# HIGH NET WORTH JOURNAL

*An Investment Update*

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McIVER WEALTH MANAGEMENT
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## What's News

By Neil McIver

The investment topography we stand on is shifting in some very profound ways, yet few investors have seemed to notice; fewer still have begun to tweak their strategy in order to protect their capital and take advantage of these changes. However, the spoils always go to those who have the foresight to see change coming, and are proactive enough to make the adjustments required.

Just over 30 years ago, in 1981, the great Bond Bull Market began. With interest rates peaking as central bankers tried to stamp out the last of the 1970's inflation, it was possible to buy a 10-year Government of Canada bond at an interest rate of 16%. The fundamental concept to understand here is that bond prices have a direct inverse mathematical relationship with interest rates. As interest rates fell over the next 30 years, the capital value of these bonds rose. For example, if an investor had bought a 10-year GOC bond in 1981, by 1985, when interest rates had dropped to 10%, that bond would have provided a capital gain of 60%, *in addition to* the 64% interest collected over those four years. Clearly, it was a case of having your cake and eating it too, with this investor experiencing a 120+% overall rate of return on the bond, translating to approximately 30% a year.

For the past 30 years, as interest rates have continued to fall steadily, bonds have steadily provided capital gains in addition to their annual coupon rate. However, it took a few years for investors to wrap their heads around the idea that bonds were a good investment because in previous years the stock market had provided even higher returns. In fact, when I began my career over 20 years ago, I used to give seminars urging investors to buy only guaranteed 20-year and 30-year government bonds in their RSP's. If it was possible to lock in a minimum 10% rate of return for an extended period of time, with 100% liquidity and zero risk, it was a slam-dunk as far I was concerned. In today's economic environment, who wouldn't choose to do this if it were possible? However, back then I ran into investor resistance (as I am now) because individuals have a great tendency to place an incorrect and disproportionate amount of weight on their most recent investment experience, which in their case produced a large bias towards stocks.

Fast forward to July of last year when the U.S. 10-year Treasury bond yield hit 1.39%, marking a new all-time low. More importantly though is that since then, it has risen to over 2.50%, and technical research (charting) suggests that the rate will continue to rise. Further factor in that U.S Federal Reserve Chairman Ben Bernanke recently stated that he can foresee The Fed 'tapering', and eventually ending, its policy of creating mass liquidity and cheap money, which had been artificially driving rates lower. Lastly, just for fun, overlay all this with the fact that Bill Gross, manager of the world's largest bond fund, is now negative in his outlook for bond prices. It paints a pretty compelling picture, doesn't it?

This is not the first time I've said it, but I will say it again so it is clear; after 30 years, the great Bond Bull Market is over.

While almost all the indicators suggest that the fixed-income market landscape has changed dramatically, individual investors are not getting the memo, and are still piling dollars into bonds through balanced funds. In May of 2013 alone, Canadian investors bought $11.7 billion of balanced funds, and sold (redeemed) $4.1 billion worth of equity funds. These investors are blindly following their bias towards investing in areas that have been successful in the past. 'falling-interest-rate' environment, without any knowledge of the current changing topography and the near mathematical certainty that those past returns on bonds can't be achieved in the foreseeable future. Despite the recent sell-off in equities, ironically caused by the Federal Reserve Chairman's comments on potentially ending its experiment with Quantitative Easing (printing cheap money), equities without question offer a far greater potential return than bonds do over the medium and long term.

That being said, it is important to note that there are select bonds that make sense to own given the current environment, and we currently hold these in your carefully selected Asset-Allocated portfolios. However, we further reduced your overall exposure to bonds in the spring rebalancing, and we strongly believe that this puts us in an enviable position moving forward.

## On the Mark

By Mark Jasayko

### The Dash for Trash

In May I was in Singapore for the 2013 CFA Annual Conference. It was a great opportunity to learn about current global investment and economic issues. Because the Conference was held in the Asia-Pacific region, many of the presentations focused on the opportunities and pitfalls of investing there with an emphasis on China and Japan.

However, another recurring theme during the Conference was a focus on the impact of rampant monetary easing and outright money-printing in the developed world, a general policy that is now a half-decade in age and designed to stimulate the global economy back to 'normal' pre-2008 growth.

In the weeks leading up to the Conference, I was constantly reading about how the yields on high-yield (or junk) bonds were at all-time lows and how the spreads above government bond yields were historically narrow. A few clever columnists recently coined phrases such as "The Dash for Trash" and "The Investments Formerly Known as High-Yield." [1]

As an example of this phenomenon, one of the speakers during the Conference stated that in April his firm had eagerly participated in a new issue of 10-year Rwandan bonds priced to yield 6.90%. Amazingly, the issue was oversubscribed by 7 ½ times!

Rwanda?!? Wasn't Rwanda best known in the 1990's for the genocidal insanity which claimed more than half a million lives, mostly involving the governing Hutus butchering Tutsis? And, now they are able to get unhindered financing at 6.90%?!? That's right.

What was also a little surprising was the lack of response from the audience. It was as though the Rwandan bond issuance was just a matter of fact and unsurprising in the Brave New World of Ben Bernanke.

In the better managed African countries, inflation is currently running at about 6%. But that shouldn't mask some of the recent experience. Zimbabwe, for example, has suffered from hyper-inflation that was reminiscent of the Weimer Republic in the 1920's. And, further to the south is South Africa, a fantastic holiday destination where I have enjoyed things for 40% of what they would have cost in North America thanks to a devalued South African rand. It is hard to imagine that Rwanda is going to be an island of monetary discipline in a sea of monetary policy mismanagement.

Rwanda's potential monetary prudence is also hampered by the fact that it is primarily an agrarian economy where foreign aid accounts for 38% of all government spending, which adds up to 10% of the GDP.

Over the last decade, inflation in Rwanda has been averaging about 10% with a peak of 22% in late 2008, and then flirting with deflation when prices went flat about two years ago. In April, the most current statistic available, inflation was at 4.37%. So the *real* return on the Rwandan bonds is sitting at a little over 2%. However, an investor would need to have faith that inflation in Rwanda does not rise back up to the historical average for the last 10 years. There isn't universal faith that developed nations will be able to keep a lid on inflation for the next 10 years. But, there *is* a group of investors who are apparently confident that Rwanda will be able to do so.

While Rwanda is an eye-popping example (to me anyways), we are now seeing this phenomenon generally played out elsewhere around the world too. In the Zero-Interest Rate era of the U.S. Federal Reserve, investors are rushing to buy securities at yields that would not have been considered a couple of years ago. At the same time the Rwandan 10-year bonds were being issued, investors were also stampeding to buy 10-year Apple Inc. bonds yielding as low as 2.50% and 30-year Apple bonds yielding 3.75%. The fact that Apple is considered a "quality" company to most, I suppose it is no wonder that trashy investments like the Rwandan 10-year are getting snapped up at 6.90%. What are much more common are riskier companies that are able to get investors' attention simply by raising their dividend yield. However, if the yield is increased by virtue of paying out cash that would normally be needed to reinvest back into the business, then there will be plenty of days of reckoning in the future, and crowds of investors wondering what happened to that attractive yield.

These phenomena should continue for a while, as the U.S. Federal Reserve no longer talks about undoing and reversing the Quantitative Easing-induced money-printing (or QE) as originally promised; so far it has only alluded to "tapering" the pace of it. The Rwandan Minister of Finance must be thrilled to know that.

Until the Fed ceases (never mind reversing) QE, it will mostly be the status quo in our clients' Asset Allocated Portfolios; a relatively high weighting in U.S. stocks and relatively short bond maturities.

[1] The inspiration for this phrase was as follows: In the 1990's, the singer Prince, while in a legal dispute with his record label, changed his name to "The Artist Formerly Known as Prince."

## Good Karma

By Karim Bhatti

### TFSAs

A Tax-Free Savings Account (TFSA) is a fantastic way to grow money tax-free throughout your lifetime. Any individual who is a resident of Canada and at least 18 years of age is eligible to establish a TFSA by simply providing a Social Insurance Number. Contributions are not tax-deductible. However, the advantage is that withdrawals are not taxable.

The additional annual contribution room for 2013 is $5,500. The cumulative contribution room for someone who was at least 18 years old during 2009 is currently up to $25,500. Any unused contribution room may be carried forward indefinitely. Any amounts withdrawn from your TFSA will be added back to your contribution room.

It is *very important* to note that it is each client's personal responsibility to record and keep track of their TFSA contributions and withdrawals. Any individual is permitted to have TFSAs at multiple financial institutions and this information *is not shared* between the institutions. As a result, any single institution, including Richardson GMP, cannot be fully aware of the TFSA status of any one client. The penalties for an over-contribution are significant and it can easily happen when making contributions at more than one institution.

If you would like to make your contribution for this year, please call me directly at 604-678-6563.

## Preserve and Protect

By Mike Geroge

### U.S. Tax and Estate Tax Update

Finally, after many months of "fiscal cliff" political maneuvering and negotiations, Congress reached an agreement to address the tax rate increases that were scheduled to take effect automatically on January 1, 2013.

**Top individual tax rate(s):** The top federal income tax rate increases from 35% to 39.6%for individuals making more than $400,000 per year ($450,000 for joint filers; $425,000 for heads of household). However, due to the application of the new 3.8% Medicare tax on "net investment income," discussed below, some taxpayers will actually pay a top tax rate of 43.4%!

**Capital gains tax and dividends tax:** The top rate for capital gains and qualified dividends will permanently rise to 20% (up from 15%) for taxpayers with incomes exceeding $400,000 ($450,000 for joint filers). For taxpayers whose ordinary income is generally taxed at a rate below 25%, capital gains and dividends will permanently be subject to a 0% rate. Taxpayers who are subject to a 25%-or-greater rate on ordinary income, but whose income levels fall below the $400,000/$450,000 thresholds, will continue to be subject to a 15% rate on capital gains and dividends.

**3.8% Medicare contribution tax:** This new tax affects individuals whose modified adjusted gross income (AGI) exceeds $250,000 for joint filers, $200,000 for single taxpayers and heads of household, and $125,000 for married individuals filing separately (not indexed for inflation). It also applies to certain trusts and estates and at a much lower threshold. The 3.8% tax applies to the lesser of the taxpayer's (1) net investment income for the tax year or (2) the excess of modified AGI for the tax year over the threshold amount. *This tax is in addition to the income tax that applies to that same income, resulting in a top federal tax rate of 43.4% on certain types of income.* The net investment income that is subject to the 3.8% tax consists of interest, dividends, annuities, royalties, rents, and net gains from property sales. Income from an active trade or business isn't included in net investment income, nor is wage income, but passive business income is included.

**Additional 0.9% Medicare tax on wage and self-employment income:** Some high wage earners will pay an extra 0.9% Medicare tax on a portion of their wage income, in addition to the 1.45% Medicare tax that all wage earners pay.

(The 0.9% tax applies to wages in excess of $250,000 for joint filers; $125,000 for married individuals filing separately; and $200,000 for all others). The 0.9% tax applies only to employees, and not to employers. An extra 0.9% Medicare tax also applies to self-employment income for the tax year in excess of $250,000 for joint filers, $125,000 for married individuals filing separately and $200,000 for all others.

**US estate, gift and generation skipping transfer tax:** The estate, gift and generation-skipping transfer (GST) tax exemption is now made permanent and unified at $5,250,000 (indexed for inflation), and the top estate, gift, and GST tax rate is also permanently increased from previous 35% to 40%. The portability feature that allows the estate of the first spouse to die to transfer his or her unused exclusion to the surviving spouse has been continued and made permanent as well.

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