Nexus Notes

October 2020
Vol. 25, No. 3

Featuring:

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Uncertainty…Who needs it? Apparently, we do.

When Should I Start my CPP Payments?

The (U.S.) Taxman Cometh

A Virtual Nexus Welcome

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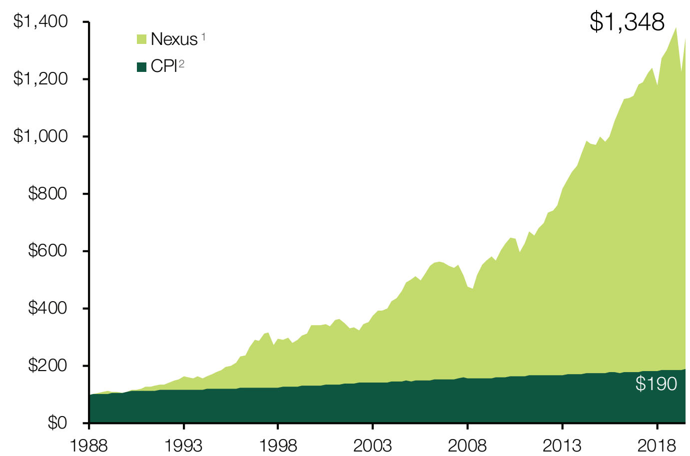
$100 Investment with Nexus in 1989



1 "Nexus" reflects the performance of a composite of Nexus accounts managed to a balanced mandate (until September 30,1997) and the Nexus North American Balanced Fund (thereafter). Returns shown prior to the deduction of investment management fees.

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

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FROM THE EDITOR

Off-Kilter

Fall is usually my favourite season. It feels more like the start of a new year than does the start of a calendar year. I look forward to setting new resolutions and starting fresh. This fall, however, feels slightly off-kilter. We enter the fall with a volatile stock market, ultra low interest rates, a red-hot housing and renovation market (just try and find a contractor), high unemployment and a rising tide of COVID-19 infections. Our neighbours to the south are preparing for what is sure to be a circus of an election. There is legitimate concern about the fragile state of the economy and there is still a lot more of 2020 to come!

These challenging times are driven by uncertainty. As you will learn from Alex Jemetz's article in this issue of Nexus Notes, uncertainty manifests itself as volatility for investors, and uncertainty absolutely increases risk. The good news, however, is that time reduces risk. Alex goes on to say that in theory investors should be able to handle short-term volatility because they should be confident that equities will have positive returns over the long term. It turns out that uncertainty is the reason to build a portfolio that has both growth potential but also defensive characteristics. Uncertainty is the reason to focus on one's strategic asset allocation and not try to time the markets.

Of course, I have been spending a lot of time thinking about the concerns and challenges that our clients face in this environment. One that is top of mind is the persistence of low interest rates. Clients' desire to flee to safety in times like these can have real risks. Low returns on cash and bonds mean zero or negative real return after inflation and taxes. There will also be capital losses if interest rates rise. Cash and bonds may have little or no return right now, but that does not mean they do not have a place in an investor's portfolio. The question becomes how much do you need? Cash and bonds provide short-term liquidity and stability. Depending on your short-term needs from your portfolio, it might make sense to increase your equity allocation. At Nexus, we are well positioned to help clients work through what asset allocation makes the most sense for their circumstances and help them navigate these uncertain times.

A client's portfolio is only one part of retirement planning. Another is the different income sources available. Most working Canadians will be eligible to collect income from the Canada Pension Plan at some point in their lives. We are often asked "When should I start my CPP payments?" which just happens to be the title of an article by Brad Weber in this issue of Nexus Notes.

The final article featured in this issue focuses on one aspect of a raft of increasingly penetrating and personal questions that financial providers like Nexus must ask in the guise of "knowing our client", but which in reality arise because of a legal or regulatory obligation. If you want to have a better understanding of the long arm of the IRS, then read Denys Calvin's article about the foreign tax compliance requirements we face.

In closing, I would like to welcome Preethi Khatri Chetri to the Nexus team. Preehti joined us in September as our Pooled Fund Administrator and we are thrilled to have her on board. While these are strange times to hire and train a new employee, Preethi is up for the challenge! You can read more about Preethi inside this issue. Happy Thanksgiving to all.

Dianne White
CPA, CA, CFP, TEP

Uncertainty...

Who needs it? Apparently, we do.

Alexandra O. Jemetz
CIM

"Uncertainty and affect are fundamental and interrelated aspects of the human condition. People have a propensity to simulate negative outcomes, which result in a propensity toward negative affective responses to uncertainty."[1]

It is not exactly a revelation to say that uncertainty contributes to stress. In "normal" times – take 2019, for example – three common sources of stress stood out. According to the American Psychological Association:

- More than a third of Americans cite unexpected expenses as a source of stress related to money.
- Nearly a third of Americans say economic uncertainty is a source of stress when thinking about the economy.
- When it comes to health-related issues, around two-thirds of Americans cite uncertainty about the future as a source of stress.[2]

Money, the economy, health. Reading this through a 2020 lens, it is no wonder current stress levels are at historical highs.

Uncertainty is inevitable and the stress it causes is often viewed as unwelcome. However, a study conducted in 2016 by researchers at University College London suggests that uncertainty-induced stress may not be that bad for you. Their conclusion instead was that "stress may inform judgements of risk."[3]

In the study, participants played a computer game in which they had to guess whether the rocks they turned over had snakes under them. If they found a snake, they would receive a mild electric shock on their hand. The program was coded so that the odds of finding a snake changed over time, thereby changing the levels of uncertainty. The model allowed the researchers to predict participants' stress levels based not only on whether they actually received shocks, but also on how much uncertainty they had about getting shocked. "Our experiment allows us to draw conclusions about the effect of uncertainty on stress. It turns out that it's much worse not knowing [if] you are going to get a shock than knowing you definitely will or won't", explains lead author Archy de Berker. The results showed that participants who had a 50% chance of receiving a shock were the most stressed, while the subjects with 0% or 100% chance were the least stressed. "People whose stress levels tracked uncertainty more closely were better at guessing whether or not they would receive a shock".

They explain further using real-world examples such as applying for a job, waiting for a train or expecting your medical results. "The most stressful scenario is when you really don't know. It's the uncertainty that makes us anxious," says co-author Dr. Robb Rutledge. "From an evolutionary perspective, our finding that stress responses are tuned to environmental uncertainty suggests that it may have offered some survival benefit," explains senior author Dr. Sven Bestmann.

What this Means for Investors

From an investing viewpoint, uncertainty manifests itself in the concept of volatility, typically measured by price fluctuations in security prices. It captures investors' jitteriness as they react to news of events that lead to unpredictable outcomes. But, there is a factor that can undermine the perception that uncertainty *categorically* increases risk, and that is the passage of time. Equity investors, theoretically, *should* be able to handle short-term volatility because they should be certain that equities will have positive returns over time. Anyone invested in capital markets pretty much has to believe that humans will consume goods and services in the future and companies will continue to exist in order to profit from those activities. Otherwise, people would be investing only in things such as art, stamps or gold bullion, or – at worst – stuffing money under their mattresses.

What Nexus has Learned

We've learned a lot in our over thirty years in this business. Two key takeaways stand out:

One – don't stray from a proven process. Perhaps being burned in the past does indeed improve judgement and decision-making ability. Nexus has been in business since 1988 and has applied the same investment approach through the crash of 1989, the late '90s bear market, the 2002/03 tech wreck and the global financial crisis in 2008/09, with a keen focus on long-term growth and capital preservation. We firmly believe in this approach and that market timing does not work in the long run. Uncertainty is the very reason to have a portfolio that has elements of growth potential for the ups and defensive characteristics for the downs. Having this tried-andtrue long-term strategy helps us stay the course and avoid doing something just for the sake of looking busy. Most investors who tried to time the market crash in March by moving to a more conservative positioning paid a dear price as the market bounced back with whiplash speed.

Two – an important foundation clients can rely on is their financial plan. Nexus takes a conservative approach to planning, using moderate return assumptions. These return assumptions are based on what we think is a conservative estimate of future long-term returns. These estimated returns are meant to "average out" over time. That is, capture in the plan what in reality will surely include both significant up years and severe market downturns. Even so, when real life looks like 2020 – the worst global pandemic in a century causing the most rapid market and economic decline in as many years – it is challenging for any investor, even the most disciplined one, to "keep calm and carry on". However, a client that has completed a proper plan can put a poor year like 2020 into perspective and reduce the negativity associated with it. These clients can remain focussed on managing the controllable aspects of their plan, such as their spending and savings, and not stress about the uncontrollable ones, like each individual year's returns. These clients can take comfort that, even in a bad return year, the good and the bad years will average out and they will continue to move towards the longer-term goals outlined in their plan.

Conclusion

Although uncertainty is often viewed as negative, it's not always the case. Removing uncertainty from activities such as watching sporting events, gambling or reading scary books also removes some of the pleasure associated with these activities. This suggests that it could be the uncertainty that people *identify* as problematic that causes stress, not that all uncertainty does.

So, go ahead, open up that box of chocolates and pick one. Not knowing what's inside may actually help you make better decisions in the future. In the meantime, you may just have to learn to like Pink Nightmare cream filling.

1) The Relationship Between Uncertainty and Affect, Eric C. Anderson, R. Nicholas Carleton, Michael Diefenbach and Paul K. J. Han, Frontiers in Psychology, 12 November 2019, https://www.frontiersin.org/articles/10.3389/fpsyg.2019.02504/full
2) Stress in America Survey, American Psychological Association, October 1, 2019, https://www.apa.org/topics/stress-uncertainty
3) Uncertainty can cause more stress than inevitable pain, ScienceDaily, 29 March 2016, www.sciencedaily.com/releases/2016/03/160329101037.htm

When Should I Start my CPP Payments?

Brad Weber
CPA, CA, CFP

The majority of working Canadians will be eligible to collect income from the Canada Pension Plan at some point in their lives. You can start CPP payments as early as age 60, and it's something you apply for. Since you have the option of when to apply, a typical question is "when should I start collecting CPP?"

I think the underlying concern is, "how do I get the most out of CPP?" People are advised in many ways when to start CPP, but a recent study seeks to provide more clarity to the topic.

Let's start with some of the basics. CPP essentially uses age 65 as the baseline year for calculating payments, although the amount of pension you will receive is based on many factors. While 65 may be the base year, you can start CPP as early as age 60, but there is a cost to doing so. Your CPP payments will be reduced by 0.6% for each month you start your pension before 65, which can mean a total reduction of 36% if you start your pension at age 60. That decrease is permanent for your lifetime. You also have the option of deferring the start of your payments until age 70. By delaying, you increase your pension by 0.7% per month, or a permanent increase of 42% if you wait to start until age 70.

If your CPP pension is permanently reduced by starting it early, what are the reasons that people choose to do so? Some people may have retired before age 65, and their circumstances are such that they simply need the cash flow from CPP. Others might have health issues, resulting in a shortened life expectancy, causing them to want to start their pension early. Some simply want to start their pension as soon as possible, thinking, "a bird in the hand is worth two in the bush." They would rather know they've received some benefit by starting CPP at 60 rather than waiting for another 5 or 10 years.

The advantage of deferring your pension to age 70 is straightforward: larger CPP payments. Over a long enough timeline, those larger payments will translate into more lifetime income. While the prospect of more income would seem like a clear advantage, over 95% of Canadians start their CPP pension sometime between age 60 and 65. This means that the vast majority of Canadians do not defer starting their pension, even when cash flow or health concerns are not the driving factors. But is this the correct decision? A recent study by the Canadian Institute of Actuaries titled "The CPP Take-Up Decision" concludes that far more Canadians should be deferring their CPP to age 70 then actually are.

One of the first points the study made was that when you include inflation, deferring your pension will actually permanently increase your CPP payments by 50% in real terms. The research focused primarily on those who have sufficient savings in the form of an RRSP or RRIF (which they referred to as bridge funds) to compensate for the effect of delaying the start of CPP payments. The researchers reviewed two

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The (U.S.) Taxman Cometh

R. Denys Calvin
CFA

Like the medical patient who expects to endure a fair bit of poking, probing and prodding from the doctor, clients of financial providers have had to get used to answering a raft of increasingly penetrating and personal questions when opening a new account.

In the investment world, most of these questions are intended to equip the firm with a clear understanding of the client's circumstances and objectives that will inform the account/portfolio management process.

However, there's no denying that many questions arise more from the firm's legal or regulatory obligations than because the answers will truly help the firm "know the client" and serve them better. Moreover, it seems the number of such questions is increasing. For better or worse, financial services businesses have surveillance and quasi-policing roles in such diverse realms as tax collection, anti-money laundering, and securities law compliance. In principle, the privilege of being a part of the financial system comes with a responsibility to protect that system from those who abuse it.

One realm where the number of these "legal questions" has grown steadily may surprise you: *foreign* tax compliance. It started with the United States' *Foreign Account Tax Compliance Act* ("FATCA") 10 years ago as the U.S. broadened its tax enforcement efforts in two directions: to ensure U.S. taxpayers report earnings on *all* their financial assets, including foreign ones; and to ensure U.S. persons living abroad file U.S. tax returns and pay any taxes owing. (Unlike Canada and most other nations, the United States taxes based on citizenship, not just residency.) Subsequently, other nations around the world have joined the parade under the moniker of the "Common Reporting Standard" – what some refer to as "FATCA for the rest of the world".

For FATCA to work, the Internal Revenue Service in the U.S. needs information from foreign financial institutions about the accounts they maintain for U.S. nationals. Tax treaties between the U.S. and various other countries are the mechanism for gathering that information. In Canada's case, domestic tax laws were revised to oblige Canadian financial institutions to provide the requisite information to the Canada Revenue Agency, and CRA gives it to the IRS.

FATCA has been like a steamroller: moving slowly, but inexorably. It started by requiring firms like Nexus and custodians like RBC Investor Services Trust to determine if holders of new accounts are or *might reasonably be* U.S. persons, so that information about their (non-registered) accounts could be reported to the IRS via CRA. The requirements subsequently broadened to include holders of so-called "large" accounts existing when the new rules came into force, and then broadened again to include holders of all existing accounts.

As you might imagine, the accompanying reporting and record-keeping obligations are not trivial, and, they, too have expanded over time. A U.S. taxpayer is obliged to provide Nexus with their social security number, if they have one, and obtain one if they don't. Initially, Nexus's only obligation was to ask for it, and to follow up periodically to obtain it. There were no dire consequences to firms like Nexus or custodians like RBC for not getting an accountholder's social security number.

However, that has now changed. Thanks to recent little-noticed amendments to FATCA and the bilateral treaty that governs Canada's tax reporting obligations, starting this year, Canadian financial firms can be fined for continuing to operate an account without a social security number for a U.S. person. There are only two "escape routes" to avoid financial penalties: obtain the social security number or close the account.

This is not an enviable position for either Nexus or the client. Both face a dilemma. Consider the following. By maintaining an account for a client who committed no offence greater than simply being born in the U.S., Nexus has become a vehicle for transmitting U.S. tax law – part of the IRS police force, if you will. The client is unlikely to view Nexus in a favourable light in the circumstances, even though the requirements to have a social security number and file a U.S. tax return are not new – wishful thinking to the contrary notwithstanding.

To comply, the client faces a stark choice. Close the account entirely. (It may not be possible to transfer it to another financial institution without a social security number as all firms are subject to the same obligations and potential penalties as Nexus.) Or obtain a social security number and undertake the arduous and potentially expensive process of filing back tax returns with the U.S., perhaps to incur penalties, despite possibly not owing any actual income tax to the U.S. Add into this unpleasant mix the fact of exploding U.S. fiscal deficits, and it's easy to imagine the IRS ramping up its enforcement efforts and having little appetite for leniency.

The (U.S.) taxman cometh.

When Should I Start my CPP Payments?

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scenarios. The first involved delaying CPP until age 70 and using the bridge funds to generate the missing income between age 65 and 70 equal to the "age 70 CPP". The second involved starting CPP at age 65 and self-managing the RRSP savings to top-up their CPP pension over their lifetime to match the age 70 CPP. A few numbers might explain this better; suppose CPP at age 65 was $100 per month, but if deferred to age 70, it would be $150 per month. The first scenario used the bridge funds to create an income of $150 per month between ages 65 and 70. The second scenario started CPP at age 65 for $100 per month and used the bridge funds to add to the pension by $50 per month for the individual's remaining lifetime.

The study concentrated on the risks of deciding when to start CPP payments and highlighted that the two key risks which most impacted this decision were investment returns and life expectancy. Most people do not adequately evaluate the risk associated with future investment returns versus the secure lifetime income that comes with CPP payments. And they typically assume a shorter lifespan for themselves than probabilities would suggest. "The research shows that given today's low interest environment and general population longevity expectations, delaying CPP payments is clearly a financially advantageous strategy."

The study concluded that individuals that start CPP at age 65 would likely deplete their bridge funds by age 80. Typically 80% of female CPP recipients and 75% of male CPP recipients are expected to live longer than that. It should be noted that among the underlying assumptions was a risk-free rate of return of 1%. But the report acknowledges that many Canadians will invest their savings in pursuit of a higher return. Even assuming various higher rates of return, the researchers found that by starting CPP at 65, a typical male had a 73% chance, and a typical female had an 81% chance, of receiving less lifetime income, than if CPP had been deferred until age 70. Even when combining a high investment return assumption with a low longevity assumption, there was only a 49% chance of producing more income by starting CPP at 65.

While the study does show that the probabilities support starting CPP at age 70, it does recognize that not everyone's situation is the same. Other factors, such as the Old Age Security clawback or being single versus married, can produce different conclusions. All of this analysis supports the need for you to have your own financial plan, unique to your individual needs and circumstances. So whether it's deciding on when to start CPP or making another important choice, that plan will be an essential part of your ability to make an informed decision.

INSIDE NEXUS

A Virtual Nexus *Welcome!*

Joining us as a Pooled Fund Administrator, Preethi will work closely with the administrative team and the portfolio managers – a role that we are happy to fill after the retirement of Amy Kahl in January of this year. Her focus will be on the daily operations of the Nexus pooled funds, the valuation process, and completing the funds' transactions.

Preethi joins us after previous experience as a NAV Analysis Analyst in the Investment Fund Accounting department of Franklin Templeton Investments in Toronto. Prior to that, she was a Senior Operations Analyst, Global Trade Services with Franklin Templeton in India.

Outside of the office, Preethi enjoys cooking with her husband, gardening and DIY home decor, and spending time with her family and friends.

While we can't provide Preethi with an in-person Nexus welcome with the full team at this time, we have embraced our virtual options since her start with us earlier this month. We are delighted to have Preethi on board and look forward to her becoming a key member of the Nexus team.

Invest
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At Nexus, we offer thoughtful wealth planning and investment management with unparalleled personalized service to private clients and foundations.

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