

# NetWorth

## What the next generation needs to know about money

**While some people are learning more about money in school, Rebecca Clark, Director of Wealth Planning for BMO Private Wealth and part-time personal finance lecturer at Toronto Metropolitan University (TMU), says personal finances is still a big gap in the education system.**

Many young adults continue to wonder about financial basics. Here's what the next generation needs to know about managing and protecting their wealth.

### Don't count on a free ride

Children from high-net-worth families often have the most difficulty managing their budgets. "Affluent parents think they're helping their kids, but those kids end up being worse spenders than children who have to struggle, who fare the best long term."

Clark dishes out tough love because she feels it's risky for anyone to expect family support or an inheritance. Parents can have bad spending and money-management habits, so they aren't always the best role models for the younger generation, who may not have access to the same level of wealth to maintain their lifestyle.

Also, just because you or your parents got help doesn't mean your kids can assume the same, she explains. These days, not every family plans to pass on their wealth to their children. It's not because parents are spendthrifts, it's often because they are living longer lives in retirement, healthcare costs are increasing, or the family wealth is tied up in the business.

Clark cautions the younger generation that family circumstances can change suddenly. The death of a parent or divorce can have a significant impact on the transfer of wealth, for instance. "It happens more than you'd think," she says.

### Understand the value of money

The more you spend, the more expensive your life is and the more you need to save," says Clark. It sounds obvious, but it's a concept that individuals in all income brackets can struggle with. Overall, people believe that having wealth today will ensure it will be there for them in the future.

"People don't realize how much life costs when you start to let go of the reins," she says. "Once you've had a taste of a different lifestyle, it's very hard to pull back." She's seen even multimillionaires run out of money by age 80 because of their spending habits. "They don't think anything of it because that's what they've always done," she says.

### About BMO Private Wealth

Backed by the heritage, stability and resources of BMO Financial Group, BMO Nesbitt Burns, BMO Private Banking and BMO Trust have come together under the unified brand, BMO Private Wealth. Professionals from one of North America's leading full-service investment firms and Canada's best Private Bank\* are partnered to help you navigate the complex process of managing your wealth. Our multi-disciplinary wealth management professionals take a proactive approach to helping individuals and families achieve their wealth goals. Services include wealth planning, investment management, banking, trust and estate, and philanthropy.

To learn more visit [www.bmo.com/privatewealth](http://www.bmo.com/privatewealth)

## Live like a student

Regardless of your financial situation, Clark encourages everyone to live like a student at some point in their lives to appreciate the value of money. On occasion, for her high-net-worth clients, she'll highlight the advantages and disadvantages of gifting large sums of money to the kids every year, noting that kids will naturally start to factor it into their budgets.

Clark isn't against parents lending a hand, but she thinks there are better ways to help children become self-sufficient. She'll often suggest that clients give a one-time gift, like a down payment on a home, and then leave it to the kids to cover the mortgage. That encourages the kids to find something they can still afford if interest rates rise.

## Read up

To help kids understand the basics, taking a personal finance course and talking with your advisor are good places to start.

**The other tip Clark gives all her young pupils is to take advantage of the excellent money-management content available. One source she recommends is a book entitled *Millionaire Teacher* by Andrew Hallam. His key tips include:**

- You can *look* wealthy or *be* wealthy – it's hard to do both.
- Invest early to capitalize on compound returns and earn gains off your gains.
- Control your emotions and resist the temptation to sell when markets get choppy.
- Avoid home-country bias and diversify your investments globally.
- Avoid hot stocks or opportunities that seem too good to be true.
- If you wish to pick individual stocks, limit your exposure to no more than 10% of your total portfolio.

Clark adds to that list: Avoid analyzing your investments all the time. "Play the long game," she says.

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# How to save for retirement when you're running a business

**Successful entrepreneurs do a lot of things well, but many fall short when it comes to saving for their own retirement and addressing personal and family wealth planning.**

"Corporate business owners don't spend enough time looking at their personal situation," says **John Paniccia**, Vice President, National Director of Business Advisory and Succession Planning at BMO Private Wealth.

So, what can you do now to ensure you're building up a nest egg? Here are some ideas.

## Make use of traditional investment accounts

Registered Retirement Savings Plans (RRSPs) and Tax-Free Savings Accounts (TFSA) are key components of the retirement playbook, but they may not be top of mind for business owners who would rather put their extra cash straight back into their business.

However, these tax-sheltered vehicles should be the starting point of any retirement plan as they provide compound returns over time. "Gains in the TFSA are fully tax-sheltered similar to the principal residence exemption and lifetime capital gains exemption on the sale of private company shares, whereas RRSPs have the benefit of being an effective tax deferral strategy," Paniccia explains.

## Set up an Individual Pension Plan

Unlike defined contribution plans, where the value of the account can fluctuate with the markets, an Individual Pension Plan (IPP) will give you a set amount of money for life.

One of the big benefits of an IPP is that you can put more into it than you can an RRSP. For instance, with an RRSP, no matter how much you make, you can only contribute 18% of your earned income into the account up to the annual maximum. With an IPP, those who are 45 – the recommended age to open an IPP – can contribute up to 21% of their income. And, this amount increases with age. By 65, for instance, you can put in 29% of your income. The other big benefit is that all contributions and administrative costs are tax-deductible to the business.



### Develop a corporate insured retirement strategy

Consider a corporate insured retirement strategy, which involves accessing funds from a permanent life insurance policy purchased by your company. It's a highly sophisticated endeavour that can provide retirement funds before you pass away and gives a tax-free benefit to your estate. Given the complicated nature of this approach, you'll want to talk to a tax advisor to get more details as to how it works.

### Consider a holding company

Another strategy involves setting up a holding company that owns the operating business and then investing funds generated by the business that's not required to support operations through the holding company. Here's how it works: money that's not used to run your company can be paid as a dividend to the holding company, typically on a tax-free basis. (And that money would already be taxed at a lower business rate than income earned personally.) Your holding company would invest those funds into stocks and bonds or whatever other investments you'd like, and you can pay those funds out and receive them as taxable dividends at your discretion.

Using a holding company instead of simply investing within the operating company has certain benefits, explains Paniccia. Firstly, it can protect your retirement assets from litigation the operating company may be exposed to that could put those assets at risk. Secondly, it removes redundant assets from the business, helping to ensure you meet the lifetime capital gains exemption tests when you eventually sell the shares of your private business.

### Take advantage of tax efficiency

Like all retirement and tax strategies, it's best to talk to your tax advisor before making any moves, but here are some strategies applicable to business owners: paid-up capital (PUC) reduction – essentially, it

represents the amount originally contributed for share acquisition plus or minus certain adjustments in the Income Tax Act. PUC attaches to a class of shares and not to a shareholder. The PUC can generally be returned to a shareholder tax-free, and anything returned to a shareholder more than the PUC would be considered a deemed dividend.

You could also take advantage of shareholder loans, which are after-tax funds loaned to your corporation. That money can be returned tax-free to a shareholder.

It's also important to ask your advisor about capital dividends, which are tax-free dividends paid by private corporations to a Canadian-resident shareholder.

### Sell your business

While investing in stocks and bonds in an RRSP, IPP or holding company are important, your biggest asset will likely be your business. Many entrepreneurs do indeed fund their retirements from the sale of their company, but to do that, you need to start preparing for your exit today.

Paniccia advises planning at least three to five years before selling to get the business to a place where you maximize the commercial transferable goodwill and value to achieve the highest price in the marketplace.

Ultimately, you will need to think about what you'll do in your golden years, and for some, that will mean leaving the business and enjoying retirement. But to do that, you need to start saving. "Successful entrepreneurs live and breathe the businesses as their legacy," says Paniccia. "Part of our role is to educate them, and have discussions with them early in the process – often years before – to ensure parallel planning to address both personal and business objectives well in advance of any business transfer."

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# Five ways our brains make us bad investors

**If only I'd invested earlier. If only I'd sold sooner. "If only I'd..." are three words that haunt investors when they realize they could have made a lot of money – or spared themselves a lot of pain – if they'd arrived at an investment conclusion quicker.**

Investing can be tough, but investors often make it even tougher on themselves by letting their brains get in their way. Extensive behavioural finance research suggests it's because we have difficulty letting go of our biases. The theory is that investors don't always act rationally, have limited self-control, and aren't consistent in their decision-making. It's human nature.

Understand how cognitive biases influence us and recognize them before you start investing. Here are five common behavioural biases that can lead to bad investment decisions:

## 1. Loss aversion

That stomach-churning feeling that comes with losing money on a stock seems to hurt more than the joy of seeing your portfolio rise. That is loss aversion, and it can cause you to make irrational decisions, such as panic-selling investments, that can thwart your financial plans. In March 2020, investors sold their stocks *en masse* fearing economic fallout from pandemic lockdowns. The markets bounced back within weeks and within months reached new highs, rewarding those who stayed calm and held on. Loss aversion can also drive you to sell your winning stocks for quick returns even when there are signs the market can climb higher, or hold on to losers, hoping they'll move higher.

## 2. Herd mentality

There's nothing like a hot stock or sector to rally investors to buy more. Herd mentality happens if you follow the crowd or market buzz around an investment without asking questions or doing research. Examples include the early-pandemic "meme stock" frenzy and the recent cryptocurrency craze. While joining the herd may lead to huge short-term gains, many investors lose out when they jump on bandwagon investment decisions. Do your research and consult with your financial professional before selecting stocks and determine how much, if any, of them are suitable for your portfolio.

## 3. Confirmation bias

We've all felt unsure about a purchase or personal matter and sought validation from someone who shares our perspective. It's called confirmation bias: we actively seek, interpret, and retain information that aligns with our beliefs. It makes us feel better and can help us make decisions, but it can also create blind spots. When you only focus on what you know or believe, you risk missing contradictory information that could negatively (or positively) impact your portfolio. Confirmation bias also causes investors to obsess over a few companies or investment types, making their portfolios less diversified, which could expose them to too much risk – or too little – depending on their investment goals.

## 4. Overconfidence

When you're starting a company or growing your wealth, you need to be confident in your decisions – but overconfidence can be costly. Ever driven to a new destination without consulting a map, only to end up lost? That's overconfidence bias. Some investors' self-assurance when wading into a stock or a sector leads them to take unnecessary or excessive risks. While successful investing may require some hubris, it always requires due diligence and consultation with your financial professional to examine a stock's fundamentals, the sector's health, and broader macro-economic trends that may impact its performance.

## 5. Anchoring bias

Many of us prefer the path of least resistance, so when we hear or read something that sounds convincing, we'll rely on that piece of information to make a decision. It's like agreeing to go to a movie because you like its actor, without knowing what it's about, but when investing, the consequences can be much bigger! For instance, you might invest in a stock based on your first impression of a product without investigating how well the company's managed.

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