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Don't Get Caught Up In The "Yield" Bidding War

One of the biggest features investors are looking for today, is the ability to create an income from a portfolio. I'm at the tail end of the baby boom generation and this is something I have to address and try to solve for client situations continually because it is Boomers that are steering billions of dollars collectively, in a quest for income producing assets.

To really appreciate the significant challenge of that, all you have to do is look at the table below. It shows how much money you would need to produce $50,000 of income per year (GOC = Govt of Cda):

YEAR	5-yr GOC Bond Yield	Amount required to generate $50,000 in income**
1990	10.23%	$489,000
2000	5.33%	$938,000
2015	0.73%	**$6,849,000**

Just 15 years ago, you could generate $50,000 of income with a portfolio that had less than $500,000 in it. Today though, the "yield" environment is astronomically different. If you just want a portfolio made of "safe" investments (those that don't fluctuate in value), you would need to build a portfolio that is more than 10 times that size.

With what seems to be an insurmountable hurdle to overcome, many people are looking for investments that pay more than the, less than 1% or so, that they can earn in interest.

Dividends and rental income are the most common solutions however, anything that pays a healthy "coupon" is where the masses have been moving their money to and the push for that is getting stronger and more intense. This building pressure has bid up the price of all "yield assets", many of which have gone way beyond their fair value. This buying is being done with no regard for any other measurement than the level of income it pays along with the perceived level of safety of the investment.

As a general rule, if the masses are moving in the same direction, the end result always ends in catastrophe. It's the proverbial, everyone moving to one side of the boat that eventually capsizes it.

The counterintuitive thing to do today is to construct a portfolio that isn't paying out the highest levels of income. Over time, **<u>overall</u>** long term returns are what will provide you a healthy, lifetime income from your portfolio. These don't necessarily have to come in the form of interest, dividends, rental income, etc. that are paid on a regular basis. You can simply take part of the capital gains to produce the monthly income you need. That is actually easier to do today when so many are simply looking for the highest yielding.

You can't get a healthy overall return if you overpay for an investment. That is what so many are doing today in this "quest for yield". Don't follow the herd because with investing, the herd can't be right, it never is. History and stats show that only those who think and do things differently by measuring and calculating methodically, will survive and thrive. This gate is narrow and few are finding it.

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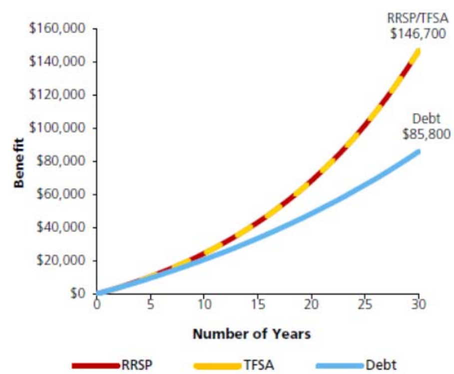
Lowering Volatility Can Increase Your Risk

The widely held belief within the financial industry is that lower volatility is better. It is also often advised that this is particularly true for portfolios spitting out a retirement income to their owner, that being you. It has been said that dollar cost averaging, investing on a regular (ie monthly basis), works better with more volatility. When you are withdrawing money from your portfolio on a monthly basis however, it is believed to be worse.

I'm always looking at conventional wisdom for evidence contrary to it and I found a research piece that actually shows the opposite. Reducing volatility reduces the amount you can safely take out of your portfolio on a monthly / annual basis. If you want your portfolio to produce the highest income, for the longest period of time, a higher volatility portfolio will do that. In other words, a portfolio with a long term return that is exactly the same as lower volatility portfolio will in fact, be able to give you a higher monthly income with less risk of your portfolio depleting. How's that for counterintuitive.

Paying Down Debt Could Make You Worse Off

Getting rid of debt is a feel good thing to do. Everybody wants to be debt free. What can be better than paying down debt, right? Well, to be frank, paying down debt at the expense of portfolio building can actually work against you.



We'll use the 2 most common alternatives to paying down debt. These are, RRSP and TFSA contributions The decision on what will put you in a better financial position rather than a better feel good position is simply mathematical. The question to determine this is, "Can you get a higher rate of return in your TFSA and / or RRSP than what the interest rate on your debt is?" If your debt's interest rate is in the low single digits (2 to 4%) the answer is probably, yes.

Look at the chart on the right. It assumes you have $2,500 / year that you can place somewhere else; 1) paydown debt or 2) RRSP / TFSA. This chart is is using a 3% cost of your debt and a 6% return within your RRSP / TFSA. As well, it takes into account tax being taken off of the RRSP at the same income tax rate as when you put the money in. In other words, this shows the after-tax increase in your net worth for all your choices. Although not shown, taking out the money when in a lower income bracket has the RRSP route pulling away upwards, from both the debt paydown and TFSA options. Again, it's just math and math makes it quite clear what is your best financial choice.

Well it usually does, but not in this case: If you have a high level of debt and are living paycheque to paycheque then you probably need to minimize your risk by paying down debt. Having said that though, if you have been living like this for some time (several months or a year or 2), you should re-structure your finances. This may include living in a cheaper home, increasing your family income and cutting away a bit in several areas where you spend money.

Life Insurance For Feast & Famine Times

You are self employed, earn a very healthy income and need life insurance. You can buy what I most often use, which is a term life insurance policy. With "term", you pay the least amount of money for the most coverage you can get. What happens though should your income drop significantly and you need to cut back on expenses? Life insurance is one of those things you put in place so that should an income earner in your family die prematurely, the income can be replaced through the proceeds of the life insurance. Cancelling a policy is usually not an option though. Should you, have or later, get a serious ailment (ie. cancer), it could disqualify you from getting life insurance in the future, when you most need it.

Instead of buying a term life insurance policy, you can buy a policy where part of your payments go into building a "cash value". This gives you a lot of options including the flexibility to take a premium holiday for the time you need to go through a potential financial set back. You can simply stop making payments on the life insurance and have that cost be paid from within the policy itself, by way of the policy's cash value. A policy like this is fully customizable and flexible to fit with the changes in your life. Again, this is particularly important should you have an illness that could potentially disqualify you from getting life insurance in the future, something I have come across several times.

Dividends vs Salary Misunderstood

For business owners, you have a choice on whether to take income from your own corporation, in the form of salary / bonus, dividends or a combination of the two. There seems to be a common perception that, taking dividends can save you a lot in tax. The reality is this doesn't always work that way and if it does, it is in a very small way.

The government recognizes you as a business owner, have a choice in how to take your income. Because dividends do have a lower tax rate, they use a mechanism called "dividend gross-up". This ensures equal tax treatment between those who earn income through a corporation and those who earn money personally or who choose to take compensation from their company as a salary / year end bonus. This tax integration never matches up exactly, however the difference between choosing salary / bonus vs dividends is relatively small at around 1% in most cases (varies by province and tax year).

You will find the biggest reduction in cost, for taking dividends vs salary, relates to CPP contributions. Taking a salary / bonus means you need to make CPP contributions. Because you are the business owner and the employee of the business, your corporation has to write a cheque for up $2,544.30 (4.95%) of $51,500 of salary to CPP and you, as the "employee" have to contribute the same amount (those are 2016 numbers—the salary threshold goes up with inflation every year).

Salary costs more only because of the mandatory CPP contributions that need to be made however, CPP contributions increase the CPP benefits you will be receiving. When you are set to retire at 65, 67 or 70, and you have chosen to take dividend during your self employment life, your monthly CPP benefits will be much smaller or virtually non-existent.

5 "Beware"s In Switching To Joint Ownership

Many people, as they age, recognize their own mortality. With that, the idea of shifting your assets into joint name with someone younger, is a common light bulb that turns on in their brain. The objective is to 1) have the assets move smoothly to who you want it to go to should you become mentally challenged or 2) to save income tax or probate fees. Here are the 5 things you need to watch out for when contemplating a change from single owner to joint ownership:

1) Trigger A Tax Bill—When you add a person other than a "spouse" as defined in the Income Tax Act, you will have been deemed to have sold that portion at fair market value.
2) Unequal Estate Splitting and Infighting—if you plan on splitting your assets equally among all of your children and you don't put all of their names on the asset you want held jointly, upon your demise, you could have an unequally split estate even though that wasn't your intention. Potential sibling squabbles and infighting could be the result.
3) Creditor attack— Should the person you hold the asset with jointly make some bad financial decisions that put them in a precarious position, their creditors will come after anything they can get their hands on in that person's name. Because they are joint owner, their share will disappear into the hands of their creditors.
4) Principal Residence Could Become Taxable— Any one person can only have 1 principal residence at a time. If you name an adult child, one who already has a principal residence, 1/2 of what was solely deemed to be your principal residence, is now not a principal residence. Any gains on that portion going forward will be taxable.
5) Loss of Control— It isn't just in your name anymore so technically, if you have named 1 person as joint owner, you lose control of 1/2. Add 3 names to the asset and you give up 75% ownership and control. This change could be permanent unless the other(s) agree to you switching things back. This is huge. Are you okay with all of that?

An Estate Planning Safety Net

There is that guy who lives across the street from you. Based on things he does, you have wondered about his mental capacity. As well, you don't think he has any family members to alert to this fact. Do you ignore it? Who do you alert?

Every province has a "Public Guardian and Trustee" (PGT) office to handle cases like this. They are the social safety net for aging people who don't have their own family or friends to assist them. Anyone can make a referral to the PGT when they see an adult is not coping with life or being financially abused. Your identity is kept confidential by law.

The first thing the PGT does is to see whether the adult is actually incapable. Someone can make bad decisions but still be considered capable so quality of decisions isn't the measuring stick, it's mental capacity. If assessed as incapable, the PGT can freeze assets for up to 120 days while it investigates further. A PGT ruling of incapacity is considered a last resort since it takes away a person's decision making power. If all other options are exhausted and 2 physicians and court hearing find a person incapable, the PGT then appoints an individual "committee (pronounced CAW-mit-TEE) or guardian in some provinces. This person is now responsible for making financial and legal decisions for this person.

Of course, an enduring Power of Attorney (POA) overrides all of this. Within a POA you name the person (or people) who you want to handle your affairs and make decisions for you, should you be incapable of doing so.

Tech Gems— MySMS

All phones come with a built-in texting or SMS app. There are a plethora of others you can use instead and one I found very helpful is MySMS. I often see people at Starbucks sitting with their tablet or laptop and continually picking up their phone when an incoming text come in. MySMS gets rid of that 2 device dance because every text you get on your phone you get on all your other devices. Often I'm at my desk and I will get a text message notification on my computer just before I get it on my phone. With MySMS, when I'm working at my desk, my hands and eyes don't have to stray from where they are, on my PC. Plus, I can get texts when my phone is somewhere else. Of course, it's much easier to type a response on a full size keyboard than a phone. Take advantage of small advantages. This is one of them.

Hhhhhmmm……

Canadian pension plans produced a 0% return in the first 3 months of 2016, before management fees were deducted. This was measured over 342 pension plans managed by 50 investment management firms. Morneau Shepell Survey of Pension Plans

For the past 15 years, shares of General Mills have sold for a slight premium to the market as a whole. Today it is priced at a significant premium, despite its earnings per share growing slower. Stephen Groff, Partner - Cambridge Global Asset Management, July 2016 (paraphrased)

Valeant's modus operandi consisted of buying companies, cutting R+D, increasing drug prices and structuring it in a way they could avoid paying income tax. Essentially, they reduced innovation, fired people, increased health care costs and avoided paying taxes (to the U.S. government, their largest customer) – not a sustainable business model in the long run. Brandon Snow, Partner - Cambridge Global Asset Management, July 2016

Microsoft is buying LinkedIn. It has $100 Billion of cash but is going to be borrowing most of the money to make the purchase. Bloomberg.com, June 2016

1 portfolio management firm I use, reported to me that 1/3rd of their portfolio holdings elected to return cash to shareholders in 1 form or another. This is not what companies do when their leadership team is worried about the near future. By raising dividends and buying back shares these companies are sending a message that current and expected cash flow generation from the business is more than sufficient and that building more of a safety net for unforeseen economic bumps in the road isn't necessary.

Contribute $1,500 into an RDSP and you get $3,500 from the government. That is / year on family income of $90,563 or less.

In 2012 to 2013, the Canada Student Loans Program gave $2.6 billion in loans to more than 472,000 full time, post-secondary students (that is $55,000 / student). No detailed financial histories are required to be completed and they don't talk about re-payment options to the students who they give the loans to. Advisors Edge, April 2016

Canadians have the largest debt-to-income ratio of any G7 country, with the average spending 165% of their salary. In contrast, at the height of the US housing crisis in 2008, Americans carried what was then considered an outlandish 147% debt-to-income ratio.. Hexun (China's largest finance portal) July 2016

Sina.com is warning that Canada will have a housing crash worse than the US. While the average home price in Vancouver is up more than 30%, the province is in a state of "stagflation." Stagflation is a fancy word that describes when the cost of living increases but there is stagnant demand in the economy. They go on to say BC has one of the lowest median incomes in the country. BetterDwelling.com reporting what Chinese media is saying.

Vancouver's home prices have risen 172% in the last 15 years; Incomes have only moved up 10%. BetterDwelling.com

Gains from flipping a property are taxed as regular income, not capital gains. Advisor.ca, July 2016

The US's Drug Enforcement Administration (DEA) indicated it would keep marijuana illegal for any use. States that allow marijuana for medical use or legalize recreational use remain in defiance of federal law. USA Today, August 2016

We bought an LP and bonded with that record. We read the liner notes, we studied the photos, we got to know every note of that album. We had a deeply personal relationship with that recording. Instead of having relationships with albums kids are just "hooking up" with songs. The intimacy is gone. Peter Erskine interview, Modern Drummer, June 2016

CRA charges exorbitant penalties for RRSP overcontributions. This penalty was set in place many years ago to stop people from sheltering extra money in their RRSP from tax. However, now that can be done within a TFSA. If someone hasn't used their TFSA however (which they could contribute to achieve the same tax sheltering), CRA will still charge the RRSP overcontribution penalty despite it being obvious that an individual obviously didn't or couldn't benefit from it.

A new keyless remote for my car, including programming at the Cdn dealer is $347.22. At the US dealer in Bellingham it's $257.83 (US $199.95). I easily found a used remote on Ebay, programmed it myself in about 2 minutes by pushing my car's lock button, for only $40.15 May 2016

PS. Questions, comments? I'd love to hear them. carey@careyvandenberg.com or call me directly @ 604 541 2690 or… send me a message through Facebook (ask for friend request first), LinkedIn or Twitter.

Carey