Manulife Securities

ELAINE'S NEWS & VIEWS

JANUARY 2017

TAX SLIP REMINDERS

In January, all the fund companies will be sending out yearend statements. You should pay attention to those statements for your unregistered accounts because they let you know if you should expect a tax slip. (The Manulife account numbers for unregistered accounts end in A, B, E or F. They could be called cash, margin or unregistered accounts.) If the statement, usually on the last page, shows there was a distribution (like a dividend that got reinvested), then expect a tax slip. Or, if the statement shows that you sold all or some of a fund for a profit, you will have to declare that profit as capital gains (only half of which is taxable). On occasion, the fund company statement will even have the tax slip you need on the last page. While no one likes to be taxed, keep in mind that you only get tax slips when a fund made so much money that it could not write off all the profits against costs or losses, or when you sell at a profit. It means your fund did well, which is what we all want. Occasionally you get a fund that does well early in the year and triggers taxable income but then falters later in the year. You still have to pay tax on the early gains or income. One good thing is that any gains that you pay tax on increases the recorded cost of your stock or fund, which reduces later taxable capital gains.

Be careful not to file your taxes before all the tax slips have arrived. Many slips (like capital gains summaries for unregistered accounts beginning with the letter N) won't be mailed out till near the end of March. For client name unregistered (also called open or cash) accounts beginning with the letter B, you may need the fund company's year-end statement to calculate and report any realized capital gains or losses. If you didn't understand the information above, please call me for further explanation.

OUR MARKET STRATEGIES PAID OFF AGAIN THIS QUARTER

Thank goodness <u>we didn't try to be market timers by getting out of the market before the U.S. election</u> in anticipation of a drop in the market after the election. The market actually dropped before the election (for 9 days, the longest unbroken drop since the 1980's). Then the day before the election, markets rallied and, surprisingly, after the election the market rose to new highs. Those who were brave enough to buy into the market on the drop before the election succeeded in buying on a dip and profited. If we had panicked and sold instead, we would have sold low and had to buy back in at higher prices. So <u>buying on dips and otherwise holding for the long-term continues to work more often than not</u>.

Some of our managers are holding onto more cash than usual because they are finding it difficult to find bargains to buy in the U.S. stock market. However, no analysts or managers I have heard from are reporting any signs of a recession, and instead we are seeing improving earnings momentum in the U.S. Earning momentums could help offset some overpricing in the U.S. market. So <u>I am</u> <u>not counselling reducing exposure to the markets or making any changes to our present strategy of underweighting Canada in favour of the U.S.</u> Even if my analysts are wrong and there is a down market coming sooner than later, a recent study by Bank of America shows that it isn't worth the risk of getting out of the market in anticipation. Ever since 1937, if you had been out of the market during the last year before a market fall, you would have missed more gain (typically 21%) than what you would have lost in the down market (typically 15%) 2/3 of the time. (Source: Globe and Mail Oct 25, 2016 quoting a Bank of America study)

Trump's win had unexpected consequences for the market. First, U.S. financials and pharmaceuticals rallied in relief that Clinton would not be adding more regulation in those industries. Then bonds had a fierce fall in anticipation of the inflation and higher interest rates, which could result if Trump comes through with his promised infrastructure spending. In the month of November alone, "the bond markets erased $1.7 trillion in value as yields around the world [rose] … This is the steepest monthly loss in 26 years since the [The Barclays Aggregate bond] index was initiated". (Source: Canoe Financial Weekly Fund Update Nov 28-Dec 2, 2016) So, thank goodness my clients have ultra-low exposure to bonds, most people having zero exposure. And based on 400 years of interest rate cycle history, this rise in interest rates and the fall in the value of existing bonds is just the beginning.

WHERE DOES SUPERIOR MARKET PERFORMANCE COME FROM – NEW AND OLD RESEARCH

When I started in this business 19 years ago, or even when I did my MBA in the early 1980's, research indicated that there were 2 sources of outperformance when investing. The first and most powerful came from choosing the right asset class to invest in. For example, if you chose to invest in stocks rather than bonds, your portfolio would get returns close to the stock market's returns rather than the bond market's. So the selection of an asset class or a specific stock market to invest in determines the general range of your returns and can bring you superior or inferior returns depending on whether you make the right choice of asset class or market. That source of out-or-under-performance continues today. Throughout history, over longer investment timeframes, the choice of North American stock markets over bonds has always provided higher returns. So with long time horizons, we know a general area to invest in.

The second factor determining performance, considered less influential, was which specific stocks or bonds you held in the chosen asset class or market. That is why I study the fund managers and their investment styles so much to try to get fund managers who choose stocks differently (with a value or low volatility bent) and enjoy fairly consistent outperformance over the long-term compared to stock market indices or other fund managers investing in the same markets. Making the right choice of a fund manager or specific stock can make a big difference in returns.

The major study "The Value of Advice 2012" by The Investment Funds Institute of Canada (IFIC) (available on the IFIC website) uncovered another factor that seriously impacts wealth accumulation by investors – the factor is the use of an advisor. Using an advisor for 4-6 years resulted in 60% more wealth on average compared to never using an advisor. Using an advisor for 15 or more years resulted in 170% more wealth on average. This wealth increase may be due to the influence of an advisor to improve tax efficiency or prevent knee jerk reactions to market volatility etc. While traditionally investors think they need an advisor to get tips on what funds and stocks to buy, this study suggests that even more of the value of an advisor may come from their planning advice.

This past October the Certified Financial Analyst (CFA) Institute and the State Street Center for Applied Research put out a paper "Discovering Phi: Motivation as the Hidden Variable of Performance" (available on their website) based on a study of 7000 investors and investment professionals. This study found that the fourth big factor that accounts for better or worse investment performance is motivation – both that of the investor and the advisor.

The study found that investors who had deep positive motivations, like reaching a retirement goal, significantly outperformed those who had no goals, or had less mature motivations, like achieving high returns just to outperform their peers. This is consistent with previous research that showed men in their 20s, who were after exciting returns, underperformed other demographic groups who had longer term goals tied to something meaningful. This point about investor motivation is consistent with my experience. Investors who meet with me periodically to review their objectives and holdings tend to outperform those who completely ignore their investments. Serious investor motivation helps returns. The study also said that being driven by fear of loss is not the same as a positive goal and does not help deliver good performance. Boy, have I seen that be true too through my years as an advisor.

Not surprising to me, the study found that the financial advisor's motivation impacts returns and the client's chance of meeting their financial goals. Advisors who are motivated by compensation or who don't see a greater purpose to their profession are far less likely to have satisfied clients. Advisors who really care about helping clients meet their goals have a 55% better chance of having satisfied clients. Unfortunately the study found that only 33% of advisors were motivated by helping clients or contributing to economic growth compared to motivations not seen as being part of a greater purpose. While this is unsettling and the result of new research, it isn't surprising. I remember the client who told me she had expected her last advisor to be terrific, because he was obviously successful. He had the title of VP at a big bank firm and had a corner office. I explained to her that that meant the advisor made lots of money for his employer. The title and corner office said nothing about what the advisor accomplished for his clients.

So how do you maximize your chance of meeting your financial objectives? The five things you can do, from least to most important, are:

- Try to find an advisor who is good at selecting stocks or funds which outperform their asset class
- Try to find an advisor who is good at strategizing about what sectors or asset classes of the market to invest in
- Set financial goals for yourself and do what you can to meet those goals, like regularly meeting with your advisor to check your progress toward those goals
- Use a financial advisor who is passionate about helping people not just passionate about the game of outsmarting markets or about earning a living
- Use a financial advisor for as many years as you can.

ADVISOR CONFLICT OF INTEREST

The Ontario Securities Commission is proposing new rules that require financial advisors to work in the best interest of their clients, rather than just make "suitable" investment recommendations. This is a higher level of duty to clients than current rules require. This rule would hopefully prevent advisors from recommending "investments that pay higher fees for the advisor and are more costly for the investor" that may not be in the investor's best interest but which aren't obviously unsuitable. Isn't this how all advisors should have been working all along?

The response of the head of wealth management of CIBC bank to this proposal struck me as strange. He said big firms could end up changing their services to offer "discount brokerage operations that simply fill orders without providing advice" and also offer a full-service advice channel where investors pay a flat fee. He said that would be the only way to operate "in a best-interest world when we have advisors being paid based on commission, to mitigate the risks sufficiently". The danger I see with this is that, even though study after study shows that having an advisor adds to a client's wealth after fees, only a fraction of clients are likely to hire an advisor if they have to pay a flat fee unrelated to transactions. And another reason I am concerned about such a move in the industry is what we are already seeing as RBC clients are being converted now to flat fee accounts. For accounts under $3 Million the fees clients are paying are on average 48% higher than what they paid under the old trailer fee system such as my clients are still under. I do understand that new regulatory requirements have drastically increased the administrative burden on every advisor, but these requirements were meant to protect clients from excessive charges, not to cost clients more in fees.

Is it really so hard to find advisors who operate with integrity and who care for their clients, as the CIBC bank representative implies? Maybe. A former executive of National Bank Financial and DundeeWealth Inc commented that the investment industry has changed so much over the last 20 years that "conflicts of interest that used to be minor are now prevalent."

Source: Globe and Mail Dec 7, 2016

I guess that's what you get when only a third of advisors, as quoted from the CFA Institute study in the section above, are motivated by the desire to help their clients. [Maybe that's why it took me 8 years to find anyone I would take on to train as a partner. And in the end, I found a person whom I would personally trust with my life and my money (he actually has my personal health care and financial powers of attorney) and who happens to be my son as well. I first knew he would be a potential candidate for the job when he was driving me in a snow storm to a store to replace my worn-out snowblower. We saw a car in the ditch and Jordan was delighted. Why? Because that gave him another opportunity to help someone by pulling them out of the ditch with his truck. People who get such joy from helping other people are rare treasures. Of course I am not biased…ha, ha, ha.]

A FRANK TALK ABOUT STATEMENT CHANGES AND DEALERSHIP FEES

As I have been telling you for many months now, starting this month statements will now be showing account returns. Some firms are only going to publish one year returns. Manulife statements will show 3 and 5 yr returns too. I've seen the return numbers as of November and they look good. I can definitely see which clients have been more conservative or who has been holding a lot of cash for a specific reason. I can see who started investing at the height of the market and who didn't have this headwind. And, I can clearly see who have been investing for the long-term and have accepted regular market volatility, because their returns look really good, even after fees. As my long-term clients will know, we won't have great returns every year. When the market is hot, our funds usually get good returns, but still lag the hot funds. Then when the market falls, our funds usually fall way less. That is our strategy for long-term outperformance. Our own numbers as well as academic studies show that that strategy works over the long-term.

I'd like to comment on 1 yr returns too, even though it is long-term returns that really matter. In 2016 one of the best returning markets in the world was Canada. That is because in 2015 Canada was one of the worst performing markets. Oil and materials (like copper, gold etc) fell in price in 2015 and then recovered in 2016. <u>Over the 2 year period the Canadian stock market had a steep fall and then a recovery. It was a whole lot of volatility for minimal net gain.</u> We didn't fall in 2015 and we didn't get the rebound in 2016. We also aren't in commodities now, which are not expected to have another good year in 2017. Commodities are often extremely volatile and over 10 and 20 year periods they seldom have good returns. So, true to our strategy of owning quality, low volatility companies for superior returns, we have avoided commodities. Being invested outside of Canada we also faced almost a 10% headwind due to currency. In Jan 2016 the Canadian dollar was worth about $0.69 USD. Then it rose to about $0.75. This hurt foreign investments. Of course in 2015 when the Canadian dollar fell against the U.S. dollar, we enjoyed the gain in value of our foreign holdings. In 2017 the Canadian dollar is expected to retreat by a couple of cents, which should help our portfolio values again.

Statements from now on also have to show how much clients have paid in fees. Your statement will show what commissions, trustee fees and recurring trailer fees were paid to Manulife Securities Incorporated. Dealership costs are high and are rising with all the extra regulation in the industry (which you have seen in all the extra paperwork we have to do each meeting). This has had such an impact that some dealerships, like Wood Gundy, have started to dismiss advisors who only bring in less than $650,000 in annual gross revenue. Other dealerships, like Nesbitt Burns, are forcing clients who have less than $300,000 in investments to leave, trying to get them to use a roboadvisor service or go to a bank branch advisor who will be licensed for mutual funds but not stock and bond licensed too, because the dealerships don't feel those clients are profitable enough for a full-service advisor. A third trend we have seen as costs rise is that clients are being taken out of standard mutual funds in favour of programs where the client pays a set percentage of their assets to the dealership regardless of what activity happens in their account or what assets they hold. There is nothing wrong with this, but where 1% is the most a dealership can make from standard mutual funds, the average fee RBC Dominion Securities clients with less than $3 Million in investments are paying is 1.48%. Now that is expensive. A last trend is that some advisors are being cut from their firms if they aren't selling enough of the dealership's proprietary product, where the firm makes extra money. Manulife has not been forcing clients into more expensive fee arrangements or into working with lower service or lower skill advisors. And Manulife never tells advisors they have to use Manulife's in house products. We are one of the few places left where an independent advisor can work.

After Manulife Securities Incorporated takes their portion of the fees, the rest comes to me, so I can pay my rent, computer system and licensing fees, office costs and staff salaries. Whatever is left over is my income. Some weeks are good, and some weeks there is nothing left after Manulife takes its expenses out. When market returns or at least my clients' returns are good, I make more. When my clients' returns are poor, I make less. In my office, we try to give the best advice and service we can, without charging a premium for it. We won't however cut our service to compete on price, because the client loses in the long-term. We compete on service and quality of advice. As you read earlier in the newsletter, a properly motivated advisor, especially with good strategies and skills, can make a **huge** difference in the likelihood of someone reaching their goals and accumulating more wealth. A good advisor provides good value and return to their clients.

As stated above quite a few advisors have been leaving the industry (many not by choice). I think there are going to be a lot of investors looking for new advisors, either because their advisors have left, or the investors no longer qualify to be clients at their existing firms, or the clients find their returns are terrible or that they are paying for service that they are not getting. Yesterday I met with a client who asked me to look at his "other RRSP" because no one at the other firm has talked to him about it for years and possibly no one at that firm has even looked at his account. And the many people, who think that they aren't paying anything to the banks to handle their investments, may be shocked and disappointed when they find out that they pay the same percentage to a bank branch to handle their investments as they would pay to a full service dealership and advisor. Some even pay the same fees to a discount broker age where there is not even the possibility of getting advice.

Now that I have a new advisor in my office to help me with financial plans, administration etc, I have the capacity to take on new clients. So if you have been satisfied with my advice, my strategies, my availability and your results, feel free to pass my name on to your friends and family who may be recognizing that they aren't getting good results or service, and who may be looking for a new financial advisor who will really put their interests first. Please note though, that I do have expenses and cannot afford to take on new clients with less than $50,000 in investments anymore, unless they are family members of my existing clients. As always I will do my best to help your friends and family reach their financial goals.

A BROKEN RECORD ON THE HOUSING MARKET

Many Toronto people are very confident that the prices of their homes cannot go down. They tell me how cheap Toronto houses are compared to New York's houses and condos, and that Toronto is a world class city whose prices are finally reflecting that. That may well be true but I see growing evidence that housing prices could seriously drop in Hamilton and Toronto (not in places like Ottawa).

Hamilton and Toronto are still on Canada Mortgage and Housing Corporation's list of dangerously overpriced markets, and the International Monetary Fund is still warning of a potentially massive housing price drop in Canada. Vancouver is already experiencing a significant drop, since the city implemented a surcharge on foreign purchasers. I heard on 680 news on Dec 5/16 that housing prices dropped 20% this fall and sales volume is down 50%. There is talk of Toronto implementing a similar foreign buyer surcharge, so a similar price drop could follow. The Fitch Rating service estimates that Canadian housing prices are 25% overvalued. Since some cities aren't overvalued, that would imply that in places like Toronto, the overvaluation could be even worse. (Globe and Mail Dec 7, 2016)

In the last 2 months, new rules have made it harder for buyers to quality for mortgages, mortgage interest rates have risen slightly, and China has started prosecuting those who have taken more cash out of China than is allowed. This cash is reputed to have fuelled the Vancouver and Toronto housing price booms. In December, mortgage rules further changed to charge higher interest to landlords. This could dampen the demand by investors, and lower demand usually translates to lower prices.

There is still the issue that at current prices, homes in Toronto are far from being affordable based on historical norms of what houses should sell for compared to income levels and even Hamilton houses have passed the high end of affordability. And as I reported in last quarter's newsletter, there are hundreds of thousands of Canadians who won't be able to handle their debt if interest rates rise even .25%. Manulife Bank released a survey in Nov, that 11-17% of various demographic groups in Canada would have difficulty paying their mortgage for even 1 month after a job loss. And between a third and half of all Canadians would not be able to keep up with their mortgage for 6 months or more, if they suffered a job loss. An interest rate rise or the next recession (which typically causes job losses) could force a lot of homes to come up for sale and depress prices. It's no wonder that some of my favourite fund managers have opted to rent rather than own a home in Toronto with house prices at current levels. A housing correction might not come in 2017, but interest rates are probably going up in 2018 and that could well make housing prices fall.

Maybe houses will just stay flat for years until wages rise enough to make current prices affordable. But if I had to bet, I would expect to see a repeat of 1981, when housing prices fell dramatically.

If you are downsizing, this may be the time to sell. If you are buying a more expensive home, what is the hurry? You might be able to save a tidy sum of money by waiting a little longer.

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