Money Ideas

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FUND STRATEGIES

If inflation is returning, are these funds types set to rise too?

As the pandemic situation began to improve with the launch of vaccination programs in many major economies, market watchers and economists began to raise the spectre of inflation. A rapid economic recovery, fueled by unprecedented monetary and fiscal stimulus and economies reopening with consumers flush with unspent earnings all signalled that inflationary pressure, long dormant, might resurface.

A little bit of inflation is to be expected – it means that the economy is growing at a healthy pace. If inflation gets out of hand, however, it can be a drag on companies' profits as the cost of borrowing to invest and expand increases. It can also increase operating expenses such as salaries, rents and equipment purchases. Lower profits can drive share prices down.

If the inflation threat materializes, fund investors may want to take a look at these fund types:

- **Financial services funds.** As inflation picks up, banks and other financial services do well as their core services become more profitable as interest rates rise; they may also benefit from greater demands for products like mortgages as the economy expands. As well as specialty funds, keep in mind that most Canadian equity funds hold a large percentage of financial services firms in their portfolios.
- **Real estate funds.** Property prices and rental income tend to rise when inflation rises. Witness the runaway price of real estate across Canada this year. Specialty real estate funds exist, but also check the fund facts of broad-based equity funds to see how much they invest in the real estate sector.
- **Equity funds.** Look for equity funds that invest in the sectors that do well in an expanding (and inflationary) economy. In addition to financial services and real estate as mentioned above, firms serving consumers' discretionary spending on things like home improvement, appliances or entertainment should be expected to do well.
- **Real Return Bond (RRB) funds.** A Real Return Bond is a bond issued by the Government of Canada and some provincial governments that pay a rate of return that is adjusted for inflation. This type of bond ensures that your rate of return is maintained regardless of the future rate of inflation. RRBs pay interest semi-annually based on an inflation-adjusted principal, and at maturity they repay the principal in inflation-adjusted dollars. These bonds are not plentiful (representing only about 9% of federal debt) and a relatively few funds are available in Canada.

Remember that monitoring economic indicators of all kinds, including inflation, is the job of the professional fund managers overseeing your portfolio. If returning inflation has you anxious about your investments, let's talk.

T-series funds: part of a tax-efficient retirement income strategy

Once you've retired, your financial focus becomes making the most of your retirement savings – and that means paying as little tax as possible. Mutual fund investors have a unique tool available to them: T-series mutual funds.

Part of your plan

Fortunately, there are several things you can do to structure your income flow in a way that maximizes your after-tax income. These include withdrawing your income in the most tax-advantage way possible, splitting income if your personal tax situation allows, and using your Tax-Free Savings Account (TFSA) room to shelter as much investment gains as possible from tax. These ideas should be examined alongside T-series funds for a complete tax-efficiency strategy.

Planful cash flow

T-series funds are designed to provide a predictable and sustainable cash flow, often at a set percentage which helps with cash flow planning. Depending on the fund's earnings (usually interest income, dividends and capital gains) the fund may also distribute a portion of the investor's original investment, known as Return of Capital (ROC). ROC is usually not taxable, resulting in a more tax-efficient payout for you. If you are not currently in T-series funds, it may be possible to transition to the T-series version from the series of the fund you currently hold without triggering a tax liability. One word of caution: when you receive an ROC distribution, you will lower the Adjusted Cost Base (ACB) of your holding, which could have tax implications later. Careful planning and monitoring are required.

Find the right balance

Everyone's situation is unique and there is no "out-of-the-box" solution. While obtaining tax-efficient cash flow is an important goal, so is maintaining the right asset allocation in your mutual fund portfolio for adequate growth and managing risk according to your own risk tolerance. Professional tax and investment advice are needed to achieve the right balance.

FUND TIME

Tips and lessons in mutual fund investing

Fixed-income maturity

What is it? The maturity of a fixed-income security, such as a bond, is simply the date on which the investment ends or "matures." For example, a 10-year bond ends at the 10-year mark, meaning any interest payments end and the amount of the principal is due to the investor.

How does it work? In the world of mutual funds, funds tend to be organized by types of maturity or some strategic combination of maturities. In Canada, a long-term bond or fixed-income fund must hold at least 90% of its holdings with an average maturity of greater than 9 years. Typically, these are bonds issued by the Government of Canada, the provinces or Crown corporations and agencies. Conversely, Canadian short-term bond or fixed-income funds focus on securities with an average duration of less than 3.5 years. In funds with broader mandates such as balanced or tactical asset allocation funds, the maturity dates of holdings may vary according to the fund's mandate or the manager's strategies.

Why does it matter? Different kinds of bonds and bond funds will play different roles in a diversified mutual fund portfolio and come with different risk profiles. Generally speaking, longer-term bond funds have a higher risk profile because the longer a bond is held, the more it could be affected by changes in interest rates, inflation or market declines. Your reward is potentially higher returns than with shorter-term bond funds.

A resilient fund portfolio will help you weather the next big crisis

It's likely that none of us would want to relive 2020 again – whether we're talking about the devastation of the pandemic or the more mundane crisis in the financial markets last spring. But, as experts in both the health and financial fields tell us, inevitably the future will hold more crises. It's only prudent, then, to make sure your mutual fund portfolio is built to handle the bad times as well as the good. So, what does a resilient portfolio look like?

A solid core provides stability. Your portfolio has been carefully constructed to help you stay on track to your long-term goals through calm and turbulent times alike, anchored by your "core" holdings. Fixed-income funds, conservatively managed balanced funds, and similar holdings help provide income and can provide relatively stable returns. Blue-chip or dividend funds, and the like, offer steady growth over the long term with their exposure to established corporations with a history of stable and increasing returns.

Geographic diversification disperses the risk. Remember that Canada's economy represents a tiny portion of the global economic engine (roughly 3%). By investing in global or international mutual funds, you can gain access to the growth potential of emerging markets and sectors (such as technology) not easily found at home. But perhaps more importantly, your international holdings also provide diversification. Exposure to other economies and currencies can help when a crisis hits just one or a few regions, including our own.

Professional management offers discipline. When markets are volatile, investors have a tendency to shy away from equity or growth-oriented mutual funds in favour of cash and cash equivalents – or even to "cash out" altogether. It is one of the investment markets' big ironies that this can actually magnify risk. Sure, savings accounts or Guaranteed Investment Certificates (GICs) might seem like a safe haven during times of market worries, but their low returns may make it more difficult to reach your long-term goals. Professional management, whether provided across a portfolio of multiple funds or in a simple balanced fund, keeps you in the market with a managed minimum of risk. When your diversified portfolio is aligned with your long-term objectives and risk comfort level, you're far less likely to be disturbed by temporary declines.

Professional support prevents impulsive actions. The market correction at the beginning of the pandemic was a good example of how an impulsive sell-off can hurt investors. While some predicted a rapid "V-shaped" recovery, the speed of the recovery in the stock markets meant those who sold had difficulty recouping their "locked-in" losses. A little "hand-holding" in tough markets can really make a difference.

In fact, a landmark Canadian study found that investors who worked with an advisor over a 15-year period accumulated almost four times the wealth of investors who didn't. The reason? The study found that the discipline provided by a financial advisor on investor behaviour was a key factor in improving asset values compared to those of investors without an advisor.[1]

If you'd like to revisit the resilience of your own mutual fund portfolio, let's schedule a portfolio review soon.

[1] Claude Montmarquette, Nathalie Viennot-Briot, *The Gamma Factor and the Value of Financial Advice*, 2016.

Keep performance in perspective, especially after a major market event

If you pay close attention to your mutual funds' performance, the past 12 months may have put up some wonky numbers. That's because the crash of 2020 and the quick recovery could mean wild swings in short-term performance periods like 1-month, 6-month, or 1-year returns. To keep perspective, consider relative performance.

- **Appropriate benchmarks.** To gauge how well a fund did, look at the benchmarks that reflect the fund's holdings. For instance, a broad-based Canadian equity fund might use the S&P/TSX Composite Index as its benchmark. Meanwhile, a small-cap fund, or one focusing on technology stocks, would be better served by a different benchmark.
- **Peer performance.** Consider how a fund performed versus funds of a similar nature. A common measure of this kind of performance is quartile ranking. Look for a fund that is consistently finishes in the first or second quartile of its peer group or similar-type funds.
- **Long-term numbers.** Returns for a 5- or 10-year timeframe are a better indicator of quality than the performance of just one or two years.

Ultimately the best marker of mutual fund performance is whether an individual fund is meeting the goals that your portfolio requires of it. A portfolio review is the best way to understand how each fund, and your overall portfolio, is performing for you. ◄

Are fund investors learning not to panic?

When the stock market experiences a crash, as it did in the spring of 2020, the script is predictable: investors sell their stocks and take refuge in "safer" fixed-income and cash-equivalent securities. A U.S. research company, DALBAR, has been documenting this behaviour and the price mutual fund investors pay for forgetting the buy-and-hold philosophy of mutual fund investing.

However, during last year's crash, fund investors went off script. Their 2020 study found investors "fleeing fixed income but holding steady with the equity levels."[1]

The study reports that only 11% of investors cashed out investments in response to the market crash. Further, it found that many who sold off equities shifted their money into a different equity investment – seemingly searching out better investments for the market environment rather than fleeing the markets altogether.

Any shift in behaviour would be welcome as investors have paid a significant price for their lack of patience. As the 2018 DALBAR study noted, the average balanced-fund investor experienced an annual rate of return 4.2% lower than investors who stayed the course in a balanced portfolio. Based on an initial investment of $100,000 on January 1, 1998 excluding fees, this would have added up to a difference of over $206,059 at the end of 2017.[2] ◄

[1] DALBAR Inc., *Quantitative Analysis of Investor Behaviour (QAIB), 27th edition*, April 2021. www.dalbar.com

[2] DALBAR Inc., *Quantitative Analysis of Investor Behaviour (QAIB)*, 2018. www.dalbar.com

The right funds for down payment savings, real estate profits

Canada's hyper hot housing market means lots of Canadians are parking savings on both sides of a housing transaction: many younger people are saving for a down payment and some sellers need to bank their profits while they downsize, move to another town or rent as part of a retirement lifestyle shift.

Investors like these need to act prudently. In rising markets, it's tempting to try to make quick profits with riskier funds and increase your savings, but liquidity and security are the watchwords if your time horizon is a matter of a few months or years. Options to consider include:

- **Money market and other cash-equivalent funds.** These offer liquidity and safety and are ideal for very short-term parking of cash.
- **Short-term income funds.** These carry less risk than other fixed-income funds and offer better potential returns than the cash equivalents.
- **Conservative balanced funds.** These with a majority of assets invested in fixed-income securities may work if you are saving with a time frame of three years or more.

Don't hesitate to call us when you have short-term savings or investment needs. We're here to help with all your goals – not just retirement. ◄

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