Investment **Insight**

The Real Risk? Not Participating

After another year of performance gains by North American stock markets, many investors are asking: where are the markets headed in 2018?

Some have found it difficult to enjoy the market's advances, instead expressing concerns about market prospects — eight years of a bull market can do that!

Of course, nobody can predict the course of near-term markets, except to say that fluctuations in either direction should be expected. Investing is often unpredictable, and this is a good reminder that your portfolio has been built to be enduring throughout the inevitable market cycles. We work to control risk in your portfolio in many ways, including maintaining a certain asset mix, ensuring diversification, limiting the size of any holding and emphasizing quality — all based on your own personal risk tolerance and objectives.

Having this discipline is important even in up markets. We have all seen superstar stocks turn into supernovas over time. Risk control helps to ensure that events such as these do not cause significant harm to overall portfolio values. During down markets, it helps to mitigate risk and limit the downside. Remember that avoiding all risk will often mean forgoing most return as well.

A focus on the longer term can also serve us well. Renowned investor Warren Buffett recently declared that the Dow Jones Industrial Average (Dow) will reach 1,000,000 points within the next 100 years. At first glance, this figure seems extraordinary; 100 years ago, the Dow opened at a mere 77 points. Yet, this level could be achieved with an average annual growth rate of less than 4 percent.

But Buffett's view is not a bearish prognostication; rather a message for investors to focus on long-term expectations and goals. Over time, the markets are expected to continue their climb. Regardless of what happens in the short term, longer-term wealth-building potential remains strong. The real risk? Not participating.

In the short term, there are many reasons to remain optimistic. Our resource-dependent economy continues to grow despite lower resource prices. Oil prices have shown modest increases and corporate earnings have been strong. There are also challenges: ongoing NAFTA negotiations may potentially impact Canadian business competitiveness and growth is anticipated to slow this year.

Nevertheless, don't overlook the opportunity for markets to continue their climb. Participate, for the sake of your future prosperity!

L to R: Michael Tomkins, Colleen Thorpe, Michael Mereszak, Victor Chan

To Our Clients:

Happy New Year! While we cannot control the direction of the markets, there are many wealth-building opportunities within our control. As the government continues to focus its tax initiatives on higher-income earners, have you made full use of your tax advantaged accounts or other tax-planning opportunities, such as income splitting? Plan for your future care and make sure your powers of attorney and estate planning documents are updated. If you are in need of ideas, perhaps we can help.

Here's to a happy and prosperous 2018!

Michael, Victor, Michael & Colleen

In This Issue

Perspective on Returns	p. 2	TFSA Over-Contributions	p. 3
Small Business Tax Changes	p. 2	Segregated Funds	p. 4

A Perspective on Long-Term Returns

What kind of average return should you expect on your investments over the long term? If you were to look solely at the performance of U.S. equity markets which have achieved record highs over recent times, you might have an inflated view of expected returns.

Recent projections developed by actuarial professionals for the Financial Planning Standards Council suggest that Canadian equities are expected to return around 6.5 percent over the long term. When considering a portfolio that includes fixed income investments, they believe that conservative investors should expect a 3.25 percent return over the long term.[1]

Although these figures may pale in comparison to some of the recent gains highlighted by the media as stock markets achieved new record highs, they provide some perspective. Let's not forget that short-term returns will vary considerably. Over the past 25 years, S&P/TSX Composite annual returns have varied from a low of -35.1 percent to a high of +31.6 percent. However, when taking a longer-term view, this variability evens out. When looking at 10-year trailing investment periods for the past 25 years (i.e., starting with the period: 1983 to 1993), the average annual return was around 8 percent. As these are nominal returns, when factoring in average inflation during this time, which was around 3 percent, the real return was around 5 percent.[2]

Keep in mind that a real return of 5 percent is still excellent and well beyond the returns of many bonds and money-market instruments.

Some observers would note that times have changed since the start of the decade, with slower growth putting downward pressure on the financial markets (see chart for average 10-year returns of the TSX). Economic growth is one of the key influencers of longer-term asset returns, impacting corporate earnings, interest rates and other factors that drive asset prices. Over the next decade, global growth may be challenged by various factors including an aging population and therefore lower labour productivity, as well as peaking globalization.

As such, in spite of the current market performance, keep perspective about long-term returns. At the same time, remember that while returns will vary, equities are expected to continue to be one of the best performing asset classes over the long run.

S&P/TSX Composite Total 10-Year Returns[3] (Dividends Reinvested)

Year Ending	10-Yr. Avg. Return	Year Ending	10-Yr. Avg. Return
2010	6.6%	2014	7.6%
2011	7.0%	2015	4.4%
2012	9.2%	2016	4.7%
2013	8.0%	2017*	4.3%

Sources: 1. http://fpsc.ca/docs/default-source/FPSC/news-publications/2017-projection-assumption-guidelines.pdf; "conservative" portfolio = 25% equities; 70% fixed income. 2. Avg. annual Canada CPI figures, 1983 to 2017. 3. S&P/TSX Composite Total Return Index for 10-year trailing period. *2017 data to 09/31/2017.

Changes to the Small Business Tax Proposals

Last summer, the federal government released a consultation paper targeting certain tax planning strategies that it believed unfairly reduced the taxes of incorporated business owners. It focused on three areas: income splitting through income sprinkling, holding passive investment portfolios and converting regular income into capital gains. During the consultation period over 21,000 responses were received. After significant backlash by many small business owners, the government announced last fall that it would be making adjustments to these proposals. Here are some of the changes:

The small business tax rate has been lowered. Although this was not part of the original paper, a reduction in the small business tax rate was likely made to help temper the resulting response to the consultation paper. The small business tax rate is proposed to be lowered to 10 percent (from 10.5 percent) as of January 1, 2018. It will again be reduced to 9 percent as of January 1, 2019. (The tax rate for non-eligible dividends will be adjusted to maintain integration of corporate and personal taxes.)

Income-sprinkling measures will be focused on those who do not meaningfully contribute to a business. The government had originally targeted owners of private corporations who were lowering taxes by sprinkling income to all family members. At the time of writing, draft legislation is pending but changes are expected to be effective for 2018 and subsequent tax years. Measures to limit access to the Lifetime Capital Gains Exemption have been abandoned.

An annual threshold of $50,000 for passive investment income has been proposed. The government originally proposed limits on the use of private corporations to make any passive investments within the corporation. The newly proposed threshold was created as it was determined to be the equivalent of $1 million in savings, based on a nominal 5 percent rate of return. This is intended to provide a financial cushion for emergency or retirement purposes for business owners. Existing passive investments and related income will not be affected. Draft legislation, including an explanation of how the threshold works, is expected in Budget 2018.

The proposal to limit the conversion of income to capital gains has been abandoned. The government indicated that this proposal would have made it difficult for certain business owners, including farmers/fishers, to pass their businesses to their children.

At the time of writing, these tax measures are still in proposal stage. For more details, see the Government of Canada website: fin.gc.ca

Review Your TFSA for Over-Contribution Errors

If you have multiple Tax-Free Savings Accounts (TFSAs), have you transferred funds between accounts? Or, have you withdrawn TFSA funds and recontributed them to the same TFSA within a calendar year? If you answered yes to either of these questions, you may have inadvertently over-contributed to your TFSA.

Over recent years, the Canada Revenue Agency (CRA) has increased its reviews of the TFSA, targeting holders that it considers to have over-contributed to the account. As part of the assessment process, if an individual has exceeded their TFSA contribution limit for the first time, the individual is sent a warning letter and/or *Form RC243-P, Proposed TFSA Return*. This form shows the amount of penalty tax due according to CRA records. If the individual has removed the excess TFSA amount prior to receiving the letter, no further action is required.

As such, if you may have over-contributed to your TFSA, it may be worthwhile to review your TFSA now to make any corrections before a penalty tax is assessed. Here are two areas where over-contribution mistakes are inadvertently made:

You withdraw TFSA funds and recontribute them within the same year. TFSA withdrawals do not create contribution room until the following calendar year. So, if you do not have contribution room available in a particular year, any recontributed funds would be considered to be an over-contribution for that year.

You withdraw TFSA funds to transfer them to another TFSA at a different financial institution. Although this can be done without penalty, it must be done through a direct transfer completed by the financial institution. Otherwise, if funds were withdrawn from one TFSA as cash and moved to another TFSA, this would be considered to be a withdrawal followed by a contribution. Contribution room for the withdrawal would not be created until the next calendar year.

What is the penalty? A TFSA penalty is assessed at one percent of the over-contributed amount per month, until the excess amount has been removed from the TFSA (or contribution room becomes available). For example, if you made an indirect transfer of $5,000 from one TFSA to another and it was considered an over-contribution for the year, the penalty would be $600 per year ($50 per month for 12 months). Over time, these penalties can quickly add up.

How can you determine your contribution room? Information about TFSA contribution room is available on your CRA online account: "My Account". You can also contact the CRA to request a *TFSA Room Statement* or *TFSA Transaction Summary* showing your contribution and withdrawal information.

If you have multiple TFSA accounts at different financial institutions, consider consolidating them to simplify their administration and avoid contribution errors. This may also improve visibility and management of your asset allocation or ease the settlement of an estate.

Finally, if you have received a penalty notice, but have not yet removed excess contributions, do so immediately and contact the CRA for a review of your particular situation. There have been instances in which the CRA has provided relief for unintentional over-contributions.

RRSP Season Again: Help Kids Get an Early Start

It is Registered Retirement Savings Plan (RRSP) season once again. **Remember that RRSP contributions for the 2017 tax year must be made by March 1, 2018.** Contribution limits are 18 percent of your previous year's earned income, to a maximum of $26,010 (less any adjustments or plus any unused contribution room). If you are planning ahead for the 2018 tax year, the RRSP contribution limit increases to $26,230.

If you have teenage children or grandchildren who hold a part-time job, the benefits and discipline of investing in an RRSP should not be overlooked! Sometimes, income earned from a part-time job is less than the basic personal amount for tax purposes, so an income tax return may not be filed as no taxes are owing. However, if this earned income is not reported, the child loses the opportunities to compound savings for additional years on a tax-deferred basis and potentially reduce future personal income tax liabilities.

If the child reports income but decides not to contribute to the RRSP in the current year, the unused RRSP contribution room carries forward. This may be beneficial as it can be used to make a contribution in future years to reduce taxes. If they contribute to the RRSP and their taxable income is below the basic personal exemption, they can elect to not claim the RRSP deduction until a future year when they are in a higher tax bracket, as non-deducted RRSP contributions carry forward indefinitely.

Having built up an RRSP balance while children are young may provide additional benefits as they grow older. They could potentially access up to $25,000 from the RRSP under the Home Buyers' Plan to aid in the purchase of a home, or they could time withdrawals to create a tax-efficient income-replacement strategy to match a maternity leave or a sabbatical from work.

Don't overlook the value of an early start!

Segregated Funds to Support Your Retirement & Estate Planning

Did you know that segregated funds can play a valuable role in both retirement and estate planning? For conservative investors planning for retirement, they offer security through a partial or full guarantee of principal on the investment. Given low interest rates, segregated funds have the potential to offer higher returns than those achieved through traditional fixed income investments like guaranteed investment certificates. As part of a diversified portfolio, certain segregated funds may offer the prospect of having a predictable income stream in retirement.

For estate planning, segregated funds offer a death benefit feature that may preserve capital for named beneficiaries, with a partial or full guarantee of the initial investment at death.

Segregated funds are the insurance industry's equivalent to mutual funds. While these two products are similar in many ways — in that investors' funds are pooled and invested in stocks, bonds and other securities — there are some key differences. Technically, they are insurance contracts. Under insurance law, they must guarantee the protection of at least 75 percent of an investor's principal investment upon maturity or death. Many insurance companies actually offer a 100 percent guarantee. However, they must typically be held for a certain length of time to benefit from this guarantee, usually 10 years.

Here are some of their advantages:

Locked-in Returns: In addition to the guaranteed principal, there is also a death benefit guarantee for the policy holder. If the fund value increases over a period of time, some funds allow you to "reset" the guaranteed amount to a higher value. However, this often resets the length of time required by the investor to hold the fund.

Creditor Protection: Segregated funds may protect assets from creditors in the event of bankruptcy or litigation. As such, they may be beneficial protection tools for business owners or other professionals.

Bypass Probate: Insurance proceeds generally bypass the probate process. As such, proceeds to a named beneficiary would not be subject to probate fees, in provinces where applicable. As assets pass outside of the estate, this may help to keep their distribution private.

Be Aware

Since segregated funds are insurance products, they generally have a management fee that is higher than other funds. Depending on the type of fund, this could range from an additional 0.15 percent to 1.0 percent. This extra fee helps to cover the cost of the insurance protection offered by the fund. Investors should also be aware that money is typically locked in for a period of time. If an early withdrawal is made, the market value of the investment will be returned (which may be more or less than what was originally invested) and there may be an associated penalty charge.

Segregated funds can play a role in retirement planning as part of a diversified portfolio. If the benefits may appeal to your situation, please feel free to get in touch.

With the compliments of...

Victor Chan
CFP®, CIM, CFDS, FCSI
Investment Advisor
519-977-6619
victor.chan@nbpcd.com

Michael Mereszak
CFP®, FCSI, FMA
Investment Advisor
519-977-6122
michael.mereszak@nbpcd.com

Michael Tomkins
CFP®
Investment Advisor
519-977-6424
michael.tomkins@nbpcd.com

Colleen Thorpe
Investment Representative
519-977-6519
colleen.thorpe@nbpcd.com

Lorraine Bortolin
Administrative Assistant
519-977-5213
lorraine.bortolin@nbpcd.com

BMO Nesbitt Burns Inc.
100 Ouellette, Suite 1100,
Windsor, Ontario, N9A 6T3
Tel: 519-258-7430
Toll Free: 1-800-354-9127
Fax: 519-256-3093

BMO Wealth Management
BMO Nesbitt Burns

This publication is for informational purposes only and is not and should not be construed as professional advice to any individual. Individuals should contact their BMO representative for professional advice regarding their personal circumstances and/or financial position. This newsletter was produced by J. Hirasawa & Associates, an independent third party for the individual Investment Advisor noted. Opinions, estimates and projections contained herein are those of the author as of the date hereof and are subject to change without notice and may not reflect those of BMO Wealth Management. BMO Wealth Management and the publishers accept no liability whatsoever for any loss arising from the use of this report or its contents. The information contained in this publication is based on material believed to be reliable, but BMO Wealth Management cannot guarantee the information is accurate or complete. The comments included in this publication are not intended to be a definitive analysis of tax applicability or trust and estates law. The comments contained herein are general in nature and professional advice regarding an individual's particular tax position should be obtained in respect of any person's specific circumstances. All rights are reserved. No part of this publication may be reproduced in any form, or referred to in any other publication, without the express written permission of the publishers.
Insurance services and products are offered through BMO Estate Insurance Advisory Services Inc., a wholly-owned subsidiary of BMO Nesbitt Burns Inc. BMO Wealth Management is the brand name for a business group consisting of Bank of Montreal and certain of its affiliates in providing wealth management products and services. Not all products and services are offered by all legal entities within BMO Wealth Management. ®"BMO (M-bar roundel symbol)" is a registered trade-mark of Bank of Montreal, used under licence. BMO Nesbitt Burns Inc. provides comprehensive investment services and is a wholly owned subsidiary of Bank of Montreal. If you are already a client of BMO Nesbitt Burns Inc., please contact your Investment Advisor for more information. "Nesbitt Burns" is a registered trade-mark of BMO Nesbitt Burns Inc. All rights are reserved.