gas in recent years. Growth in this U.S. energy supply may have significant positive implications for its economy. Drilling and extraction employment has grown rapidly as shale projects get underway. Still to come, with even greater employment and investment potential, will be the construction of required infrastructure—gathering systems, pipelines, processing facilities, and storage. Over and above employment gains, vastly cheaper natural gas than can be had in Asia or Europe is leading to lower domestic manufacturing costs, shifts in the levels of trade imbalances, and a lower cost of living for the American consumer.

All is well in corporate America. Profitability levels remain very high. Interest rates remain near historic lows and have provided relatively easy access to financing and credit. Balance sheets are strong, and dividends continue to rise. Despite a healthy backdrop for businesses, capital spending remains subdued. U.S. companies continue to hoard cash as they await clarity on U.S. fiscal policy and the prospects for the global economy given the international nature of many businesses.

Finally, credit has once again started to flow. Most banks have begun to lower lending standards from ultra-tight to something closer to normal. Small-to-medium size businesses, as well as consumers and home-owners are finding it easier to access credit. This represents an important reduction in what had been a powerful headwind to growth.

Earnings Outlook Supports Higher Dividends and Share Prices

Year	Overall GDP Growth	Private Sector GDP Growth	S&P 500 Earnings Growth
2011	1.8%	3.0%	+26%
2012	2.2%	3.1%	+5%
2013 EST	2.2%	3.0%	+5%
2014 PROJ	2.8%	3.8%	+8%

Source - RBC Investment Strategy Committee, RBC CM and RBC Global Portfolio Advisory Committee

The table above illustrates an important fact: although overall U.S. GDP growth has been lacklustre, held back by increasing government austerity, the private sector economy has been gathering impressive forward momentum.

That improving growth profile for the part of the economy investors care most about has produced a string of solid corporate earnings gains. We are of the opinion this trend will continue over the next several years at least, helped by the fact that the drag from government will be greatly diminished next year and pretty well gone completely in 2015. Higher projected earnings should produce commensurately higher dividends over the next number of years. In turn, because stocks are reasonably valued at approximately 14x forward earnings, those earnings and dividend gains should translate into progressively higher share prices. In fact, increasing conviction on the part of investors that earnings growth can be sustained is likely to gradually produce a somewhat higher price-earnings ratio for the market.

Stock market corrections—oftentimes deeper and more prolonged than is comfortable—can't ever be ruled out. However, a bigger, more-damaging, more-sustained decline in the U.S. stock market looks unlikely to begin from here. The chief threat to this constructive outlook would come from the arrival of a pronounced economic downturn. Certainly, on an absolute and momentum basis, the U.S. economy is operating well above recessionary thresholds despite tax increases and spending cuts. Importantly, the usual signposts that would say a recession is on the way are not in evidence—most models calculate the probability of a U.S. recession arriving in the next 6-12 months at less than 5%.

Investment Conclusion

In our view an allocation to U.S. stocks gives a Canadian investor an attractive opportunity to diversify away from the Canadian stock market's magnified exposure to commodity/resource issues and to financials. We believe the time is right to utilize a richly valued Canadian dollar to accomplish this.

Tax implications for Canadian investors investing in the U.S.

There are important tax considerations for Canadian investors with respect to investing in U.S. equities. This article is not intended to provide legal or tax advice. Speak to an independent cross-border tax or legal advisor specializing in tax and estate planning before acting on any of the strategies discussed in this article to ensure your specific circumstances are taken into account. Some of the considerations that need to be made include the following;

1) Estate Taxes

U.S. estate tax may apply to the market value of U.S. assets (e.g. U.S. equities and U.S. real estate but not American Depositary Receipts) owned in personal name at death (including U.S. equities in RRSP/RRIF). U.S. estate tax is more of a concern if death is sudden – i.e. U.S. equities can always be sold or gifted prior to death. No U.S. estate tax will apply if U.S. assets are less than US $60,000 or if the total world wide estate of the deceased is less than the exemption amount applicable for the year of death (for 2013 the exemption is US $5.25 million). If the total world wide estate after eligible deductions exceeds the exemption amount, the estate tax is calculated on the market value of U.S. assets based on applicable rates. It is important to review exposure to potential U.S. estate tax annually to assess the impact of any changes in the exemption amount and/or tax legislation.

Importantly, there are a number of estate planning strategies that can be employed to minimize, eliminate or defer the potential tax liabilities. Some of these include setting up a Canadian corporation to hold U.S. equities, investing in Canadian mutual funds or structured notes that invest in U.S. markets and the use of life insurance trusts and other trusts.

2) Withholding tax and registered accounts

Canadians investors generally face a withholding tax rate of 15% on dividend income received from publicly traded U.S. corporations, while they face no U.S. tax on capital gains triggered on the sale of shares. To eliminate or minimize the potential for double taxation, Canadian investors can claim foreign tax credits on their Canadian tax return for U.S. tax paid.

There is a special exemption from U.S. withholding tax for certain U.S. investments held inside a trust set up exclusively for the purpose of providing retirement income (ie. RRSP, RRIF, etc). However, U.S. investments in accounts such as RESPs or TSFAs do not quality for this exemption. Furthermore, income distributed from U.S. equity vehicles such as Master Limited Partnerships (MLPs) do not qualify for the special exemption even though they may be held in registered accounts, and there may be other U.S. tax filing requirements associated with owning them (such as the requirement to file a U.S. income tax return).

3) Corporate actions and Canadian tax filing

Certain corporate actions, such as takeovers, mergers, and spin-offs involving shares of U.S. companies may lead to tax consequences for Canadians. Certain events such as foreign spin-offs may be classified as non-taxable for Canadian tax purposes if the reorganization meets certain criteria. Nevertheless, to minimize taxation, Canadian shareholders may have to file certain forms in their annual tax filing with the Canada Revenue Agency.

4) Canadian Information Reporting of Foreign Assets

The Canadian government requires all Canadian residents to provide information on foreign assets (including U.S. investments) if the total cumulative cost of these foreign assets exceeds $100,000 Canadian at any time during the year on Form T1135 - Foreign Income Verification Statement. The requirement to provide this information does not create a tax liability but failure to complete this form may trigger penalties.

Talk to your investment advisor about estimating your potential U.S. estate tax exposure using the RBC U.S. estate tax calculator and ask for a copy of our article discussing the tax implications of investing in the U.S., including estate and withholding taxes and strategies to minimize exposure.

A number of investment solutions

Investors have a broad array of solutions at their disposal today, ranging from traditional stocks to vehicles customized for particular client needs. Below, we highlight the five primary options available to Canadian investors that want to invest in U.S. equities.

Each investment solution offers its own advantages and challenges. As a result, some solutions are likely to be more appropriate than others depending on a client's particular circumstances.

1) Individual U.S. stocks.

Key advantages may include client and/or advisor ownership of the stock selection, investment process, and decision making, as well as the ability to customize investment portfolios. Considerations that need to be made include the need to achieve adequate diversification, ongoing portfolio maintenance, and potential tax implications, among other issues.

2) Exchange traded funds.

Vehicles that can offer diversification and relative tax-efficiency at a low cost, with the added benefits of transparency and intraday-trading flexibility. These features make ETFs effective tools for implementing a wide range of investment strategies. Investors own units in the ETF, which represent a fractional ownership in an underlying portfolio of securities, as opposed to shares of individual companies. ETFs are typically tied to an index, and are generally passively managed.

Currency-hedged ETFs offer exposure to underlying assets without the exposure to currency fluctuations between the Canadian dollar and the foreign currency. However, given our long-term view of the U.S. and Canadian dollar, we believe investors with a longer-term perspective should use un-hedged ETFs that provide exposure to the U.S.

3) Mutual funds.

Vehicles that can offer active portfolio management and diversification through ownership in units of the fund as opposed to shares of individual stocks. They may also offer Canadian tax advantages over owning individual stocks and ETFs. More specifically, Canadian mutual funds are not considered U.S. assets for U.S. estate tax purposes and some funds may have specific tax efficiency mandates. Considerations that should be made include management fees and the history of the fund manager, among other issues.

4) Third party segregated managers.

Vehicles that can offer advantages of professional money management and individual stock ownership as opposed to units in a fund. Key considerations include potential tax consequences given clients own individual stocks, management fees, and history of the portfolio manager, among other issues.

5) Structured products.

Investment vehicle whose attributes such as underlying equities (ie. an index, other baskets of pre-defined securities, etc), maturity, payout, and currency exposure, among others, can be entirely customized. Advantages include the flexibility and ability to tailor to a particular client need and/or preference, and the relatively low cost and tax efficiency. On this latter point, Structured Products are not eligible for U.S. estate taxes. Considerations include minimum asset size, and the education requirements given the more sophisticated nature of these vehicles.

Important Disclosures

This document is produced by the Global Portfolio Advisory Committee within RBC Wealth Management's Portfolio Advisory Group. The RBC Wealth Management Portfolio Advisory Group provides support related to asset allocation and portfolio construction for the firm's investment advisors / financial advisors who are engaged in assembling portfolios incorporating individual marketable securities. The Committee leverages the broad market outlook as developed by the RBC Investment Strategy Committee, providing additional tactical and thematic support utilizing research from the RBC Investment Strategy Committee, RBC Capital Markets, and third party resources.

The strategies, advice and technical content in this publication are provided for the general guidance and benefit of our clients, based on information believed to be accurate and complete, but we cannot guarantee its accuracy or completeness. This publication is not intended as nor does it constitute tax or legal advice. Readers should consult a qualified legal, tax or other professional advisor when planning to implement a strategy. This will ensure that their individual circumstances have been considered properly and that action is taken on the latest available information. Interest rates, market conditions, tax rules, and other investment factors are subject to change. This information is not investment advice and should only be used in conjunction with a discussion with your RBC advisor. None of the Companies, RMFI, RBC WM FS, RBC DI, Royal Bank of Canada or any of its affiliates or any other person accepts any liability whatsoever for any direct or consequential loss arising from any use of this report or the information contained herein.

Disclaimer

The information contained in this report has been compiled by RBC Dominion Securities ("RBC DS") from sources believed by it to be reliable, but no representations or warranty, express or implied, are made by RBC DS or any other person as to its accuracy, completeness or correctness. All opinions and estimates contained in this report constitute RBC DS' judgment as of the date of this report, are subject to change without notice and are provided in good faith but without legal responsibility. This report is not an offer to sell or a solicitation of an offer to buy any securities. Additionally, this report is not, and under no circumstances should be construed as, a solicitation to act as securities broker or dealer in any jurisdiction by any person or company that is not legally permitted to carry on the business of a securities broker or dealer in that jurisdiction. This material is prepared for general circulation to Investment Advisors and does not have regard to the particular circumstances or needs of any specific person who may read it. RBC DS and its affiliates may have an investment banking or other relationship with some or all of the issuers mentioned herein and may trade in any of the securities mentioned herein either for their own account or the accounts of their customers. RBC DS and its affiliates may also issue options on securities mentioned herein and may trade in options issued by others. Accordingly, RBC DS or its affiliates may at any time have a long or short position in any such security or option thereon. Neither RBC DS nor any of its affiliates, nor any other person, accepts any liability whatsoever for any direct or consequential loss arising from any use of this report or the information contained herein. This report may not be reproduced, distributed or published by any recipient hereof for any purpose.

RBC Wealth Management