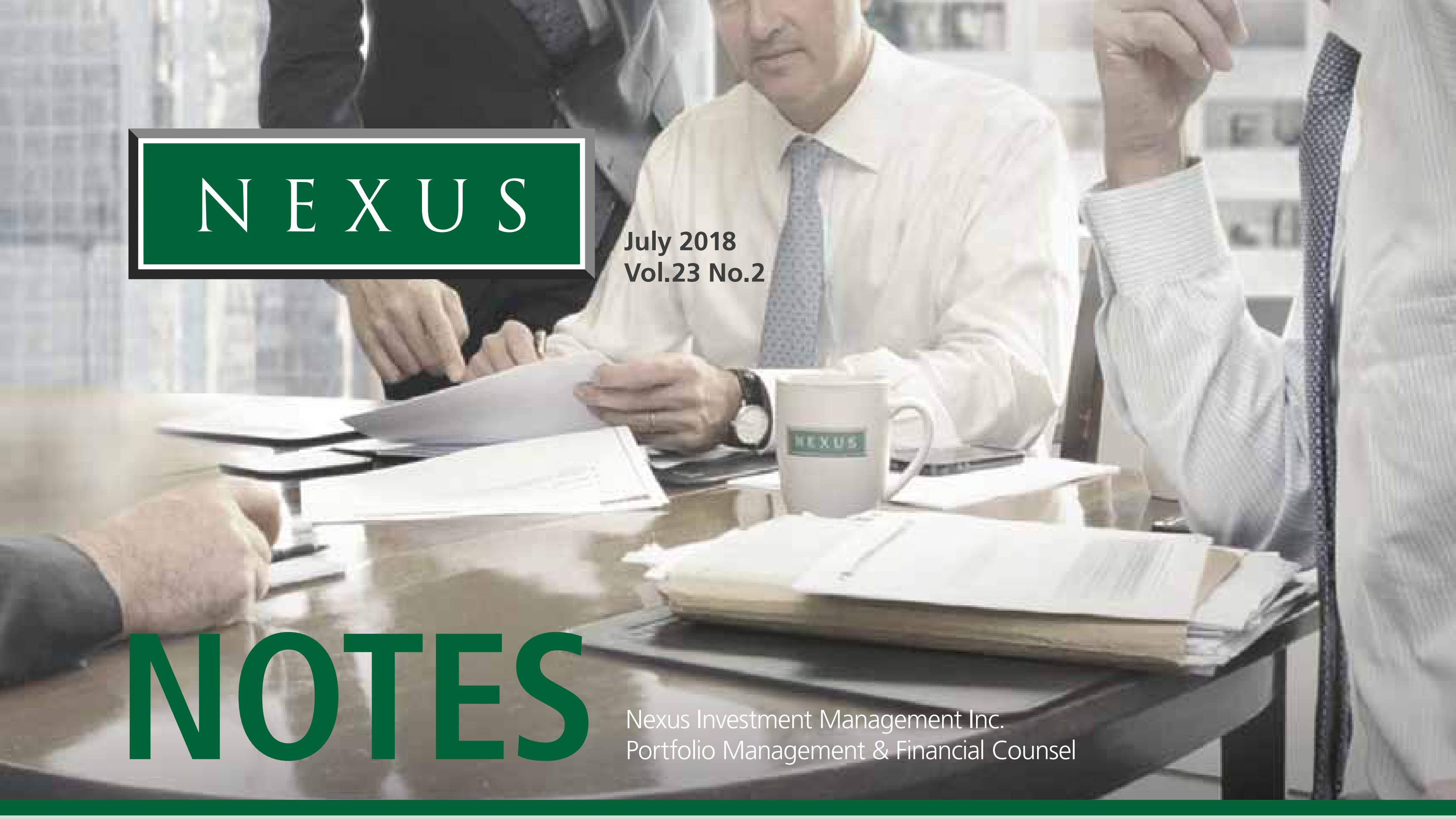

NEXUS

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NOTES

Nexus Investment Management Inc.
Portfolio Management & Financial Counsel

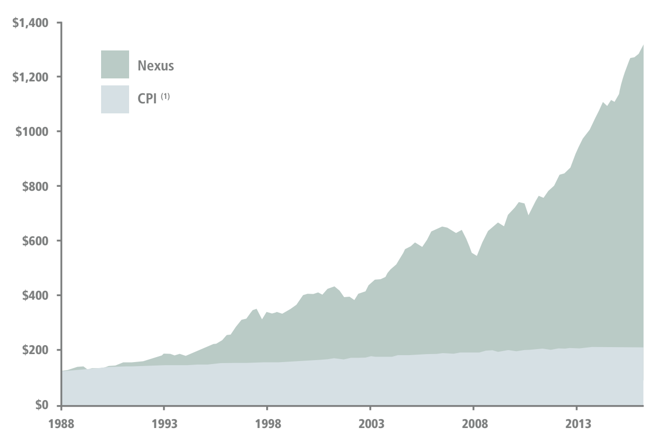
Inside Articles

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



Shift Happens

Mo and I just returned from a financial planning conference in Halifax. The three-day conference covered

many of the topics you would expect: tax changes, current federal government policy direction (and if there is any logic behind it), and the current maturing bull market. However, there was also considerable attention given to the shift in Canadian demographics. It is not new news that Canada's population is getting older. However, there are several interesting statistics in *The Canadian Longitudinal Study on Aging (CLSA) Report on Health and Aging in Canada*. You may be surprised to know that in 2016, for the first time in our history, the number of Canadians over age 65 exceeded the number of those aged 14 and under. In fact, by 2031, one in four Canadians will be 65 or older. The implication is that the proportion of those who participate in the workforce is shrinking. But one of the other shifts noted is that the employment rate for adults age 55 and older has been increasing for both women and men, leading to an overall older workforce. [(1)]

Most clients probably think I am slightly crazy, but are far too polite to say so, when I present them with a financial plan that has them living out to age 100. I do this because one Nexus client lived to age 103, and more than a handful are in their late 90s. Planning for your assets to last until age 100 is an insurance policy in case you live a long life. One way to ensure that you are engaged, healthy and in good financial shape as you journey through retirement, is to work longer. I have anecdotal evidence that many are choosing to go back to work after what would be considered a traditional retirement age, but not in the 9-to-5 sort of way you might think. Perhaps this trend can be called the next-wave entrepreneur. I see clients consulting, coaching and some have started small businesses.

Living longer has implications for financial planning. Health, wealth, disability and caregiving obligations all contribute to clients' retirement planning and what age they might choose to retire. One of the speakers at the conference suggested that a mindset shift is required when talking about retirement planning today. Conversations should no longer be about financing for retirement, but rather financing for longevity.

Longevity also has implications on portfolio construction for investors. Equities, while volatile, provide inflation protection in a portfolio with a long time horizon. Plus, the dividends and realized capital gains from equities are taxed at preferred rates to interest and other forms of investment income. However, equity volatility can affect the longevity of a portfolio, especially for investors living off their portfolios if they are forced to make withdrawals in down markets. Therefore, income requirements on a portfolio often demand more stability than equities offer. This is where fixed income (or bonds) come in. Bonds have traditionally been used for income generation and to mitigate volatility. But in today's investment environment, bonds pose a conundrum. Returns on this traditionally safe and reliable asset class have recently been negative. In this issue of *Nexus Notes* we have an article that addresses this fixed income conundrum.

Also in this issue, Alex Jemetz has written a third article in our Leaving a Legacy series. This article focuses on special needs. Estate planning is important for everyone, but even more so for parents dealing with a child who has special needs.

Happy reading and I hope everyone enjoys the shift into the lazy days of summer!

DCW

[(1)] Delayed Retirement: A New Trend? Statistics Canada, Carriere, Galarneau

Leaving a Legacy, Part 3

When Special Needs Is a Part of Your Life

We've spoken and written extensively about estate planning and leaving a legacy lately (Part 1 and Part 2 have appeared in previous editions of *Nexus Notes*). At Nexus, we believe that everyone, no matter how simple or complex your financial situation is, should go through some degree of estate or tax planning. There is always some benefit that results from thinking ahead. For parents dealing with a child who has special needs, it's even more important.

Much is written about the technical aspects of financial planning for individuals with special needs, such as how to maximize the RDSP (Registered Disability Savings Plan), navigate ODSP (Ontario Disability Support Program) and get the Disability Tax Credit. However, not as much is written about the 'softer' side of estate planning for dependents with special needs. As we stated in our Leaving a Legacy article, *"To create a good estate plan you need to establish the goals of the wealth first, and understand the dynamics of the family itself."* In the case of special needs planning, there is added complexity which makes these 'softer' elements even more important.

DIVISION OF ASSETS

Most typically, parents divide their estate equally among their children. For parents with significant wealth, an equal share might be sufficient, or even excessive, for a child who has special needs. Equal division, however, may not be the best solution if an equal share is not enough to provide for an individual incapable of providing for themselves. Properly estimating the amount of capital that will be required so that a child with special needs can live without reliance on social assistance is important when considering how to divide assets. One way to estimate this is to do a cash flow and net worth projection for that child alone, and then incorporate the results in the parents' estate plan to determine if an equal split of assets is appropriate.

TRUSTEES

In the case of trusts – either inter vivos (living) or testamentary (upon death) – you need to name trustees. In particular, if you have set up a Henson Trust for your adult child with a disability, the trustee will need to understand the implications of managing the income your child receives from the trust such that it doesn't significantly interfere with the government support your child receives. Certain disabilities come with a shorter-than-average lifespan. What happens to the money if the child themselves die? Once a child is no longer a minor, they should also have a will which will determine what should be done with the Trust assets. Once you choose a trustee, consider introducing them to your financial planner, and even invite them to meetings when discussing the Trust(s). The Trustee will feel more prepared to take on this responsibility, and feel more confident that they can manage the Trust according to your intentions.

LETTER OF WISHES

A letter of wishes is not legally binding, but will let the courts, family and future caregivers know what kind of life you hoped and dreamed for your child, and could affect decisions they make. It can include basically anything you want. But make sure it does not contradict your will. Here is a list of some items to consider when creating a letter of wishes:

- Your child's medical history
- Living arrangements both short term and long term

Leaving a Legacy, Part 3 *cont.'d*

- Key people in your child's life and relationships you want nurtured
- Information on current and future entitlements for your child
- Information on Trusts you've established
- Instructions for the Trustee in the proper use of money left in the Trust
- Guidance on what to do when circumstances change

Most importantly, document your child's passions, joys, hobbies and your hopes for your child's life. (1)

THE 'TALK'

In our Women & Wealth session about Leaving a Legacy, much time was spent on encouraging parents to discuss their financial wishes with their heirs, the point being to minimize surprises and misunderstandings after the parents die. It cannot be more true than in the case of siblings of a child with special needs, especially if the division of assets decision results in an unequal split. Here, understanding family dynamics is key. Even in the most challenging relationships, having these discussions while you're alive is significantly better than waiting until you're dead and have no more control. You may be surprised by your other children's reactions and inputs.

RESOURCES

If you are looking at writing or updating your will, a good place to start is with a lawyer who specializes in special needs law and estate planning. For parents with a child with special needs, more frequent review of your will and letter of wishes is often necessary. And, of course, the financial counsellors at Nexus are here to help guide you through the estate planning process from a financial perspective. Minimizing the obstacles that could get in the way of your child living as full a life as possible should be the focus.

AOJ

"If there is anyone who objects to this union, either here or on the Internet, speak now or forever hold your peace."

Image used with permission: John Caldwell, The Cartoon Bank/The New Yorker Collection

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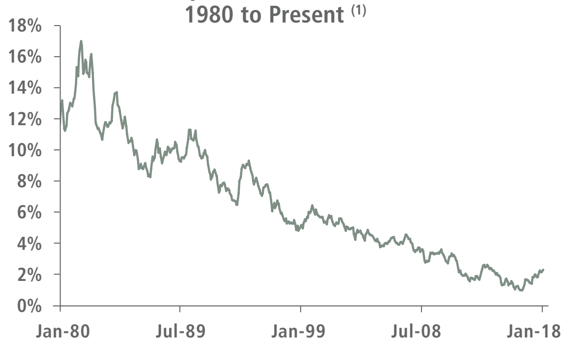
(1) www.financialwellbeing.ie

The Fixed Income Conundrum

Bond holdings have been a key component of Canadian investors' portfolios for generations. Historically, bonds provided a steady and useful stream of income. In fact, through the 1980s, with interest rates well above 10%, bonds provided an income stream that seems lavish in hindsight. However, since their peak in 1982, interest rates have been on a steady and unrelenting decline. More specifically, in September 1982 the yield on the 10-year Government of Canada bond touched 17%. Today, it yields 2.15% – before tax and inflation. The idea that bonds provide a useful source of income now seems an historic curiosity.

Another key attribute is safety – a bond represents a promise or contract by the issuing company to pay back your principal at maturity and to pay you a set rate of interest along the way. It typically is backed by a senior claim on the assets of the issuer. Because of this, a bond's market value is not likely to fluctuate nearly as much as the same company's stock. But along with the assurance of safety is the fact that there is no upside. Today's remarkably low yields guarantee a low return in the future.

Canadian 10-year Government Bond Yields, 1980 to Present [1]



Those who follow Nexus's many writings on this topic will know that we have been predicting the end of the bond bull market for many years. Yet, despite our prediction for higher interest rates, rates have remained frustratingly low. Bond returns have been good … until now, when suddenly they aren't. A growing number of clients have noticed, and remarked on the fact, that returns on this safe and reliable asset class have turned negative. For the 12 months ended May 31, 2018 the FTSE TSX Universe Bond Index, the principal bond market index in Canada, provided a total return of -1.0%. [2] For the three years ended May 31, it provided a measly return of +1.6% per year. This has caused a number of investors to ask the reasonable question, why should I own bonds at all?

One response to this dilemma is to reduce one's allocation to bonds and increase the allocation to stocks. Given the low expectation that Nexus and many others have for bond returns going forward, this is a tempting proposition. Without doubt, it is reasonable to expect stocks to provide a far superior return to bonds over the next 10 and 20 years. But, given the nature of bonds and stocks, this has always been the case.

Undoubtedly, some investors can sensibly increase their allocation to stocks and accept the greater volatility in their portfolio that comes with that. Many, however, cannot. Income requirements often demand more stability in a portfolio – the worst thing that can happen is to be selling stocks to pay the rent just after the market has tumbled. It may also be that an investor's psyche (and stomach) is not strong enough to watch their portfolio lurch higher or lower from month-to-month. The luxury of a high equity weighting is suitable for a relative few.

For those that don't have the luxury of choosing a high equity weighting, bonds may be a necessary evil. They continue to offer a critical attribute: safety and stability. A well-used (perhaps over-used) expression at Nexus is that they provide ballast in the boat as the equities in a portfolio bob up and down on choppy seas.

(1) Source: Federal Reserve Economic Data (FRED), Federal Reserve Bank of St. Louis.
(2) In other words, the modest interest payment was exceeded by the decline in price.

The Fixed Income Conundrum *cont.'d*

With the negative return over the last year, however, and the possibility of further negative returns as interest rates drift higher, can this be logical? How can we say that something with a negative return is useful for many investors? Part of the answer is the fact that the apparent negative return provides only the illusion of a loss. All bonds that we would purchase have a positive yield-to-maturity, and this is the return that an investor will earn if he or she owns it to maturity. The illusion of loss arises because the market price of existing bonds fluctuates. Recently, prices have moved lower as the general level of interest rates moved higher. A bond held to maturity will provide the return promised at purchase regardless of market prices along the way. It will be low, but positive.

A few investors have turned to alternative investment strategies as an antidote to the low return expectations for bonds. Strategies such as distressed credit funds, commercial mortgages, and levered long-short bond funds promise higher returns that are less tied to the predicted rise in interest rates. Unfortunately, these strategies are no panacea – they typically are much riskier and demand higher fees. They also are much less liquid than a traditional bond portfolio.

A more common alternative to bonds are GICs, or other savings products. One does not need to worry about the ebb and flow of bond prices since GICs are fixed contracts. And because there is no explicit commission or fee attached they may seem like an intelligent option. Indeed, for some, this may be a sensible approach. However, bonds have some considerable advantages over GICs.

As is the case with alternative credit strategies, GICs have considerably less liquidity than bonds. They often require tying your funds up for a fixed period of time in order to get a good rate. Should a need for cash arise, or should a great investment opportunity present itself, you may be out of luck. The only option is to wait until maturity. Bonds, such as those Nexus owns, can be sold almost instantaneously, and at almost no cost.

The more important reason to embrace bonds is more subtle. Bonds typically are negatively correlated with stocks. In layman's terms, this means they often go up when stocks go down. Conceptually, the reason for this is straight forward: during a crisis, investors dump stocks and run to the safe stuff, which they bid up in price with the extra demand. So while a GIC provides stability in a portfolio by staying constant, bonds can be even better. They can actually increase in value when it is most needed – when stocks are in a swoon. They represent an attractive insurance policy.

The dynamic of negative correlation also answers a question asked by a few clients: "If you think interest rates are going modestly higher, why own bonds with maturities greater than one or two years?" The answer is that to take advantage of the negative correlation you need to have bonds with at least some "duration". [3] Our goal is to try and balance the risk that comes from long-dated bonds with the usefulness that duration provides as insurance. This is an art, not a science. Our bond portfolios are considerably shorter than the principal Canadian bond index, but longer than some might expect, in order for us to have a little bit of "duration insurance."

Our conclusion, therefore, is that bonds remain an important component in most Nexus client portfolios. Moreover, it's also important to remember that we actually want higher interest rates. The unusually low rates that have been in place for years are bad for savers, who can't earn enough to support themselves in retirement, and bad for society should borrowers act in economically dubious ways as the result of an artificially low cost of capital. The road to more normal rates will be bumpy, but it will be better for us all in the end.

Thankfully, the normalization process is underway. Since trading at 0.95% in September 2016, the 10-year Government of Canada bond has risen 120 basis points to its current level of 2.15%. We expect the trend to continue. But with our short duration portfolio, the pressure on capital values will be manageable and our maturing holdings and collected interest payments can be re-invested at progressively higher rates. All the while, these bonds will provide the ballast in the boat so crucial for most investment portfolios.

JCAS

[3] Mathematically, a bond's duration is the weighted average length of time over which an investor receives cash flows – both the interest payments and the final principal repayment. The longer the duration the more sensitive a bond's value is to changes in interest rates.

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

NORTH KOREA: RISKS OR REWARDS?

Among the many current issues worrying investors, the geopolitical risk surrounding North Korea is often near the top of the list. At its core, the worry from a narrow investment perspective is that if a major conflict erupts into a full-fledged war, this would be – to say the least – highly disruptive to the world economy. It's a worry, and indeed a reasonable one given the country's history of authoritarianism and isolation. What's more, the risks have been magnified by North Korea's new nuclear capabilities. However, this view skews towards a pessimistic interpretation of how the future will unfold. What if things don't turn out quite so poorly? The market, as ever, has its contrarians. We read with interest the story of Busan Industrial's recent stock surge of 500% since late April. Its Korean investors are betting (with gusto!) that the small cap South Korean construction company will be a big beneficiary if relations with North Korea thaw and the two economies become more connected over time.

(The Wall Street Journal, June 12, 2018)

A GOOD IDEA IS HARD TO FIND

How much effort do we have to put in to come up with a good idea? The romantic view of "ideation" is that, like Newton's experience with the falling apple, great ideas are borne from a flash of insight seemingly derived from thin air. However, the more pragmatic reality is that many of the world's great ideas come from years of hard-slogging research. In a sobering academic paper, professors from Stanford and MIT came to the conclusion that it's getting that much harder to find new, breakthrough ideas:

"We present a wide range of evidence from various industries, products, and firms showing that research effort is rising substantially while research productivity is declining sharply. A good example is Moore's Law. The number of researchers required today to achieve the famous doubling every two years of the density of computer chips is more than 18 times larger than the number required in the early 1970s. Across a broad range of case studies at various levels of (dis) aggregation, we find that ideas – and in particular the exponential growth they imply – are getting harder and harder to find."

(Bloom, Jones, Van Reenen, and Webb, "Are Ideas Getting Harder to Find?," March, 2018, web.stanford.edu)

NEXUS

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.
- ☐ **Alignment with clients' interests:** as the Firm is wholly owned by its principals, we are committed to your financial success.
- ☐ **Cost-effective management:** our services are accessible directly, without the costs of branding and distribution.

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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.