Jeff Scoten Group Newsletter

Spring 2023

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Volatility Continues

It has been said that change is the only constant, and the investing world is no exception. For more than a year, we've seen the effects of a rapid change in inflation and interest rates on the financial markets.

These have been difficult times for investors. As the central banks have continued their fight against inflation, much of the financial market volatility has been driven by uncertainty over the path forward for interest rates. To start the year, good economic news was perceived as bad news by the markets. Stronger labour market and consumer spending data created worries that the central banks would continue raising rates to slow economies and bring down inflation. Now, new jitters have emerged as a result of the recent collapse of Silicon Valley Bank in the U.S. — the unfortunate reality that the aggressive rate hikes by the central banks were bound to have consequences.

For now, we can expect continued volatility. While it may be difficult to see beyond today, there will be a time when inflation is eventually brought under control, though patience has been needed. As investors, we would be wise to remember that changes in interest rates, inflation, monetary and economic policy and many other factors have always created near-term uncertainty in previous times. Every financial cycle has its own challenges that differ from those that came before. Throughout time, the companies that succeed in meeting the challenge of change are rewarded with higher stock prices. And, over time, in spite of the many challenges, economies have continued to grow, demonstrating our collective ability to adapt and advance. This time is no different.

One such reminder may come with the excitement generated by the artificial intelligence (AI) chatbox, ChatGPT. With its potential disruption capabilities, in a recent OpEd, Henry Kissinger went so far to as say that the evolution of AI may "redefine human knowledge, accelerate changes in the fabric of our reality and reorganize society." While these are very early days — it is premature to suggest exactly how this technology will shape the future — ChatGPT demonstrates the human pursuit to innovate, one of the underlying drivers of growth throughout time. Business cycles have operated under long waves of innovation; Earlier revolutions, such as those sparked by the development of railroads, electricity and the automobile ignited waves of economic growth that lasted for many decades. Our focus has always been on the longer term, and though we face current challenges, there are many reasons to expect that future growth will continue.

Equally important, we are here to manage through the ever-changing times. A sound investment process involves having a plan to set priorities, assessing the changing landscape and the potential opportunities to come, in conjunction with the risks involved, and making informed decisions when necessary — all with a view for the longer term. Thoughtful analysis, evaluation and portfolio oversight are skills that should be trusted to help guide us through the unavoidable cycles. While it may be easy to get discouraged with current conditions, have the patience to see this period through. Try to look beyond today — we will get through this difficult period — there is growth that lies ahead.

1. https://www.wsj.com/articles/chatgpt-heralds-an-intellectual-revolution-enlightenment-artificial-intelligence-homo-technicus-technology-cognition-morality-philosophy-774331c6

NATIONAL BANK FINANCIAL WEALTH MANAGEMENT

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“Take Five, Tell Two” — Protecting Yourself & Others Against Scams

A recent article in the popular press provides a candid reminder: “the fraud landscape is exploding...targeting anyone and everyone.”[1] And, as the number of scams continues to grow, fraud has become increasingly sophisticated.

Phishing attacks, where deceptive messages fool victims into providing sensitive information, are now using multiple channels concurrently to target victims. For instance, scammers leave voicemails or texts about an email or phone call they just made to add credibility or increase the urgency of the request.[2] Scammers are increasingly forming longer-term relationships with victims to build credibility. In one type of financial scam, scammers befriend victims via text or social media, and over time eventually convince them to invest using websites that look like legitimate trading platforms. Victims are then tricked into thinking their investments are making money and are encouraged to invest more. This scam was commonly associated with cryptocurrencies, but has since evolved to focus on the gold market.[3]

How can we protect against these rising scams? As a starting point, one expert suggests adopting the approach of: “take five, tell two.” If you are solicited by others, “take five minutes to think about it, and then talk to two different people about it before doing anything.” This can prevent us from making rash decisions. Educating ourselves and others, especially the vulnerable, is also important. Often, there are common “red flags” that indicate a scam:

› **It seems too good to be true**. Many financial scams offer the opportunity for quick gains. If it appears too good to be true, it likely is.

› **Personal/financial information is requested**. Be wary when personal information of any kind is requested or asked to be confirmed. Credible sources are unlikely to ask for this.

› **There is a sense of urgency**. Many scams pressure individuals to act immediately or focus on lost opportunity or penalties to evoke fear.

› **There is secrecy or you are made to feel guilty**. Scams often try to evoke feelings of guilt or shame, or prey on loneliness or isolation. In many cases, victims are asked to keep matters secret.

It goes without saying that we should all maintain a sense of vigilance when it comes to sharing our personal information. Not responding can be one of the best ways to stay safe. Don’t answer a call if you don’t recognize the caller; often a scammer’s goal is to find out if a phone line is active. Never respond to emails, text messages or social media requests from unknown sources. If you aren’t certain if a situation is credible, double check. An internet search can often determine if others have received similar messages/calls. Or, if a source claims to be a legitimate company, try calling a general number found on the internet.

There are tools that can add an additional layer of protection. Anti-phishing software and other cyber security tools can help protect against potential attacks. Many mobile phone companies now offer “call control” that can help screen out robo-callers or spammers.

Stay updated on evolving scams and new targeting methods. Many online resources report the latest scams and offer ways to protect against fraud: Better Business Bureau, www.bbb.org/ca/news/scams; Canadian Anti-Fraud Centre, www.antifraudcentre-centreantifraude.ca

1. www.cbc.ca/news/canada/toronto/fraud-scams-tips-avoid-ontario-1.6764432; 2. www.cnbc.com/2023/01/07/phishing-attacks-are-increasing-and-getting-more-sophisticated.html; 3. www.consumeraffairs.com/news/fools-gold-the-story-behind-a-fake-gold-market-pig-butchering-scam-021523.html

Educating (Grand)Kids: The FHSA — A Potentially Valuable Tool

With the cost of home ownership becoming increasingly out of reach for many younger folks, our clients often have questions about the opportunity to assist (grand)children with buying a home or condo.

There are a variety of ways to help fund a (grand)child’s property, including purchasing the property in your name, gifting cash for the purchase or lending funds to the child. Each comes with various tax and family law issues. For example, if the home is not designated as a principal residence, there may be future significant tax consequences to the owner on any capital gain realized upon its sale. Or, if the child is married/common-law, there may be concerns about what will happen to the property if the couple splits. As always, we recommend seeking advice from tax and family law experts.

Planning Ahead

IIf (grand)children are still years away from a first home purchase, the First Home Savings Account (FHSA) may be a valuable tool. The FHSA is a registered plan that combines the tax benefits of the RRSP and TFSA; tax-free in and tax-free out. Eligible Canadian residents ages 18 and over can contribute up to $8,000 per year, to a maximum of $40,000, toward a first home. Contributions are tax deductible, and qualified withdrawals are tax free. The FHSA can remain open for 15 years.*

While the limit has been criticized as being too low given current housing prices, the potential to invest funds and allow them to grow in the FHSA may be significant (chart). A couple who are both first-time home buyers could potentially each access the FHSA. As well, the rules now permit the use of the existing Home Buyers’ Plan (HBP) alongside the FHSA.[1] The HBP allows first-time buyers to withdraw up to $35,000 from the RRSP, subject to repayment in 15 years and other conditions. Together, these tools could provide a substantial down payment for a home.

Potential Growth of FHSA in 15 Years – Assuming 5% Annual Growth; Not Including Tax Benefit from Contribution

Year	Contribution	Start of Year	Growth	End of Year
1	$8,000	$8,000	$400	$8,400
2	$8,000	$16,400	$820	$17,220
3	$8,000	$25,220	$1,261	$26,481
4	$8,000	$34,481	$1,724	$36,205
5	$8,000	$44,205	$2,210	$46,415
...15	–	$72,005	$3,600	$75,606

If you are having conversations with (grand)children about saving for the future, the FHSA may be an important consideration. If you are in need of support with this, or any other financial literacy discussions with adult children, please don’t hesitate to reach out.

*This article is intended to provide a brief overview of the rules. For more information, please get in touch; 1. This was changed from the original proposals in Budget 2022.

Estate Planning: I Don't Want to Act as Estate Executor

It can be an honour to be named as estate executor (liquidator),* as it signifies a person's trust that you will carry out their wishes as intended. Sometimes individuals accept the position without fully understanding the duties or responsibilities that come with the role. Or, circumstances can change and the person may no longer be able to assume the role, perhaps due to health issues, incapacity, job change or a move to another province or country, which can make the role challenging or difficult.

What happens if the named executor decides that they aren't able to carry out the duties — or maybe that they no longer want to?

It is possible to step down from the position. If the executor hasn't yet applied for probate, they are generally able to renounce the role as executor by providing formal documentation to the courts.** However, if the executor has applied for probate and started administering the estate (called "intermeddling"), renouncing the role may be more difficult. They may need to apply to the courts and provide an explanation of why they wish to step down. Since the estate administration has begun, they may be held liable by the beneficiaries for any loss in value to the estate. It is also possible that the court could refuse this request, especially if the executor is well into administering the estate.

As you consider your own estate's executor...

- Make sure the person you ask is comfortable in the role;
- Consider naming an alternate executor;
- Periodically review your named executor's circumstances to account for changes. Reach out to them to discuss their current capacity to ensure they are still willing and able;
- Don't be afraid to consider the support of a corporate executor, to act alongside an appointed executor or as sole executor.

If you are asked to be someone's executor...

- Recognize that the role can be difficult and may involve many hours of work, emotions and potentially complex family dynamics;
- Don't be afraid to ask questions. Is it a complex estate? Are there any potential surprises that may emerge?
- Remember this is a fiduciary role with legal obligations and liabilities;
- If your circumstances change, make sure to let the person know. This includes if you plan on moving jurisdictions, face health issues or have a change in responsibilities that make it difficult to assume the role.
- Don't be afraid to say no if you don't think you can handle the obligation.

As always, consult an estate planning professional as it relates to your particular situation.

*For the purposes of this article, we refer to the person who has been appointed to settle the estate as the executor, also called the liquidator in Quebec, and may go by other terms based on province of residence. ** **May vary by province: i.e., in QC, the liquidator cannot refuse the role if they are sole heir.

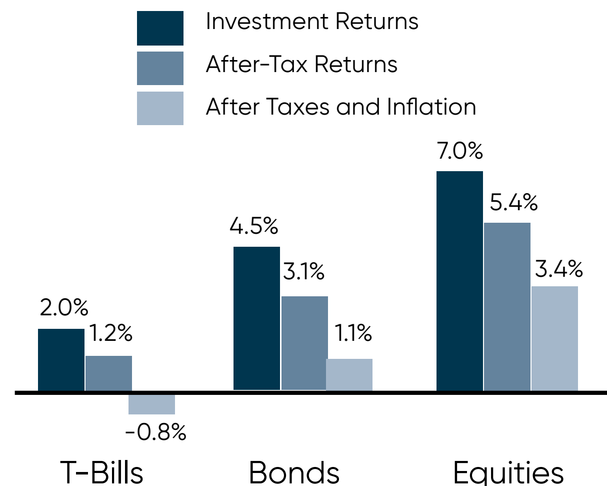
Don't Overlook the Impact of Taxes & Inflation on Investment Returns

As a reminder, when we think about our investments, consider the impact of taxes on returns. And, as inflation continues to be at above-average levels, we should also not overlook its effect on returns.

Consider the way that different types of investments in non-registered accounts are taxed. Interest income from fixed-income investments like guaranteed investment certificates or treasury bills is taxed at an investor's highest marginal tax rate, similar to regular income. Equities receive the most favourable tax treatment because only 50 percent of the capital gain is subject to income tax. Dividend income is generally taxed at a lower rate than interest income because of the dividend tax credit that applies to most dividends received from eligible Canadian corporations.

Inflation can also erode an investment's returns as it reduces purchasing power over time. Today, as interest rates have risen to levels not seen in decades, there may be excitement at the prospect of achieving a four percent rate of return on low-risk, fixed-income investments like guaranteed investment certificates (GICs). While the "nominal" return — before inflation — may be around 4 percent, with inflation hovering around 6 percent today, the "real" return ends up being negative, at around -2 percent, and this is even before considering taxes. Today, savers can't even keep up with declining purchasing power. Of course, historically, interest rates have generally been higher than the inflation rate, which makes today's situation unique. And, inflation isn't expected to remain at these elevated levels; it continues to show signs of moderating. Since 1990, the longer-term average inflation rate — and the target of the central banks — has been closer to 2 percent. The chart shows the potential effect of both taxes and inflation on varying investment returns in a non-registered account based on longer-term averages (illustrative).

The Impact of Tax and Inflation on Investment Returns (Illustrative)



*Based on non-registered accounts. Assumes 40% tax rate on interest income; 20% on capital gains; 30% on dividend income. 2% long-term inflation rate. T-Bill returns: 2% interest income; Bond returns: 2.0% capital gains; 2.5% interest income; Equity returns: 5.0% capital gains; 2.0% dividend income.

The bottom line? As investors, we need to ensure that our assets can grow enough to offset the potential effects of inflation. History has shown that being invested in equities over the longer term has been a good way to stay ahead of inflation. We also should not overlook the impact that taxes can have on our investment returns, using tax-advantaged accounts, such as the RRSP and TFSA to our benefit. The opportunity to allow investments to grow over time while being sheltered from taxes has never been more important.

Personal Finance Tips for Surviving Tough Economic Times

Are we in for a "hard" or a "soft landing"...or "no landing" at all? While we can never control the timing of more challenging economic times, there may be ways to better survive...and even thrive.

This was the conclusion of a Harvard study that looked at the performance of 4,700 public companies through three recent recessions. While 17 percent fared particularly badly, almost 10 percent did the opposite: they flourished, outperforming competitors by at least 10 percent in sales and profit growth.[1] What made the difference? Preparation. When a downturn eventually hit, companies with contingency plans that had thought through alternative scenarios could switch to survival mode and react defensively.

This may be equally applicable to our personal financial positions. How we survive — and possibly thrive — through a downturn may come down to how well we prepare. In this regard, here are some personal finance ideas that may be valuable regardless of the prevailing economic conditions:

1. **Maintain an Emergency Fund** — This typically consists of the equivalent of three to six months of living expenses set aside in the event of an unforeseen financial situation, such as job loss, illness or damage to your home. While the obvious benefit is to help buffer against financial hardship, it can help to avoid taking on debt. For high-net-worth individuals, an emergency fund may be useful to prevent the need to liquidate investments on short notice.

2. **Take Stock of Your Cash Flows** — Having visibility over your cash inflows and outflows can help better plan your finances. A personal cash flow statement provides a snapshot of your sources of income, as well as what you're spending and saving. Many of us have good visibility over our income, but we may not have as clear a picture of where our funds are going. Often, when our clients undertake this exercise, they discover their expenses aren't exactly what they thought. Once you determine how much you are spending, you can incorporate different rules for managing money. For instance, some set goals like the "50/30/20 Rule," which budgets 50 percent of inflows for needs, 30 percent for wants and 20 percent for saving and investing.

3. **Prioritize Your Spending** — There may be an opportunity to increase savings by cutting back on non-essential spending. Debt-relief experts suggest that there are common ways we can all reduce expenses, such as focusing on insurance, unused memberships or subscriptions and "unconscious spending."[2] For instance, consider revisiting insurance coverage to negotiate better rates through bundling (i.e., home and auto insurance), raising a deductible or dropping non-essential add-ons. Or, you may be unknowingly paying for unused subscriptions, especially if you signed up for a free trial that has since been forgotten. There may be areas to reduce unconscious spending: thoughtless purchases made out of convenience, such as one-click online purchases, expensive coffees or food delivery that add up over time.

4. **Pay Down Debt** — Historically low interest rates made it easy and affordable to assume debt. With rising rates, the cost of debt has increased. If you hold debt, it may be beneficial to focus on paying it down. Consider prioritizing debt subject to the highest interest rates first, such as credit card debt, to reduce the interest paid and allow the principal to be paid down. If you hold a mortgage that will be renewing, shop around to get the best rate possible.

5. **Review Your Goals** — One way to help keep on track is to review your wealth plan to see how you are tracking to your goals. Wealth management can consist of many elements, not just your investments. Tax strategies, insurance planning, risk management/contingency planning, retirement planning, business succession planning and estate planning can all contribute to building wealth. Remember that we are here to assist.

1. http://hbr.org/2019/05/how-to-survive-a-recession-and-thrive-afterward;
2. https://www.cnbc.com/select/ways-people-waste-money/

Saving Tax is a Year-Round Exercise: Income Splitting Ideas

As we complete our tax returns, we may feel as though we pay a significant amount of tax. A recent study suggests that high-income families pay a disproportionately large share of all Canadian taxes — in fact, the top 20 percent of income-earning families pay 61.4 percent of the country's personal income taxes! In contrast, the bottom 20 percent of income-earning families pay only 0.8 percent of total income taxes. This study was done by the Fraser Institute to debunk the political misperception that top income earners do not pay their fair share of taxes.[1]

This is just one reason why tax planning remains important: Saving tax is a year-round exercise. If you have a spouse/common-law partner ("spouse") or adult kids, don't overlook the opportunity to split income by shifting taxable income from a higher-income earner to a lower-income earner to save taxes. Here are just a handful of ideas:

Pension Splitting — Up to 50 percent of eligible pension income may be split between eligible spouses on their respective tax returns. This may also allow both spouses to claim the pension income tax credit of up to $2,000 per year depending on age. For those ages 65 or over, payments from sources such as a life annuity, registered pension plan, or RRIF could qualify. For those under 65, payments from a registered pension plan (except Quebec) and certain other payments received resulting from the death of a spouse may qualify. CPP/OAS payments do not qualify.

CPP/QPP Sharing — Spouses can apply to have their Canada/Quebec Pension Plan (CPP/QPP) pensions split between them. It is important to note that the CPP pension sharing rules are separate from the pension income-splitting rules and work differently. For example, pensioners must proactively apply for CPP pension sharing, while a couple can elect to apply pension income splitting when they are filing their income tax returns after they have already received the pension income.

Transferring Unrealized Capital Losses — In some situations, it may be possible to transfer unrealized losses in a portfolio between spouses using the superficial loss rules. This could allow a spouse who cannot effectively use unrealized capital losses (i.e. due to a lack of capital gains and/or is in a low tax bracket) to transfer those losses to a spouse who would be able to realize and utilize the capital losses more effectively.

Spousal RRSP — If the high-income spouse contributes to a spousal RRSP for the benefit of the lower-income spouse, future withdrawals may be taxed in the lower-income earner's hands. Be aware that the spousal RRSP would be owned by the lower-income spouse, so any funds withdrawn are considered that spouse's assets to be included on their income tax return, and the income attribution rules generally apply.

Household Expense Allocation — Household cash flow could be allocated so that the higher-income spouse could pay for family expenses. After tax-advantaged accounts have been maximized, the lower-income earner's funds could then be used for investment purposes to enable future investment income to be taxed at their lower marginal tax rate.

Gifting to Adult Kids — Gifting money to an adult child who is in a lower tax bracket can put subsequent capital gains and income in the hands of the child. The adult child may also be able to contribute the funds into tax-sheltered accounts such as a TFSA. However, it is important to consider the loss of control over the funds once they have been gifted.

Business Planning — For business owners, reasonable salaries for services rendered in the business may be paid to lower-income family members. This not only has the potential to take advantage of the individual's lower marginal tax rate, but also build up RRSP contribution room and generate pensionable CPP/QPP earnings.

Seek Assistance: If you are considering income-splitting opportunities, please consult a tax advisor regarding your situation.

1. https://www.fraserinstitute.org/studies/measuring-progressivity-in-canadas-tax-system-2022

Your Money & Your Heirs: What's Your Plan for Wealth Longevity?

As part of your wealth planning, have you considered your wealth's longevity? Many of us have heard of the "shirtsleeves curse": Family wealth is often built up and lost within three generations. Studies suggest that it takes the average recipient of an inheritance just 19 days before buying a new car. This is because many heirs are not focused on the longevity of new-found wealth.[1]

What are high-net-worth families doing to help prevent this loss? There has been an increasing focus on intergenerational wealth planning, with the objective of supporting wealth longevity. This involves getting existing generations to meet about their finances and form shared financial goals and values to help encourage lasting wealth. Here are some steps that can be taken as part of this planning process:

Start with a plan and document it. Start by thinking about your vision for your wealth for the generations to come. The plan should set out goals and provisions for how you wish funds to be used, accessed and replenished. For instance, you may wish for family members to invest in themselves to gain the experience needed to create and grow wealth, using funds for higher education or a business start-up or expansion. Others may wish to leave endowments to a charity. Once you determine your goals and provisions, it is important to formally record them as this document will be passed along to future generations.

Communicate your plan. Once the plan has been documented, it should be communicated to family members. Often, parents keep their finances and related values to themselves, missing the opportunity to pass along their ideals to children. While specific financial details need not be disclosed, sharing your vision is intended to be a catalyst for meaningful discussions. Some families use this plan to form a family constitution to help future generations carry forward your intentions.

Engage in regular meetings. Regular family meetings are intended to help cultivate family values based on your vision for your wealth. If wealth has been carefully built up through the generations, it may involve exploring family history. Or, you may use this time to educate children about finances or managing money, or introduce high-level strategies to carry out the intergenerational plan relating to running a family business or a family giving strategy.

Consider protection tools. You may determine through family meetings that beneficiaries will need support. Certain tools can support beneficiaries to meet your goals, or protect future wealth in situations in which beneficiaries may not be capable. For example, a trust can put assets under the control of a responsible trustee, with the terms of the trust specifying the conditions, timing and amount of distributions to be made to heirs. Other tools, such as life insurance, can protect and grow assets while also providing access to cash. Setting up a support system of trusted professionals may help to ensure a successful wealth transfer, especially if heirs do not have the skills to manage funds independently.

Monitor the plan's success. By having an ongoing dialogue with family members, you will be able to identify and address any gaps or concerns as they arise. You can also continue to define and refine family roles to ensure that your plan has a greater chance of success.

Here to Provide Support

While intergenerational wealth planning may not be for everyone, consider that creating a lasting legacy can be one of the greatest gifts you leave behind. If you need assistance with family discussions or educational tools to support children, please call the office.

1. https://financialpost.com/personal-finance/retirement/inheritance/how-to-help-prevent-your-heirs-from-blowing-through-the-family-fortune

Should I Delay My OAS Benefits

Many high-net-worth investors do not require income from Old Age Security (OAS) benefits, thus having the option to defer the start of payments. While the decision of when to take OAS benefits depends on many factors, including your income requirements, health status, life expectancy and tax planning, if you are in good health and have the opportunity to defer the start of OAS, what is the break-even age when deferring starts to pay off?

As a reminder, OAS benefits can start at age 65 and are based on how long you've resided in Canada after age 18 — generally, a 40-year requirement. OAS benefit rates are adjusted quarterly to increases in the cost of living. Starting July 1, 2022, an additional 10 percent is added to monthly benefits at age 75. As of January 1, 2023, the maximum monthly OAS benefits are $687.56 (ages 65 to 74) and $756.32 (ages 75 and older). OAS benefits are income tested, so if income is higher than $86,912 in 2023, you will have to repay part or the entire amount of OAS (at a clawback of 15 percent on income exceeding the threshold).[1] OAS payments can be deferred to age 70, resulting in an increased benefit of 0.6 percent for each month it is delayed past age 65.

Why consider deferring payments? The following case study shows how the increased benefit for each month of delaying the start of OAS can accumulate and become significant over time:

Chris just turned 65 years old and has lived in Canada her entire life, entitling her to maximum OAS benefits. Her income is less than $86,000, so she will not be subject to a clawback. She received a letter from Service Canada stating that OAS will begin in January 2023.

However, after a quick analysis, she decides that deferring OAS may be beneficial. Assuming a two percent inflation rate, she calculates how much she would collect if she waited until age 70.

Chris sees that just after she reaches age 80, the pension growth will outpace the amount she would otherwise receive by starting at age 65 (chart). And, by age 90, she will have collected almost $50,000 more. While the break-even age is around 80 years, Chris is reminded that because she has already reached the age of 65, her life expectancy is around 86 years old (or 82 for males who have reached age 65).[2] It should be noted that in some cases, Service Canada will automatically enroll an individual for their OAS benefits, like Chris. In other circumstances, the individual must apply. The good news is that Chris is able to cancel and defer OAS benefits within six months of receiving the first payment, subject to repaying any amounts received. She requests this in writing.[3]

Table: Cumulative OAS Pension at End of Year (Illustrative)[3]

Age on Jan. 1	Start OAS at 65	Start OAS at 70
65	$8,251	–
70	$52,046	$12,389
75	$101,406	$79,518
80	$160,131	$159,385
85	$224,970	$247,564
90	$296,556	$344,922
95	$375,593	$452,411
100	$462,856	$571,089

*Based on an annualized monthly maximum pension of $687.56 on January 1, 2023. Assumes conservative inflation adjustment of 2% per year on the annualized monthly pension. Adjusts pension by 10% at age 75.

In Chris' case, due to her life expectancy and sufficient income/cash flow, it makes sense to defer OAS benefits. Each situation is different, and the decision of when to begin OAS may involve many factors, including income requirements, current and future sources of income, life expectancy and others. As always, seek the support of a professional.

1. www.canada.ca/en/employment-social-development/programs/pensions/pension/statistics/2023-quarterly-january-march.html; 2. Average life expectancy increases with age: www150.statcan.gc.ca/t1/tbl1/en/tv.action?pid=1310013401; 3. https://www.canada.ca/en/services/benefits/publicpensions/cpp/old-age-security/while-receiving.html

What if Circumstances Change? If you encounter a shortened life span, Service Canada may allow for retroactive payment of OAS. An individual who is above the age of 65 and has not yet applied for OAS may request an earlier effective OAS start date. Generally, retroactive payments will be available for up to a maximum of 11 months from the date that the application has been received.

https://www.canada.ca/en/services/benefits/publicpensions/cpp/old-age-security/benefit-amount.html

Fixed Income: Where to From Here?

After a difficult year in 2022, some investors have been asking: what lies ahead for the fixed-income market?

Modern portfolio theory has been built upon the premise that portfolio risk can be reduced through diversification — investing in assets that have low positive correlation or even negative correlation. Typically, stocks and bonds have had negative correlation — when the stock market falls, bonds provide safety.

However, in 2022, the stock/bond correlation turned positive, and both asset classes experienced significant declines. This prompted the question: Is the 60/40 portfolio dead? Regardless of the percentage of a portfolio's allocation to equities and fixed income — 60/40 or 70/30, as examples — last year's situation demonstrated that diversification isn't always a sure thing.

Yet, consider that 2022 was largely an anomaly. The central banks aggressively raised interest rates to fight inflation — much faster and higher than many market participants expected. As a reminder, as interest rates rise, bond prices generally fall. And, since bonds started 2022 with such historically low yields, this led to significant volatility and repricing of the bond market.

Consider that since 1929, there have only been three calendar years when stocks and bonds were both down in the U.S. — it's quite rare to see both decline in the same year (see Table 1).

Table 1: Years When Both Stocks & Bonds Declined

Year	Stocks – S&P 500	Bonds – 10-Yr. U.S. Treasury
1931	-43.8%	-2.6%
1941	-12.8%	-2.0%
1969	-8.2%	-5.0%

Source: https://pages.stern.nyu.edu/~adamodar/New_Home_Page/datafile/histretSP.html.

So, Where to For Fixed Income?

After many years of artificially low interest rates, yields needed to reset to higher levels. Last year saw a substantial adjustment within a very short period of time, which led to a significant repricing. However, history has shown that this variability generally smooths out. A look back at the returns for 10-Year U.S. Treasuries following large down years shows this mean reversion (see Table 2).*

Table 2: 10-Year U.S. Treasury Worst % Returns Since 1928

Year	Return	+1 Year	+3 Years	+5 Years	+7 Years
2009	-11.1	8.5	29.6	30.5	33.0
2013	-9.1	10.8	12.9	16.1	41.7
1999	-8.3	16.7	41.8	48.7	56.0
1994	-8.0	23.5	37.7	45.2	78.8
1969	-5.0	16.8	31.8	39.3	67.4
1987	-5.0	8.2	35.3	70.2	78.7
2021	-4.4	-17.8	?	?	?
1980	-3.0	8.2	48.3	112.0	150.4
1959	-2.7	11.6	20.4	27.0	31.7
1931	-2.6	8.8	19.6	31.3	38.7
Average		9.5%	30.8%	46.7%	64.0%

*It should be noted that interest rates were higher in many of these periods than they are today, which helped to bolster the impressive returns of the 1980s and 1990s. Source: https://awealthofcommonsense.com/2023/01/how-do-stocks-bonds-perform-following-big-down-years/

As well, higher yields and the potential for lower volatility are expected to support fixed-income markets. At the time of writing, inflation continues to show signs of easing and the pace of policy rate increases appears to be slowing. Of course, prices could be driven lower and yields higher if economic conditions or fundamentals dramatically change, though it is unlikely we will experience hawkish surprises from the central banks similar to what we saw in 2022. Even if prices do remain volatile in the short term, consider that yields are now at highs not seen in decades.[1] Higher income, through increased yields, contributes to supporting total returns over time.[2]

1. At the time of writing. Yields are "above the 20 year average and roughly in line to....the 30 year average for bond yields based on major indices": https://www.pimco.ca/en-ca/resources/video-library/media/bonds-are-back-the-3-fs-pressure-points-and-moderating-inflation; 2. If we are, indeed, returning to an environment of higher yields, the traditional benefits of capital preservation, income and diversification should not be overlooked.

During Volatile Times: Perspectives on the Equity Markets

Renowned investor Warren Buffett is well known for saying, *"our favourite holding period is forever. When we own portions of outstanding businesses with outstanding managements, we expect to hold them for a long time."*[1] Yet, despite these words of wisdom, consider how the average holding period for stocks has changed over time. For the NYSE, back in the 1950s, the average holding period was 100 months, or 8 years. By 1990, this dropped to 26 months. And today, it is closer to 5.5 months![2]

What has caused this decline? Technology has been one of the biggest drivers. Up until the 1970s, trading systems were not automated, which limited the number of trades that could be processed each day. The chart below shows how trading volume has grown over time. Technology has also significantly lowered the cost of transactions. And, with the connectivity of the internet, it has enabled investors of all kinds to trade, with information widely distributed and easy to access.

NYSE Trading Volume History

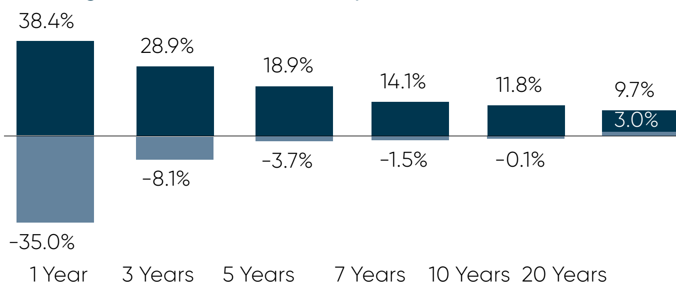
Year	NYSE Avg. Daily Trading Volume (# Shares)
1886	1M
1982	100M
2020	1,000M

https://www.visualcapitalist.com/the-decline-of-long-term-investing/

Yet, history shows that when it comes to investing in the stock market, the longer your ability to focus, the better. Why? The variability of equity market performance smooths out substantially as the investing period grows. The graph (top, right) shows the range of outcomes for the best and worst annualized returns of the S&P/TSX Composite Index (not including dividends reinvested) from 1956 to the start of 2023. These figures were calculated using rolling annual returns. Over one-year periods, the variability is substantial: historically, you could have experienced a variation in annual returns of between -35.0 percent and +38.4 percent (and if you were to use rolling monthly returns, the analysis shows that the variance would be even greater!) However, as the time horizon extends to decades, the range of outcomes narrows significantly and the likelihood of negative returns also diminishes.

During volatile times, for some investors it may be difficult to maintain a longer-term view. But, the long and the short of it is that by extending a time horizon, historical probabilities continue to favour the long-term investor.

Best & Worst Annualized Returns Over Different Holding Periods: S&P/TSX Composite Index Since 1956



Using S&P/TSX Composite Index rolling annual returns (not including dividends reinvested), 1956 to 2022.

Let's also not forget that equities continue to be one of the best asset classes in which to generate wealth and beat inflation over time. We could choose to invest in other assets like low-risk, fixed-income investments to avoid this volatility, but then we would also forego the potential returns over the longer term. Just how much of a difference can this make over time? The chart (below) looks at the period from 1975 to 2022, which includes times of higher inflation and interest rates. History has shown that being invested in equities over the longer term has been a good way to stay ahead of inflation. Equities also receive favourable tax treatment: capital gains are taxed at a lower rate compared to interest and other income.

Historical Real Returns 1975 to 2022 (Inflation Adjusted Returns)

Asset Class	% Real Return	Amount if $100 Invested in 1975*
Equities (S&P500)	8.0%	$20,656
Bonds	3.8%	$3,796
Cash	0.5%	$726
Inflation	3.7%	–

Equities: S&P 500 with dividends reinvested; Bonds: 50% 10-year Treasury, 50% Baa Corporate Bonds; Cash: 3-month T. Bill. *Does not include impact of taxes. Source: https://pages.stern.nyu.edu/~adamodar/New_Home_Page/datafile/histretSP.html

The Bottom Line: While we continue to endure more challenging equity market times, maintain a longer-term perspective. Markets have always been cyclical and better days lie ahead. Equities continue to be an important part of building wealth for the future. Continue looking forward!

1. https://www.berkshirehathaway.com/letters/1988.html; 2. New York Stock Exchange (NYSE) data from https://www.visualcapitalist.com/the-decline-of-long-term-investing/

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