Manulife Securities

ROYDS REPORT

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Markets – Understanding the Background to see the Future?

What a roller coaster! From Dec 2021 to mid Jun 2022 markets fell (using the S&P 500 as a gauge). Then in Jul and Aug, there was a lot of recovery, followed by a terrible Sept, hitting the low on Oct 12. For the rest of Oct and Nov, markets rallied, followed by a bad Dec. Jan 2023 was nicely positive. For Feb and the first half to 2/3 of Mar the market retreated again, but not to the low of Oct 12, or even to the previous low of mid Jun. Maybe this is a classic case of the market climbing a "wall of worry", where it inches its way up in sawtooth fashion, with lots of media focus on and where Oct 12 will prove to have the low for this market cycle. This is very different from the market crashes of 2018 and 2020, where the markets fell quickly in 3 and 1 months respectively and then rallied in a fairly consistent and relatively quick fashion to reach new peaks. This kind of slow downturn and recovery (if indeed that is what we are seeing, rather than it just being a bear market rally, which is a brief upturn during a market's march downward) is much more tiring emotionally for investors. And, this market is more complicated, because economic factors are more numerous and less common.

We started the period with the lowest interest rates in about 5000 years (so in all of recorded history) which made it almost free to borrow money. This allowed companies to borrow lots of money to grow faster, but also led to consumers racking up mountains of debt. Then we started seeing labour shortages, perhaps not caused so much by an overheated economy creating new jobs, as by an unprecedented, huge wave of babyboomer retirements, Covid related withdrawals from the workforce, and a smaller proportion of the population just entering the workforce, because we've had low birthrates for decades. (Thank goodness for immigration to offset some of Canada's workforce shortages.) We have painfully high inflation caused by supply chain issues, higher wages as employers compete for workers, a spike in demand from re-openings after Covid restrictions, and shortages from things like avian flu, natural disasters and the war in Ukraine. In response to the high inflation, central banks around the world, like the U.S. Federal Reserve and the Bank of Canada (a crown corporation), raised interest rates quickly. All of a sudden, the stocks of companies which needed to borrow money to grow, or which already had high debt, were re-valued downward to reflect their new, higher debt expenses and slower growth prospects, and this led to the drop in stock prices of the rest of the stock

market too. Thanks to rising interest rates, 2022 was terrible for bonds, some saying it was the worst year for US bonds in history. Based on other metrics, some said it was the worst since 1926, and others said it was the worst for the world bond market since 1788! (This caused balanced funds, traditionally a mixture of 60% stocks and 40% bonds, to fall more, not less. So more conservative investors holding bonds or balanced funds got hurt worse than many medium volatility investors. And, aggressive investments with a lot of high tech exposure saw their values fall even worse.)

The higher interest rates caused a sizeable correction in housing prices, which may contribute to the huge pain some mortgage holders may feel when they renew their historically low interest rate mortgages. Some will find their payments doubling, tripling, or worse. And some mortgage holders will find their lenders will not renew the loans, because their houses aren't worth as much as they owe on them. (There may be lots of forced house sales or foreclosures in Canada. Lucky US mortgage holders got to lock into low fixed rates for up to 30 years, so neither they nor their banks are facing a crisis.) For once, investors did not retreat to gold and push its price up, which would have made gold an effective hedge against market drops or inflation for those holding it. All these things happening at once is like the "perfect storm", but also has created a situation that Central Banks and economists have not seen before and have no proven solutions to fix.

This may have sounded very doom and gloomy. How can the economy recover? How is anyone supposed to make money? Will the stock market ever recover? Let's address these questions, one at a time, starting with the economy. We listen to and read commentary from many, many economists and we have 3 favourite ones. The RBC and CIBC ones speak in plain language, in concrete terms, about the next year or two. The third, Frances Donald (one of only two only female economists we know of, and the Chief Economist for Manulife Investment Management), offers insightful, 40,000 foot views of what is going on and why. She has been labelled a "thought-leader". She was interviewed in the March 22, 2023 Globe and Mail "Report on Business" Magazine and had these thoughts that we wanted to share:

- In "this new economy, particularly the post-COVID-19 economy, we're asking central banks to solve problems they cannot solve"
- "A lot of the inflation we believe will still remain in the next few years is going to be driven by themes like deglobalization, climate change, ESG concerns, the search for alternative fuel. These are global trends that raise prices everywhere, and they are not interest-rate sensitive. The Bank of Canada can hike interest rates all it wants. It's not going to suddenly give us access to the bread basket in Eastern Europe. It's not going to cure the avian flu that has decimated chicken flocks and led to egg prices rising. We're in a situation where we're asking monetary policy to solve problems it cannot solve, and putting the weight of curing us of higher prices on one entity. And if we ask the central banks to do that, their only method to achieve this mystical 2% is to decimate prices in the areas that they are capable of controlling, and leaving the prices they can't control floating high. So, 2% inflation is a general guidepost, but it's more and more irrelevant."
- "Every leading indicator we have tells us that we are likely to face a recession in 2023, potentially later in the year, or into 2024. Now lately, a lot of experts look at strong job growth and strong consumer spending and say, "How could we possibly be in a recession?" The challenge is that some data points lead and tell us where we're going to be in six to 12 months, and some data points lag, or are coincident, and explain only where we are now. Indicators that lead tend to be things like the housing market, yield curves or how much credit banks are willing to provide. Indicators that lag include things like consumer spending and jobs. If I'm going to make the case that Canada will evade a recession, I have to make the case that every leading indicator that told us in the past that a recession was coming is no longer valid. There are

certainly a lot of things about the current environment that are different than they have been in the past"

- "My biggest fear in the next one to two years—on a global basis, U.S. economy in particular—is that we may or may not hit a so-called technical recession, often described as two quarters of negative growth. We may be in for something more challenging, which is a prolonged period of low growth. We may see an environment with very low growth, but still unemployment rates that are not particularly worrisome. We may see a recession in which labour hoarding is the defining feature, and companies try to cut costs in other ways. Probably we are going to have to re-evaluate how we think about this word "recession." Frankly, I think we're going to be discussing whether or not the next 12 months will be a recession for the next 10 years"
- … a concern is "Canadian psychology. We're on several decades now of this concept that home prices always rise. I remember when I was younger my father telling me, "Frances, buy a house you can't afford, because home prices always rise, and your income always goes up." He's not with us anymore, but I wish I could tell him how faulty that advice was. The U.S. is still recovering from the psychological impact of 2008—that prices can decline. Canada did not experience that reset. In Canada, there are some areas where the market's already reheating, because now it's "a good time to buy." So, this concerns me."
- "The Bank of Canada spent the last year being very hawkish, hiking rates quickly. So, just the pure math of it suggests Canada could have the lowest GDP growth in 2023. However, does it have the lowest GDP growth in 2024 and onward? There, I think we may come out looking a bit stronger. Canada has one of the most educated populations in the OECD. We have what economists like to call high human capital, which is just a good way of saying we're all pretty smart. We have several functioning industries. We have a growing tech industry. There's a lot of upside for our economy. This is, no doubt, going to be a rough patch, and it's going to hurt a lot of Canadians who are already feeling the brunt of it. But I am more optimistic when I think about where Canada can be in five to 10 years."
- If my sons ever said they want to economists, I'd "buy them history books, psychology books, political science books, physical science books, and I will remind them that <u>we are better thinkers and thought leaders when we take a holistic approach to the world</u>."

The future is unknown and it's not going to be smooth and easy. But, when has it ever been? Our great grandparents (or their parents) had to face WWI, the Spanish Flu, the Great Depression, WWII, the Korean War etc. Then there was the Cuban Missile Crisis, JF Kennedy's assassination, bank collapses, oil shortages, the Cold War, recessions, more bank collapses, the Iran War, the Afghanistan War, 9/11, the Great Financial Crisis, also called the Great Recession with more bank collapses, the US housing crash and a lengthy recession, Covid, the Ukraine Invasion and so many other catastrophes in between. Despite all of this, stock markets rose.

The oldest US stock index, the DJIA (Dow Jones Industrial Average) was 74.45 in 1915, just after the start of WWI for Europe and Canada, but before the US entered the war. As of Mar 26, 2023 it had risen to over 32,237. That's over 43,000%. It wasn't straight line growth, but a constant repetition of several steps forward and a few steps back. Despite all the crises the world has faced, the stock market has risen. Why and how? Somebody is always going to make money in capitalist societies. If oil is in short supply, oil companies make money. If countries are spending on defense supplies, airplane and munitions manufacturers will make money. If there are droughts and floods causing crop failures, other farmers will spend lots on fertilizer to get better crops, while food demand and therefore prices are up. If people want to convert to EV (electric vehicles) or buy fridges, thermostats and watches that talk to each other, then semi-conductor producers will sell lots of their products, and make money as long as

demand exceeds supply. If we invest strategically, in profitable industries, in companies that have a competitive advantage and therefore price or cost advantages, and we buy those companies for less than their expected future profits (net of reinvestment costs) are worth, then we have a good chance of making money. Of course, we are still dependent on the cycles of investor psychology and confidence. We must hold onto our shares in such good companies through periods when other investors are fearful and aren't willing to pay a logical price for a future share of the companies' profits. Does this sound familiar, maybe like Warren Buffett's style of investing?

So, we need to be strategic, cautious and picky with investments, using fund managers with proven expertise and doing in depth research, and we need to have patience. But we don't need to be fearful.

What's Changed About Investing in Oil?

For the first 50 years of so of Warren Buffett's investing career, he was not known to hold any oil, gas, gold, copper or other resource companies. Why? His stated style and thoughts on commodities (which oil and gas are), as found on **https://www.suredividend.com/warren-buffett-quotes/** and quoted below may explain it:

- "Buffett prefers to invest in businesses that have *differentiated themselves* from the competition. Commodity selling businesses don't have a differentiator (unless they are the low cost producer).
- *"Stocks of companies selling commodity-like products should come with a warning label: 'Competition may prove hazardous to human wealth.'"*

The copper, zinc or nickel produced at one mining company is the copper, zinc or nickel produced at other mining companies. So, resource companies are all get the same global price for their products, and can't set their own prices. The only way they can make any extra profits is to be the low-cost producer, and even then, they have limited control on their profit margin, because worldwide supply is determined by their collective competitors, and price depends on supply. The pricing power and predictability of recurring profits that Buffett has traditionally sought are missing.

Buffett also preaches against investing in businesses that have to keep reinvesting large amounts of their profits to keep operating. For example, oil companies have always needed large amounts of capital to explore for more oil or dig more wells to keep production levels up, because the longer their operating oil wells are in use, the less volume they produce. Companies that have to reinvest most of their profits to keep operating don't typically make outsized profits from their shareholders, and were always avoided by Buffett. This all makes sense, right? Source: **https://www.suredividend.com/warren-buffett-quotes/**

There have been some short-term exceptions, when there was good money to be made in resources. When people get scared about the value of currencies (paper money), they sometimes buy gold and push its value way up. 2008, during the Great Recession or Financial Crisis, was one such time. Because the value of their inventory rose as the market price of gold rose, gold mining companies really appreciated in value. A few years prior to that, when construction in China was happening at a blistering pace, there was a worldwide shortage of copper, steel and other building materials. Prices for those commodities rose and any company producing them became more valuable. But when there are high prices, there is a big incentive for companies to bring on more supply. And when supply catches up with demand, resource prices plummet and resource companies fall back in value, often very severely. So, to make any profit on those resource companies, one has to time when to buy them and

also when to sell out. As we all know, few people are able to successfully time the market consistently. Such companies have not historically been Buffett's kind of long-term hold companies.

So what has changed now? Buffett's company Berkshire Hathaway bought $25 Billion USD in oil and gas companies in first quarter 2022 alone. And some of our GARP managers who have previously not held resource companies also bought oil companies in 2022. Should we dump those funds because they're not following Buffett's traditional GARP investing advice? What made Buffett change his mind about oil company investments? (Source: **https://www.fool.com/investing/2022/08/02/2-investment-lessons-from-warren-buffetts-massive/#:~:text=Buffett%20has%20been%20investing%20in,trend%20of%20increasing%20oil%20prices**.)

These days, oil companies are reluctant to make more investment in fossil fuel energy production, because they see oil production is in long-term decline and government permits for more of it are hard to get. So, reinvestment by oil companies is the lowest it's been in years, and new oil wells are not being brought online to replace oil wells that are drying up. There is lots of investment in renewable energy, but it will still take a long time to start producing enough energy to replace energy currently coming from oil or to increase supply enough to meet current demand. With demand expected to continue to exceed supply, possibly for years, and oil companies keeping money they would historically have invested in new oil production, oil company profits are expected to remain very high for years to come. Some of our managers are investing in this area, like Buffett is doing. These managers will have to figure out how long it's safe to stay invested in this sector, that is, how long before supply catches up to demand. (Source: https://www.iea.org/reports/world-energy-investment-2022/overview-and-key-findings)

Choosing a Variable or Fixed Mortgage Rate Now

Until the past couple of years, we had had decades of falling interest rates. Mortgage holders who had floating interest rates more often than not saw their rates drop over the course of each term. They did run the risk, that rates could have risen, and then they'd have ended up paying more over time. People who didn't want to face that risk opted for fixed interest rates on their mortgages (meaning that the interest rate and payment would not change for a certain period of time), and that fixed rate was usually quite a bit higher than the variable rates by the end of the term of the mortgage. So, having a variable rate was usually, in hindsight, a cheaper option. The trend in interest rates reversed in the last while. To quote a CNBC news item, "markets are entering a phase not seen in 72 years: A rising rates cycle." Source: https://www.cnbc.com/2018/02/16/bonds-are-entering-a-rising-rates-cycle-for-the-first-time-since-the-1940s.html Not everyone agrees that the falling rate cycle was as long as 72 years, but it was certainly many decades long. Historically, rates tend to follow trends for long periods of time which suggests we are only at the beginning of rate increases. Is it any wonder then that now, long after it was more beneficial to have a floating interest rate, and now that floating rates are likely to float higher, people are getting calls from banks suggesting they lock into fixed rates! On Feb 23, 2023, the Globe and Mail published an article entitled "When your bank suggests you lock in your variable rate mortgage, it has an angle". Some of the main points in the article are:

- "Apart from borrowers desperate for payment certainty, locking in no longer has a favourable risk/reward. Prime rate is well over double its 10-year average."
- "Lenders love selling five-year fixed rates all day long, but especially near the top of a rate cycle. Five-year contracts are more profitable and earn them big prepayment penalties when rates drop [if you want to renegotiate to newer lower rates, or if you sell your home ad have to break your mortgage]. That essentially binds most customers to the lender."
- ""The potential new OSFI rules will make switching lenders more difficult and time-consuming in the future," Mr. Eisner [True North Mortgage chief executive officer] says. If you're someone

whose debts are a high percentage of their income, for example, he suggests that "it might be your best bet to renegotiate your mortgage now before you lose the ability to threaten to switch lenders.""

- "Just because a lender proposes a limited-time special doesn't mean its rate can't get more "special." Call a mortgage broker for more quotes, scan online rate sites, check The Globe and Mail's "Lowest nationally available mortgage rates" rate table and use lower rates as leverage when appropriate."
- ""For a less-qualified client, rate stability matters, especially if income isn't keeping up with inflation," Ms. Pope [a Premiere Mortgage Centre mortgage broker] says. Moreover, if it's unlikely you can qualify elsewhere because of income loss, credit problems or otherwise, and locking in makes sense for your situation, taking your existing lender's offer might make sense."

Mortgage Holders - Focus on Debt Before It's too Late

Have you ever sensed there was a problem and just buried your head in the sand, until it became a certainly you couldn't avoid? If you're worried about being able to afford your mortgage payments, when your current term is up and you have to renew, don't wait to find out for sure. Do something about it now!

"New data from CIBC show that $52-billion worth of mortgages – the equivalent of 20 per cent of the bank's $263-billion residential loan portfolio – were in a position where the borrower's monthly payment was not high enough to cover even the interest portion of the loans. The bank has allowed these borrowers to stretch out the length of time it takes to pay off the loan, which is known as the amortization period. As well, borrowers are adding unpaid interest onto their original loan or principal." Source: https://www.theglobeandmail.com/business/article-mortgage-negative-amortizations-cibc/ Put into simpler English, this means that when 20% of all CIBC mortgage holders go to renew their mortgages, they are going to find that they owe more than they borrowed in the first place and/or the time they were expecting it to take to pay off the mortgage is going to be lengthened by years. For example, a couple might have been making payments for 5 years already on a schedule that was supposed to result in their home being paid off in 25 years total, only to find out that it might take 30 or even 40 years more to pay off their mortgage, unless they are prepared to make very significantly higher mortgage payments. And these people may be the lucky ones. There will be people who bought, particularly in early 2022, who may not be able to renew their mortgages at all. Their house value may have shrunk to less than they owe on it, and a bank won't extend their loan, because there isn't enough collateral value in the house any more. If those people wait until they get a renewal notice from the bank, a few weeks before the mortgage term expires, they may be forced into bankruptcy and have their homes foreclosed on. Of course, it's possible that interest rates might fall enough or house prices might rise enough again to save these people from these problems. We favour more concrete action over wishful thinking and slim possibilities.

Step 1 would be to call your mortgage lender to find out what your amortization period and payment would look like, if you were renewing today. Find out if you will be in trouble, so you know if you have to take action today and how drastic that action has to be.

Step 2 would be to do all you can to pay off high interest, non-mortgage debt now, as quickly as possible. As soon as you pay it off, you can save the amount you were paying on it to pay off on your mortgage on renewal, and you'll have the cash flow that you were using to pay down that debt to pay off on your mortgage instead.

Step 3 is to accumulate as much money as possible to pay down your mortgage on renewal. Stop eating out or buying new clothes or buying anything not essential. Turn your thermostat down, turn off lights when not in use, do laundry and run the dishwasher in off-peak hours only. See if you can renegotiate your Internet or cell phone charges, or switch to cheaper carriers. Shop around for cheaper car and home insurance. (Elaine was recently amazed to find that her perennially low-cost insurer was going to quadruple her rates, when she moved back to a house in Ancaster, but Elaine found another provider who would only charge marginally more than her old policy for her Burlington home. There can be huge savings, if you shop around.) Forget about a vacation away from home for a few years. Get a second job. See if you can work overtime. Sell unused things on kijiji or the like. Shop the sales for food. Take a lunch to work and make your own morning coffee. Ask for cash instead of gifts for birthdays and Christmas. Let your friends and family know you can't be as generous with gifts as in the past and offer your services instead of purchased gifts, and suggest getting together at each other's homes instead of going out together. Instead of buying lottery tickets for a 1 in a million chance, save the money for your mortgage. Scrutinize every expense. Every penny counts. And with the money you save, put it in GICs or high interest savings accounts, preferably in Tax Free Savings Accounts, that earn more than your current mortgage rate (call us if you need help with this), and have the cash plus interest ready to reduce your mortgage principal owing at renewal time. Don't spend your tax refund, but save it to pay down your mortgage as well. If you can reduce your principal, your payments will go up less, and reducing your living expenses, leaves you more cash flow to cover the new higher mortgage payments. The earlier you start to economize and save, the more of a dent you'll be able to make in your mortgage debt.

Step 4 is to shop around, using a mortgage broker, to ensure you are getting the best interest rate at renewal time, or maybe just to find any mortgage lender who will approve a mortgage for you.

Are You Worried about a Canadian Bank Failure?

Some Canadians are worried about bank failures, since the failure of 2 US banks recently. Here's some information about how Canada's situation is different than the U.S.'s.

"Last week, the Office of the Superintendent of Financial Institutions, which is responsible for ensuring Canada's banking system functions smoothly today, made headlines when it took control of Silicon Valley Bank's Canadian operations. According to Tim Shufelt, what has unfolded is uncannily familiar to the collapse of the Home Bank of Canada 100 years ago, which triggered a homegrown banking crisis. Tens of thousands of depositors faced the loss of their savings, sparking a debate over how much bank deposits should be guaranteed at the federal level. Home Bank's demise inspired key features of Canada's modern banking system, including deposit insurance, federal regulatory oversight and a more concentrated sector built around a handful of big banks. It has proven to be a durable structure. Home Bank's failure was the last of any major chartered bank in Canada – unlike what we've seen unfold in the U.S."" Source: The Globe & Mail online edition Mar 26, 2023

Is it time for Tech Stocks?

Tech stock prices fell a lot in 2022. A lot has been written about the role higher interest rates had to play in that. Whether those tech companies are a good investment now is partly dependent on whether they will have strong growth rates, like so many tech companies had in the last decade. Tony Genoa, is one of many fund managers we have noticed migrating their portfolio away from high tech. We read all the updates that we can get from Tony, because his experience and long track record have shown that

he understands stock valuations and opportunities. Here's what he wrote in February about tech. "Accounting for the announced recent layoffs, the employment is still 77% higher than the start of this decade, which is 20% higher than the real sales growth that has occurred. While the Q4 2022 tech results showed a slowing of revenue growth leading to cost reduction initiatives, our opinion is that there will be more cuts to come. It would not be unreasonable to think the robust pandemic-induced growth experienced in the last few years has brought forward demand and a consolidation phase is in order before growth resumes." Tony calls it a Pandemic Hangover. There's still too much staff, and therefore salary expense which reduces profit, and product sales that should have happened over the next few years were advanced into the past couple of years, because of Covid. So where would any big sales growth come from?

Source: AGF Fund Perspectives Feb 2023

Of course, there will still be a few tech company exceptions, like a company with no debt problems and a proprietary product in a high growth segment of the economy, or maybe a low debt company with slow growing sales that is grossly undervalued. If our value or GARP managers find a few of these gems, we may see the occasional tech company in our funds' portfolios.

Can Low Income Families Save More Money for Your Children's Education by Making RRSP Contributions??

Besides saving for your retirement, "tax expert Evelyn Jacks has a double-barrelled argument for making RRSP contributions. As she explains it, the first benefit of an RRSP contribution is that you **may put yourself in a position to benefit from higher refundable tax credits such as the Canada Child Benefit**. An RRSP contribution lowers your net family income, which is the number on which the CCB is based. The second benefit is a tax deduction that helps get you a bigger refund on your 2023 taxes. Source: https://www.theglobeandmail.com/investing/personal-finance/retirement/article-why-parents-should-try-to-find-the-money-for-an-rrsp-contribution-even/ And let's not forget the normal benefits that you actually build your savings for retirement.

The following chart from Planeasy.ca shows you what CCB you could receive if you get your family taxable income level down (perhaps while one spouse is on mat leave?). For those at all near this level of income, it could be hugely worthwhile to make the effort.

	2022	
	Annual	Monthly
CCB (base benefit, child under age 6)	$6,997	$583.08
CCB (base benefit, child aged 6 to 17)	$5,903	$491.92

Source: https://www.planeasy.ca/canada-child-benefit-increase-what-will-your-monthly-ccb-be/#:~:text=The%20new%20CCB%20amounts%20are%20in%20the%20table,had%20taxable%20net%20income%20below%20%2432%2C797%20in%202022.

Do the Rich Pay Their Share of Taxes in the U.S.?

The IRS just reported statistics on who pays how much tax in the US, as shown in the chart below. While there is a lot of talk about the uber-rich not paying their fair share, it looks like the rest of the top 1% are doing some heavy lifting.

	Category of Earner		
	Top 1%	Next 49%	Lowest 50%
% Paid to to the US Govt of Total Income Taxes Paid	42.30%	55.40%	2.30%

Due to Canada's similar graduated tax system, where anyone, or in Ontario even an estate which had to take a big RRIF into income on a person's death, earning over $221,709 pays up to 53.53% income tax, the statistics in Canada are in a similar vein. Sources: https://taxfoundation.org/publications/latest-federal-income-tax-data/ and https://assets.ey.com/content/dam/ey-sites/ey-com/en_ca/topics/tax/tax-calculators/2022/ey-tax-rates-ontario-2022-01-15-v1.pdf

Remember that duplicate tax receipts are available on the new on-line access system that we wrote about in the previous newsletter. It's not too late for you to sign up for the new access. Read how in the Feb newsletter.

Elaine

Elaine Royds, MBA, CFP®
Senior Financial Advisor,
Manulife Securities Incorporated
Financial Planner,
Manulife Securities Insurance Inc.
Suite 303 - 1685 Main St W, Hamilton, ON L8S 1G5
Office 905-393-0787 Toll Free 1-855-640-1857
Website www.roydsfinancial.com

Jordan

Jordan Royds, CFP®
Financial Advisor,
Manulife Securities Incorporated
Financial Planner,
Manulife Securities Insurance Inc.

Investment Advisor Assistant, Manulife Securities Incorporated: Sarah Breimer
Senior Administrative Assistant: Dharini Jani
Administrative Assistant: Pauline Marchong

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