The Tinnerman Wealth Brief

Fall 2017

Summertime, and the livin' is easy

From the song by Du Bose Heyward / George Gershwin / Ira Gershwin

It is not just summertime. For investors around the world the living has been unusually easy since Donald Trump was elected the 45th President of the United States last November.

The second quarter saw equity markets around the world continue to climb with the result that the MSCI World Index has now gained 11.02% year-to-date. Investors have been rewarded almost without exception as equity markets in the United States, Europe, Latin America, Japan and the Far East have posted solid numbers so far in 2017. The exception has unfortunately been the Canadian investor, who has missed out on the global rally in two ways.

First, the S&P TSX Composite Index did more than just lag its global counterparts – it lost 1.64% for the three months ending on June 30th. And second, the Canadian dollar strengthened during the quarter, and in so doing reduced the solid returns seen in the international market. In the case of the United States, the 3.09% return generated by the S&P 500 Index fell to 0.59% for Canadian dollar investors. Consequently our benchmark, which consists of equal weightings of the S&P TSX and S&P TSX Composite indices in Canadian dollars terms, produced a total return of -0.53%. Against this negative backdrop we are pleased to report that the portfolios of our client families again outperformed our benchmark by posting positive returns in the mid to high single digits for the quarter*.

The "what" that global investors have achieved so far this year in the way of good portfolio results is, however, only one part of the story. The other potentially more important part of the story is "how" it is that these good results have been achieved. This is to say, calmly. The CBOE Volatility Index (VIX), or

*Please note that summary performance results are not provided in our quarterly letters because the Tinnerman Wealth Group does not employ a "one size fits all" approach in the management of our client families' portfolios, as is practiced by mutual funds and pooled funds. Investment portfolios are tailored to meet the unique goals and objectives of each of our client families, and in this regard we ask that you please review your account statements or call us directly for your individual portfolio information.

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fear index as it is commonly known, has been falling for months and recently set an all-time record low of 8.84 despite myriad reasons for concern, which include:

- asset prices that are expensive on the basis of historical measures,
- geopolitical risks which are rising with North Korea, China, Russia and numerous lesser players,
- growing uncertainty as to whether the Trump administration can implement the key policy initiatives (e.g. immigration, health care and tax reform) that sparked the current rally, and
- central bank policy that appears to be undergoing a fundamental change.

For our part, the most important reasons for concern are usually new ones, which therefore makes the last point worthy of further discussion. The U.S. Federal Reserve raised rates for the second time this year in June, the Bank of Canada announced its first rate increase in nearly seven years, and the central banks of Japan, Europe and the U.K. are making noise about reducing monetary stimulus. In short, it appears that central banks are changing course, and the zero interest rates and money printing which have pushed up asset prices indiscriminately for the past eight years are now coming to an end.

We have yet to see much concern about the possibility of rising rates, likely because it is widely thought that the central banks will not want to do anything to upset financial markets. There will eventually be some fallout though, and in our view it will probably come first to lower quality businesses and assets. Investors have been ignoring risk and buying such issues for reasons other than fundamental business considerations. What has been especially dangerous in our view is the buying of lower quality issues because they have higher payouts, a.k.a. "reaching for yield".

To the Tinnerman Wealth Group of BMO Nesbitt Burns, the fundamental attributes of a business are not a reason to invest – they are the only reason to invest. As we note in each letter, our focus is on finding and making informed investments in "better businesses" which have: (i) simple and easy to understand business models, (ii) strong balance sheets, (iii) predictable and sustainable revenues and dividends, (iv) the proven ability to generate above average returns over the long term, and (v) can be purchased at prices that provide a margin of safety. We are confident that our clients' portfolios will do well in the long term because we make such selective investments, but we are well aware that broad market corrections negatively impact virtually all investors in the near term.

Thanks to nearly nine years of easy money policies investors have not had much to worry about in a long time. The S&P 500 is in the midst of the second longest bull market in history, which is remarkable also for the fact that it has not experienced a 20% correction since it began in March of 2009. We have no idea when the current bull market will end, but we in the Tinnerman Wealth Group would welcome a bit of a correction. Assets are expensive today, and negative market events typically provide an opportunity to purchase good businesses at prices which are attractive relative to their long term prospects.

The idea that investors can benefit in the long term by taking advantage of short term crises is a core message of financial commentators. It is also a dangerous one. Major corrections often occur when an asset class or market sector has reached an unsustainable level. Once this point is passed, the prices for that asset or sector invariably plummet, and in so doing drag down the overall market (as happened when the tech bubble burst). Contrary to popular belief, investment success is not achieved simply by having a long time horizon when buying stocks. It is achieved by buying a business which the market has mispriced relative to the long term fundamental value of that business. Many Nortel investors learned the hard way the lesson that price and value are not the same thing.

Having a long time horizon is similarly not enough when it comes to family wealth planning. Success depends first on understanding the fundamental characteristics, needs and goals of the family, and second on the transferring of the experience, stories and skills of the family to its next generations. As we do each year, at this time we will address both of these components.

The first component addresses the structural or tactical elements of family wealth planning and is relatively straightforward, although it can be a bit time consuming. Serious thought is required to develop solutions for each of these issues (of which there are many), and to integrate these solutions into a comprehensive wealth plan that meets the specific goals of your family. We have done this for our client families for some 30 years now, and we are prepared to help you address your family's retirement planning, education funding, tax planning, estate planning, family gifts, lending, charitable giving, insurance, trusts, powers of attorney, wills and other wealth needs.

The foregoing planning elements may be critical for financial success, but ultimately it will be your family's "Emotional Inheritance" which determines how well your wealth and heritage are preserved through future generations. Emotional inheritance planning is far from simple, and specialized knowledge is needed to help the next generations acquire the skills necessary to assume their roles as family stewards. To this end, I hold the designation of Heritage Design Professional, as I believe that there is currently no better program for addressing the emotional inheritance challenges of our client families than Heritage Planning.

As practised by the Tinnerman Wealth Group, the goal of our Heritage Planning Services is to prepare the next generations of our clients to "take over the family – not take from the family". It takes time and patience to engage an entire family in such a strategic program, but I can assure you that it is worth the effort. If you have yet to explore what Heritage Planning could mean for your family, please contact us at your earliest convenience.

Summertime is family time and I always find myself learning new things about my family when I am away from the office for a few days. I enjoy having the free time to reflect unhurriedly on what the future will bring, and how to make sure that our next generations thrive. There was unfortunately little time for quiet reflection this year, as the Federal Government released a “discussion paper for consultation” which will have far reaching tax implications for the owners of private corporations and their families, as their total tax paid on investments will increase.

Many of our client families will be impacted by this new tax initiative, and so we feel an obligation to inform them about the key facts surrounding the proposed changes. In retrospect, we think all of our clients would do well to reflect on not just the content, but also on the manner of this new tax initiative.

Most Canadian families try and take vacation during the summer, so the fact that the discussion paper for consultation was released in mid-July means a lot of people are going to be playing catch-up after Labour Day. It will not be easy as the discussion paper alone is a 63 page treatise on taxation. The paper is accompanied by a 27 page document entitled Legislative Proposals Relating to the Income Tax Act and the Income Tax Regulations. And a further 47 pages of explanatory notes which describe that proposed amendments to the Income Tax Act are provided “for the assistance of Members of Parliament, taxpayers and their professional advisors”. It may be summertime but “the livin’ is definitely not easy” for a lot of doctors, dentists, lawyers, farmers and small business owners.

We in the Tinnerman Wealth Group consider ourselves pretty well-versed when it comes to financial matters, but the volume and detail of the materials are such that we can only offer a few factual insights. The first is that under this proposal taxes will take 73% of the return which private corporations earn on their investments – far higher than the eye-watering 53.53% that top earners in Ontario already pay. The second is that anyone who owns shares in a private corporation should immediately call their tax accountant and/or tax lawyer to get informed about the new tax regime and how it may affect them. And the third is that the Federal Government is soliciting input on its tax proposals until October 2, 2017, so you still have time to explain the impact that this initiative will have on your family and your business. For your convenience, we have attached a copy of the Invitation for Comments from the website for the Department of Finance.

> “ There’s always an Arquillian Battle Cruiser, or a Corillian Death Ray, or an intergalactic plague that is about to wipe out all life on this miserable little planet, and the only way these people can get on with their happy lives is that they do not know about it!“
>
> – Agent K, from the 1997 movie, *Men in Black*

Like the intergalactic dangers mentioned above, taxes are an ever present threat to the financial well-being of Canadian families. Ontario residents know this all too well, as top earners saw the taxes that they pay increase by 15.34% in the span of four years. It was a joint effort between the Ontario Government which increased the tax rate from 46.41% to 49.53% (in 2012) and the Federal Government which increased the taxes it takes from top earners by 13.8% by boosting the top tax rate to 53.53% (in 2016). Now, barely a year and a half later, the Federal Government has tabled a new tax initiative which carries significant implications – not just for current taxpayers, but also for the next generations of Canadians.

Our team has seen innumerable changes in policy during the 30 years that we have been advising client families, and for the most part such changes have targeted structural elements, as was the case with the Ontario rates increasing from 46.41% to 53.53%. We know about the changes, and because taxes are a financial fact of life we address them as best we can and move on. What concerns us so much now is that the proposed tax changes go beyond the financial realm, and will threaten the emotional heritages of our next generations.

In working with our client families on their Heritage Plans we have found that, while our client families have vastly different experiences, stories and skills, they share many common values in terms of the Emotional Inheritances that they are seeking to impart to their next generations. It’s a bit of a laundry list, and includes things like recognizing that one should work hard at school. That success ultimately comes from taking the long view, so one should be willing to dedicate the many hours of additional work needed to get into a professional or post-secondary program. That it is worthwhile to become a doctor or a lawyer or a dentist, even though you will miss out on six or seven or eight years of income while at the same time incurring huge debts to pay for your education.

The above principles hold true when one is developing an idea for a new business, as starting new businesses can take many years before generating a positive return. That, statistically speaking, the cards are stacked against anyone who wants to start a business as more than half of new businesses fail by year five, and more than two-thirds fail by year ten. That running your own practice or business or farm is not going to be a nine to five job.

That building a successful practice or business requires you and your family to accept that you will never truly be "off the clock", and so must be willing to sacrifice family evenings, weekends and vacations. That your family will take huge financial risks at the outset, and you will be held personally responsible for everything that happens with that practice or business. That even before you are successful, you should freely give your time and money back to the community, especially to help those who are less fortunate.

That you must recognize that you will have to provide for all of your family's future needs, and accept that no-one will help you should you fail to set enough aside. That unlike government employees, you will not have a health plan, or an insurance plan, or a guaranteed pension plan to fall back on should your practice or business or farm encounter difficulty. And finally, that there will be endless people who will not understand, accept or appreciate the sacrifices that you have made in your life, and who will begrudge you and your success.

If there is a theme in the "emotional inheritances" we have listed above, it is that families want their next generations to understand that it is worth it to make sacrifices and take risks in the short term, because it means that their families will have the chance to thrive in the long term. The problem we have with the government's discussion paper for consultation offers nothing but downside for our client families and their next generations when it comes to their Heritage Planning. As this letter has gone far overtime, we leave it to you and your tax advisers to determine whether this latest tax initiative from Ottawa is "financially fair".

In closing, we hope that you found this letter to be thought provoking and interesting. If nothing else we expect that you now have an idea of what sorts of things keep us up at night when it comes to our looking out for the well-being of our clients and their families. With this in mind, we ask that you please call us if you have any questions or concerns about your family's wealth management plan. And, as always, please give this letter to any friends, family members or associates whom you think might benefit from our perspectives on wealth management.

Sincerely,

Mark Tinnerman

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Portfolio Manager

BMO Wealth Management
BMO Nesbitt Burns

Tinnerman Wealth Group

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