NEXUS

October 2019
Vol.24 No.3

NOTES

Nexus Investment Management Inc.
Portfolio Management & Financial Counsel

Inside Articles

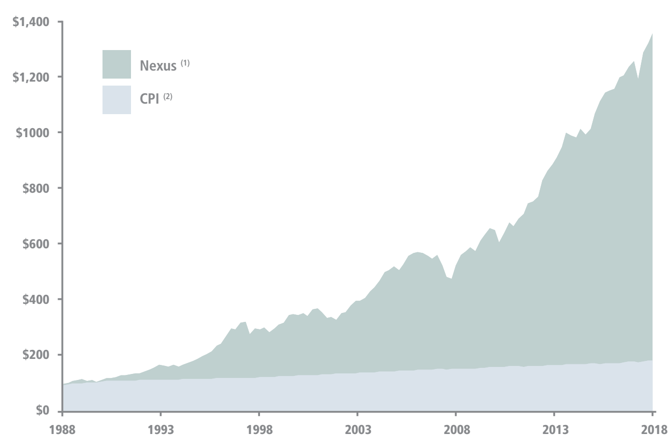
Building Value for Clients

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 $1,340 at September 30, 2019.

(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.

$100 Investment with Nexus in 1989



Happy New *Planning* Year

As the weather cools and the leaves begin to change colour, it seems to me that fall is the more natural start

of a new year compared to the start of the calendar year. Perhaps it's the reflex of the back-to-school routine that makes me feel this way. But, in the fall, I am ready to embrace a new season and make some changes. It is a time to identify potential resolutions – those areas of opportunity for growth and development. So, why not start with an assessment of your financial life? Ask yourself, is everything in good order?

The first step is to make sure you have a financial plan and you are sticking to it. A good, comprehensive financial plan includes an assessment of where you are and where you are heading. It also addresses what your objectives are – is it "freedom 55" or owning that country estate? The plan captures all the financial details required to assess if you will be able to meet your objectives.

The next step is to consider whether you have all your "ducks in a row" when it comes to estate planning. We recently hosted the fourth instalment in our *Women and Wealth* presentation series where we revisited the topic of estate planning. Laura Ross, an estate consultant who has a wealth of hands-on experience dealing with estates, agreed to join us to discuss what clients can do to get their "ducks in a row". Laura's presentation focused on some of the softer issues that come along with estate planning. When most people think of estate planning, they focus on the documents required: wills, powers of attorney and various trusts that represent the legal framework of an estate plan. It is easy to get bogged down in the legalese of these documents and forget about how important it is to communicate your wishes. To quote Laura: "Death is the elephant in the room. It happens to all of us, but no one wants to talk about it. Talking about your wishes with respect to your health, finances and your estate is the best gift you can give your family to ensure they maintain a solid relationship after you pass." Key take-aways from our events with her: make sure your will is current, make sure your executors and powers of attorney understand your wishes in plain language (not just have a copy of the legal document), and organize your affairs so your family knows where everything is. We plan to ask Laura back in early 2020. These new sessions will extend beyond our *Women and Wealth* series and all clients will be invited to attend. More information will be available in the coming months, so stay tuned!

In this issue of *Nexus Notes*, we continue to look at planning and returns, specifically expected investment returns. This article is an extension of one published last quarter on the return assumptions Nexus uses and how they translate into the asset projections in each plan. The article is penned by the newest member of our Nexus team, Brad Weber, who recently joined us from BMO Private Wealth. You can learn more about Brad in our Inside Nexus feature.

Also in this issue is an article that, at first glance, appears to be about literary classics, but is in fact about interest rates. Yes, the abnormally low, historically unprecedented, and potentially negative interest rates have become a significant global development. Investors are indeed living with strange circumstances just like Gulliver and Alice. You can read about how these otherworldly rates are causing real-world problems and about the implications for borrowers and savers. We hope you enjoy this edition of *Nexus Notes* and happy new *planning* year to you!

DCW

What to Expect from Expected Returns

The foundation of financial planning often starts with financial models that are used to make projections into the future.

Those projections rely on making a number of assumptions about expected returns, and the quality of those assumptions is of premier importance. In addition, understanding how those assumptions translate into the real world is critical to measure how your actual experiences compare to what was planned.

The rate of return expected on your investments is a key input into any financial planning model. That rate of return determines both how your assets are assumed to grow towards retirement, as well as how much income they might generate throughout retirement. The return assumption that is used in planning should ultimately be net of all fees that you pay: in other words, the actual return you are going to keep. Understanding your investment returns and what fees you are paying will help provide a basis for evaluating how you are doing against your plan.

In the last issue of Nexus Notes we provided details of our latest financial planning assumptions when it comes to rates of return:

	FP Canada	Nexus Current Assumptions
Inflation	2.1%	2.0%
Cash / Money Market	3.0%	1.0%
Fixed Income (Bonds)	3.9%	2.0%
Canadian Equities	6.1%	6.5%
Foreign Developed Market Equities	6.4%	6.5%
Emerging Market Equities	7.2%	6.5%

Note: the rate of return assumptions are nominal and before investment management fees.

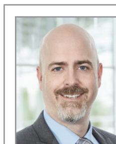
Blending Expected Rates of Return

The returns above represent the return on each potential component of a portfolio, not the expected return of the portfolio as a whole. For example, while our return projection on equities is 6.5%, a typical client invested in our Balanced Fund should anticipate lower returns as that fund includes a portion of bond holdings. As a result, the Balanced Fund would project returns of approximately 4.9% based on the 35% of its assets invested in fixed income and cash. It's important to reiterate that these return assumptions don't include the impact of expenses, as the investment management fee paid will be different for each individual. We provide a separate assumption for each client based on their average management and custody fees plus applicable taxes.

Financial planning can provide many benefits, including aiding in investment decisions and providing insight into what type of portfolio will meet a client's needs. Planning can also help underline the importance of reasonable expectations by outlining what a realistic return expectation for a given portfolio might be, and if that will allow you to achieve your long-term goals.

It might be tempting to think of the asset projections in your plan as an annual report card against which to check your actual performance. While there can be some directional benefit to this, it's important to realize that this isn't a perfect comparison. A plan encompasses a long period of time and utilizes average annualized returns. As a result, the volatility that comes with investing gets smoothed out in the numbers that are presented in the plan.

Whether returns in any given year are higher or lower than the long-term rate of return assumed in the plan matters much less than how your portfolio performs on average over the long run.



BW

Living in a World of Lilliputian Interest Rates

One of the most important developments in global capital markets over the last many years has been the prevalence of abnormally low interest rates. Today's low rates are historically unprecedented, and negative rates are truly "otherworldly." To me, they seem more out of a novel like Gulliver's Travels or Alice in Wonderland than from a macroeconomics textbook. In this piece I'll try and explain how low rates are squeezing investors, share some data about our Income Fund (NNAIF), and offer a reminder about the importance of asset allocation and planning. It would be comforting to think that a straight-forward solution exists to the pinch in the wallet that comes from low rates. Unfortunately, unlike Alice, this is no dream. Investors need to moderate return expectations and incorporate lower interest rates into their financial plans.

Through the Looking Glass…

Government bonds in many developed economies, across a wide range of maturities, yield less than zero. Historically, academics have discussed the concept of negative interest rates, but mostly it was to describe the theoretical limits of how low interest rates in the real world could fall. After the Great Financial Crisis, the concept of negative interest rates moved from its arcane place in the academic world into consideration as a tool to provide extra monetary easing - part of a range of Quantitative Easing (QE) tools that central banks felt necessary to stave off a possible slide into a 1930s-style depression.

Since being adopted by the European Central Bank and the Bank of Japan in 2014, and despite a recovery in the global economy, negative rates have become an increasing feature of government and even corporate debt markets. Over US$17 trillion of debt now trades at a negative yield, representing 30% of the global stock of marketable investment-grade debt. Unsurprisingly, negative yields have produced a legion of heretofore unconsidered issues. For instance, policy makers in Germany are discovering that rather than encourage people to borrow and spend, Germans are actually saving more to adapt to a world of low returns. Likewise, the European banking industry is being slowly strangled by declining lending margins. It's now possible to get a negative yielding mortgage in Denmark. That's right, the bank pays you to borrow!

Depending on one's station in life, this era of low and even negative rates ranges from a blessing to a curse. For borrowers, it is a blessing. Businesses can more affordably acquire capital equipment and consumers can likewise more easily afford car and mortgage payments. However, it is a curse for clients who are accumulating capital (saving), or those who are living on the return from their savings.

Otherworldly Interest Rates Make for Real-World Problems

This burden has two related, but separate parts. The first is that bond returns will assuredly be lower in the future than they have been historically. For many investors an allocation to fixed income (bonds) is fundamental to reducing the volatility in their portfolio, especially when equity markets are unsettled or when they are in the stage of life when they are living off their accumulated capital. Quite simply, low current interest rates will reduce the future returns of any "balanced" portfolio. The second aspect of this problem is that, as a practical matter, everybody needs a certain amount of liquid cash. From an investment portfolio perspective, Nexus clients generally have a target allocation of 5% to "cash". We invest those funds in money market instruments that currently return about 1.75%. But outside their investment portfolios clients need cash for transactional purposes as well. In today's world of low rates, that cash is truly idle, often earning nothing at all. [1]

Low interest rates also penalize people who have cash from other circumstances. Consider the case of someone who has received an inheritance or sold a house or a business. Historically, they could have used bank GICs and rolled them for an indefinite period while deciding how to invest or how to spend their new capital. The returns were not extravagant, but at least the balance grew. Today, that's a much

Living in a World of Lilliputian Interest Rates cont.'d

tougher task. Rates are low, taxes are high, and together with fees, it is likely that the value of these sorts of balances loses ground to inflation.

Prompted by clients frustrated with large cash balances and the prospect of meagre returns, we recently looked at whether our Nexus North American Income Fund (NNAIF) might provide a feasible solution.

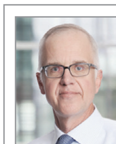
Since being established in 2002, through a combination of capital gains, dividends and interest, the NNAIF has produced excellent tax-efficient returns (+6.1% pre-fee compound annual growth rate), and has an excellent comparative record against its benchmark, the FTSE Canada Universe Bond Index. But we have been reluctant to broaden the usage of the NNAIF. It is designed and managed to provide better returns than the bond market, and it is explicitly *not* a money market instrument. If a client had cash set aside for an upcoming use, we generally counselled that unless they could give it to us for at least two or three years, it probably wouldn't be best for us to manage it. However, examining the return data of the NNAIF more closely, the Fund may have somewhat broader utility than we have generally assumed. As long as a client doesn't need their funds for at least 12 months, the risk of noticeable capital loss is actually quite low. In support of this assertion, we note that there were only six instances of the 190 12-month periods since the Fund was established, that the Fund declined in value from where it had been 12 months before, and never was that loss greater than 1.5%. (2) In the other 184 12-month periods returns were variable, but averaged more than 5%. So, for funds that are not going to be spent for more than a year, the NNAIF might be a more valid alternative for client funds than we have previously counselled. (3)

Unfortunately, for amounts of money that need to be liquid and available at short notice, the NNAIF remains unsuitable. The components of the Fund that generate superior long-term returns also produce more volatility over short periods than what is suitable for a "cash" substitute.

No Happy Ending

Low and negative interest rates are a huge penalty for savers and those with lower risk tolerances. They make it more difficult for people to have a comfortable retirement. In such a low return world, there is a temptation to over-allocate away from cash to other asset classes as a means of generating better future returns. This needs to be avoided, because liquidity, especially in times of crisis, is exceedingly valuable. Likewise, sitting on cash that really should be invested for the long-term comes with a huge opportunity cost. The current environment, with its abundant geopolitical and economic worries has encouraged many investors to move some portion of their investments to the sidelines. This is understandable, but really is no different than market timing - an approach to investing that almost guarantees a sub-optimal experience.

In *Gulliver's Travels,* Gulliver repairs his boat and leaves Lilliput for England. In *Alice in Wonderland,* Alice awakens from a dream and drinks tea! Alas, such a "happily ever after" solution does not exist for the strange circumstances that investors are living with today. Instead, having a plan, and sticking to it, is the best way to achieve realistic financial goals for you and your family. Plans should be customized to your individual circumstances and directly address how much cash / liquidity you need in your life. How this world of low or negative rates eventually plays out remains unknown. But a disciplined investment process, along with a customized financial plan, can help you make the best of it.



GJG

(1) Does anyone else besides me get a kick out of the labelling Canadian banks use for their "savings" accounts? For annual rates between 0.9% and 1.05%, they label their savings accounts with names that stretch the meaning of Premium, Bonus, Advantage and High Interest.

(2) There were four 12-month periods where the fund had returns between 0 and 1.0% and two where the fund's returns were between 1.0% and 1.5%.

(3) Fees and taxes will also factor into the suitability of the NNAIF and whether or not it provides better value than what's offered by the banks. Please contact us to discuss your specific situation.

Ch-Ch-Ch-Changes, Part 2!

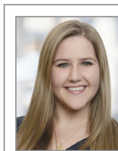
In our last edition of Nexus Notes, we shared some changes to the Nexus team. In this edition, we are once again pleased to announce another new member of the team – Brad Weber.

As Vice President Client Services & Financial Planning, Brad will work with clients to create comprehensive personal financial plans and advise on issues related to financial, tax and estate planning.

Brad joins us from BMO Private Wealth where he was a Director of Wealth Planning and prior to that, with BMO Private Bank as Senior Manager of Reporting. He is a CPA, CA (Deloitte), a Certified Financial Planner and has completed a Masters of Management and Professional Accounting from University of Toronto's Rotman Business School.

Away from the office, Brad and his wife Kim have a love for travelling – and have been to over 20 countries as well as many road trips throughout Canada. When spending time at home, Brad enjoys reading, cooking, and even dabbles in creative writing.

The next time you are in the office or attend one of our luncheons, please take a moment and say hello to Brad. Also, if you know of someone who could benefit from Nexus's approach of integrating financial planning and investment management, please don't hesitate to contact us.



NMW

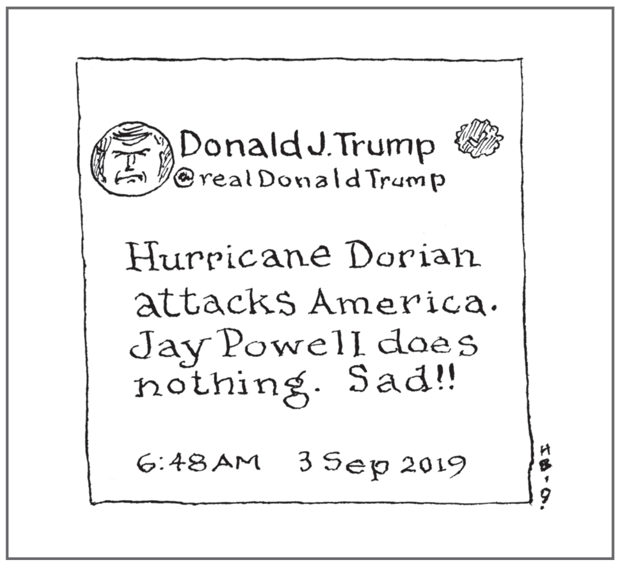


Image used with permission: Hank Blaustein, Grant's Financial Publishing, Inc.

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

51% OF THE WORLD POPULATION USES THE INTERNET

More than half the people in the world – about 3.8 billion humans – are now considered "Internet Users". Fifty-one percent is an increase from 24% ten years ago and is illustrative of the rapid adoption of the Internet and connected devices. Use of the Internet is particularly exceptional in Asia Pacific: the region accounts for over half of these 3.8 billion Internet users. By country, China holds the largest proportion of Internet users (21% of the 3.8 billion total) followed by India (12%) and the USA (8%).

("Internet Trends 2019", *Mary Meeker – Bond,* June 11, 2019.)

THE HAND THAT FEEDS YOU

Grocery store chain Whole Foods (owned by Amazon) is experimenting with technology that could allow customers to pay by waving their hand in front of a scanner. The scanners use computer vision to analyze and identify an individual human hand. Customers will be able to scan their hands at the store and link them to their credit or debit cards. While the idea is similar to fingerprint or retina scans, the thinking is that waving a hand will be simple and hassle-free, thereby enabling Whole Foods to whisk customers through the checkout line faster than ever before.

("Amazon tests Whole Foods payment system that uses hands as ID", *New York Post,* September 3, 2019.)

GOOGLE'S YOUTUBE: A RUNAWAY SUCCESS

In 2006, Google bought YouTube for US$1.65 billion. Today, some analysts estimate it is worth $180 billion. That kind of value creation is rare and the result of extraordinary business success. There is no single measure that can sum up YouTube's achievements. However, some of the facts and figures presented in a recent book authored by the Chief Business Officer at YouTube clearly paint the picture of just what a phenomenon the platform has become.

- *Size of viewership:* More than 1.9 billion people watch YouTube each month.
- *Global reach:* YouTube broadcasts reach 95% of the people on the Internet. Existing videos can be seen, and new videos can be uploaded, from just about anywhere except China which doesn't allow YouTube.
- *Content creation:* "Content creators and sharers" uploaded more than 400 hours of video to YouTube *per minute* in 2017.

("Streampunks: YouTube and the Rebels Remaking Media", Robert Kyncl, HarperBusiness 2017.)

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.

Nexus Investment Management Inc.
111 Richmond Street West, Suite 801
Toronto, Ontario M5H 2G4

Tel: (416) 360-0580 or 1 (888) 756-9999
Fax:(416) 360-8289
email: invest@nexusinvestments.com
website: nexusinvestments.com

The Nexus Notes newsletter is published and distributed by the principals of Nexus Investment Management Inc. for the purpose of providing relevant information to our clients and other interested parties. For additional copies, or to be removed from our mailing list, please contact our office.

Publication Mail Agreement 40033917.

[1] The Nexus North American Balanced Fund has earned 9.2% per annum, pre-fees for 10 years. The return from a notional investment in market indices in the following weighting was 8.2% over the same period: T-Bill (5%), Bonds (30%), TSX (40%) and S&P 500 (25%).