

# ADVISOR'S EDGE REPORT

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BY MELISSA SHIN

## Retirement no-brainer

Back-to-back annuities great for healthy retirees

**NEWS** Set it up and leave it alone. That's the dream of every investor: a low-risk, high-yield investment that provides a guaranteed payment. Thanks to prescribed taxation, the power of arbitrage, and low interest rates, there is such an investment: the back-to-back annuity.

"In a world that's gone mad with volatility, isn't it nice to be able to offer an exact" continued on page 2

BY DEAN DISPALATRO

## OH CANADA!

Opportunity and risk in the Great White North

**NEWS** Pat McHugh, Canadian Equity Strategist at Manulife Asset Management, is positive on the outlook for the Canadian marketplace. "From a big picture perspective," he says, "the Canadian market has advantages we don't think any other market really has."

McHugh's assessment is based on three key factors. "Number one is that we're the U.S.'s largest trading partner, and the U.S. is now just starting to recover. Our chief economist, Bill Cheney, believes that when we get through 2011 and look back, we'll see the U.S. in fact came out a little bit better than what we'd expected.

"Expectations are pretty low. That doesn't mean the U.S. economy is going to leave skid marks, but we think there will be a number of positive surprises as we go through 2011," McHugh adds.

His second point: over half our



DISPALATRO

index is pinned to commodities, which means we have a direct leverage to the emerging markets' growth prospects.

The last point is risk. "When you look at the Canadian landscape — our balance sheets, the government, or our banking system — the risks versus other areas an investor can go are fairly low."

McHugh adds the mood surrounding our currency is positive, which is critical for investors. "If you have investments in a market, and that currency has taken a hit, there's a risk to the value of your investments in that market from a global perspective."

So this, McHugh says, is "how things look from 30,000 feet." In his assessment, however, the landscape looks no less promising from

The **Canadian marketplace** offers a range of opportunities for impressive returns, but there's little consensus on where those opportunities lie.

ground level.

As 2011 unfolds, he expects Canada, absent an exogenous shock, to be among the strongest performing stock markets of the G8 countries. "We are expecting the market from this point going forward to advance 10%, plus a dividend yield. So what we're calling for is another double-digit return. Call it mid-teens." This would put us in double digits for a third straight year.

"This always throws people off. But when I look at the numbers, it just seems like the most likely scenario. An advisor reading this may be saying, 'We've had two great years of double-digit returns, and McHugh thinks we're in for a third — no way.' But if it looks like there's further room to grow,

that means maintaining or increasing your exposure to equities, if it's prudent.

"When you look at the valuation of the 10 sub-sectors in the index on a price-to-book basis, they're trading below their long-term average. So there's more room, and one could argue there's more appreciation potential in all 10 sectors, especially given the fact that one could argue it's still early in this economic cycle, given the circumstances of the U.S."

That said, there are sectors clients don't need to look at right now, specifically the defensive sectors like healthcare, telecommunications, and consumer staples.

"At this stage, we should look at the economically sensitive sectors: energy, mate-

continued on page 3

BY DEAN DISPALATRO

## Big questions

New directions for distribution

**NEWS** How is Distribution evolving, and what are the forces at play in this evolution? Will managing general agents (MGAs) get

their own self-regulatory organization? Does the Mutual Fund Dealers Association (MFDA), and the distribution model it oversees,

have a future? Is there a place for smaller players in the emerging landscape, or does the writing on the wall say only big guns need apply? What does the evolution of the distribution space mean for advisors, and the clients whom they serve?

These are the questions we posed to a group of industry leaders for a Big" continued on page 16

### WE SPOKE TO:

> **Terri DiFlorio,**  
PRESIDENT,  
HUB FINANCIAL INC.

> **Chris S. Reynolds,**  
PRESIDENT AND CEO,  
INVESTMENT PLANNING  
COUNSEL INC.

> **David Velanoff,**  
PRESIDENT AND CEO, MGI  
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## A NATIONAL REGULATOR FOR CANADA?

WE POSED THIS QUESTION TO **MARG FRANKLIN**, Chair of the CFA Board of Governors, and **FRANÇOISE BERTRAND**, President and CEO of the Fédération des chambres de commerce du Québec.

See what they had to say at <http://pov.advisor.ca>.

## NEWS

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## OH CANADA!

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materials, consumer discretionary. That's things like Magna International (TSX:MG), Canadian

Tire (CTC.A), and cable stocks, industrials, railways, SNC-Lavalin (SNC), Russel Metals (RUS), the high-technology sector and financial services. These are areas we think will do well from this cycle forward. But each one really depends on a whole pile of factors."

For example, McHugh likes energy more than materials because materials have had a really good run, while energy hasn't. He also likes insurance companies more than banks. "Banks have had a good run, and the insurance companies have leverage to higher interest rates; as bond yields increase, it will benefit insurance companies. "But we think there's money to be made in all these sectors," McHugh adds.

When choosing which sectors to home in on, investors need to stay attentive to the factors that drive markets up. One of these factors is the flow of foreign investment capital. "We know foreigners are putting money into Canada. Are they buying healthcare and Bell? Or Canadian Natural Resources (CNQ), Imperial Oil (IMO), and Teck Resources (TCK.B)?" The latter, McHugh explains, are "the ones they're going for."

Another factor to be mindful of is earnings expectations, where the defensive sectors are lagging. "So just because you're trading below the long-term multiple doesn't mean you're going to make your clients a ton of money," McHugh explains. "But there's room for capital appreciation across all sectors — some more than others."

McHugh emphasizes his strong preference for equities should

not be taken to mean there's no room for bonds in a sound portfolio. "Bonds definitely belong in a diversified portfolio — they are the cornerstone. But an advisor who is increasing his clients' allocations to bonds must know that above inflation, they're getting a very small return based on historic standards. That's another reason why we like Canadian equities."

## Advising risk-averse clients

For clients with lower risk-tolerance thresholds, McHugh suggests financial services. "In our recent lifetime, none of the banks have decreased or eliminated their dividends. We've seen Laurentian Bank (LB) [and] Canadian Western Bank (CWB) increase their dividends. National Bank (NA) increased its dividend last year, and more banks are expected to [do the same]," he says.

"For a client who's risk-averse, the 3.5% yield you're getting on financial services is as good as a 10-year [Canadian bond], plus you're getting a dividend tax credit. So to me that's a great opportunity. And it's a sector clients understand. We have confidence in our financial services industry," he adds.

McHugh suggests other areas for risk-averse investors: "Gas stations and merchandisers, railway stocks, telecom stocks, utilities and pipelines. There are lots of stable companies with long-term growth potential, great balance sheets, good dividends and dividend improvement going forward."

## Planning for long-term gains

"There's more than one way to skin a cat," says Garey Aitken,

chief investment officer, Bissett Investment Management and co-lead manager of the Bissett Canadian Equity Fund.

"We have a distinct investment style in terms of the types of companies we're looking for, and we've got strong views on the importance of valuation. And all of that we do in pursuit of superior long-term risk-adjusted returns."

Aitken explains that whether he's overweight or underweight on a given sector is "really just a function of where we find the best individual ideas at any point in time. That tends to be fairly static. We've got a low-turnover approach. Historically, there are sectors where we're pretty consistently over- or underweight."

The pillars of Aitken's approach are the secular growth companies, the companies that "will stand the test of time. They have a business model that gives them a competitive advantage, and we think they're there for the long term. We're long-term investors in the way we analyze companies and value companies," Aitken adds.

Populating a fund with these kinds of companies will mean a slightly lower return-volatility profile than that of the index. "Over long periods of time, our volatility typically runs about 10% to 15% lower than the index. The beta of the strategy is about 0.8 to 0.9," Aitken explains.

## The horses

Aitken's biggest overweight is financials, but he's underweight on commercial banks. "We do like the banks and have exposure to five of them; they're such index

heavyweights that they make up a big part of our portfolio. But we're not in the game of starting with the index weight of a security and then going from there.

"All that overweighting is a function of what we're doing with what I loosely refer to as the non-bank financials group. So that would be the lifecos, investment managers, and some of the niche plays in that sector," he says.

Aitken says the Power Group of Companies — Power Corporation (POW), Power Financial (PFW), Investors Group Financial (IGM) — TMX Group (X), Home Capital Group (HCG), and Brookfield Asset Management (BAM.A) are in his non-bank financials lineup.

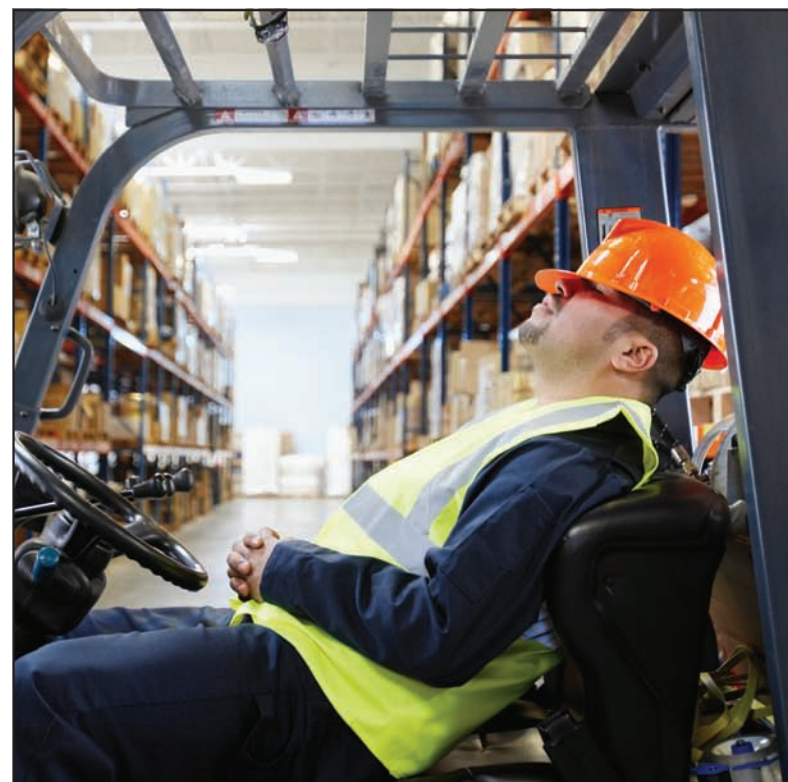
"Those are the types of long-standing names consistent with our approach. We like the underlying businesses, and we're comfortable with the valuations," he adds.

Aitken says he's also overweight on consumer discretionary and energy. "On the surface," he says, "we are pretty close to the energy sector weight in the S&P/TSX Composite Index, 26%-to-27%. So at first blush it looks like we're not making much of a stance there.

"But when we look at it in more detail we've got more exposure to mid-cap oil and gas producers and energy service providers. So the composition of our energy weight is quite a bit different than the benchmark. We like the growth potential of some of the more mid-cap oil and gas producers, and we put a lot of emphasis on track record and management quality."

Aitken singles out Peyto Exploration and Development (PEY),

continued on page 4



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## NEWS

## OH CANADA!

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Celtic Exploration (CLT), and NuVista Energy (NVA) as top-calibre mid-cap oil and gas producers. Aitken also has significantly more exposure to the energy services sector than its representation on the index through five companies that again fall into the mid-cap range. These five horses, Aitken says, are Calfrac Well Services (CFW), Trican Well Service (TCW), Flint Energy Services (FES), Savanna Energy Services (SVY), and Mullen Group (MTL).

While materials represent about 23% of the composite index, Aitken is running only about 7%, consistent with his fund's historically light positions in this sector. "When we look at that in more detail, that underweighting comes from the fact that we have no exposure to the golds, and golds would represent about 12-13% of the index. We don't have a bias against gold companies, but they tend not to fit as well with our approach as other businesses in the Canadian marketplace," he says.

## Bullish environment

"I'm bullish on the Canadian stock market," says Darren Lekkerkerker, manager of the Canadian equity sub-portfolio of the Fidelity Canadian Balanced Fund and co-manager of the Fidelity Global Natural Resources Fund.

Lekkerkerker gives five reasons for his assessment. The first? "Strong profitability growth is going to continue as the economic recovery continues, and profit margins will remain high for companies," he says.

Second, Lekkerkerker sees the U.S. economy improving. "It's definitely not a strong economic recovery, but it's picking up steam. It's kind of in the sweet spot, because if it were too strong you would worry the U.S. Federal Reserve would pull back some of the quantitative easing and start raising rates faster, which would not be as good an environment for stocks to go up."

This is good news on our side of the border because "to the

extent they do a little better, it's definitely going to help our economy, it's going to help our companies. Ontario has a lot of auto parts manufacturing companies, and if the U.S. economy does better, auto purchases will pick up," Lekkerkerker explains, adding that while the U.S. market is "less important than it was 10 or 20 years ago, it's still important."

Third, Lekkerkerker is bullish on resources. "Roughly 50% of the S&P/TSX Composite Index is either energy, materials, mining, gold or fertilizers. So it's a big part, and I think they're going to continue to do well," he says.

Lekkerkerker's fourth point: "CEOs have regained their confidence from the crisis and have the debt capacity available — they can borrow in the bond market for pretty attractive rates of return, and that's going to continue."

Finally, Lekkerkerker points to valuations around 14-15 times forward earnings for the S&P/TSX Composite Index. "We think it's low in the context of historical averages," he says.

## Parts, potash and TD

Lekkerkerker identifies Magna as one of the larger and more successful positions he holds. "It's a position we started buying in the third quarter of 2009, and it's more than doubled since then. So it's been a big success for the fund," he explains.

Looking ahead, Magna remains a good call, according to Lekkerkerker. "It has leverage to recovery in auto demand in the U.S. There's still a good amount of recovery there."

Magna has also reduced costs, especially in its European division, which has been less profitable than the North American division.

Lekkerkerker also points to the fact that the company now has only one CEO, having cut the position from the European side of the business. "The company has improved its corporate governance, and as they improve it further, I think investors will reward them with a higher multiple."

On the energy side, Lekkerkerker likes Suncor (SU), which also holds a top position in his fund. "It has very high leverage to oil prices, and one thing a lot of people don't realize about Suncor is that 30% of their oil, because it's in places like the North Sea, eastern Canada, and Syria, has leverage to Brent pricing.

"So they're actually getting higher net realized pricing than most Canadian companies, which have leverage to WTI. And also because they're in the oil sands,

which is a little higher in price, so it has higher leverage to oil," he explains. Lekkerkerker further notes the strong profitability of Suncor's refining business, which benefits from the spread from WTI to Brent.

Finally, Lekkerkerker points to the fires in December 2009 and February 2010 that disrupted the company's Alberta operations. "The stock sold off, didn't do well, and as a result, we think it's cheap relative to other oil stocks. We recently met with the CEO, and think they've got a renewed focus on execution. The company's operations should run smoother."

Lekkerkerker also likes PotashCorp. (POT). When Ottawa denied the merger, he purchased more shares the very next morning, adding to his position because he saw the fundamentals getting better in their core fertilizer business. The stock has climbed more than \$40 per share since. As people in emerging economies become wealthier and begin to enter the middle class, their diets will become more protein-rich, requiring more feedstock grain, he says.

"But there's a fixed amount of arable land in the world, so farmers have a huge incentive to maximize their productivity per acre, which means they're going to apply more fertilizer. So we think fertilizer prices, on nitrogen and phosphate, will remain high."

Lekkerkerker suggests potash prices will likely rise in both the North American and international markets, and notes PotashCorp. is "increasing its volume capacity through brownfield expansions, which are much cheaper than building a new mine."

But the biggest position in Lekkerkerker's fund is TD. "If you look back 50 years," he says, "it's been a long-term winner among Canadian banks. We think [that] will continue. They've got a big U.S. division in the northeast and a bit of Florida. And U.S. bank earnings are going to grow faster than Canadian bank earnings, as they're still recovering. The key driver will be lower credit losses there; that benefits TD," Lekkerkerker explains. He also expects TD will raise their dividend in the short term, and adds he's positive about the Chrysler Financial deal announced shortly before Christmas.

On the negative side, Lek-

kerkerker doesn't like natural gas or natural-gas-leveraged equities. He also notes that while gold was a big part of his fund last year, he's since reduced his exposure. "Long-term, I like gold, but I think in the short term it could be range-bound or sideways in 2011."

## The positives

Mark Jasayko, portfolio manager with the McIver Wealth Management Consulting Group at Richardson GMP Limited, notes he's trimmed back his Canadian exposure in favour of the U.S. market. "But we're still a significant Canadian investor," he says.

Jasayko is overweight in energy, with some of the names in his Canadian pool including Encana (ECA), ARC Resources (ARX), Suncor, and Canadian Oil Sands (COS). "Suncor has oil sands exposure, but Canadian Oil Sands is our pure play," he explains.

Jasayko stresses that he's "reticent to sell out on the negative news with respect to environmental concerns. We think that's a red herring, and obscures the incredible potential going forward."

Another overweight sector in Jasayko's lineup is materials, including gold producers such as Barrick (ABX) and Goldcorp (G). "One of our rationales for holding on to this position," he explains, "is bullion is still in relatively limited supply. This is really the main factor driving price." Jasayko's view is some analysts are erroneously stuck on the question of gold as a hedge against inflation. But "that's not what the argument should be."

The key question at this point is whether price "reflects current supply, and near-term future production," Jasayko says. In his assessment, it falls short, "so the producers are good because bullion has some strength ahead of it."

Finally, Jasayko has recently added a position in Agrium (AGU) to his agricultural exposure. Food security, he explains, is "something we've been following for about three years now. This doesn't resonate with Canadians because we produce so much. We can export it and our social and political

institutions are flexible. Yet in the emerging world, where political institutions may be more rigid, this is a heightened concern.

"What we've seen recently in Egypt and Tunisia, but also going back to Tiananmen Square, started with rumblings over the cost of food becoming too much of a burden with respect to the household budget. And then it spilled over into other grievances that other people took advantage of, turning it into political protest."

The main consideration here, Jasayko says, is the price emerging countries are willing to pay for increased crop yields. "It's anything they can afford to secure ahead of other emerging countries that may also be worried about food security," he explains. "This is a price we think is beyond the assumptions for potash and other crop nutrients in the case of valuing companies like Agrium."

## Holding the line

One area where Jasayko is maintaining market weight is information technology. "We have a fairly significant position in RIM; it's trading at a multiple of a little over 11 and we don't think it's ready to be a value stock yet.

"There are opportunities for growth, and RIM's execution has been pretty respectable given the competition it's faced with. As that general pie grows, they're going to see some growth in top-line revenues. We still think they've got some unique strongholds with respect to email server security. If they're smart with it, as far as leveraging, we think there's further growth there," Jasayko explains.

He also takes issue with the view that RIM will become the next Palm. "We don't think that's the case at all, so we're happy holding our position," Jasayko says. He's also holding market weight on consumer staples. "We're not doing much there; we think the valuation is fair so we're just going to stay with the market weight."

Jasayko counsels caution on financials, a position quite at odds with those taken by McHugh, Aitken and Lekkerkerker. "We are continuing to trim

**"We are expecting the market from this point going forward to advance 10%, plus a dividend yield. So what we're calling for is another double-digit return. Call it mid-teens," says McHugh. This would put Canada in double digits for a third straight year.**

**"I'm bullish on the Canadian stock market." — Darren Lekkerkerker.**

## NEWS

run it. If something goes wrong, you automatically have to put up capital to offset the risk, and unless you have a strategic reason for existing, like the manufacturing arm, you start to scratch your head and ask yourself what you're doing this for.

products, whether it's mutual funds, insurance, or whatever. But in this particular case we're talking about mutual funds. The company that's put between the manufacturer and the advisor is the dealer. And over time, more and more responsibility has been



TERRI DIFLORIO

**[Dealers] seem a lot more willing to push back at the MFDA. And the MFDA seems more willing to listen.**

##### 5. What changes would help you serve both advisors and the investing public better?

**Terri DiFlorio:** If I could wave my magic wand I'd love to have the ability to overlay more common sense and logic in the rules-based environment.

It's sometimes very difficult to operate in both [the insurance and mutual fund] environments because they are so very different — from a regulator perspective, but also from a processing perspective. In terms of technology, the mutual fund world is absolutely light-years ahead of the insurance world.

It makes it so much easier for us to recognize economies of scale and to make sure we're using technology to the best of our abilities. That obviously translates into better service for the advisors, which means better service for the investing public. So the changes I would make are probably already underway in the two areas of financial service, and coming together to a happier medium for both.

**Chris Reynolds:** The most important person in this value equation is the advisor. The advisor is the face to the public, the one who holds their hands. They're the ones who provide the entire realm of what I describe as the value of advice. The conduit, or how they get paid, is through the selling of various

downloaded onto the dealer for the behaviour of the advisors, when the value creation is at the manufacturing level. There has to be much better co-operation between the manufacturing and the distribution levels.

**David Velanoff:** Education will be a catalyst for change. We need to move to a university model, similar to lawyers, accountants and doctors. Providing financial planning and investment advice is a profession and it has to be sanctioned by a higher educational platform.

This would mean most people would be hired on salary, at good wages with bonuses and share-purchase plans. The big, well-capitalized players in the industry will hire them.

This is pretty radical, but I think the banks can certainly make it happen, and the other big players will eventually fall into line because it makes a lot of sense from a margin and valuation perspective, and also from the point of view of doing the right thing for the client. The client is going to get better financial and investment advice because there will be no conflict of interest in terms of an advisor needing to be compensated by commission. **AER**

DEAN DISPALATRO is Advisor Group Senior Editor.

## AT A GLANCE

BY ADVISOR STAFF

### TURMOIL BOOSTS CANADIAN-FOCUSED FUNDS

The political upheaval in North Africa and the Middle East has stifled returns in foreign equity fund categories, while Canadian investments have benefited from **surging resource prices**, according to Morningstar Canada. When international tensions mount, there's usually **an upside for gold**. February followed the historical pattern — bullion topped \$1,400 per ounce.

SEARCH: Canadian-focused

### INTERNET HELPS WITH DECISIONS

A survey conducted for Investors Group found 42% of Canadians who save and invest are using **social and online media** to guide their investment decisions. The preferred sources for financial information are the **websites of financial services firms, traditional media and investment firms (40%)**. But 6% said they use information gleaned from **blogs, Facebook and Twitter**.

SEARCH: blogs

### SETTLEMENTS FUND FINANCIAL LITERACY

The OSC has allocated nearly **\$2 million in settlement money** from enforcement proceedings to fund financial literacy education in Ontario schools beginning September 2011. "The OSC supports educational efforts to help Ontarians develop the skills and knowledge needed to succeed in an increasingly complex financial world," said Howard Wetston, chair of the OSC.

SEARCH: financial literacy

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### RETIREMENT NO-BRAINER

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typically not indexed for inflation, another reason she recommends a less-than-30% allocation. "You can buy an annuity that increases with inflation, but the yield at the beginning isn't as great, and then you're getting an average yield over time," she says.

Moreover, the favourable tax treatment of prescribed annuities may not last. "The issue on annuities is the amount of taxable income on a prescribed annuity is based on old mortality tables that assume people are going to die by an average of age 80, when in reality people are living longer than that," Crozier points out. "What that means is less of the income is taxed than what should be coming out of the annuity." Crozier says the risk of Finance changing the rules with detrimental impact for in-force cases is also low, and there are currently no motions before Parliament related to the tax treatment of annuities.

#### Continued demand

Despite the overwhelming benefits, some advisors are still wary of annuities. "I bet if you talked to 100 advisors, 90 would say, 'Ugh, horrible time to be buying annuities,' because that's what they've always heard," says Cumming.

And then there are the compensation implications: if a client locks up money in a back-to-back annuity, that money isn't in play for investing. Commissions, while ongoing for mutual funds, offer a one-time payout for annuities.

Cumming says annuities will continue to grow in popularity for two reasons: lower-than-expected saving rates among clients, and advisors' inability to deliver consistent, 8% returns. "The equity markets over the last 10 years have not allowed us to make any money," he says.

Moir's team has told its advisors that offering back-to-backs is in the best interests of clients. "What is better, getting 7%-to-8%, or 3%? A lot of our advisors realize this is a good fixed-income alternative," she says. "And ultimately, if they're not presenting it, someone else may. I've had clients call me up and thank me. I've had clients come back and buy more because they see how well it works.

"This is more of a holistic plan versus just a transactional business that a lot of [advisors] were used to 10, 15 years ago." **AER**

MELISSA SHIN is Advisor Group Managing Editor.

### OH CANADA!

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back the financials, mainly because over the last two years the environment has offered a lot of tailwinds. The environment's been favourable, but these are not sustainable tailwinds," Jasayko says, adding that an accommodative monetary policy is what's sitting behind this "fantastic environment" for banks.

"We don't see that extending much beyond the middle part of this year, because you start running into political resistance." Jasayko doesn't expect conditions to "completely reverse and become horrible," but "the environment is going to become more challenging."

A rise in inflation will likely be one of the byproducts of the accommodative monetary policy coming out of the U.S., Jasayko says. "Everybody is seeing stories about food inflation throughout the world, but that's happening elsewhere, not here. Central bankers here say if you take a look at core inflation, it's not an issue."

In Jasayko's assessment, inflation will eventually be more of an issue than most people expect, putting the banks in a more difficult position. "This isn't some kind of indictment against the banks — we still have holdings such as BMO, Bank of Nova Scotia (BNS) and Royal Bank (RY) in our Canadian pool. But we're trimming back because we think the environment is going to be challenging if inflation does rear its head. But fundamentally, Canadian banks are [still] the cream of the crop internationally," Jasayko explains.

Concerns about inflation are also behind Jasayko's call on consumer discretionary. It's difficult — especially for manufacturers and retailers of mid-level discretionary consumer items — to pass price increases along to consumers, he says. "It's an area I would [see] us probably avoiding for the foreseeable future."

One more area Jasayko says he's avoiding is the telecommunications sector in general, and the cable companies in particular. "At these valuations, visibility has become more clouded," he says. New delivery methods offered by companies like Netflix make the landscape too ambiguous for a clear call, Jasayko explains. "We want to back off until we can get a better assessment." **AER**

DEAN DISPALATRO is Advisor Group Senior Editor. The opinions expressed in this article are provided as general market commentary and are subject to change based on market or other conditions. They do not constitute investment advice.