Investment Insight

The Pendulum Swings

Spring 2021

Investor sentiment can swing from one extreme to another, resulting in wide variations in the prices of securities over time. Consider how today's concerns differ sharply from just one year ago.

During euphoric times, some stocks may become wildly overpriced as buyers abandon all sense of value or analysis in their efforts to get in on the action. During bear markets, stocks may become wildly undervalued, as sellers abandon all sense of value or analysis in fear. Somewhere in the middle of the pendulum's swing is fair value and if we buy at or below this level, we are more likely to do well with our investments over time.

While markets are forward looking in nature, their rapid rise — in the midst of the greatest economic and public health crisis of our time — has surprised many. The S&P/TSX Composite (TSX) and S&P 500 indices have posted record highs and, by a variety of measures, many stock valuations appear stretched. At the start of February, the S&P 500 CAPE ratio* hovered around 34X, its highest level since the dot-com bubble years when it topped 44.2X. The TSX sat more modestly at 23X.

The reasons are many. Historically low interest rates have led to paltry returns of low-risk, fixed-income investments. With central banks pledging to keep rates low for the near-term, investors have turned to equity markets as — "TINA" — there is no alternative. Stimulus measures have also inflated asset prices. A rise in commission-free trading platforms has enticed new investors to enter the markets, often operating with little knowledge about the stocks they trade.

Some market observers are asking: can markets continue their climb? Yet, focusing on how far the markets have climbed can be counterproductive. It raises anxiety levels — "how high can the markets go?" And, may prompt us to take unnecessary action — "how can I protect my gains?" Consider, too, that markets can sometimes advance further than many believe. In 1996, during the dot-com years, after then-Federal Reserve Chairman Alan Greenspan's infamous "irrational exuberance" speech, the markets continued their rise for more than three years. Today, while there is a considerable amount of excess, some suggest that there isn't the same magnitude of financial leverage that has accompanied past exuberance. And, certain areas of the markets are still expected to benefit from continued economic recovery as things return to normal.

Regardless, there is often limited value in trying to predict the direction of the markets — after all, the success of your overall wealth plan isn't dependent on calling the top of any cycle. Instead, a longer-term commitment to, and confidence in, the plan that has been constructed to achieve your goals will continue to serve us well, as the pendulum inevitably continues its swing.

*Cyclically-adjusted price-to-earnings ratio measures a stock price by the average earnings for past 10 years, adjusted for inflation.

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To My Clients:

Spring is the season of renewal, and with the changing of seasons there is the hope for brighter days ahead.

Volatility has also returned to equity markets. Seasoned investors will remember that it plays a common role in equity markets and, after many months of market advances, should be expected. It may also provide opportunities to put capital to work as we continue to build portfolios for the future.

Stay safe and healthy, and please don't hesitate to call for any investing matters.

Peter

In This Issue

BMO Private Wealth

Investing During Strong Market Times

In the first six weeks of 2021, the S&P/TSX Composite Index hit six new all-time highs. Despite being a year in which a pandemic made economic conditions some of the worst in history, the S&P 500 Index hit 30 new all-time highs in 2020.

For some, these buoyant market times may be cause for discomfort: while markets can climb, they can also fall. But here are a handful of considerations that may help to keep perspective:

Don't forget your time horizon — With many of us spending extended periods of time at home, it may be easy to pay greater attention to daily market movements. Yet, most of us are longer-term investors with a time horizon extending beyond today. Longer-term investors will see numerous peaks, and troughs, across market cycles. But, history has shown that the longer your time horizon, the greater the possibility of positive outcomes.

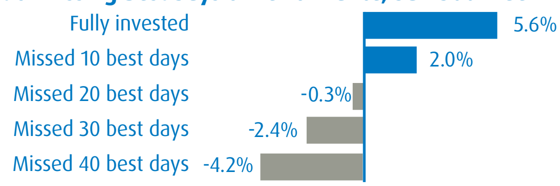
Likelihood of Positive S&P/TSX Composite Outcomes Based on Time[1]

Time Frame	Positive	Negative
Daily	56%	44%
1 Year	75%	25%
5 Years	88%	12%
10 Years	95%	5%
20 Years	100%	0%

Source: S&P/TSX Composite Index, 1970 to 2020.

Timing the markets is difficult — While avoiding a drop in the markets is good in theory, accurately timing the markets is a difficult, if not impossible, task. And, it's not just about protecting your investments from market drops — equally important is benefiting from market gains. After the market lows last spring, many were surprised at the speed in which markets reversed their course. Consider the consequences of missing the best days of performance in the markets.

Impact of Missing Best Days of Performance, S&P 500 Index[2]



Source: S&P 500 Total Returns over 20 year period, 1/1/1999 to 1/1/2019.

Don't liquidate, rebalance — If strong gains in your portfolio make you want to take action, consider making adjustments to your asset allocation or portfolio diversification. When we think about the process of reallocation, we often look for opportunities to adjust into areas that stand to benefit in changing environments or pare back positions that have exposure to negative dynamics. Rebalancing, to get your asset allocation or portfolio diversification back to its target, may be one way to take some gains while keeping invested for the future.

Rely on professional support — The high valuations of current markets may make it difficult to see opportunity. Yet, there are areas of the markets that haven't experienced the same acceleration in performance. For example, at the time of writing, value stocks have had a sharp run over the past seven months, but not the extended gains of growth stocks. One of our roles is to critically assess the potential opportunities that may exist, or are to come, while managing risks in a challenging landscape.

Continue to look forward, enjoy the advancements of the markets and leave the day-to-day worries of your portfolio to the professionals who are here to manage it.

Tax Season Reminders: Did You Work From Home in 2020?

It's personal income tax season once again. If you worked from home as a result of the pandemic, the Canada Revenue Agency (CRA) has introduced two simplified methods for claiming the home office expense deduction on your 2020 personal income tax return:

New Temporary Flat Rate Method — If you worked more than 50 percent of the time from home, for at least four consecutive weeks in 2020 due to Covid-19, you may claim $2 for each day worked from home, to a maximum of $400 per individual.

Simplified Detailed Method — For home office expense claims exceeding the temporary flat rate method maximum of $400, the CRA requires individuals to use a "detailed method," in which a worker must calculate the employment use of their home workspace. The CRA has now created a simplified form for the detailed method, *Form T2200S*. While this form does not have to be attached to the tax return, it should be saved for auditing purposes. The CRA has also provided an online calculator to help perform workspace calculations.

In both simplified processes, employees must complete and attach *Form T777S, Statement of Employment Expenses from Working at Home Due to Covid-19*, to their tax return. The CRA will accept an electronic employer signature on *Form T2200S*.

Changes to Eligible Expenses — The CRA has also expanded the list of claimable expenses. As a result, reasonable home internet access fees may now be claimed. Detailed information regarding allowable expenses and claims can be found at the Government of Canada website: canada.ca/cra-home-workspace-expenses

Spring Cleaning: Review Your Estate Plan

When was the last time you reviewed your estate plan? While this should be done at least every five years or when personal circumstances change, the pandemic reminds us of the value in revisiting plans when circumstances around us also change.

As part of your review, one place to start is with those appointed to help carry out your estate plan: the attorney (mandatory) named under power of attorney (POA) documents and the executor (liquidator) of your Will. Here are a few considerations that may prompt action.

The importance of checking in. When was the last time you spoke to your named executor or attorney about the role? The pandemic may have altered an individual's capacity to act on your behalf. A front-line healthcare worker may not be able to manage additional duties if under significant work obligations. Immune-compromised individuals may be unable to safely perform certain functions of the role. If the individual is not aware that they have been appointed, consider that court intervention will be required if they are unwilling or unable to act and an alternate has not been named. Under normal circumstances, this is a lengthy and costly process; throughout the pandemic, this has been complicated by further delays as court operations have been impacted in many provinces.

The value in communicating the "basics." Have you provided direction to help support those acting on your behalf? With your executor/attorney, have you communicated where important documentation can be found? This is important to prevent an unnecessary search, and with many businesses now having reduced operations (including banks, law firms), access to documents may be made more challenging. Is your executor/attorney aware of the financial or healthcare choices you wish to make in the event of incapacity? The health consequences of Covid-19 have highlighted the differing outcomes that some may find more controversial, such as the use of a ventilator for life support.

Is your executor/attorney aware that their tasks may need to be carried out differently? There have been advancements as a result of the pandemic — many provinces have allowed for virtual witnessing of certain documents or electronic submissions for some court-related applications.* However, the pandemic has also made seemingly easy procedures more difficult or time-consuming, such as constraints on in-person meetings. Jointly appointed executors/attorneys may struggle to effectively act in unison. With the limits on travel, if an appointed executor/attorney doesn't live locally, can they fulfil their role?

In some cases, changes may be needed, such as appointing temporary alternatives during this period. However, the impact of the pandemic on those appointed to support you is just one area to contemplate as you review your estate plan. For a discussion on this, or other aspects of your estate plan, please get in touch.

*Some of these measures have been approved under emergency conditions and may be temporary.

The Flight of the Loonie

The Canadian dollar (CAD) has been gradually appreciating in value. What's driving the loonie's flight?

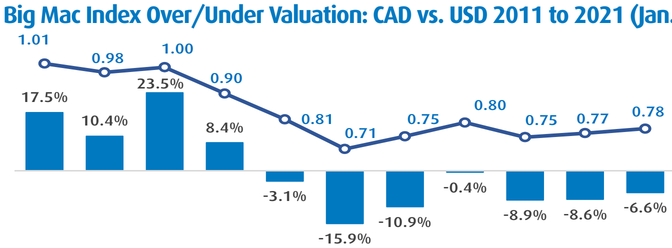
In less than a year, the CAD has risen by over 15 percent, after it fell to a low of 0.69 USD in March 2020. Oil prices, which briefly turned negative a month later, were one reason why the loonie struggled. The CAD is largely impacted by the price of oil since Canada earns a large portion of its U.S. dollars (USD) from the sale of oil. As oil prices have risen to pre-pandemic levels, this has helped to strengthen the CAD.

At the same time, the USD has been losing its lustre. The significant stimulus injected into the U.S. economy has increased the money supply, creating concerns about future inflation and placing downward pressure on the greenback. With near-zero U.S. interest rates and a yield on U.S. government bonds closer to that of other developed nations, this may reduce the demand for U.S. Treasurys and further weaken the USD.

Will the loonie continue its upward flight? Here is some "food for thought." The "Big Mac Index," published by *The Economist* magazine, is a fun tool to make exchange rate theory digestible. It compares the purchasing-power parity (PPP) of global currencies. PPP suggests that over the long run, exchange rates should adjust so that an identical basket of goods/services costs the same in each country. Instead of using a basket of goods, it creates an exchange rate by comparing the cost of a Big Mac in a nation's currency to its cost in the U.S. Comparing this to the prevailing exchange rate determines whether a currency is considered under- or over-valued. The bar chart shows the under/over valuation of the CAD versus the USD based on the Big Mac. The actual exchange rate is shown on the blue line.

Currency fluctuations are a normal part of the financial markets. While a stronger CAD may provide better buying opportunities to purchase U.S. assets, for longer-term investors the impact of currency changes on returns has the tendency to even out over time.

Big Mac Index Over/Under Valuation: CAD vs. USD 2011 to 2021 (Jan.)



Source: January data: github.com/TheEconomist/big-mac-data, accessed 2/11/21.

The Great CPP Debate Continues...

It is a decision that many Canadians will need to make prior to retirement: when should you start Canada Pension Plan (CPP) benefits? At age 60, 65 or wait until 70?

Despite the potential for a higher CPP payout — an increase of 42 percent if the CPP is deferred to age 70[1] — less than one percent of Canadians wait until age 70 to collect CPP. For those who have a choice,[2] taking CPP before 70 may not be that surprising. In the 1972 Stanford Marshmallow Experiment, psychologist Walter Mischel gave his young participants a choice — one marshmallow immediately, or two if they waited 15 minutes. While most wanted to wait, less than one-third were able. As the experiment showed, humans tend to favour instant gratification.

When considering delaying benefits, here's the good news — most of us are likely to live longer than we may believe. If you reach the age of 65, chances are you will likely live to age 85 (see chart below).

This may mean many wonderful years in retirement, but it may also create worries for those concerned about outliving retirement savings. For many, income challenges from the pandemic haven't helped to ease these concerns.

The Probability of a 65-Year-Old Reaching Various Ages

Age	75	80	85	90	95
Females	90%	82%	69%	50%	26%
Males	86%	75%	59%	38%	17%

Yet, given our life expectancy, studies continue to show that deferring CPP results in greater overall lifetime income for the average individual. A recent study published in the popular press will have you believe that taking CPP early at age 60 instead of 70 could cost you over $100,000.[3]

While there is no disputing that waiting until age 70 may deliver higher lifetime payments for the average retiree, there may be reasons to consider taking an earlier CPP.

Need for early income — Retirement costs aren't often linear in nature and may mirror life stages. Often, more income may be needed earlier in retirement, and CPP may provide this supplementary income.

Concerns about longevity — Some individuals may worry about longevity due to family history or illness. Life expectancy is difficult to predict.

Opportunity cost of other income — If CPP is deferred, other sources of income will be used. This may require withdrawing investments, which involves an opportunity cost of the potential loss of future growth. The recent study suggesting that you may forego $100,000 by taking CPP early may be misleading as it does not factor in this potential loss, which would reduce this gap.[4] In other cases, individuals may expect to leave certain investments to family members. A study done by the Society of Actuaries suggests that if the goal is to maximize a RRIF/RRSP for beneficiaries, then the best option may be to take CPP at age 65 so that the RRIF can be depleted more slowly.[5]

There are other factors that may impact the decision of when to start CPP benefits, including amount of CPP to which you are entitled, the preservation of other income-tested benefits, and your current or future income tax bracket. All of these considerations can vary significantly by individual. For a thoughtful analysis specific to your particular situation, please call.

1. Or 0.7 percent for each month; 2. With other sources of income enabling the delay of CPP payments; 3. financialpost.com/executive/executive-summary/posthaste-canadians-who-take-cpp-at-60-lose-100000-in-retirement-income-study-finds; theglobeandmail.com/investing/personal-finance/article-taking-cpp-early-can-cost-you-100000-and-limit-your-long-term/; 4. fpcanadaresearchfoundation.ca/media/5fpda5zw/cpp_qpp-reseach-paper.pdf; 5. cia-ica.ca/docs/default-source/research/2020/rp220114e.pdf

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