Serber Speaking

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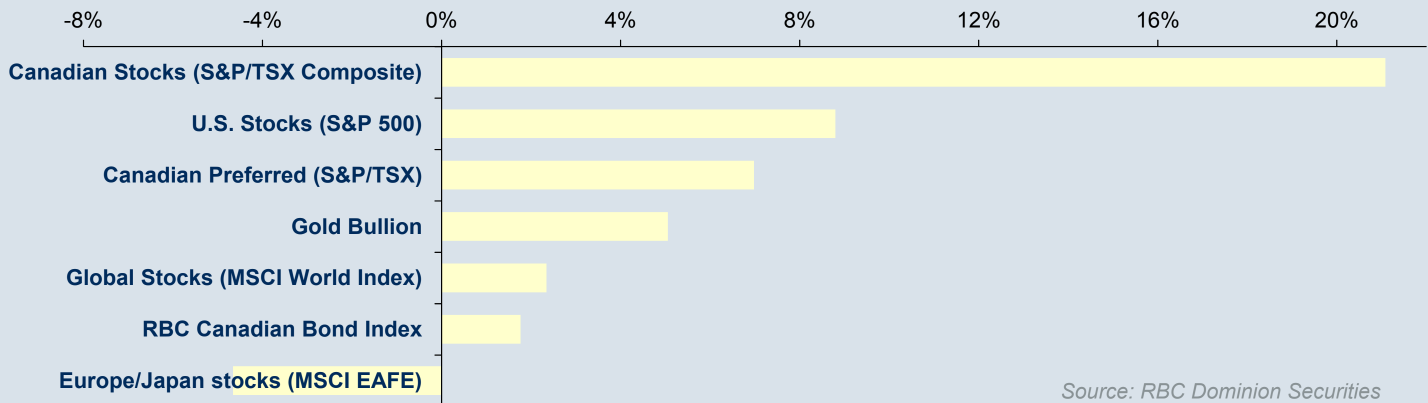
Commentary for the quarter ending December 31, 2016

2016 - Investment Markets Bounce Back

In the early days and weeks of last year, 2016 was shaping up to be a challenging one for investment portfolios. The price of crude oil, considered a barometer of global economic growth, cratered by 30 percent in January, plunging to a low of around US$26 per barrel. Global stock markets fell by 11 percent (MSCI World Index), and some specialty markets such as preferred shares dropped by even more. In June, the U.K. voted to exit the European Union, and prospects for global growth were further dashed. In early July, the U.S. 10-year bond yield hit an all-time low of 1.32 percent -- in effect, a no-confidence vote on the global economy.

Performance by Asset Class: January 1 to December 31, 2016 (in Canadian $)



Then, a few days after the Brexit vote, the mood began to shift. After all, ultra-low interest rates and cheap fuel costs are a powerful tonic to an economy attempting to get up off the floor. And the medicine seemed to be working. The Canadian market, which lost eight percent in 2015, powered to a 21 percent gain last year, as seen on the above chart.

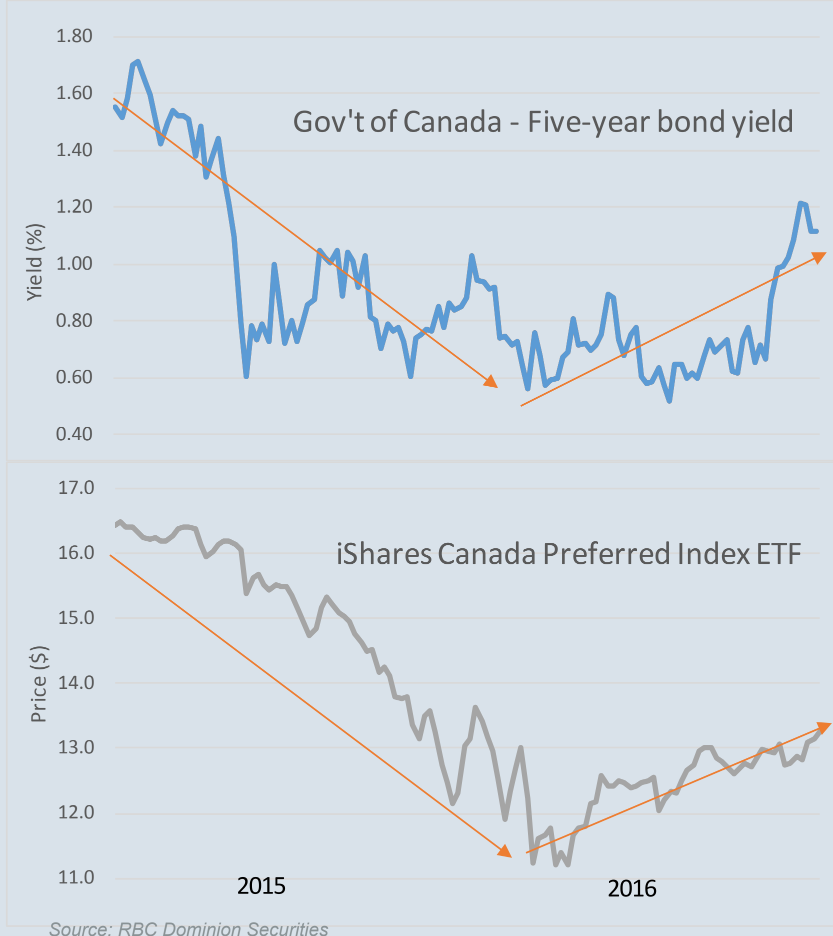
Other stock markets, however, were less buoyant, adding only a small single-digit contribution to portfolio returns. Canadian preferred shares recovered substantially, from a 16 percent deficit in Q1 to close out the year with a seven-percent total return, including dividends. Gold contributed a respectable five percent, which was better than the paltry 1.7 percent delivered by the bond market. The worst performer, at minus five percent for 2016, was the MSCI EAFE index, representing stocks of European and Japanese companies. Still, 2015's underperformer (Canada) became 2016's winner, and I wouldn't be surprised to see the same thing happen this year with the EAFE index.

Bond market update

Last quarter, I wrote that bonds, offering returns at best of 1.7 percent for 10 years, were a bad deal. Within days, bond prices began falling and then dropped further after the Trump victory on November 8. The incoming president's plan to increase fiscal stimulus and protectionism will be inflationary in the long term, and pressure will continue to build for higher interest rates. The average bond now yields about 2.5 percent, which is better than 1.7 percent, but still not sufficiently enticing.

Rising Interest Rates = Opportunity in preferred shares

Generally, while rising interest rates are a negative for bond returns (especially longer-term bonds), they should prove positive for the Canadian preferred-share market. As can be seen on the chart below, the yield on Government of Canada five-year bonds fell from about 1.6 percent in late 2014 to less than 0.6 percent in 2016. Over this same period, the iShares Canadian Preferred Index ETF, representing the preferred market, fell by some 30 percent. This is because the majority of preferreds pay dividends that are adjusted periodically to reflect changes in the five-year bond yield. When this rate fell throughout 2015 and into 2016, preferred-share investors apparently worried that their dividends would be adjusted lower and lower, forever. This decline, plus a Canadian economy that wobbled in early 2016 after the shock of oil prices dropping to less than US$30 per barrel, caused preferred-share investors to panic. Sellers overwhelmed buyers, and prices fell.



Source: RBC Dominion Securities

The result was the drop in preferred share prices as seen on the chart. We can also see that the rise in interest rates in the latter half of 2016 coincided with a recovery in preferred prices.

Preferred shares have now recovered almost half their earlier losses. Assuming interest rates rise, or even remain where they are, I expect this recovery to continue. A typical preferred offers a current yield of about 4.5 percent. I would expect another four percentage points in potential capital gains over the next year for an expected total return of about 8.5 percent. Adjusting for favourable taxation of dividends and capital gains, this is the equivalent of making about 11-percent interest, far exceeding the 2.5-percent return offered on bonds (albeit with more risk). Currently, all of my managed portfolios are overweight preferreds and underweight bonds.

Outlook for 2017 and beyond

The positive momentum seen in the second half of 2016 should carry through into 2017 and lead to decent returns for the year. That said, certain markets have moved a bit too far, too fast. Take the Dow-Jones at plus 10 percent since the U.S. election, so a near-term pullback would be normal. The portfolios I manage are currently slightly underweight equities, and I will be a buyer on a price correction of about five percent or more.

Longer-term, there are challenges. From 1982 to the present, a “buy-and-hold” balanced portfolio has generated an average return of about 10 percent per year. According to BCA Research, this period was an historical anomaly, representing a near-perfect combination of falling inflation and interest rates, rising profit margins, a starting point of cheap valuations, rapidly expanding globalization and strong growth in consumer credit.

However, none of these tailwinds remains in place. Inflation and interest rates are likely to climb, profit margins will shrink as labour demands a larger piece of the pie, valuations are not cheap, enthusiasm for globalization is on the wane, and overleveraged consumers and governments are not in a position to materially boost spending through increased borrowing. The projected returns from a buy-and-hold balanced portfolio are now expected to be closer to four percent. As a result, achieving a respectable return of even five or six percent will require thought, effort and timely decisions to move from more overvalued investment-market sectors to more undervalued sectors -- exactly what I spend my time worrying about, so you, ideally, don’t have to.

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Wealth Management and Financial Planning

With the top Ontario marginal tax rate now at 53.5 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. These are being repeated from my last quarterly report as I am convinced not enough people are taking advantage of these strategies, which are tax-saving no-brainers.

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, which otherwise would 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 beneficiaries of the trust. If the beneficiaries have little or no other income, they will likely pay zero tax.

4. Result: $20,000, which otherwise would 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 investment risk! I can help with these strategies and would welcome the opportunity to discuss them with you. Please call or email any time - my coordinates are at the top of the page.

Until next time, best regards,

David Serber

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