Wealth for Life

Wealth Management
Dominion Securities

Summer 2020

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COVID-19 Recovery

The second quarter equity market recovery was met with all the skepticism that has plagued the bull market since 2009. At the same time, as many are forecasting a retest of the March low, others are labeling the recovery as the start of a new "bull market." The divergence in opinions is exactly what financial markets are made of, and presents the uncertainty of the future outlook. However, as we are frequently reminded, financial markets themselves are the single most effective forecasting tool we possess.

Progress in containing COVID-19 has been made in many countries, permitting controlled economic reopenings in some places. Although financial markets remain uncertain, they seem to have gained greater confidence that COVID-19 will be contained and a vaccine will be delivered. As more vaccine candidates enter various stages of trial, it's apparent that science and governments have expedited the discovery and production of a vaccine or vaccine candidates. It's only a matter of time until a vaccine is delivered – making it a matter of when, not if – a timeline that has consistently become more imminent, as time has passed!

Make no mistake, economic activity is progressing in a very positive way, even though we are coming off very low levels in March/April. In the U.S., June retail sales surpassed all expectations, U.S. home sales in June by builders was the best in over 15 years, dating back to the last housing boom, one-third of all U.S. jobs lost in the lockdown have been regained [https://www.theglobeandmail.com/business/economy/article-canadas-economy-added-record-953000-jobs-in-june/] and the U.S. June manufacturing index recorded 52.6 – better than expected and in "expansionary" territory. In China, the service sector grew at the fastest rate it has in 10 years. In Canada, 41% of all jobs lost due to the lockdown have been regained. [https://www.cbc.ca/news/business/canada-jobs-june-1.5644672]

Earnings announcements at the time of this writing have been equally as good or at least better than expected.

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COVID-19 Recovery

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Companies remain guarded about the future, as we would expect, given economic reopening uncertainties. Global arbiters of growth such as the CAD$, the price of gold, copper and oil have improved, raising the prospects for global growth. As we move forward, economic momentum will be influenced by pent-up demand, as we have seen in U.S. home builder sales, retail sales and eventually, auto sales.

The recovery in equity markets in Q2 has been resounding. Although some sectors outperformed others, all equity sectors in Canada and the U.S. were positive except Canadian communications, which were barely negative. The economic lockdown highlighted the benefit some companies have through extensive digital/internet platforms and has accelerated the need for other companies to develop a more robust digital presence and internet revenue and order fulfilment. Companies with strong subscription-based businesses were able to maintain better economic momentum than other businesses reliant on in-person product or service sales. Going forward, corporate success in the retail/service sectors, as well as other businesses, will be much more dependent on a company's digital/internet reach and efficiency.

The TSX and S&P 500 gained 17% and 20.4% respectively in the second quarter. On a year-to-date (YTD) basis, the TSX is down 7.5% and the S&P 500 is off just 3.1%. In both Canada and U.S. markets, financials have lagged in comparison to the recovery of other sectors, in percentage terms. As we have seen in the past, financials will announce provisions for loan losses emanating from an expected recession. In the midst of the recessionary uncertainty, financials will reflect the "worst" outlook forecasted (current environment). As the economy evolves, realized loan losses are typically less severe than feared, lifting the cloud of uncertainty – and financials' valuations – is our expected outcome.

Although current equity markets remain 10% and 5% off their respective 2020 highs in Canada and the U.S., respectively, the debate about the shape of the recovery continues. Make no mistake, the equity market recovery has been a "V"-shaped recovery. Commentators and forecasters have been further frustrated by the equity market resiliency – as it shrugs off bad news and continues higher. Much of the debate focuses on the extended valuation of equity markets and the elevated price-to-earnings ratio. However, equity markets are fully discounting 2020 earnings and looking out to 2021, when the economic landscape is expected to look much different/better, leaving many companies with attractive valuations. Lastly, the economic lockdown will incentivize all companies to drive and accelerate development of their digital and internet platforms, which will expand efficiencies and profits – all of which will be complimented by the deployment of more efficient remote work access.

We are all-too-well-aware of the downside to the economy and equity markets if COVID-19 is not contained, or flares into a second wave of new cases. But imagine if/when we get a vaccine? Furthermore, the current 10-year bond interest rate is less than one-third of the level hit at the 2009 equity market low, and investors couldn't live on such a low yield then – how about now, at 0.63%? Also, with equity markets at current levels, the total assets in "retail money market" assets are now greater than the peak hit at the 2009 equity market low (Fundstrat) [http://dsnet.fg.rbc.com/assets/advisornet/docs/investment-management/pag_security_commentary_recommendations/fundstrat/technical/2020/20200630_ta.pdf]. Where does all this money go for income – dividends? Equity? Like 2009 and thereafter, we expect retail money market assets to eventually find its way into equity, cascading down eventually from the high-quality, dividend-paying companies to more growth-oriented companies of quality.

There has been much debate about the role of central banks and how long or how much they can afford to support/underpin the economy from the side-effects of the economic lockdown. I think the resolve of central banks is clear – the economy has to restart and they appear ready to do what is required and deal with the aftermath to reap the benefit of a fully functioning economy. I think it's prudent to assume that taxation will be a component of the payment plan for governments, therefore, as we execute wealth management plans, tax efficiency and planning opportunities will be on our radar and more important than ever.

During the quarter, the price dislocation in equity markets afforded us an opportunity to build on core equity positions that would benefit in the recovery. Our focus paid particular attention to companies hthat have strong digital/internet platforms, subscription businesses and sustainable businesses with leading brand recognition. On balance, we increased our exposure in consumer discretionary, communications, health care and industrial sectors. Nobody is certain as to when the economy will regain full operation, but one thing is certain – if the reopening unfolds like all other milestones during the pandemic, it will happen sooner and in a more robust fashion than originally forecast.

We salute all our heath care employees and first responders for the sacrifices they and their families are making for all of us!

Steve Lester

Protect your assets from taxes and creditors

Strategy 4 – Effective use of surplus assets

By preparing a financial plan (see "Strategy 1 – Comprehensive financial planning"), you can determine if you have adequate income and assets to meet your retirement income needs for your and your spouse's estimated life expectancy.

Lifetime gifts, trust planning, permanent life insurance and charitable giving can all be incorporated into your financial plan to help protect your assets.

If, after developing a financial plan, you determine that you have surplus assets you are unlikely to need during your lifetime, even under very conservative assumptions, you may want to consider ways to utilize those assets to fulfil some of your estate planning goals while you are living. This way, you get to see the difference your assets can make.

Three options include:

1. Lifetime gifts and trust planning
2. Purchasing a permanent life insurance policy
3. Charitable giving

Lifetime gifts and trust planning

Do you have surplus assets that you will definitely not need during retirement? Are you also planning on providing funds to your children or grandchildren in the future to help with things such as paying for education, purchasing their first home, starting a business or paying for their wedding?

If so, then it probably does not make sense to continue exposing the income from these surplus assets to your high marginal tax rate. Instead, consider giving some of these surplus funds to family members now, either directly or through a trust if you do not want the children to have control of these assets.

If you gift your assets to a child or grandchild, directly or through a trust, attribution of interest income and dividend income will apply if the child is under 18, which means that you will be taxed on that income. Capital gains are not subject to the attribution rules for a child under 18. If you are concerned about direct gifts to your children, then lending funds and providing your children with only the income earned on these funds is another effective strategy, as you can call the loan principal back any time. If the children are minors, a loan to a family trust at the CRA-prescribed rate may accomplish the same thing.

See the Wealth Management Report "Strategy 9 – Family Income Splitting" for more information about income splitting with family members.

Permanent life insurance

Do you have surplus assets that you wish to pass on to your heirs when your estate is settled? If so, it probably does not make sense to continue exposing the income from these assets to your high marginal tax rate.

You may consider speaking to your insurance representative about putting these highly taxed (typically interest-bearing) assets into a permanent life insurance policy. Some permanent solutions may include tax-exempt life insurance, which allows you to make deposits in excess of insurance costs (within policy limits) in investment type accounts. Insurance benefits typically include this exempt account value.

Under the Federal Income Tax Act, assets accumulate within a tax-exempt life insurance contract free of annual accrual taxation. When you pass away, proceeds of the policy are distributed to your named beneficiaries on a tax-free basis outside the scope of your estate, bypassing its associated costs.

The use of permanent life insurance provides the ability to manage your tax risk today and in the future. It is important to keep in mind that you must medically qualify for coverage in order to purchase life insurance and implement this type of strategy.

Charitable giving

If you want to give some of your surplus assets to charitable organizations, you have many options that can help you create a charitable legacy while providing some tax relief. These include giving directly to qualified charitable organizations, creating a private foundation or donating through a public foundation.

Recent tax changes also make it more attractive to donate publicly listed securities such as shares that have appreciated in value. Now, when you donate publicly listed securities directly to a qualified charity, you are completely exempt from capital gains tax. Ask to see the Wealth Management Report "Strategy 7 – Charitable Giving" for more information about tax-effective charitable giving strategies with surplus assets.

Note that due to the potential of escalating health care and long-term care costs, it is essential that you be prepared for these contingencies before redirecting your surplus assets. Critical illness insurance, long-term care insurance and easy access to credit are a few options to consider.

Family wealth management tip

If you have assets accumulating in a corporation, bear in mind there may be a higher tax rate on investment income earned in a corporation than on investment income earned personally. Furthermore, there is a potential for double taxation related to the assets inside a corporation at death. As a result, corporately owned tax-exempt insurance is an attractive solution for surplus funds accumulating in a corporation. This way, the surplus assets in the corporation can grow tax-free during your lifetime and proceeds in excess of the policy's adjusted cost basis may be paid as a tax-free capital dividend to shareholders or successor shareholders.

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