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Canada Outperforms

As the global economy has slowed, rocked by the spillover of the U.S. housing debacle and ensuing credit crunch, inflation pressures have continued to mount. Commodity price increases are particularly troubling, especially for food and energy. They are now working their way through the economy, leading to rising costs of production, heating, driving and grocery bills. Moreover, virtually every sector of consumer spending is directly or indirectly impacted. At the same time, central banks are still concerned about weak economic growth and the potential for further financial unrest.

The GDP numbers have slowed even more in Canada than in the U.S., but that has largely been the result of an auto-inventory correction and reduced real net exports thanks to the continued strong Canadian dollar. Ironically, our domestic economy is much stronger than in the U.S. by almost every other measure. In particular, real incomes have outpaced the U.S. Consequently, our living standards, as measured by real income, are rising and wealth is rising relative to income, while both measures are falling in the U.S. Not only has our housing market dramatically outperformed the U.S., but Canadian stocks and bonds have, on balance, outperformed as well. And, thanks to the strong loonie, food and gasoline prices have not risen nearly as fast here as in the U.S. What's more, our job market is stronger; our financial institutions have not been as hard hit by the subprime meltdown; and, our government balances remain in surplus. Inflation is currently less of a problem here than in the U.S., which has been reflected in the relatively modest rise in long-term interest rates in recent weeks in Canada compared to the U.S.

There is good reason to believe that the rise in energy and food prices reflects, in large measure, underlying excess demand for these products emanating from the rapid growth in demand in the emerging world and the stall out in productivity gains in agriculture, the diversion of food to fuel, changing diets, and limited exploration success for new energy sources. While financial speculation plays a role, we estimate that it is a relatively small role. In consequence, commodity prices are likely to remain high, boosting profit potential for many Canadian companies and sectors—a far larger proportion of our stock market than in the U.S. market. Moreover, while all banks are experiencing rising risk of loan losses and are provisioning for such, our financial sector is largely in much better shape than in the U.S. The combined materials and financial services sectors represent a whopping 45% of the TSX. If we outperform in these two sectors, wealth creation will be significantly greater than for the S&P 500, given our view that the Canadian dollar will likely continue to hover around par. Interest rates will rise less than in the U.S., so our bond market will continue to outperform. With any luck at all, we will skate through the rest of this year without a recession and most consumers will feel little need to significantly tighten their belts.

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Investing for the Future?

Consider Environmental, Social and Governance (ESG) Factors

One of the emerging trends in investing is the consideration of ESG factors in the investment process. The origin of ESG investing resides with socially responsible investing (SRI) – owning companies that enhance the world in which we live, has been around for generations. Ethical or negative screening was initially used to exclude individual securities or entire sectors from investment consideration based on social or environmental criteria. A simple example is the exclusion of companies involved in the tobacco industry because of its link to cancer.

Positive Screening

The potential downside often associated with negative screens led to the creation of positive screening. This involved investment managers investing in companies that demonstrated a set of positive values rather than avoiding those exhibiting negative qualities. This positive screening approach resulted in the concept of best-in-class. No longer were companies or industries automatically screened out of the investment universe. Investment managers tried to identify and invest in companies that had the best practices within each sector. Simply put, rather than excluding the oil and gas sector, for example, you would target companies with a good track record, compared to their peers, of addressing environmental and aboriginal issues.

Shareholder Involvement

Once investment managers identified the best-in-class companies, being actively engaged as shareholders has been shown in some instances to further influence corporate behaviour in a positive way. These efforts included initiating conversations with corporate management on issues of concern, and submitting and voting proxy resolutions. These activities are undertaken with the belief that socially responsible investors, working cooperatively, could guide management on a course that would improve financial performance over time and enhance the well being of the stockholders, customers, employees, vendors, and communities.

What about performance?

Is it possible to meet your investment objectives and still leave the world in a better position than when you started? Many academics believe the answer is “yes”. Mercer’s investment consulting business in conjunction with the United Nations Environment Program’s Finance Initiative’s Asset Management Working Group conducted a study of 20 academic papers and 10 broker studies on the subject of returns from ESG investing.[1]

Of the 20 academic papers, 10 concluded that the consideration of ESG factors in the investment process improved investment returns. Seven studies indicated that the impact was neutral and only three papers indicated there was a negative impact to returns. Environmental and governance factors were more strongly associated with positive impacts on performance, whereas the reports identified that simple negative screening, as used historically in SRI, has the potential to have a negative impact on performance.

At best this approach adds investment value; at worst it appears to be performance neutral. As such, there appears to be no clear evidence that ESG investing will compromise performance.

Implications for Manager and Investment Selection

Many managers and investment opportunities are now available, so how do you decide which one to select? In our opinion, when selecting an investment manager, the best approach is to use a manager that has fully integrated the ESG approach within their portfolio management and research process. The implication is that the firm has made a dedicated effort to understand ESG issues and the impacts that related decisions will have on investment portfolios.

Additionally, a fully integrated approach implies that a more robust and diversified portfolio will be created. In contrast, there has been a proliferation of investment funds that have narrow investment mandates such as “green energy”. By investing in just one narrow segment, investors face higher levels of risk because of the lack of diversification and could be disappointed if that particular segment underperforms.

In Summary

Research is providing evidence that investors who are concerned about ESG issues do not have to sacrifice return potential when considering these factors and it may in fact be a source of added value.

[1] *Please see the following link for the full report: http://www.mercer.com/attachment.dyn?idContent=1292200&filePath=/attachments/English/Demystify_Responsible_Investment_Performance.pdf*

Portfolio Strategy

Global equity markets have rallied since mid-March 2008. The Canadian market, as measured by the S&P/TSX Composite Index has shown particular strength, setting a new record high of 15,128.56 on May 21 before falling back a bit to close the month at 14,714.73.

Our primary investment thesis since 2002 has been that whether by design or by default, central banks globally have adopted a posture that encourages higher rates of inflation. We believe this because interest rates are low, which in addition to fuelling inflationary pressures makes the prospective return from bonds less compelling in relative terms to equities.

Equities Favoured Over Bonds

In light of this backdrop, we have encouraged investors to reduce holdings of bonds – which do very poorly in inflationary environments – in favour of equities, which historically have shown better performance than fixed income securities in inflationary periods.

We recommend a pronounced bias towards equities in our asset allocations across all balanced and growth investor profiles. We favour the stocks of companies that are as close as possible to the real economy, and other real assets including real estate.

Equities of financial companies are expected to fare less well than those closer to the resource side. Those in the areas of resources – energy, base metals, precious metals – would be expected to excel.

We also advocate significant international diversification: we recommend that the majority of equity investments be made outside of Canada. Our reasoning for the relatively high weighting in international investments is twofold. First, we wish to purchase equities in sectors that are under-represented in Canada, in order to improve portfolio diversification. Second, we wish to take advantage of the strength in the loonie, which enables us to purchase quality international equities 'on sale' in Canadian dollar terms.

Is a Global Currency Revaluation Looming?

In addition to the rallying global equity markets since mid-March, the U.S. dollar as measured by the U.S. Dollar Index has also strengthened markedly. The U.S. dollar has strengthened against most of its major trade counterparts.

To us this makes sense, because prospectively economic strength in the U. S. should rebound as a result of the monetary policy of the Fed, and the economic stimulus package that recently got underway, with rebate cheques hitting the mailboxes of 130 million taxpayers in recent weeks. It is important to note that the Fed has once again aggressively eased monetary policy before the onset of recession, and the stimulus package was agreed on, and indeed may have been implemented before the onset of recession.

With this in mind, in our international equity allocation, we recommend a higher exposure to U.S. equities than to global equities.

Investment Thesis Intact

In 2008, we have seen evidence of the dominance of real economy assets over financial economy assets. For example, the Canadian equities market, with its high percentage of resource companies, is the only major equity index to have reached a new all-time high in 2008. This has been largely on the back of the energy and materials sectors.

Canadian financial stocks have fallen more than 13% on a total return basis since peaking in May 2007, their worst performance since 2000. We believe that the dominance of real assets over financial assets is likely to continue.

Market Outlook

There are a great many encouraging signs that the credit crisis is abating, and that markets are on a firmer footing. From a fundamental and technical perspective, at the end of May the bull market for the S&P/TSX Composite Index is still intact.

Looking ahead, BMO Capital Markets Research remains in the bullish camp for the equity market, expecting continued central bank action to improve market liquidity. On a valuation basis, equities are attractively priced, with a persistent positive spread between the earnings yields on equities and competing yield in the fixed income realm. In addition, BMO Capital Markets Quantitative Research finds that the S&P/TSX Composite and all 10 market sectors are undervalued on its asset allocation model.

Research has raised its one-year target to a new high of 15,500 for the S&P/TSX and maintains its target of 1,500 for the S&P 500. These targets reflect the current earnings outlook, which has firmed in recent weeks, and is significantly better than the typical cyclical decline in earnings associated with slowing economic growth. For the S&P/TSX Composite and the S&P 500, this implies high single-digit returns for both indices over the next 12 months.

Equity market sectors currently rated Outperform include: Chemicals & Fertilizers, Precious Metals & Minerals, Integrated Oils, Oil & Gas Producers, Oil & Gas Royalty Trusts, Capital Goods (ex-Aerospace), Rails, Media (ex-Cable), and Insurance.

Reduce Tax With Income Splitting

Under our current tax system, the more you earn, the more you pay in income taxes on each incremental dollar earned. With this in mind, it makes sense to spread income among family members who are taxed at lower marginal rates in order to lower your family's overall tax burden. However, the income attribution rules can prevent most income splitting strategies where there has been a transfer to a spouse or minor child for the purpose of earning investment income. The attribution rules transfer the taxation of investment income (and capital gains in the case of a gift to a spouse) back to the person who made the gift regardless of whose name is on the investment. While there are significant restrictions, there are a number of legitimate income-splitting strategies available to you.

Some possible strategies include:
- taking advantage of the new pension income-splitting rules, which became effective in 2007;
- making a gift to an adult child;
- creating formal trusts for minor children to earn future capital gain income; and
- establishing a Tax-Free Savings Account (TFSA) for a lower-income spouse (beginning in 2009).

Prescribed Rate Loan

Another popular income-splitting strategy involves transferring income-generating assets (ideally cash) to a lower-income spouse and taking back a loan (equal to the fair market value of the assets transferred) at the Canada Revenue Agency's (CRA) prescribed interest rate in effect at the time of the loan. This strategy may now be more feasible given the CRA's recent announcement to decrease the prescribed rates for the third quarter of 2008. For loans made to a family member, the rate necessary to avoid the income attribution rules is decreasing from 4% to 3% effective for loans made between July 1 and September 30, 2008. If structured properly, the prescribed rate in effect at the time of the loan will continue to apply until the loan is repaid. For loans made after September 30, 2008, the CRA's prescribed rate at the time of the loan will apply.

How it Works

Briefly stated, an interest-bearing loan is made from the person in the higher marginal tax bracket to a family member (such as a spouse) in a lower tax bracket for the purpose of investing. To avoid the income attribution rules there are a number of requirements that must be met. For example, as outlined above, interest must be charged at a rate at least equal to the CRA's prescribed rate in effect at the time the loan is made. Interest is charged annually at this rate and must be paid by the following January 30 each year. In order for there to be a net benefit, the annual realized rate of return on the borrowed funds must exceed the annual interest rate charged on the loan, which is included in the income of the transferor and should be deductible to the transferee family member, if used for investment purposes. The impact of increased income to the transferee family member (e.g. loss of spousal tax credit) should also be considered before employing this strategy. Finally, it is important to consider the possible recognition of capital gains or capital losses, which may be denied, when assets other than cash are loaned or transferred to a family member.

For more information on this and other income-splitting strategies, please ask your Investment Advisor for a copy of our publication entitled *Tax Tips for Investors*. However, given the complexity of the income attribution rules, it is strongly recommended that you consult with your tax and legal advisors to review and structure any income-splitting strategies to ensure that the strategies are implemented and documented correctly and achieve the desired results without any unanticipated implications.

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