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Financial Focus

NATIONAL BANK FINANCIAL
WEALTH MANAGEMENT

Build your financial resilience for a post-COVID world

Facing the challenges of the pandemic, many of us learned just how personally resilient we, and our communities, are. Many of us also took stock of the things that are truly important in life. With this in mind, it's a good time to assess how financially resilient we are. Consider the following:

Protecting our family. The shocking state of eldercare for many in our country became clear last year. We likely want better for ourselves and our family, but what if we needed to allocate significant money to such care? A financially resilient plan should be reflected in how much you save and how you invest. Remember, your investment strategy should mirror not only the market opportunities and your risk profile, but also what your financial goals are. Having the financial flexibility to assist family members like elderly parents or to plan for your own care should those needs arise are legitimate financial goals.

Protecting our business. Businesses large and small had to absorb some significant shocks in 2020, especially at the beginning of the pandemic. Some didn't make it. How can business owners keep their businesses agile if conditions change quickly? Ask your business advisors about the tools available to you such as, key person, and business interruption insurance.

It's also important to have a strategy to keep your personal and business finances separate but aligned, so that a hit to your business doesn't sabotage important personal goals like retirement savings or your children's education. A resilient business should also include an exit strategy for you including succession planning.

Beyond investing. Your savings and investing plans are not the only ways to build financial resilience. Insurance can offer an important and cost-effective strategy to manage risk. Seek professional insurance advice on how to build a robust safety net when personal and financial challenges may hit by exploring personal health, disability, critical illness, and long-term care insurance.

Next steps: Does your investment strategy take into account your needs for financial resilience? If not, it should be a part of the discussion at your next portfolio review.

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Is the inflation risk real? How will it affect investors?

As the pandemic situation began to improve with the launch of vaccination programs in many major economies, market watchers and economists started to raise the spectre of inflation. A rapid economic recovery - fueled by unprecedented monetary and fiscal stimulus, and economies reopening with consumers flush with unspent earnings - signalled that inflationary pressure, long dormant, might resurface.

Many of today's investors won't have experienced the "bad old days" of the late 1970s and early 1980s when inflation was a dominant concern, topping out at more than 12% in 1982. For those who do remember, even shocking figures like a five-year mortgage rate of 21.46% in 1981 will be a distant memory. So, what does inflation mean for investors? Who are the winners and losers in an economy with inflation unleashed?

Rising prices

Inflation simply means that the prices of goods and services go up over time, on average. The rate of inflation is measured as the annual rate of increase in the average rate of prices. In Canada, this is usually expressed through the Consumer Price Index (CPI). A little bit of inflation is to be expected – it means that the economy is growing at a healthy pace. That's why the Bank of Canada's inflation target is 2%, not zero.

If inflation gets out of hand, we, as consumers, can feel its effects acutely. Witness the runaway prices of real estate across Canada this year. Eventually, rising inflation will lead to rising interest rates which will affect us not only as consumers (with higher borrowing and mortgage rates), but also as investors (higher borrowing costs for companies can put a damper on growth and expansion).

Real returns

When considering the impact of inflation for investors, it's important to keep in mind the concept of real returns, or inflation-adjusted returns. Consider this example: if an investment returned 4% last year but the inflation rate during the year was 3.5%, the "real" rate of return was just 0.5%. In times of rising inflation, investment returns may appear to be better than they actually are.

Investments and assets

Inflation can have different effects depending on the kind of investment and even the sector in which the underlying company operates.

Cash equivalents. If inflation leads to higher interest rates, here is where you may see the most direct effect. Interest-bearing investments like savings accounts and Guaranteed Investment Certificates (GICs) may pay out higher rates to savers. Issuers, however, are under no obligation to change them. And, remember, even a hike in the nominal rate may not mean an improvement in the "real" return.

Bonds and fixed income. Higher rates will make newly issued bonds more attractive to investors, but they also make existing bonds less attractive as buyers will not pay as much when they have the alternative of new bonds with their more attractive rates. Keep in mind that rising rates affect bond durations differently, with short-term and medium-term bonds less sensitive to climbing rates.

Equities. As noted above, a little inflation is a sign of a growing economy and can be good for companies, especially those serving consumers' discretionary spending on things like home improvement, appliances or entertainment. Banks and other financial services also can do well as their core services become more profitable when rates rise; they may also benefit from greater demands for products like mortgages as the economy expands.

If inflation gets out of hand, however, it can be a drag on company profits as the cost of borrowing to invest and expand increases. It can also increase operating expenses such as salaries, rents, and equipment purchases. Lower profits can drive share prices down.

Next steps: Inflation rates in Canada remain low by historical standards and policymakers have tools to use should that change. Remember that monitoring economic indicators of all kinds, including inflation, is the job of the professional money managers overseeing your portfolio. If the headlines or market "noise" has you anxious about your investments, let's talk.

Headline versus core inflation: which really matters?

There are two key measures of inflation: headline inflation and core inflation. This year, headline inflation has dominated the news headlines, but which is the most important for investors?

Headline inflation. Headline inflation is a kind of "raw" inflation figure reported through the Consumer Price Index (CPI) as measured by Statistics Canada. The index measures the cost of purchasing a fixed basket of goods. The basket contains quantities of specific goods and services, weighted according to how much consumers buy on average. Headline inflation is a way of determining how much inflation is occurring in the broad economy and, as it's related to changes in the cost of living, it provides information of most interest to consumers.

The CPI is also the measure of inflation the Bank of Canada uses in its inflation targeting, with a goal of keeping inflation at or near 2%.

Core inflation. Core inflation removes the index components that can exhibit large amounts of volatility from month to month, such as the prices of foods and energy, which may distort the headline figure. These distortions may not be indicative of the underlying or ongoing inflation pressures in an economy. For instance, a crop failure or poor weather may cause shortages and short-term spikes in food prices. Without these distortions, core inflation provides a better indicator of the direction of inflation in an economy, and serves as an important measure for investment managers and investors to understand how inflation may affect markets going forward.

New normal or 'roaring twenties?' Either way, a financial review is due

It may have felt like life was on hold for much of the past year. Now, however, marks the beginning of the "post-COVID" world, even if it isn't quite here yet. Some are predicting a mini-boom as the economy opens up; others say there are still more difficult structural changes for the economy to absorb.

Are you – and your finances – ready for what's to come? You may have new financial realities to manage. New investment opportunities may be available. To get ready for whatever is in your future, consider reviewing your complete financial situation.

Here are some key elements of your financial strategy worth reviewing:

Optimize RRSPs. Registered Retirement Savings Plans (RRSPs) are a key financial tool for most Canadians. When did you last revisit yours? How much are you saving? How are you investing? What is your final target? All of these questions are worth revisiting regularly.

Do you have multiple RRSP accounts? Maintaining separate accounts can result in investment gaps and duplication. Consolidating your RRSPs may make them easier to manage and improve your asset allocation. You might also save money on administration fees.

Coordinate pensions, RRSPs and TFSAs. People often make RRSP investments without considering their employer-sponsored pension plans. Yet when RRSPs and pensions work together, the result can be a larger nest egg to meet your retirement needs. If you are using your Tax-Free Savings Account (TFSA) to save for retirement as well, then consider coordinating all three for maximum benefit.

Also factor all your plans into your personal asset allocation. A defined-contribution plan in which you make investment choices can be fully coordinated with your RRSP and TFSA. A defined-benefit plan with a guaranteed payout can be considered in a similar way to a fixed-income asset, so your other investment plans could be more aggressive than they might otherwise be.

Minimize tax. Are you holding your investments in the most tax-efficient manner? For example, the interest income generated by investments held outside a registered plan is fully taxable at your marginal rate. Inside a registered plan, it's tax-deferred. Repositioning your holdings may save you hundreds or even thousands of dollars in tax every year.

Tax rules can be complex, of course. Professional assistance can help you explore the possibilities and avoid the potential tax traps.

Manage your mortgage. Finding the best rates and features when taking out or renewing a mortgage can reduce your long-term interest costs substantially, and cut years off your mortgage. Paying down your mortgage early frees up additional cash for investment elsewhere.

Review insurance. You may not think of insurance as part of your total financial approach, but it's not a factor to overlook. Adequate life and disability coverage is necessary to protect your income, your family, and yourself. Duplicate coverage may mean you're paying more than necessary to and diverting funds away from other financial priorities.

Next steps: Remember, your investment strategy is an important part of your plan for financial success and well-being. However, it's not the only element, and by making sure all the parts of your personal financial situation work together, you can enhance the value and power of each. Professional advice is key.

What's changed for you?

Review this checklist – any of these changes could affect your financial or investment strategies and goals.

- ☐ **New job.** Will a new job change your monthly budget? If your new position comes with a salary increase, will a boost to your monthly investment plan help advance your long-term success?
- ☐ **Family and life changes.** Marriage, divorce, childbirth, and other family circumstances all have financial implications, too. And, don't forget about how these may impact your insurance and estate needs.
- ☐ **Financial milestones.** Reaching a key goal can offer new opportunities. One example: if you've paid off your mortgage, should you supercharge your retirement plans with any surplus cash?
- ☐ **Economic conditions.** Some things are out of your control, such as an economic slowdown or a change in fortune within the industry in which you work. But, you can take the lead by reassessing your financial and investment strategies.
- ☐ **Your investor profile.** Have your investment goals or your attitude toward risk changed recently? Keeping your investor profile up to date with your current thinking is a key part of managing your investments successfully.

Watch out for these four common investing traps

Investing would be a whole lot easier if the markets moved in a rational, predictable fashion. Unfortunately, they don't. Market activity is the collective result of individual investors' decisions - and investors are not always rational.

Irrational actions are the focus of researchers who study behavioural finance, or the psychological analysis of how individuals make money management decisions.

These researchers have identified four common investment traps.

1. **Fear of regret.** If we're not careful, the fear of making the wrong decision can become so powerful that we avoid decision-making altogether. For example, we might keep too much investment money parked in cash, hold on to an investment long after it should have been liquidated, or automatically reject new ideas. Also, after an investment turns out to be a disappointment, some people never buy another.
2. **Framing.** This is the tendency to divide our finances into distinct clusters and "frame" them by managing each cluster without regard to the others. For example, many people, work hard at reducing their home mortgages while continuing to carry credit card debt at much higher interest rates. The rational approach would be to view their entire financial situation and then allocate money based on potential payback.
3. **Availability.** Many investors have strong tendencies to buy whatever's new and exciting — regardless of whether it's appropriate for their portfolio or even a sound investment. One example is investing in technology; technology company stocks are often hot sellers, based on sentiment for the brand, the products or the management without due regard for the financial investment's soundness or its role in the buyer's portfolio. In addition, researchers have found that stocks and mutual funds tend to experience surges in popularity right after being featured on a magazine cover or television show.
4. **Confirmation bias.** Investors who are open only to information that confirms their thinking are exhibiting confirmation bias. For example, an investor may never review or consider changing a favourite investment, even if it is no longer an appropriate choice.

Next steps: It's one matter to identify these traps, but altogether another not to be swayed by them – after all, we are humans, not investing robots. If you think you might be susceptible to behavioural traps in your own attitudes to investing, professional advice can help. While we can't make you any less human, we can provide an objective view of the investments, and remind you of your goals and why your portfolio is built the way it is.

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