Financial Planning Guide

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FOCUS ON MUTUAL FUNDS

Monthly income funds — not for retirees only

What's in a name? "Monthly income fund" sounds like a great retirement income vehicle — and it is. Retirees use monthly income funds for reliable, tax-efficient monthly distributions that may include interest, dividends, return of capital, and capital gains.

Distributions are typically better than the interest income from Guaranteed Investment Certificates (GICs). Unlike GICs and similar instruments, however, distributions are not guaranteed.

But the monthly income stream is not the whole story. These funds can also be important components of investors' Registered Education Savings Plans (RESPs), Tax-Free Savings Accounts (TFSAs), Registered Retirement Savings Plans (RRSPs), and non-registered accounts. Instead of being paid out, distributions are simply reinvested.

There is no typical monthly income fund. Some do hold only fixed-income investments, but others are broadly diversified by asset class, geographic region, and sectors. Investments include government and corporate bonds, Real Estate Investment Trusts (REITs), income trusts, and Canadian, U.S., and global equities. Often, there's a focus on dividend-paying equities.

The appeal of monthly income funds for wealth accumulation is the potential for decent returns, combined with a lower volatility than pure equity funds. Also, well-diversified funds are designed to perform in a variety of market conditions. The funds can help stabilize a portfolio while also contributing to overall gains.

Together, we can ensure your portfolio suits your financial objectives and risk tolerance, while exploring other fund opportunities that you might be interested in. ■

Are you a victim of ‘home bias’? Don’t ignore global equity funds

Having a bias for your home country is, ironically, truly global, especially among investors. Mutual fund and equity investors alike all around the world tend to shy away from “foreign” markets, preferring to stick to the funds that are close to home — a phenomenon that’s known as “home bias” or “domestic bias.”

It’s no mystery that there’s comfort in the familiar. The question for mutual funds investors is this: what does home bias do to your mutual fund portfolio? Are these investors actually going to get closer to their goals with this approach, or are they missing out?

Blame Canada

For Canadians, there’s an even bigger explanation for home bias — performance. From 2003 to 2012, the S&P/TSX Composite Index outperformed the S&P 500 in seven of 10 years. But as disclaimers warn, past performance is no guarantee of future performance. In 2011 and 2012, the S&P 500 outpaced the S&P/TSX Composite. It is interesting to note that as of December 31, 2012, the Canadian Pension Plan (CPP) Investment Board did not show domestic bias, instead holding 82% of the CPP Fund’s equities in markets outside the Great White North.

To illustrate the risks of domestic bias and the opportunities presented by exposure to global equity funds, let’s compare the strategies of two mutual fund investors, Ian and Marie.

Ian has always trusted Canadian equity mutual funds for almost all of his equity holdings.

Marie takes a different tack. Her equity mutual funds are diversified across Canadian, U.S., and international markets — and her plan is based on her tolerance for volatility, her investment goals, and her time horizon.

Expand those horizons

Ian believes he’s playing it safe by focusing on Canadian equities, but he is limiting his investment opportunities — the Canadian market capitalization represents only about 5% of that of the world. He’s not only sacrificing diversification by geographic region, but also by sector. Nearly 80% of the benchmark S&P/TSX Composite is composed of only three sectors — energy, financial services, and materials. And what if Ian wants the security of large caps? Canada is home to only 11 of the world’s largest 500 companies.

Marie, on the other hand, gains all of the benefits of diversification by geographic region, sector, and market capitalization. She has the opportunity for higher potential returns through exposure to the best-performing markets. Marie decreases risk because she spreads out her investment dollars over a variety of markets. Also, over time, diversifying tends to smooth out the highs and lows of her overall portfolio performance.

Is your portfolio constructed to take advantage of equity opportunities around the world? Together, we can make sure your investments are well-diversified globally, without domestic bias or overemphasizing any one geographic region or sector. ■

Don’t play follow the leader

Imagine this. It’s the first week of January 2012, and an eager investor is searching for a new place to invest a holiday bonus. She sees that the Emerging Markets Equity Index dropped 16% in 2011, and decides to avoid that “loser” index by keeping her bonus out of her emerging markets equity fund.

As it turned out, if our eager investor had chosen emerging markets, she would have enjoyed a gain of 16% in 2012. Welcome to the tricky world of predicting leaders in global equity performance, where pundits try to pick what’s hot and what’s not. The key? Don’t get pulled into the game.

Take any year, and you’ll find that the market leader in equity returns tends to be a different country or region — and nobody can consistently guess which geographic market will be next year’s leader — or loser.

So how can individual mutual fund investors be sure to include the world’s outperformers in their portfolios? Not by guessing, that’s for sure. Think diversification, think about trusting your long-term plan, and think about discussing with us mutual funds that contain equities from different markets around the world.

Top equity regions in the past four years

The “winning” region is typically different from year to year.

2009	2010	2011	2012
Emerging Market Equities 51.6%	**Canadian Equities 17.6%**	**U.S. Equities 4.6%**	**Emerging Market Equities 15.6%**
Canadian Equities 35.1%	Emerging Market Equities 12.7%	Canadian Equities -8.7%	Foreign Equities 14.7%
Foreign Equities 11.9%	U.S. Equities 9.1%	Foreign Equities -10%	U.S. Equities 13.4%
U.S. Equities 7.4%	Foreign Equities 2.1%	Emerging Market Equities -16.4%	Canadian Equities 7.2%

Canadian equities: S&P/TSX Composite Index U.S. equities: S&P 500 Foreign equities: MSCI EAFE Index
Emerging markets: MSCI Emerging Markets Index
Source: Morningstar

Does your child have a summer job?

When your son or daughter gets a summer job or a part-time job during the school year, he or she may be wondering if it's necessary to pay income tax. Thanks to the federal basic personal amount of $11,038 plus any applicable tax credits, your child may not owe a dime.

While working teens don't need to file a tax return if they don't owe tax, there are reasons to file anyway. Here are just some of the benefits to doing so.

Your teen may:

1. Build RRSP contribution room. By filing a tax return and recording income, your daughter or son builds Registered Retirement Savings Plan (RRSP) contribution room that can be used for future contributions and tax deductions.

2. Get a tax refund. Did the employer withhold income tax from your child's paycheques? By filing a tax return, your child can get a refund of the amounts deducted.

3. Qualify for the GST/HST credit. Your child needs to file a tax return to qualify for the GST/HST credit. The quarterly amount is payable if your child is 19 or over; no income is required to qualify.

4. Receive student tax credits. Post-secondary students are eligible to receive tax credits for tuition fees, education amounts and textbooks, provided they file a return. When the student doesn't owe tax or even has no income, the credits can be carried forward until they can be used or transferred to an eligible family member to use that year.

Let your children know they should save their pay records and take advantage of these benefits. And if your son or daughter is 19 or over, or a post-secondary student, remember that no income is needed to file a return and benefit from the GST/HST and student tax credits. ■

Giving while living

Your will probably spells out which assets are going to which children or grandchildren. But is that the best strategy for your situation?

For some families and situations, it's worth exploring beyond the most common estate planning strategies of leaving assets to your heirs through a will. Here are some advantages to giving assets now.

Tax advantages

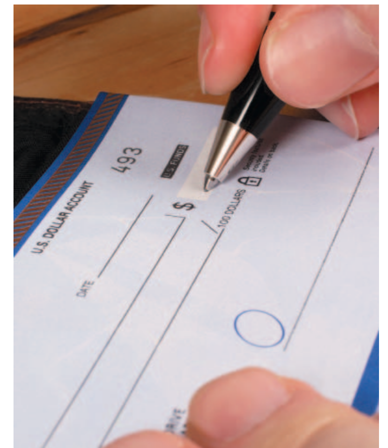
For certain cases, and for certain amounts of money, giving while living may better suit both the giver and the recipient.

- **No tax on cash gifts.** Giving while living can make a lot of sense in many situations, especially since there's no tax on gifts of cash in Canada. No tax to you, no tax to the recipient.
- **Earned income on a gift to a minor child is taxed to you.** If you give an investment to a minor child, any interest or dividends it generates will be taxable to you until the child turns 18. Capital gains however, are taxable to the child.
- **Capital gains on gifts are taxed in your hands.** If you are giving the family cottage to your child, doing it now can be a smart move tax-wise. If you are ready to hand over responsibilities for maintenance and upkeep, you may want to give (or even sell) the property to your children right now. The transfer may trigger capital gains taxes on any gain in the property's value to date, but future capital gains will accrue to the children. Make sure you discuss these strategies with a tax advisor, as they can be complex.

Benefits may go beyond the financial

By giving now, you are able to see your children or grandchildren benefit from your gift — a meaningful advantage over leaving an inheritance. You'll have the satisfaction of watching them meet life goals more easily and enjoy a better quality of life.

You may also eliminate any delays that may be caused through administration of the will, and reduce probate fees and potential executor fees (note that probate fees are not a factor in Quebec and are minimal in Alberta and the three territories).



In some cases, there's reason to distribute funds privately. A will is public, but funds given now can be transferred with discretion.

Unfortunately, heirs are sometimes known to disagree over the way estate assets are distributed. If you plan on giving now, you will be there to help settle any issues and avoid conflicts among siblings.

The concerns

If you give a gift now, you relinquish all control over the gift and you may not approve of the way it's being spent or managed. And you'll be here to watch it all!

What if something completely unforeseen happens — such as the economy suffering a deep recession or you developing a costly illness? You must be absolutely certain that you will not need the funds.

Talk to us as well as your tax advisorwhen you're thinking about estate matters. We can help you determine whether it's best to give an inheritance through your will, give while living, or use a combination of the two. ■

How's your zig-zag factor?

After the market crisis of five years ago, there was talk amongst some pundits that diversification was no longer working and that everything got dragged down together. Not so!

Diversification remains alive and well. With a diversified portfolio of mutual funds, you'll maintain a healthy zig-zag factor — making sure you have some funds zigging while others zag. In other words, when some of your holdings are experiencing temporary downturns, others are holding steady or doing well. Diversification enhances potential returns while reducing overall portfolio risk.

Holding funds that zig while others zag is all about smoothing out the ride from year to year. Here's how it works.

High or low correlation?

Technically, zig-zag is measured by correlation. High correlation is when two funds react similarly to a market force, and low correlation describes two funds reacting differently.

Just a few years ago, we saw a great example involving the classic zig-zag asset classes of stocks and bonds. In the calendar year 2008, equities plummeted around the world, but bonds held their own - with Canadian, U.S., and global bonds all posting positive returns.

The great aspect of mutual fund investing is that it provides instant portfolio diversification. Because mutual funds hold a variety of securities, even investors with small portfolios can reap the benefits of diversification instantly. With mutual fund investing, we can compare one fund against another in terms of its correlation to help design a portfolio with the best upside potential with the lowest level of risk.

Now, we can never predict with 100% certainty that two funds chosen in theory will perfectly live up to their zig-zagging promise in practice. But designing a portfolio with funds that typically do not have high correlation can help smooth out volatility and increase the potential for good returns overall.

There's also a way that's a little less scientific, but still helpful — comparing the past calendar-year returns of two specific funds. Of course, past performance is not an indicator of future performance, but in terms of correlation, this type of comparison gives us an impression of how much one fund zigs when the other zags.

Diversification options

And it goes deeper into the asset classes. In equities, we make sure you're diversified across geographic region, investment style, market capitalization, and sectors. For fixed income, we include funds that hold bonds representing various types, duration, and region.

Investing by geographic region is critical throughout your portfolio. Diversifying globally remains one of the strongest ways to balance out the highs and lows of market performance in a portfolio on a year-to-year basis.

Diversification across the asset classes of equities and fixed income is vital, and we can add cash to that mix — based on your investment goals, time horizon, and risk tolerance. Together we can ensure that the zig-zag factor is alive and well in your portfolio.

If you want to talk about your portfolio and how various funds are helping to smooth out the ride, please give us a call. ■

The evolving role of bond funds

Get ready: Interest rates are about to rise. Sound familiar? Time and again the past while we have heard that rates will soon rise. Though it's true that there may be nowhere to go but up, no one knows when or how fast the movement will be.

If interest rates do rise over the next few years, bond prices will fall and bond yields will rise. What does this mean to your investments? You may have heard in the financial media that rising rates are bad news for the bond market.

The reality is that bond funds remain solid investments. In fact, bond funds remain very capable of providing reasonable returns in a rising rate environment. Now, it does make a difference which bond funds are in your portfolio.

A good place to start is to examine bond funds holding Canadian bonds of varying duration. Next comes geographic diversification. Including global bond funds expands investment opportunities while minimizing overall risk. Funds that invest in corporate bonds are less sensitive to interest rate movement, offer the potential for higher yield, and yet remain relatively safe.

Yes, the bond market reacts to interest rate changes — so does the stock market —but bond funds still play an essential role in your portfolio. As a stabilizing force, they protect against volatility. Bond funds are still expected to help smooth out portfolio returns year over year and provide long-term returns to help you reach your investment objectives. ■

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