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Personal Newsletter from Nicole Deters, Harbourfront Wealth Management – Gilman Deters Private Wealth

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The Importance of Holding On

It has been difficult to find much market commentary that suggests positive developments in the financial and economic markets over recent times. The reasons are many: high and persistent inflation, more aggressive tightening policies by central banks and the prospect of recession. This has created significant uncertainty over the path forward.

Indeed, humans can react unfavourably to uncertainty. Studies have shown that our emotions are a key driver of stock market volatility over shorter periods. One study suggested that roughly 75 percent of short-term market variation can be explained by risk aversion.¹ This is likely because, in the short term, we underestimate our ability to adapt.

Today is no exception. We have seen significant volatility in the financial markets. Market pundits have been having a field day creating worry that this time is different. However, some perspective is warranted. Let's not forget that, over time, economies and financial markets have continued to adapt and progress. We have also come from a time in which record stimulus benefitted both the markets and economies, so a period of adjustment can be expected. Many company earnings that thrived over recent times must now adjust as consumption patterns balance towards a post-pandemic world. High inflation has been a prevailing headwind and although it has been more than just transitory, consider that it will also not be permanent.

Economies, like the markets, are cyclical in nature, so anyone who forecasts a recession has a good chance of eventually being right. In Canada, first quarter GDP grew at a rate of 3.1 percent. Although GDP contracted in the U.S., labour markets in both nations continue to be robust and, for now, household balance sheets suggest consumer resilience. We should also remember that recessions vary in their duration and intensity; the past two lasted only three and seven months.

This is not to suggest that there aren't challenges ahead. We have entered a period of slower growth globally and continue to face many uncertainties. As such, it may be difficult to not take action when experiencing market pullbacks. However, for investors who may feel the urge to sell investments for fear of a greater loss during these times, this can create two issues — selling at low prices and the inevitable need to re-enter the markets. Consider also that the biggest up and down days have historically clustered together and missing the market's best performance can significantly impact future returns (see page 3). And, it's not just the inherent difficulty in timing the market: Selling and rebuying can potentially create a costly tax situation in certain accounts or forego dividend income opportunities.

Consider also that one of the most important variables for how you'll do as an investor can be how long you are able to stay invested. This is because success for many investors comes from uninterrupted compounding over years and decades. In the words of renowned investor Charlie Munger, Warren Buffett's business partner, "the first rule of compounding is to never interrupt it unnecessarily." Don't overlook the importance of holding on.

We understand the challenges that come from an uncertain near-term outlook. During periods such as these, investors should try to stay focused on longer-term goals. Keep your eyes on the horizon, stay invested and look beyond today, as better times will eventually prevail.

1. www.nber.org/papers/w19818

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Federal Budget 2022 Recap: Few Significant Changes for Investors

This past spring, the federal government delivered its budget with few significant changes for investors: no changes to the capital gains inclusion rate or federal income tax rates. Many initiatives address the hot housing market. Here are some highlights:

Tax-Free First Home Savings Account (FHSA). The federal government proposed a new account to help Canadians save for their first home. Expected to begin in 2023, the account will have a lifetime contribution limit of \$40,000, with an annual limit of \$8,000. Contributions will be tax deductible, similar to the RRSP, and withdrawals will be tax free, similar to the Tax-Free Savings Account (TFSA). When the FHSA was originally proposed in the 2021 election campaign, it came with an age limit. This was removed in the most recent budget. If this change stands, a recent article in the popular press suggests that tax-planning opportunities may be available to older Canadians by using the FHSA as a savings tool!¹ Stay tuned for updates as the rules are finalized and details become clearer.

Multigenerational Home Renovation Tax Credit. This proposed refundable tax credit offers up to \$7,500 by allowing qualifying families to claim 15 percent of up to \$50,000 in eligible renovation and construction costs incurred to construct a secondary suite for a senior or adult with a disability.

Residential Property Flipping Rule. Under proposed rules, property sold that is held for less than 12 months would be considered “flipping” and any profits would be subject to full taxation as business income (with certain exceptions). Where the new rule applies, the Principal Residence Exemption would not be available.

Small Business Deduction. Under current rules, access to the small business deduction is reduced when a Canadian-controlled private corporation has taxable capital greater than \$10 million, reducing to nil with taxable capital of \$15 million or more. The budget proposes to change the formula such that the small business deduction will

not be reduced to nil until the corporation has taxable capital of \$50 million.

Minimum Tax for High Earners.

The federal government announced an intention to revisit the current Alternative Minimum Tax regime with a view to ensuring high-income earning Canadians pay a minimum level of tax. Further details are expected in the 2022 fall economic update.

At the time of writing, these proposals have not been enacted into law. For greater detail, please see the Government of Canada website: <https://budget.gc.ca/2022/home-accueil-en.html>

1. “Three ways to make the most of the new tax-free savings account for home buyers,” Erica Alini, The Globe and Mail, April 30, 2022, B15.



Luxury Vehicles: Prices Are Set to Increase

The federal government quietly released revised draft proposals in the spring to introduce a luxury tax on certain vehicles. As of September 2022, this luxury tax is set to apply to cars and aircraft with a retail sales price over \$100,000 and boats over \$250,000.

The tax will be based on the retail sales value of the good and is proposed to be calculated as the lesser of:

- (a) 20 percent of the retail sales price that exceeds the thresholds: \$100,000 for cars/aircraft, \$250,000 for boats; or
- (b) 10 percent of the full value of the luxury car, boat or aircraft.

For more information, see the Government of Canada website: www.canada.ca/en/department-finance/news/2022/03/government-releases-draft-legislative-proposals-to-implement-luxury-tax.html

You Asked: Transferring Family Property to the Next Generation

With the arrival of summer comes cottage and cabin season once again! Many family properties have been owned over generations and there is often a desire to keep them in the family for decades to come. Yet, many children do not have the funds needed to buy the property.

In working with clients, we are often asked questions about cottage/cabin succession planning. One question that is commonly asked is: **Can I sell the cottage to my kids for \$1, or a value substantially lower than its fair market value (FMV)?** This is often to try and avoid the capital gains tax. When a cottage is not considered a principal residence, capital gains tax will generally be due on the difference between the FMV and adjusted cost base (ACB) of the property.

However, selling less than FMV is likely to lead to significant tax consequences. The child's ACB will be determined by the actual price paid, which may lead to the child paying tax on a gain already realized by the parent when the child eventually sells the property.

Take, for example, a cottage that is sold for \$1 to a child. If the FMV is \$1 million and the ACB to the parent was \$400,000, the taxable

capital gain to the parent would be 50 percent of \$600,000 (or \$300,000). For the child, a purchase at \$1 results in the child's ACB being \$1, rather than the property's FMV.

So, if the property is sold in the future for \$2 million, the capital gain would be the full \$2 million less \$1. This results in double taxation as it includes the parents' earlier capital gain, as well as the original amount paid for the property. Instead, there may be better options, such as gifting the cottage. Although there will be a substantial tax liability to the parent at the time of gifting, the child's ACB will be equal to the FMV at the time and double taxation will be avoided.

As always, consult with legal and tax advisors familiar with cottage succession planning to help you understand the options available.



Your Estate Plan: Are There Ways to Better Protect Family Harmony?

An estate plan should consider more than just how you distribute your assets. It can also include strategies for preserving family values and relationships. This may be important: it isn't uncommon for even the most harmonious of families to undergo bitter disputes when dealing with the distribution of assets of an estate. As such, the time you invest in planning has the potential to leave a lasting legacy of family harmony. Here are some thoughts:

1. Keep documents updated — Consider reviewing your estate plan periodically to ensure it reflects your current thinking and to avoid future conflict. If you have a Will in place, how old is it? Perhaps this may be a good time for a thorough review of your estate planning documents, especially if circumstances have changed. Equally important: reviewing your designated beneficiaries, where applicable. Many investors fail to revisit these designations to account for major life changes, such as marriage, divorce or the birth of a child.

2. Rely on professional support — Improper documentation or vague instruction can lead to misunderstanding, conflict and even escalate to a costly court battle. While you are able to create estate planning documents on your own, such as by using an online Will service, even if the document is valid, do you fully understand the family and succession laws of your province, or income tax and investment rules? These can change over time and should be evaluated against your estate plan. With the rise in blended families, balancing competing interests from children, stepchildren and a new spouse may be challenging. The support of estate planning professionals can help ensure assets are distributed as intended.

3. Communicate — Sharing your intentions with beneficiaries can help manage expectations and prevent future conflict. While the topic of death is not always easily broached, consider



communicating with loved ones while you are alive about your estate. In-depth details do not have to be provided, but high-level conversations can be beneficial to avoid future surprises. These conversations can also help you understand the wishes of loved ones for when you are gone, including for items of sentimental value, which can commonly become the centre of conflict.

4. Understand the implications of joint ownership with children — Joint ownership* is sometimes used to simplify the transfer of assets on death. In certain jurisdictions, it is used to minimize probate fees. Yet, it has the potential to lead to complications, often relating to estate equalization. It is a common cause of stressful lawsuits that will easily surpass the cost of probate — perhaps the exact situation you were trying to avoid in the first place! There may also be unintended consequences, such as tax implications or exposing assets to potential creditors.

5. Consider the support of a professional executor — It may be money well spent to consider a corporate executor. This can help to preserve impartiality if you have children you were considering appointing as executor(s). More important, it can help take the burden off of loved ones during what is often an emotionally difficult time.

Please seek the support of estate planning specialists for your situation.

*Not applicable in the province of Quebec.

Perspectives for Volatile Times: Reasons to Stay Invested

During periods of significant volatility, it may feel difficult to be invested in the equity markets. However, without risk there would be no returns — and equities continue to be one of the greatest generators of wealth of all asset classes. Maintaining discipline and patience throughout volatile times and staying invested is important.

Volatility is a reminder that portfolio growth does not occur at a steady rate. Yet, time reduces the volatility of returns. As history has shown, negative market performance smooths out as an investor's time horizon increases. Over the past 30 years, the likelihood of the S&P/TSX Composite Total Return Index experiencing a negative monthly return is 38 percent. This drops to 13 percent over a three-year rolling holding period, and 0 percent over seven-year rolling holding periods and beyond (chart 1).

Time in the markets also allows investors to participate in the best performing periods in the markets, which, as discussed in our cover story, can often cluster around the worst market declines. Missing these periods can be costly. The chart shows the impact of missing the best performing months of the S&P/TSX Composite Total Return Index over a 30-year period. By staying invested, a notional investment

of \$1,000 would have grown to \$12,693. By missing the five best months, this would fall to \$7,503 (chart 2).

These are just two reasons to continue to keep perspective and stay invested during volatile times.

Chart 1: S&P/TSX Composite Index % of Negative Returns Since 1991

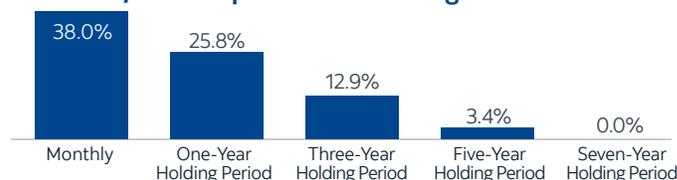


Chart 2: Return of \$1,000 Invested in S&P/TSX Composite Since 1991



Source: S&P/TSX Composite Total Return Index from 12/31/91 to 12/31/21.

The Worry of Recession? Reasons to Keep Perspective

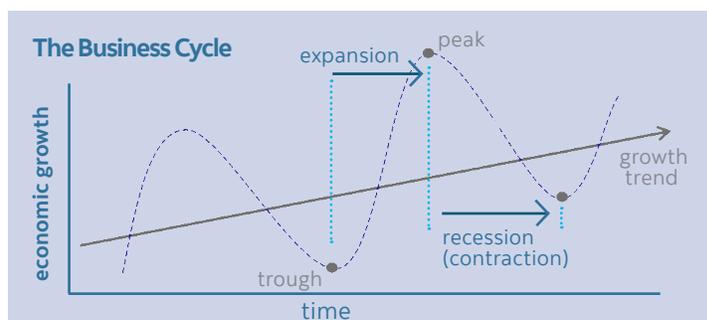
With slowing global growth, persistently high inflation rates and as the central banks have taken a more aggressive position to combat inflation by raising interest rates faster than anticipated, the media has been preoccupied with evoking fear that a recession is imminent. While this is a legitimate worry, we suggest that maintaining perspective may be worthwhile.

Economies, like financial markets, are cyclical in nature and are naturally prone to expanding and contracting over time. A recession can occur when economic activity declines — commonly defined as two successive quarters of declining gross domestic product (GDP), the measure used to gauge economic health.

It's not normal for any economy to be in a perpetual expansion, and contractions do occur from time to time. Yet, recessions can be quite different in their length and intensity. While the Great Depression of the 1930s is the longest contraction historically, consider that our most recent recession was the shortest on record. This precipitated during the depths of the pandemic due to the economic shutdowns, but lasted for just three months in length.

Some are comparing our current inflationary situation to the 1970s, suggesting that we are headed for a similar period of economic slowdown that followed. Yet, let's not forget that today's central bankers are taking more rapid action to try and curb inflation. In the early 1970s, the U.S. Federal Reserve was easing monetary policy. It wasn't until Paul Volcker headed the Fed in 1979 that he raised the Fed funds rate to a whopping 20 percent to try and end high inflation, but this wasn't until after almost a full decade of persistently high inflation. This shock led to more severe economic consequences.

Today, there are a variety of reasons to keep perspective. Labour markets and household balance sheets are at healthy levels to support consumer resilience, and consumer spending has been robust, shifting to the services industry. While some corporate earnings have missed expectations recently, it was anticipated that there would be a period of adjustment as we returned to normal from the pandemic. In some cases, record stimulus skewed



consumer demand; in others, the economic shutdowns have created ongoing supply chain issues. High inflation has also driven up many companies' costs, but this inflation is not expected to be permanent. Recessions are also usually characterized by excesses of inventory, capacity or credit, which aren't largely apparent at the moment.

This is not to suggest we don't face challenges. The pandemic has caused a variety of problems, including significant stimulus debt, higher inflation, supply chain disruptions and more. We are now confronted with new issues created by the conflict overseas. Continued patience is needed as we resolve these issues and move forward.

However, some balance may be warranted to address the current discussion of recession. Investors should also remember that portfolios positioned for the longer term have been structured with the expectation that economies and financial markets will experience both ups and downs. Most importantly, when a recession eventually does arrive, remember that it will be temporary.

Recessions in Canada Over the Past 50 Years

Monthly Peak	Monthly Trough	Severity	# Months
December 1974	March 1975	2: Mild	6
January 1980	June 1980	1: Mildest	9
June 1981	October 1982	4: Severe	16
March 1990	April 1992	4: Severe	25
October 2008	May 2009	4: Severe	7
February 2020	April 2020	5: Very Severe	3

Source: CD Howe Institute, "Business Cycles"



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