Serber Speaking

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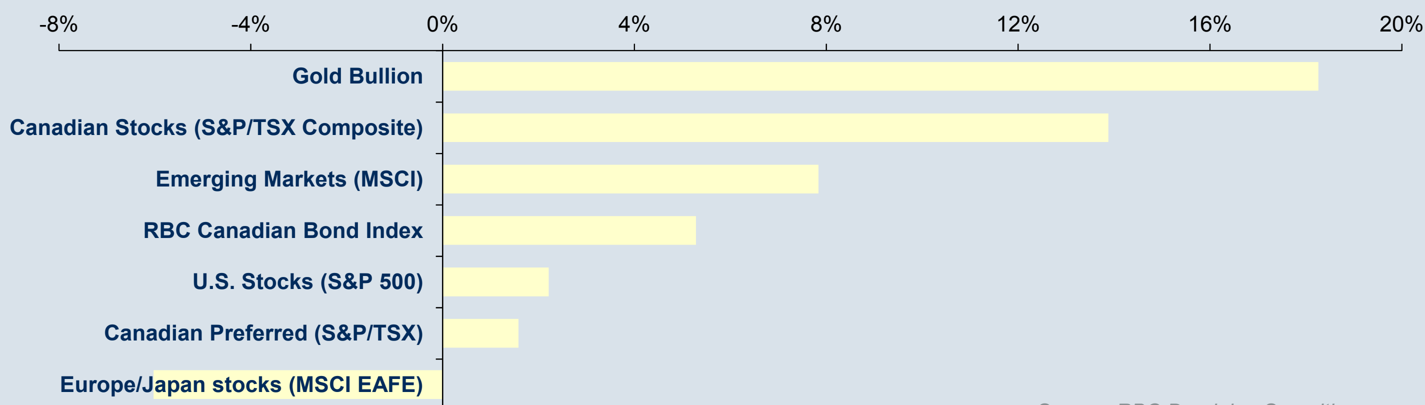
Commentary for the quarter ending September 30, 2016

2016 - Back on track for a positive year

Despite a rough start in 2016, investment markets have recovered most of their losses and are sitting in modestly positive territory, year-to-date. The equity portion of our portfolios, generally a mix of Canadian, U.S. and international stocks, has gained about four percent, year to-date in CAD$ terms. On the fixed income side, Canadian bonds performed well, with a year-to-date return of 5.3 percent. Preferred shares (part of fixed income) have struggled, losing almost six percent in the first quarter; however, their returns are now also in positive territory. Gold has put in a strong performance this year, providing a tailwind to our typical client's managed portfolio.

Performance by Asset Class: January 1 to September 30, 2016 (in Canadian $)



Source: RBC Dominion Securities

35-year bull market for bonds coming to an end

As we see on the chart above, Canadian bonds have been a good investment this year - generating decent returns with low capital risk. I do not hold many bonds in my client's portfolios, and I think it is worthwhile to explain why.

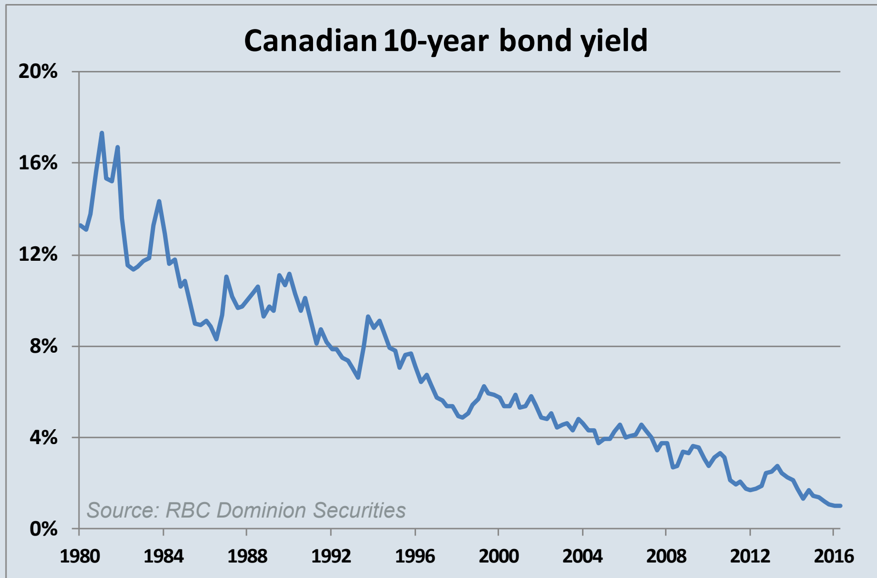
First, let's examine where the 5.3-percent return on these bonds came from. To begin, it is not that Canadian bonds are *paying* 5.3 percent. In fact, looking back to the beginning of 2016, the average Canadian bond, which has a 10-year term to maturity, was paying only about 2.1 percent.

Fast-forward to today. Interest rates have fallen, such that the average 10-year bond now yields around 1.7 percent. This means the 2.1-percent bond bought at the beginning of the year is now more valuable. A $100 bond bought on January 1 is now worth about $103.60, for a capital gain of 3.6 percent. If we add the interest earned year to-date to the 3.6-percent capital gain, we come up with the 5.3 percent year-to-date total return.

Pretty nice -- but what if interest rates hadn't fallen? Holding interest rates constant, the expected return at the beginning of the year was 2.1 percent per year for 10 years. This seemed to me like a rather long-term commitment for a rather paltry return. As it turned out, it would have been a good choice for this year, but only because falling interest rates generated a capital gain.

Going forward, the case for buying bonds has become even weaker. At current rates, the expected return is about 1.7 percent per year for 10 years. To do better than that, interest rates need to continue falling to ever-lower levels,

generating capital gains. While this is possible, it is not probable given that rates are now pretty rock bottom. On the other hand, if interest rates were to start rising, the bonds would start generating capital losses - adding insult to the injury of collecting a measly 1.7-percent annual interest income.



As can be seen on the chart, an entire generation of investors have lived the last 35 years in a world of generally falling interest rates. This means that the returns realized on bonds has been persistently enhanced, after purchase, with capital gains. It has been a truly golden era to be a bond investor. But it is coming to an end.

With interest rates at such historically low levels, the capital gains trade for bonds has simply reached the end of the road. There is little room for rates to continue falling. On the other hand, there are reasons to believe that changes taking place globally will begin to exert upward pressure on rates in the coming years.

When it comes to analyzing the interplay between politics and the economy there are numerous opinions, none of which are definitive. That said, based on my reading and observations, here is a macro point of view that makes sense to me. It boils down to this: capitalism + cautious monetary policy is deflationary, while leftist ideas (broadly meaning egalitarianism and state intervention in the economy) + aggressive monetary policy is inflationary.

From the New Deal economics of the 1930s to the rise of post-war Socialism in China and the USSR, to the Great Society rhetoric of the 1960s, leftist ideas held the upper hand in forming economic policy for much of the 20th century. However, inflation became a dominant economic problem, ending with economic crisis in the late 1970s. Starting around 1980, a new generation of politicians, led by Margaret Thatcher and Ronald Reagan, heralded a new era of more “laissez-faire capitalism” ideas such as lower taxes, less regulation and privatization of state-owned businesses. These changes led to a worldwide productivity boom. When production capacity grows faster than consumption, prices go down, and so do interest rates.

Today, politicians are increasingly facing new pressure from voters who are dissatisfied with the established order. A focus on income inequality is supporting candidates who promote “tax-the-rich” policies (Trudeau in Canada, Clinton in the U.S.). Concerns over carbon emissions are leading to increased regulation of businesses. The financial crisis of 2008 led to higher levels of government involvement in, and control of, the banking and investment industries.

It appears that the more laissez-faire capitalism/deflation trend that influenced the 1980 to 2008 period is slowly turning in the direction of greater emphasis on egalitarianism and state intervention. At the same time, global central banks have pursued aggressive monetary policies, injecting over US$10 trillion of new money into the economy since the 2008 financial crisis (Source: Yardeni Research). The U.S. has stopped for now, but Japan and Europe are printing money at full steam. Remember, left-leaning economics + aggressive monetary policy = inflation. Inflation leads to higher interest rates.

Bottom line

Owning bonds today is a low-return proposition at best. While portfolios should arguably hold a bit of bond exposure (for safety of capital, liquidity and capital gains, if rates go even lower for longer), I would keep this exposure to a minimum.

Instead, I recommend a fixed-income strategy focused on two types of securities: 1) GICs for capital protection and 2) floating rate or rate-reset preferred shares, which offer high current income and increasing income over time, if and when interest rates begin to rise.

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Wealth Management and Financial Planning

With the top Ontario marginal tax rate now more than 50 percent, tax planning is more important than ever for high net-worth families and individuals. With that in mind, here are two highly effective yet little-used strategies to reduce tax on investment income.

Splitting Income with a Spouse

If one spouse has high income and a taxable investment portfolio and the other has low or no income, a simple way to reduce the tax bill is the Spousal Loan strategy, which works as follows:

1. The high-income spouse loans funds to the low-income spouse. The loan bears interest at CRA's prescribed rate, currently one percent. Now is a great time to implement, as you can lock in this very favourable rate "forever."

2. The low-income spouse invests the borrowed money to earn a return. Let's say the loan is for $500,000 and produces a five-percent return ($25,000) on the investments.

3. After paying the required $5,000 interest (one percent of $500,000), the low-income spouse reports $20,000 of income. If s/he has no other income, s/he will likely pay zero tax.

4. Result: **$20,000 of income, which would otherwise have been taxed at more than 50 percent, is realized tax-free.**

Splitting Income with other family members

If, in addition to, or instead of, a low-income spouse, a high-income earner has children, grandchildren, parents or other dependent, low-income family members, then a Family Trust is a compelling strategy.

1. The high-income earner loans funds to the family trust. The loan bears interest at one percent.

2. The trust invests the borrowed money to earn a return. Same scenario as above: $500,000 at, hypothetically, five percent, generates $25,000.

3. After paying $5,000 interest, the trust distributes the remaining $20,000 to other family members, who are set up as beneficiaries of the trust. If the beneficiaries have little or no other income, they will likely pay zero tax.

4. Result: **$20,000 of income, which would otherwise have been taxed at more than 50 percent, is realized tax- free.**

As a Portfolio Manager and Wealth Advisor, it is clear to me that increasing net returns by reducing tax is better than increasing returns by adding portfolio risk. I can help with these strategies and would welcome the opportunity to discuss them with you. Please call any time - my coordinates are at the top of the page.

Until next time, best regards,

David Serber

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