Q3 Market Review

Despite more volatility than we had previously seen year to date, the third quarter saw equity markets largely flat overall. In Canadian dollar terms the Canadian market[1] was up 0.2%, while the U.S.[2] and International markets[3] were up 2.8% and 1.8% respectively. The positive returns outside of Canada were due primarily to currency movements. For the year the Canadian, U.S. and International markets are up 17.5%, 15.2% and 8.1% respectively, all in Canadian dollar terms.

Much like the equity markets, interest rates were largely unchanged in the quarter, and remain very low by historical standards. The 10-year Government of Canada bond finished the quarter yielding 1.51%. For the year interest rates are up modestly which has resulted in the overall bond market being down 4.0% (bond yields up = bond prices down).

Client Frequently Asked Questions (FAQs).

In this quarterly letter we are going to the take a break from discussing markets and investing, and shift our focus to a number of frequently asked questions we get from clients. Whether or not these questions are relevant will be a matter of each client's individual circumstances, but these are all topics that come up with some regularity, so hopefully the answers will be of some value. The questions are in no particular order of importance.

What is the best way to deal with capital gains?

Strong equities markets over the last decade have resulted in many taxable accounts having significant capital gains. We endeavour to manage the accounts as tax-efficiently as possible, which typically means deferring capital gains and harvesting losses. However, unless there is some offsetting credit, taxes will eventually need to be paid on the gains. Capital gains taxes can only be deferred, not avoided. A small silver-lining is that under the current rules only 50% of the gain must be included in income. The best way to deal with the tax impact is to ensure it is factored in when evaluating the realizable value of the portfolio. In a taxable account a portion of your gains belongs to the tax authority, and the exact amount will depend on individual tax rates. For example, if an individual has a taxable portfolio of $1,000,000 with a cost base of $500,000 the net value, if liquidated, is likely close $875,000. This assumes a 50% tax rate and the current 50% inclusion for capital gains. $500,000 gain x 50% inclusion x 50% tax = $125,000 in taxes owed.

What is the most tax-efficient way to make charitable donations?

For many clients (perhaps the majority) the most tax-efficient way to make charitable donations is by donating shares with large embedded capital gains. We will not get into the math here, but if you are considering making donations and have capital gains in a taxable account you should consider donating shares instead of cash. If you are considering making a material donation (i.e. in excess of 75% of your net income) you should discuss the matter with your tax preparer to ensure you have sufficient income to make use of the donation receipt. **Please do not wait until year-end to make donations**. Depending on the sophistication and resources of the charitable organization it can sometimes take several weeks to process a stock donation, so best not to wait right until year-end.

[1] S&P/TSX Composite
[2] S&P 500 (C$)
[3] MSCI EAFE (C$)

Are tax-free savings accounts (TFSA) worth it?

A TFSA is simply another type of account that can hold essentially the same investments as other accounts, the primary difference being that income and gains are tax-free. In almost every case, if an investor has the capital, it makes sense to hold as much as possible in a TFSA in order to minimize taxes. When the TFSAs were introduced in 2009 with a limit of only $5,000 many people concluded they were too small to be impactful. However, with accumulated contribution room of $75,500 they have become more meaningful. A few keys considerations:

- The advice we have received is that U.S. taxpayers should not open a TFSA (or RESP for that matter).
- The full amount of accumulated contribution room can be used at one time – i.e. $75,500 if no TFSA contributions have been made in the past.
- The contribution limit accrues to any Canadian taxpayer over 18 even if they have never opened a TFSA.
- The TFSA contribution limit noted on a taxpayer's notice of assessment (NOA) is only updated annually and is often out of date so be mindful when making contributions.

If clients do not have currently have a TFSA and wish to set one up please contact us.

Registered Retirement Savings Plan (RRSP) vs Tax-Free Savings Account (TFSA)

A high level summary of the TFSA is as follows:

- Contributions are not tax deductible
- Gains and income are earned tax-free
- Withdrawals are not taxed
- Current annual contribution limit is $6,000 with accumulated contribution of $75,500

A high level summary of the RRSP is as follows:

- Contributions are tax deductible
- Gains and income are earned tax-free
- Withdrawals are taxed as income
- Annual contribution limit is 18% of earned income to a maximum of $27,830 annually
- RRSP must be converted to a RIF at age 71

For many people the RRSP is going to remain the primary savings account for retirement simply because the contribution limits for the TFSA are too low to accumulate sufficient capital. However, the TFSA has more flexibility in terms of contributions and withdrawals and does not have the forced conversion to a registered income fund when the holder turns 71. For most people the tax benefits between the two accounts are quite similar in the long-run, the exception being that the RRSP provides more opportunities to plan around big variations in income. The more complex your tax situation, the more you should discuss with your tax preparer. Many people will want to maximize both a TFSA and RSP, but if forced to choose, we recommend contributing to a TFSA first and a RRSP second.

How are fees calculated and what is included?

Fees are calculated as a percentage of the assets under management (AUM). As the AUM increases the percentage decreases. For the purposes of the calculation, family accounts are pooled together and the total fee prorated to the individual accounts. All members of a family group benefit from a higher family AUM. Fees cover the management fee to Cypress, as well as custody and trading. Cypress does not collect any other fees. The year-end client report includes details of the exact dollar amount charged and the annual fee rate. There are small expenses embedded in the pooled funds and exchange traded funds (ETFs), but the impacts of these fees are reflected in performance and are outweighed by the benefits of using pool and ETFs. Fees in taxable accounts are tax-deductible. The standard fee schedule is as follows:

- 1.0% per annum on assets up to $1 million
- 0.75% per annum on the next $1 million in assets
- 0.50% per annum on the next $3 million in assets
- 0.40% per annum on the balance

Why isn't performance reported more often?

Each year we provide clients with a detailed investment return summary showing the annualized performance of the portfolio since inception, the annual performance each year and the performance in 1, 3, 5 and 10 years increments. We run performance internally on a monthly basis and the information is available if required. However we have made the decision to only send detailed performance information annually since more frequent reporting simply serves to highlight the short-term volatility which makes long-term investment decisions more difficult.

Should I pay down debt or invest and should I borrow to invest?

People do not typically get into trouble by having too little debt, but the reality is having some debt makes sense for many people. There is no one size fits all answer to these questions, but a few considerations:

- We suggest paying down debt as quickly as possible if the regular payments are stressful.
- There is a trade-off between debt levels and flexibility. The more debt one has the harder it is to change jobs, start a new business or deal with any kind of financial shock. The more stable your financial circumstances the more debt that can be accumulated and vice versa.
- If one is considering borrowing to invest there should be sufficient income outside the portfolio to service the debt payments if necessary.

With interest rates at historically low levels some might conclude that taking on more debt makes more sense, but our bias is to be cautious around debt levels. Ideally investments make life easier, if adding debt to invest dilutes your happiness or increases anxiety – we don't recommend it.

When do I need to convert my RRSP to a Retirement Income Fund (RIF)?

You can convert some, or all, of your RRSP to a RIF as early as age 55, but you must convert the entire RRSP the year you turn 71. Cypress will contact clients when they turn 71 to look after the conversion. Once a RRSP is converted to a RIF a minimum percentage must be withdrawn each year starting at age 72. At 72 the percentage is 5.4% and it increases each year. RIF withdrawal amounts are included in income.

Should I pull money from my RRSP early?

If you are reporting modest taxable income and have material assets in a RRSP it may make sense to pull some money from your RRSP prior to the forced conversion at 71. Since RRSP withdrawals are taxed as regular income, an early withdrawal may mean the income is taxed at a lower marginal rate. If you think this situation might apply to you let us know or talk to your tax preparer. For reference we have included the combined B.C. tax rates at the end of this letter which shows how the marginal tax rate increases with income levels.

What are clients doing in terms of wealth transfer?

Rather than leave a large estate we are seeing an increasing number of clients choose to move money to heirs and beneficiaries earlier. Obviously individual circumstances will determine if this is feasible or desirable, but moving assets early has the benefits of avoiding probate, potentially moving assets to a lower taxed individual and gives people the satisfaction of seeing the money put to use during their lifetimes.

What are you views on income splitting?

Like many of our FAQs this will depend on circumstances, but if a household has significant discrepancies between income and asset levels it is possible to shift assets to the lower income spouse. The CRA allows the higher income spouse to loan assets to the lower income spouse at a low prescribed interest rate. An accountant will need to be involved to complete the paperwork and filings, but it is a tax strategy worth considering under the right circumstances.

How much do I need to retire?

This is likely the most common question we receive, but it also requires the lengthiest answer, so we will not attempt to answer it in detail here. A comprehensive answer would likely require an entire letter. The complexity is not due to do the calculations being particularly difficult, rather the individual inputs are often unknown as people do not have a good handle on their spending needs or priorities. We would encourage those clients who are entering the phase of their lives where retirement is on the horizon to start thinking about spending needs and priorities and with that information we can have a more detailed discussion about 'how much you need to retire'.

Individual Taxable Income	Basic Tax on Salary, Interest, Pensions, and Foreign Income	Rate on Excess	2021 Marginal Tax Rates		
				Canadian Dividend Income [1]	
			Capital Gains	Eligible Dividends	Non-Eligible Dividends
$ - - $ 13,808	$ -	0.00%	0.00%	0.00%	0.00%
$ 13,808 - $ 20,576	$ -	15.00%	7.50%	0.00%	6.87%
$ 20,576 - $ 21,418	$ 1,015	20.06%	10.03%	0.00%	10.43%
$ 21,418 - $ 34,929	$ 1,184	23.62%	11.81%	0.00%	14.52%
$ 34,929 - $ 42,184	$ 4,375	20.06%	10.03%	0.00%	10.43%
$ 42,184 - $ 49,020	$ 5,831	22.70%	11.35%	0.00%	13.47%
$ 49,020 - $ 84,369	$ 7,383	28.20%	14.10%	1.63%	19.79%
$ 84,369 - $ 96,866	$ 17,351	31.00%	15.50%	5.49%	23.01%
$ 96,866 - $ 98,040	$ 21,225	32.79%	16.40%	7.96%	25.07%
$ 98,040 - $117,624	$ 21,610	38.29%	19.15%	15.55%	31.39%
$117,624 - $151,978	$ 29,109	40.70%	20.35%	18.88%	34.17%
$151,978 - $159,483	$ 43,091	44.02%	22.01%	23.46%	37.99%
$159,483 $216,511	$ 46,395	46.12%	23.06%	26.36%	40.40%
$216,511 $222,420	$ 72,697	49.80%	24.90%	31.44%	44.63%
Over $220,420	$ 75,640	53.50%	26.75%	36.54%	48.89%

Source: Raymond James Ltd. Wealth Services

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