A&Q Update

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December 2013

Volume 15

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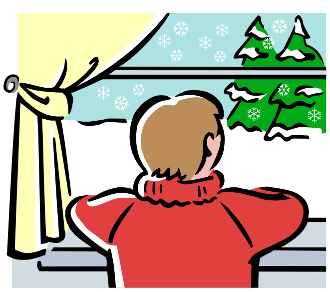
The Short Term Investment Conundrum

2013 has proven to be a very solid year for investment performance for the well balanced and diversified investor. The biggest contributors to portfolio growth have been US and international stocks. In many cases, the returns of these asset classes have been further enhanced by the fact that the Canadian dollar has fallen by about 6.5% in comparison to the US dollar year to date. If no currency hedging is in place, this translates to additional return that can be attributed solely to the shift in currency values.

We are very encouraged to see growth from non-Canadian equities, as for many years investors were not compensated for diversifying into these areas. This year it is the fixed income (bond) portion of the portfolio which has not pulled its weight. In May and June in particular, bond values were negatively impacted by talk of 'tapering' (reducing the amount of government stimulus) in the US. This led to speculation that interest rates would rise, causing bond values to fall. Having said that, we still strongly believe that bonds are an important part of a balanced portfolio. They have a strong track record of helping to preserve capital when stock markets retreat. While they may be a drag on performance when stocks are soaring, the risk reduction is well worth the price of admission.

The current economic environment is particularly difficult for shorter term money or for investors with a very low tolerance for risk. Currently 'high interest' savings accounts are paying about 1.25%, and for a 5 year commitment, GICs are paying in the neighbourhood of 2.75%. And because interest rates are low, there is real potential for bonds to experience periods of negative performance when interest rates rise. So where do you put that money that you want invested conservatively?



Option one is to put your money into interest paying investments like GICs. The rates are low, but your capital is not at risk. The main threat here is the potential for inflation to erode the purchasing power of the money. According to statistics like CPI, inflation has been low for the last number of years, but this does not necessarily reflect the inflation that *you* experience for the things that *you* spend money on. This option is also not tax efficient if the money is held in a non-registered account. Interest income is taxed fully as regular income.

Option two is to take on some degree of risk in order to benefit from what hopefully will be a corresponding increase in return. Products at the lower end of the risk spectrum certainly have the potential to outperform interest bearing investments, but there may be times when the market value drops below the invested amount.

Purchasing a mutual fund which features an asset mix that targets low volatility is one way to do this. A fund of this kind is likely to have a higher level of bond exposure and a lower level of equity exposure. Because of the interest rate risk associated with bonds (as mentioned above), active management of the bond portion of the fund is extremely important because there are a number of tactics a manager can use to try and mitigate interest rate risk. The mutual fund option also has the potential to be more tax efficient than deposit products like GICs.

This is often not an easy decision for investors. Critical to making an informed decision is understanding the risk/reward profile of the products available to you.

Registered Disability Savings Plans

In 2008 the Canadian government introduced the Registered Disability Savings Plan (RDSP). These plans are a tax-deferred savings vehicle that help parents and others to save for the long-term financial security of a person with a disability.

In order to qualify for an RDSP you must be eligible for the Disability Tax Credit, be a Canadian resident, be under the age of 60, and have a valid Social Insurance Number.

The two main benefits of the plan are: 1) the government matching of contributions, and 2) tax deferral.

Government matching takes two forms, Canada Disability Savings Grants (CDSGs) and Canada Disability Savings Bonds (CDSBs). The bonds are available only to lower income families, whereas the grants are available to all plan holders.

Money contributed to these plans is not tax deductible, so an amount equivalent to contributions can be withdrawn without being taxed. Money in excess of the total contribution amount will be taxed in the hands of the plan beneficiary at the time of withdrawal. Each withdrawal is deemed to be a combination of contributions and grant/ growth on a proportional basis. RDSPs have a lifetime contribution limit of $200,000 per beneficiary, so the tax sheltering benefit can be substantial. And because it is possible to hold a wide variety of investment vehicles within these plans, there can be very good growth potential.

There are a number of rules surrounding the operation of these plans. Detailing these is beyond the scope of this article. Our main objective here is to ensure that people know that these plans exist. For those that qualify, these plans are worth taking a close look at. If you or someone you know would benefit from additional information please let us know.

Investment Income Using a *Cash Wedge* Strategy

Let's say an investor is drawing income from their investments, and they want to continue to do so regardless of market performance. Consideration must be given to how the *sequence* of investment returns impacts the portfolio as income is drawn.

To clarify this, the sequence of returns refers to the timing of market ups and downs. Even though the investment portfolio may have a very attractive *average return* over an extended period of time, an investor's *personal* rate of return can suffer as a result of drawing money out during periods when investment prices are depressed. The impact of this situation can be even greater if investment returns are poor in the first few years of drawing income. This is where the sequence of returns comes in; even if the long term returns are quite acceptable, it will be difficult for the portfolio to recover because less money is available to participate in the investment value recovery.

One strategy we sometimes recommend is referred to as the 'cash wedge' strategy. Executing this strategy is not complicated, but it does require monitoring and it must be attended to on a regular basis.

The bulk of the money is invested with a medium to long term time horizon in mind, say 3 years and beyond. The investments selected must also be well suited to the risk profile of the investor. This portion of the portfolio has the potential to provide the growth necessary to protect the purchasing power of the investment assets, but it must be understood that this portion of the portfolio will fluctuate in value.

The remaining money represents the amount needed for the next 2 to 3 years of income. This is the portion that gives the strategy its name (picture this portion as a wedge of the overall pie). It is invested in vehicles with little or no potential for volatility, cash vehicles or possibly things like short term bonds. Income is drawn from here as dictated by the investor's income needs. Careful consideration must be given to the size of this wedge, again based on the specific needs of the investor.

Over a period of time the cash wedge is depleted by the income stream. The wedge is then brought back to the 2 to 3 years of income level periodically by replenishing it from the more growth-oriented investments. This is where monitoring and maintenance come in. In an ideal situation, this will be done during periods where the growth investments have done well, thereby locking in some of the investment gains. There is some risk in the fact that if investment values remain down for an extended period of time, it may have to be replenished at less than ideal investment prices.

We like this strategy in certain situations because it addresses the need for both a secure income stream and long term growth. Having the short term income set aside in advance can also help to provide the peace of mind many investors are looking for.

Guaranteed Income Supplement & Investment Income

Tax efficient investment income is appealing to all investors, but in the case of a retiree with a very low level of regular income but substantial investment assets, it is even more important.

Old Age Security and Guaranteed Income supplement are two *income tested* benefits. In other words, the amount you receive can be impacted by the amount of annual income you have. Benefits can be reduced or clawed back if your income is too high. For the majority of Canadians, OAS clawback is not a factor. An individual can have up to $69,562 in annual income before benefit payments start to be reduced.

The income test threshold for GIS however is substantially lower, with the benefit fully clawed back once an individual hits an income level of $16,704. For this reason, many Canadians are not eligible to receive GIS. Let's look at a situation where an investor can really benefit from a tax efficient investment income stream. This is something we occasionally see: a retired individual is receiving OAS, a small amount of CPP, and they have depleted their registered savings. They have a substantial amount of non-registered savings held in interest bearing investment. Every dollar of interest earned by their investments reduces the amount of the GIS benefit they are entitled to receive. The investor wants to see their money grow, but they don't want to see that growth have a negative impact on their income.

There are investment vehicles available that allow the investor to reduce the amount of reportable income they receive, even if they are taking a monthly income from these investments. *Return of capital* is one of the available forms of investment income. When you receive return of capital payments, you are in fact not earning any income at all, you are drawing out a portion of the money you originally invested. Return of capital payments are a form of tax deferral, because the book value of the investment gradually reduces as payments are taken. At some point in the future, when investments are redeemed, the size of the capital gain will increase by an amount equivalent to the return of capital payments taken.

Putting off taxation is generally seen as a good thing because it allows the investor to earn growth on tax dollars you have not yet paid. Return of capital is even more beneficial when you give consideration to the fact that it doesn't create current taxable income, thereby increasing the ongoing benefits you receive from government programs like GIS.

Investment funds producing return of capital income are available in a wide range of risk profiles. For someone in this situation it is of course appropriate to take a conservative approach to the investments selected. Consideration also must be given to the amount of steady income required by the investor. The amount of income paid is specific to the product and can change over time. None of these products guarantee that the income paid out will be *all* return of capital (as opposed to other taxable forms of income), but there are funds available that have a track record of consistently characterizing the majority of the income paid as return of capital.

As with any financial planning strategy, careful consideration must be given to the specific situation of the investor and the appropriateness of the strategy for them.

Year End Reminders

√ **Registered Education Savings Plan (RESP)** contribution deadline is December 31, 2013. This is particularly important if the beneficiary turned 17 years of age during 2013 (with this being the last year that they can receive CESG grant).

√ **Charitable Contributions** deadline for the 2013 tax year is December 31st. Remember that annual cumulative donation amounts over $200 receive a tax credit of 40%. Family contributions can be grouped in order to maximize the amount over $200.

√ 2013 tax year **Registered Retirement Savings Plan (RRSP)** contribution deadline is March 1, 2014.

√ **Tax Free Savings Account** contribution room increases by $5,500 for Canadians over the age of 18 as of January 1, 2014. Also, after January 1st, investors can re-contribute amounts withdrawn from their TFSA in 2013.

√ For **non-registered investment accounts**, check your year end fund company statements for capital gains or losses triggered by redemptions or switches made during the calendar year. The 'T' slips issued by the fund companies do not reflect the tax consequences of investor activity; they reflect only the details of fund distributions paid out in cash or reinvested in the fund. We are happy to provide additional details upon request for any gains or losses triggered during the year.

Armstrong & Quaile

ASSOCIATES INC.

"Providing Sound Financial Direction"

John Armstrong is a Certified Financial Planner. Financial planning and financial planning education are his key areas of interest and expertise.

Achieving balance in our lives is critical; a balance between work and family, a balance between living for today and planning for the future. Because we all have competing goals, striving for balance influences many decisions in our day-to-day lives. One thing is certain, the juggling act we do requires a long-term view. Sometimes we need to take a step back to put things into perspective.

It may sound cliché, but having a plan in place goes a long way in helping to achieve both our long and short-term goals. Simply put, planning assistance is the service we provide. We are committed to helping you find that long-term view for the good of today and tomorrow.

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Newsletter Editor : Rich Weiler

Short and Sweet!

- A cartoonist was found dead in his home. Details are sketchy.
- I used to be a banker, but then I lost interest.
- They told me I had type-A blood, but it was a type-O.
- I stayed up all night to see where the sun went, and then it dawned on me.
- I'm reading a book about anti-gravity. I just can't put it down.
- Did you hear about the cross-eyed teacher who lost her job because she couldn't control her pupils?
- When you get a bladder infection—urine trouble.
- Broken pencils are pointless.
- I got a job at a bakery because I kneaded dough.
- Velcro—what a rip off!

We would like to express our true appreciation to our clients for their support over the past year. The great relationships we have with so many of you is what makes our work worthwhile. We feel very fortunate indeed.

We hope that this is a truly wonderful time for you and your family. We hope that you are able to enjoy your holiday traditions and maybe even start some new ones. Christmases seem to mark time; we often use them to identify a particular year or period in our lives. Our simple wish is that this will be a time period worth remembering fondly for you and your family.

May you experience the peace and joy that is the true spirit of the season. We hope that you have the fortune of spending time, or at least being in touch with, the people you care about.

Holiday Office Hours

December 24th—26th	closed
December 27th & 30th	9am—2pm
December 31st	9am—12pm
January 1st	closed

Merry Christmas & Happy New Year from Our Families to Yours!

John *Rich* *Sharon* *Cindy* *Joe*