NEXUS

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Notes

Nexus Investment Management Inc.
Portfolio Management & Financial Counsel

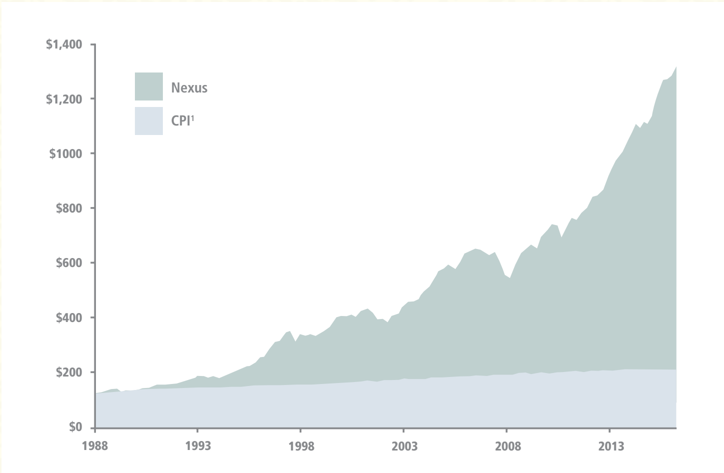
Inside Articles

Building Value for Clients

Since its establishment in 1988, Nexus has pursued an investment approach which concentrates on real growth in client wealth over the long term. The chart illustrates the impact of this long-term investment thinking – a $100 investment in a balanced portfolio in 1989 has grown to $1,338 at December 31, 2017.

[1] CPI is the "all-items" Consumer Price Index for Canada, not seasonally adjusted.

$100 Investment with Nexus in 1989



FROM THE EDITOR

The Yin and Yang of being Canadian

Canada was a medal-winning machine at the Pyeongchang Olympics with an overall third place finish and a record-setting 29 medals. As one of the sports writers who covered the games for the Globe and Mail wrote, "the rest of the world started to notice that Canada was no longer the kind of milquetoast pipsqueak who is off-limits to criticism."[1]

And there was plenty of that (think the women's curling team), as well as some ugliness at the end with a Canadian athlete arrested for allegedly stealing a vehicle.

Turning to the economy – where once Canada was an attractive tax regime for business investment, it now appears that the winds of change are upon us. The 2018 federal budget was released at the end of February and was alarmingly light in substance given the economic challenges Canada faces. In particular, Canada's long-standing corporate tax advantage over the U.S. is gone given the recent business tax reform south of the border. In addition, the U.S. personal tax system is more favourable for skilled workers when compared to Canada's high personal income tax rates. This, and other challenges like the NAFTA renegotiations, means we no longer have the same competitiveness when it comes to business investment. It was a disappointment to many that these issues were not addressed in the budget. In addition, there was no clear plan established to return to a balanced budget. In fact, since being elected, this government has increased program spending by an incredible 20.1% from 2014-2015 to 2017-2018. This represents an annualized growth rate of 6.3%, which has dwarfed the 3.3% growth in revenue![2] Planned future spending announced in the budget will make deficit matters worse by increasing program spending 23% over the next five years.

To say there was a silver lining in the budget would be an overstatement, but there was a sigh of relief when the pending tax proposals around the taxation of passive investments inside a Canadian Controlled Private Corporation ("CCPC") were essentially scrapped, including any grandfathering treatment of existing passive investments. Instead, the government introduced two new measures that will come into force in 2019. The first restricts access to the small business deduction (that allows active business income to be taxed at the lowest business rate) for those that have passive income (portfolio income) inside their corporation exceeding $50,000. The proposal reduces the amount of business income eligible for the small business tax rate by $5 for every $1 of passive investment income above the $50,000 threshold, such that the small business deduction is reduced to $0 when passive investment income reaches $150,000.

Guidance was provided for computing what is included in the $50,000 of passive investment income. It will be defined as "adjusted aggregate investment income" and there will be amounts to add and subtract in the calculation. Most notably, it will include realized capital gains from portfolio investments, but not gains that come from the sale of property from an active business.

The second measure refines how corporate and personal tax integration works with regard to dividends paid out of a corporation to a shareholder, and amends the existing refundable tax regime. This measure is quite technical. Suffice it to say that the government is trying to ensure that the deferral between personal income tax rates and the CCPC small business tax rate is minimized. There will be more to come over the months ahead that will detail how changes to the refundable tax regime will affect planning for those with professional corporations and holding companies.

In this issue of Nexus Notes we introduce you to the newest member of our investment team, discuss the recent market volatility in the context of history and revisit our Leaving a Legacy series on estate planning.

DCW

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[1] "How did the Canadian Olympians become the new Ugly Americans?", Cathal Kelly, The Globe & Mail, February 25, 2018.
[2] "Balanced Budget Still within Trudeau's Reach" Charles Lamman and Hugh MacIntyre, the Globe & Mail, February 23, 2018.

Leaving a Legacy, Part 2

In May of last year we held a session in our Women & Wealth series about the importance of estate planning and effectively transitioning wealth to the next generation – and beyond.

We followed up with an article, Leaving a Legacy, Part 1, that focused on the 'softer', but no less important side of wealth transfer. In this article, we offer some thoughts on the more technical aspects of the estate planning process.

VALUES-BASED ESTATE PLANNING

Over the next few decades the wealthiest generation to have ever lived in the U.S. will be handing down over $30 trillion to their children. This presents a tremendous challenge for beneficiaries who are expected to maintain the wealth beyond their own lifetimes.

In Part 1, we asked:

> *"If you were going to plant a garden, would you first go to the nursery and buy plants willy-nilly? It's unlikely. You would have examined the soil you'll be working with, followed the path of the sun to find out where the light will fall and know what climate zone you are in to ensure you purchase foliage that will have the best chance of not only surviving, but also being aesthetically pleasing. Similarly, if you don't know the purpose and goals of your wealth, how will you know what tax or investment strategy to implement?"*

In drilling down and clarifying the goals of your estate, some questions to ask yourself are:

- Who will benefit from your estate?
- What impact will your estate plan have on your family?
- Are there significant family assets that will need to be addressed (e.g. family cottage)?
- Do you want to divide your estate equally?
- How important is it to minimize taxes?
- Do you wish to leave money to charities?

Once you have prioritized your goals, there are many tools you can use to help you create a well-designed plan, and we'll examine a few of these. But first, let's take a look at the exciting and magical world of….taxes!

TAX ARISING ON DEATH

As Benjamin Franklin famously said, "In this world nothing can be said to be certain, except death and taxes." Unfortunately, they come as a package deal.

Two types of taxes that can be triggered upon death are the estate administration tax (commonly called "probate") and income tax. Assets that pass through the will must go through probate. Many people spend a lot of time strategizing on how to avoid the probate process, so as to avoid the estate administration tax. However, more often than not, the bigger issue is the income tax that is triggered by the deemed disposition of the assets immediately before death and particularly, as it relates to the triggering of the unrealized capital gains on the investments. So, if minimizing tax is one of the goals of your estate, first determine which tax is worthwhile for you to minimize.

INCOME TAX PLANNING

You can't avoid income tax when passing assets on to the next generation. However, there are strategies that can be used to minimize taxes along the way.

Financial Planning

Spending assets wisely while you're alive can minimize income tax the longer you live. On death, RRSP/RIFs are treated as income, and are taxed in full. Contrast

Leaving a Legacy, Part 2 *cont.'d*

that to a taxable investment account, on which only the unrealized capital gains will be taxed. The difference can be meaningful. If one of your goals is tax minimization, intentionally shrinking your RRSP/RIF during your lifetime could significantly reduce the eventual tax burden on the estate and your beneficiaries.

Lifetime Gifts

This should be considered only if you have assets beyond the scope of what you need. Gifting money to adult children during your lifetime means it won't be part of your estate. If you have excess funds and your children are in a lower tax bracket than you, there is an opportunity to minimize income tax during your lifetime. There is also the pleasure of seeing your children enjoy the money while you are still alive. On the other hand, the future is unknown, and the longer your time horizon, the more conservative your gifts should be. If you want to gift to children but maintain control over the assets, consider using a family trust.

Charitable Giving

If you have more accumulated wealth than you or your children need, then consider giving it to charity. There are numerous advantages in doing this. In terms of tax benefits, for example, every dollar donated over $200 will get a credit at the highest personal tax rate. As an added sweetener, donating securities "in-kind" can reduce your taxable income because tax on the capital gain is eliminated and you still receive the full tax credit for the value of the securities.

PROBATE PLANNING

Property that passes through your will is subject to probate. However, there are ways to avoid probate, and they include designating a beneficiary on registered accounts and life insurance policies, establishing joint accounts and establishing Alter Ego or Joint Partner Trusts. There are benefits and disadvantages to all of these. In designating a beneficiary, there are really only two wise choices – designating a spouse or an adult child. Joint accounts have their pros and cons, and always remember – joint means joint! The joint holder of a bank or investment account can withdraw *all* the funds. Finally, Alter Ego or Joint Partner Trusts are used as substitutes for wills and powers of attorney in estate planning for those over age 65. There are many benefits to these types of trusts but they are not for everyone. There are costs to setting them up, as well as trustee fees and tax filings.

CONCLUSION

When you set out to develop an estate plan, understand what you want to achieve first. Evaluate your assets and determine your financial position during your lifetime, determine your tax consequences on death, and only then implement the estate planning approach that is appropriate for you.

AOJ

"I'm just glad we got out before interest rates went up again."

Image used with permission: Mick Stevens, The Cartoon Bank/The New Yorker Collection

The Agony and the Ecstasy

The Return of Volatility

After two years of low volatility and a rising equity market, the tranquil times have been abruptly interrupted. This is no historical novel – it is a real, and painful, experience for investors.

On February 2nd, the markets began to tumble, and by the market close on February 8th, the S&P 500 had fallen 10.2% from its peak just nine trading days before.

Looking back in history, there have been larger market declines, but the remarkable thing this time is how quickly the market mood changed from ebullient to fearful. This swing has been the most abrupt momentum change for U.S. stocks in history. Putting aside the technical details, there is a standard measure of the market's direction – essentially the pace of price changes in the market. It follows then, that one can measure the change or "swing" in the market's direction over a short period of time. On February 8th, the two-week negative swing was the largest in the history of accurately measuring stock market moves (going back to 1930).[1]

A BRIEF HISTORY OF RAPID DECLINES

So, what does history tell us about what could be ahead for investors? For this, we are grateful for the data that Sid Mokhtari of CIBC World Markets has pulled together on rapid market declines. Looking back to 1950, there have been a total of 61 rapid decline events in the S&P 500, as defined as a 10% or more pull back in the market that occurs within 10 trading days. As one might imagine, in a bout of volatility, a number of rapid decline events that meet the "10% decline in 10 trading days" definition may follow in close succession. Removing these multiple events, it turns out that there have been only 11 prior rapid decline periods, as summarised in the exhibit.

Rapid Decline Periods in the S&P 500[1] from 1950 to Date

			Next 12 Months	
	Rapid Decline Period	Duration[2] (in days)	Worst High to Low Decline[3]	12-month Return[4]
1.	1962	1	-12.3%	26.9%
2.	1970	2	-9.3%	46.5%
3.	1974	45	-15.3%	17.0%
4.	1987	15	-20.8%	-4.3%
5.	1998	8	-10.0%	39.2%
6.	Spring 2001	2	-26.4%	3.8%
7.	Fall 2001	3	-32.0%	-12.0%
8.	Summer 2002	5	-19.3%	18.9%
9.	2008/09	155	-38.4%	-2.5%
10.	2011	7	-9.9%	12.5%
11.	2015	2	-13.3%	14.9%
		Average	-18.8%	14.6%
		Best	-9.3%	46.5%
		Worst	-38.4%	-12.0%

[1] Defined as containing at least one rapid decline event (a 10% or more decline within 10 trading days).

[2] Measured from the 1st to last rapid decline event in the period.

[3] The largest subsequent high to low that occurred in the following 12 months.

[4] Measured from end of the first rapid decline event (i.e. excluding the first 10% decline).

Source: No Pain No Gain, February 20, 2018. Sid Mokhtari, CIBC Capital Markets.

A NUMBER OF POINTS CAN BE DRAWN FROM THIS HISTORY.

- First, these rapid decline periods are quite rare – 11 times in the past 68 years isn't very much. You can easily identify Black Monday (1987), the Asian Contagion (1998), 9/11 (Fall 2001), and the Global Credit Crisis (2008/09), and you may recall some of the others. Note that a rapid decline period doesn't necessarily lead to a bear market, which is a declining market over an extended timeframe.
- Also, these rapid decline periods tend to occur a number of years apart, with the three 2001/02 events being the exception where three decline periods repeated with a gap of only several months.
- The duration of the decline period (the number of calendar days between the first and last rapid decline event) is quite short – although, of course, there will be a longer period of volatility and recovery that follows.

[1] The market direction measure is the 14-day RSI (Relative Strength Index), an index that varies from 1 to 100. The swing is simply the 2-week change in the 14-day RSI and was -57.7 on February 8th. Bloomberg News, February 9, 2018.

The Agony and the Ecstasy *cont.'d*

WHAT NEXT?

Now that we have had a rapid decline event, what may lie ahead for investors? The history shows… "more agony and ecstasy".

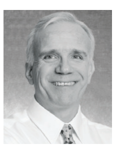
- The agony. After a rapid decline event has occurred, ongoing volatility for some time is typical. Once the market volatility has started, the rollercoaster tends to last for a while. The rollercoaster analogy is key here as the aftermath includes market ups *and* downs, so don't get alarmed when we highlight only the downs. History shows that, following the first rapid decline event, there will be more downs, with the largest subsequent high to low in the following 12 months averaging an 18.8% decline. Bear in mind that these subsequent declines usually occur *after* a recovery, so the subsequent decline is *not* additive to the first 10% decline!
- The ecstasy. The good news part of the historical picture is that patience brings better times. After the 11 rapid decline periods, the S&P 500 climbed an average of 14.6% in the following twelve months *including the effect of the rollercoaster downs.* For the three periods that still had negative returns at the 12-months point, extending the forward period led to better outcomes. This occurred promptly after the 1987 and 2008/09 periods. After the Fall 2001 period, the market took a little over two years to recover, but recover it did.

* * *

This increase in volatility is unsettling for investors. As indicated, there are some "general" lessons from history, but we also know that each time will be different. This time, here are some specifics to keep in mind:

- There has been an absence of any real negative news. Indeed, the world is enjoying a period of synchronised economic growth, corporate profitability is strong and rising, and recent corporate tax cuts in the U.S. will be stimulative. Rather, it appears that this bout of volatility was exacerbated, ironically, by the abrupt unwinding of the trading bets that many investors had placed, which were collectively premised on the continuation of low market volatility. Ouch!
- Valuations, which appeared stretched at the end of 2017, are now more reasonable. The beneficial effects of the U.S. corporate tax cuts and weaker U.S. dollar have now been factored into earnings estimates, lowering valuation multiples.

We think the best defence in an environment like this is our usual Nexus mantra. 1) No one can reliably predict where the market is going in the short term, so keep a long-term perspective; 2) The equity markets go up over time and you need to be in the markets to benefit; and 3) Maintain proper diversification with a portfolio of quality companies at reasonable valuations.



FWG

Nexus adds Depth to the Investment Team Roster

We are delighted to welcome Alana Awad as the newest member of our investment team at Nexus. Alana joins us from RBC Capital Markets where she was an institutional fixed-income salesperson and carried the awesome responsibility for sales coverage of Nexus. She is a CPA, CA (PwC), a graduate of the Queen's University Bachelor of Commerce program and holds the CFA designation.

Initially, Alana will work closely with Geoff Gouinlock in the fixed income area. Over time, she'll gradually expand her contribution to include equity analysis and security selection as an integral part of our team-based portfolio management process.

In her spare time, Alana prefers to be active – enjoying rowing, hiking and travelling. In fact, in the time between leaving RBC and joining Nexus, Alana spent four weeks in Costa Rica attempting to master the art of surfing. Alas, there is no YouTube footage of her "hanging 10" for the rest of us to see!

GJG

NW

Pearls of Wisdom

Reading is one of the principal occupations in our profession. As we digest a wide range of material, interesting ideas and surprising facts – some serious and some light-hearted – rise to the surface. We attempt to share a few of those with you in each of our issues of Nexus Notes.

DMC

WATER SCARCITY

In the past few years, several incidents of severe water shortages have made the headlines. Most recently, Cape Town's water resources have come under stress. Since February 1st, residents of that city have been limited to 50 litres per day. More restrictions for Cape Town are on the way sometime in late spring on what's known as "Day Zero" when the water supply is expected to be cut off to most homes. At that point, the city's 430,000 residents will be required to collect rationed water from 200 public distribution points. Another example is found in the densely populated state of Gujarat, India which is home to 60 million people. There, the state recently announced a clampdown on water use for irrigation and industries. What's more, expectations are that the Gujarat government will follow in Cape Town's footsteps and consider rationing drinking water supplies to local cities. According to investment firm Raymond James, the challenge of global water scarcity is increasing in part due to growing populations, emerging markets urbanization, and climate change. Sadly, high-profile examples like those of Cape Town and Gujarat are likely to remain in the headlines. According to the World Health Organization, about half of the world's population will be living in areas defined as "water-stressed" by 2025. While the challenges are all too apparent, there may be investment opportunities as well for companies that are able to deliver solutions like desalination plants and improved water management infrastructure. *(Raymond James, February 20, 2018)*

DISRUPTIVE INNOVATIONS

At the same time the Nexus team was delivering our November presentation on the "Age of Disruption", a research team at Citigroup published an interesting report on what they see as the top ten disruptions of our time. Given our focus on changes in the transportation industry, we were intrigued by what Citi had to say on the subject. Here's the summary: "In transportation, robotic piloting in commercial jets could mean that your flight is unmanned and that the days of your plane being delayed because the pilot is stuck in traffic on the way to the airport are long gone. Or maybe you don't want to take that short-haul flight at all, and instead could jump into a Hyperloop pod that shoots you 700mph in a vacuum tube to your destination. Artificial intelligence-piloted planes and Hyperloop systems could be the driver of new transportation modes." For those curious readers looking for more, we recommend their full report which you can find here: https://www.citivelocity.com/citigps/ *(Citigroup, November 2, 2017)*

HOW TO BE A CEO

Adam Bryant, a reporter for The New York Times, wrote his final Corner Office column in the fall of 2017. After a decade of interviewing CEOs about life in the corner office, he had amassed a treasure-trove of five million words from which to draw out some lessons learned. While the final column is worth a full read (and, arguably, so too are all of his columns) we will simply point out the three recurring themes he noted about what makes a successful CEO. First, he notes that they display "applied curiosity", which means they tend to question everything and be ceaselessly curious about how people work, how things work, and how to make things work better. Second, "CEOs seem to love a challenge" and embrace operating outside of their comfort zone. Third, they managed their own careers by focusing on "doing their current job well", a strategy which earned them promotions over time. For those readers who have young family members with ambitions for the corner office, the full article can be found here: https://www.nytimes.com/2017/10/27/business/how-to-be-a-ceo.html *(The New York Times, October 27, 2017)*

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Portfolio Management & Financial Counsel

Nexus Investment Management Inc. provides discretionary investment management and financial counselling services to private clients, trusts, estates and foundations.

- ☐ **Exceptional client service and objective advice:** tailored to the client's individual needs.
- ☐ **Superior investment performance[1]:** long-term record of superior after-tax returns and capital preservation.
- ☐ **Disciplined investment approach:** "*Growth at a Reasonable Price*" philosophy, using research and patience.
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Publication Mail Agreement 40033917.

[1] A composite of Nexus accounts, managed to a balanced mandate, has earned 7.8% per annum, pre-fees for 10 years. A composite of notional returns from a weighted average of the following indices: T-Bill (5%), Bonds (35%), TSX (35%) and S&P 500 (25%) earned a return of 6.3% over the same period.