BMO Nesbitt Burns | Summer 2020

Investment **Insight**

Maintaining the Long View

We have been met with many new and uncomfortable realities as a result of COVID-19, from fear of the invisible, to distancing and isolation, as well as economies being shut down virtually overnight. The effects have been unprecedented: record unemployment levels, oil futures prices dropping to negative lows and then rebounding, and declines in economic growth not seen in decades.[1]

Equity markets reacted in a similarly extraordinary manner in the spring, falling and then rallying quickly. Typical bear markets last between 18 to 36 months, yet this spring we saw one compressed into a matter of weeks.[2]

The global pandemic is far from over, but there has been progress in "flattening the curve" and with economies beginning to reopen. Significant fiscal and monetary measures continue in full swing.

What does the road ahead look like? As humans, we grasp for certainty. Yet, uncertainty has always played a common role in the financial markets and events such as these can make things even more unclear. One such example: economists attempting to quantify the effects of the shutdown on second-quarter gross domestic product predicted U.S. GDP estimates of between -8 and -50 percent.[3] Opinions continue to significantly vary about the path forward.

During uncertain times, one of our most important roles is to act as risk managers. With a focus on preserving hard-earned capital, we maintain a disciplined approach to control risk in your portfolio. At the same time, we are monitoring investments based on current market conditions and navigating the changing landscape.

While there are a confluence of factors that make today's situation unique, we must not forget that we have experienced many hardships over time. Since 1928, we have endured the Great Depression, a world war, recessions, health pandemics, market busts and lengthy bear markets. Despite periods of great disturbance, the S&P 500 Index grew from 13.4 to its current level of around 2,900[4] — a compounded annual growth rate of over 6 percent, and this doesn't include dividends reinvested. Time — if you can stick with it — has been a powerful force in investing because it compounds growth.

Nobody knows the direction of the markets in the short term, but the long-term trend has been up. We understand the challenges that come from an uncertain near-term outlook, but, as much as possible, investors should try to stay focused on their long-term goals. Look beyond today, as better times will prevail.

1. At 6/1/20; 2. bnnbloomberg.ca/agonizing-soul-sucking-experience-as-energy-batters-tsx-in-2020-s-first-quarter-1.1415440; 3. bloomberg.com/news/articles/2020-03-22/fed-s-bullard-says-u-s-jobless-rate-may-soar-to-30-in-2q; 4. macrotrends.net/2324/sp-500-historical-chart-data; 05/11/20.

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To Our Clients:

Summer is usually the time for leisurely pursuits, but this year we face new challenges. In the near term, we are likely to see ongoing equity market volatility as economic data and earnings are expected to reflect the impact of the spring economic shutdowns. During these times, try and maintain a longer-term perspective.

We continue to work hard for you and your investments in these changing times. Please call if you have concerns. We hope that you take some time to enjoy yourself after a difficult spring.

Brad

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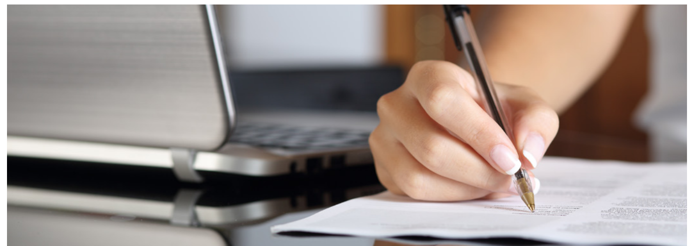
Working From Home? Keep Good Records

This past spring, working from home became the "new normal" for many office workers. A common question arising from this experience is: "Can I claim a deduction on my tax return for home office expenses?"

The Canada Revenue Agency (CRA) allows for a deduction in instances in which one of the following conditions is met: i) The workspace is where you mainly do your work (more than 50 percent of the time); or ii) You use the workspace only to earn employment income, and it is used on a regular and continuous basis for meeting clients, customers, or others in the course of your employment duties.

Deductible costs are based on the type of worker claiming the deduction: employees, commissioned salespeople or self-employed workers. Each of these groups is entitled to deduct different expenses. Expenses generally include electricity, heating, maintenance and supplies. Property taxes and home insurance are allowable expenses for commissioned salespeople or self-employed individuals, and mortgage interest and capital cost allowance may be claimed if you are self-employed. The portion that can be claimed is based on the area attributed to the home office, as a proportion of the total finished area of the home.

If individuals are not self-employed, in order to potentially deduct these expenses your employer must complete *CRA Form T2200:*



Declaration of Conditions of Employment. Also note that any expenses reimbursed by the employer, such as internet costs or office supplies, cannot be claimed.

While the current CRA rules normally require that you spend more than 50 percent of total work time in the home office during the tax year in order to claim deductions, some accounting professionals have indicated that there may be exceptions. Given the unprecedented circumstances in which people have been mandated to work from home for a portion of the year, the CRA may consider cases on an individual basis.[1] In the foreseeable future, the 50 percent threshold may likely be met by more workers if continued distancing efforts result in fewer workers returning to traditional office spaces.

For detailed information, please consult the Canada Revenue Agency or seek advice from an accounting professional.

1. theglobeandmail.com/investing/globe-advisor/advisor-news/article-pandemic-led-flight-to-home-offices-brings-tax-perks/?fbclid=IwAR24-wttdbsJ4SfIoK1d5gRR77hoUEYUyeBa0GshEy5s9oi23TXpheggZQc

For 2020: Changes to RRIF Withdrawal Factors

In March, the Federal Government reduced the minimum withdrawal amounts required for Registered Retirement Income Funds (RRIF) by 25 percent for 2020. As a reminder, the RRIF withdrawal factors are based on age. If you were 71 at the beginning of the year, under the existing rules you would be required to withdraw 5.28 percent of your RRIF in the year. For a RRIF with a value of $100,000 at the start of the year, the required withdrawal amount would be $5,280. With the changes made for the 2020 year, the withdrawal requirement would be $3,960, or 25 percent less.

Withdraw Less? Consider Other Opportunities

While the lower withdrawal requirement allows RRIF investments to potentially recover from a market downturn, there may be better alternatives for seniors who don't require RRIF income. Instead, investments can be transferred "in kind" from a RRIF to a Tax-Free Savings Account (TFSA) subject to available TFSA contribution room. The withdrawal from the RRIF will be taxable, but should investments recover, the TFSA will generate no taxable income on future withdrawals or investment income, unlike the RRIF.

There may be an additional tax opportunity. For seniors who have a lower marginal tax rate today than they expect to have in the future (including at death), drawing RRIF income above the minimum levels may be a way to potentially lower an overall lifetime tax bill. RRIF withdrawals will be taxed at the current, lower tax rate, instead of at the higher anticipated future rate. If these funds are invested in a TFSA, any future gains will not be subject to higher future marginal tax rates. Note that withholding taxes will apply to RRIF withdrawals in excess of the minimum amount. Also keep in mind that the effect on any income-tested government benefits should be considered when contemplating this strategy.

The reduction in the minimum withdrawal factors for 2020 applies to Life Income Funds (LIFs) and other locked-in RRIFs. If you have already withdrawn more than the lower minimum amount in 2020, you are not permitted to re-contribute any excess to your RRIF. Please call if you require assistance or seek advice from a tax professional.

Reminder: Tax Filing Extension for Balances & Instalments Due

The CRA has extended the deadline for balances and instalments due to September 1, 2020.

For those who follow calendar remittances, keep in mind that the regular Sept. 15 quarterly remittance occurs just two weeks later, so plan ahead to help avoid cash flow issues. However, if income has dropped significantly in 2020 compared to what was initially anticipated, the amount required for the instalment payment may be less than what was originally planned. The advice of a tax advisor regarding your situation may be beneficial.

Dollar-Cost Averaging: For Uncertain Times

Veteran investors know that it is impossible to consistently pick market bottoms (or tops, for that matter). Bottoms tend to occur when sentiment is at its lowest and the psychological barrier to committing new money to the markets is very high. Paradoxically, these times may turn out to be some of the most opportune.

It's not always easy to commit funds to an investment during down periods. However, investors may find dollar-cost averaging (DCA) to be a useful technique in these circumstances. A DCA program mandates regular, more modest investments over time, rather than one major, lump-sum commitment.

This simple example illustrates what happens when an investor uses a DCA strategy to deploy $20,000 in each of five periods.

Period	Price	Units Purchased	Total Units Owned
1	$25.00	800.00	800.00
2	$22.50	888.89	1,688.89
3	$21.00	952.38	2,641.27
4	$22.50	888.89	3,530.16
5	$27.50	727.27	4,257.43

At the end of five periods, under the DCA program, the investor would have 4,257 units worth $117,079. If the investor were to have purchased $100,000 of the same security at period 1, the investment would be worth $110,000 and only 4,000 units would be owned.

Here are some reasons why DCA can be a powerful tool.

Takes advantage of falling prices. As the amount of the investment is fixed each period, DCA automatically results in

buying more shares (units) when prices fall and fewer shares when prices are higher. Unless share prices steadily increase, DCA will mean you own more shares at a lower average cost (assuming the same investment is purchased).

Matches cash flow. A DCA program can fit nicely with personal cash flow, acting as a forced way of saving on a steady basis. Payments can be made at any regular interval, such as monthly, quarterly, etc.

Offers flexibility. Should circumstances change, such as income being temporarily halted, the DCA program can be paused and resumed at a later time.

Removes emotion. While the best time to buy securities can be when prices are low, it is often difficult to make a buying decision during down-market times. With DCA, the buying decision has been predetermined. This helps to take the emotion out of the investment decision.

Dollar-cost averaging can work with almost any investment program, but it works especially well with long-term accumulation strategies. Getting started is simple, so please call for more information.

Lessons from the Past: Markets Are Cyclical

We have encountered many new situations in response to COVID-19, including isolation, physical distancing and voluntary economic closures globally that have created uncertainties for the short term. Doomsayers cite these factors, and others, to suggest that this time is different and the current economic downturn will somehow last forever. However, economic cycles go up as well as down.

Equity markets are also cyclical. Bear markets happen from time to time. Yet, even in the worst situations, equity markets have eventually turned their course. The worst bear markets in history have seen drawdowns of over -86 percent (1932) and -56 percent (2007). Yet, the average returns following some of the worst bear markets in history (chart, right) were 53 percent, 78 percent and 143 percent over the ensuing one, three, and five year periods, respectively. Although these positive returns came after the depths of the bear markets, history reminds us that time can heal even the worst market declines.

Forward Returns Following History's Worst Bear Markets — S&P 500 Index

Peak	Trough	Drawdown	1 Year	3 Years	5 Years
1929, SEP	1932, JUN	-86.2%	162.9%	170.5%	344.8%
1937, MAR	1938, MAR	-54.5%	35.2%	38.2%	84.5%
1968, NOV	1970, MAY	-36.1%	34.8%	50.6%	42.2%
1973, JAN	1974, OCT	-48.2%	38.1%	72.7%	117.5%
1987, AUG	1987, DEC	-33.5%	23.2%	55.5%	121.7%
2000, MAR	2002, OCT	-49.1%	24.4%	59.0%	105.1%
2007, OCT	2009, MAR	-56.8%	53.6%	98.0%	181.6%

Source: fortune.com/2020/03/19/coronavirus-stock-market-predictions-bear-market-stocks-bottom-what-to-expect/

Worth repeating: While nobody knows the direction of the equity markets over the near term, the long-term trend has been up. In preparation, a disciplined approach emphasizing quality, diversification and a solid plan should serve us well over the long term.

Our Role as Risk Managers

The exogenous event of COVID-19 has been an uncomfortable reminder that we are all vulnerable to unforeseen risks that can have unprecedented effects. As investors, we could try and avoid these terrible events, but for most of us, overly defensive tactics, such as not participating in the markets, wouldn't help in achieving our goals over the longer term.

As the saying goes, perhaps "the correct lesson to learn from surprises is that the world is surprising." Equity markets inherently come with risks — in order to reap the potential returns offered by the markets, investors must be willing to accept that surprises can happen from time to time.

While risks in investing can never be eliminated, they can be managed. This is one of our main roles — to act as risk managers. As risk managers, we have significant concern and care about preserving your capital and growing it over the longer term. We put this into practice when we construct and manage portfolios — positioning them so they don't do terribly in any one particular outcome, but also have the chance to do well across the many potential paths the markets could take.

During buoyant market periods, such as the extended bull market run we recently experienced, the need for risk management may not be overly apparent. It may have been easy to get caught up in the prevailing momentum and continuous market advances. Yet, risk management does not focus on achieving the highest possible rates of return — it is about preserving hard-earned capital to support investors in achieving the returns needed to accomplish their goals. Often, it's only when prices head downwards that the value of risk management becomes more obvious.

This means following various guidelines that have been established to control risk. We do this in various ways, such as maintaining a strategic asset allocation, rebalancing portfolios back to target allocations when they drift too far, limiting the size of any particular holding, diversifying exposure across sectors and geographies and paying particular attention to an investor's personal risk tolerance levels.

We're also here to provide counsel. As hard and fast as equity markets fell in late February, the rebound in April was equally stunning. As award-winning finance columnist Morgan Housel has said: "You will likely be more fearful when your investments are crashing and more greedy when they're surging than you anticipate. And most of us won't believe it until it happens." Sometimes emotions can pose risks to our short-term decision-making that can affect our longer-term well-being.

While everyone has an idea about how things will continue to unfold, in reality, nobody can be certain about the near-term path forward. Risk management practices are intended to help protect investors from the potential changes. During these challenging times, investing requires patience to understand that the markets will inevitably encounter surprises along the way, as well as the resolve to remember that portfolio guidelines have been put in place to support your journey to investment success. Please call if you would like to discuss.

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