KEATS CONNELLY
ENRICHING YOUR CROSS-BORDER LIFESTYLE

September 30, 2015

REVIEW OF THE THIRD QUARTER

3Q15 Investment Commentary

The third quarter of 2015 saw already jittery stock markets around the world lose steam after a six year bull market in many countries. The US stock market, as measured by the S&P 500, a large company stock index, was down for the quarter after being up for 10 quarters in a row.

Emerging markets and international developed market stocks declined in US dollar terms. International developed market stocks have fallen less than US and Canadian stock markets year-to-date through September 30, 2015 as measured by large stock indexes.

Year-to-Date Return of Indexes through September 30, 2015
-6.4%: S&P 500 (USD return of US stock market index)
-9.8%: S&P TSX 60 (CAD return of Canadian stock market index)
-4.9%: MSCI EAFE (US return of International developed market index)
-15.2%: MSCI Emerging Market Index (USD return of emerging market index)
Chart for illustrative purposes only. You cannot invest in an index. Past performance is not indicative of future results. Source: MSCI, Standard and Poor's

Commodity prices continued to fall in the third quarter.

Our diversification strategy worked in the third quarter as investors experienced losses that were considerably lower than losses in the stock markets in most cases.

As we move through the first half of October we have seen a move back up for stock markets and energy and commodity prices.

We want to remind everyone that empirical research has shown that markets are not predictable and any investment strategy that focuses on short-term results is not likely to produce sustainable benefits. We advise keeping portfolios well diversified in asset markets around the world.

Income vs Total Return
Many clients come to us with a history of investing for income. If they need $100,000 per year to live then they feel they should have a portfolio that produces $100,000 per year of income. While on the surface this makes sense, it breaks down when looking at the overall investment picture.

A better way to think about investing is to focus on the after-tax *total return* you can achieve. Total return investing is the concept that your end goal is to have the highest total return commensurate with your willingness and ability to take risk. A total return portfolio will have allocations to growth assets and income producing assets with the goal of having the highest value maximization instead of producing the most income.

Income investing is when investors pick investments based on how much income the investment is expected to pay. This seems like a reasonable approach until you really look under the hood at what this involves. We can't predict or control markets. What we can partially control about investing are three things; taxes, risk, and costs. By focusing on income we are arguably giving up or at least decreasing our ability to control these three. Taxes will be higher because, by choosing investments that will pay higher income each year, we will pay higher taxes every year rather than being able to defer income and the tax. Income investing also decreases the focus on costs because the priority shifts from costs to income. Modern portfolio theory, the body of knowledge about the best way to build investment portfolios, considering the trade-offs of risk and return, gets hamstrung when the focus shifts to income.

Most investors with an income orientation do not understand that when a stock pays a dividend the stock price is marked down by the amount of the dividend. We will use an example to illustrate this. Let's say Royal Bank of Canada (RBC) has an annual dividend yield of 4%. The dividend is paid quarterly so 1% per quarter. If you hold $100,000 of Royal Bank stock, you should expect to receive dividends of $1,000 per quarter. On a specific date each quarter, known as the ex-dividend date, the stock price is adjusted down and the dividend is paid. So instead of having $100,000 of RBC stock, you then have $99,000 of RBC stock and $1,000 in cash, plus now you have to pay tax on the dividend income that was distributed to you!

Proponents of income investing will point out that the stock price usually goes back up. This may or may not be true. The stock price will go back up if the company earns more money to support future dividends. The stock rise is funded out of future earnings and the expectation that the company will pay more dividends. If, instead of paying dividends, the company elected to invest its earnings in future growth opportunities, the stock price should rise faster.

Think about it this way. Let's say you own a business and each year you can choose to pay yourself a dividend or leave the money in the business to pay for operations and future opportunities. At the end of the year you sit down with your accountant to review the amount of cash you have in the bank and your upcoming cash needs both in the business and your personal life. You may also consider using the cash for other investment opportunities, both inside and outside your business. Then you make a decision to pay a dividend based on all of these factors. If you decide to pay the dividend you have to physically make a withdrawal of cash from the business bank account into your personal account.

When you take money out of your business in the form of dividend distributions, is your business still worth the same amount it was before you paid the dividend? No, it is not. The total value of all assets in your business will be lower by the amount of money that was withdrawn and transferred out to you.

This is what happens when a stock pays a dividend. The money leaves the company so the price of the stock gets adjusted down each quarter by the amount of the dividend payment. You don't really earn anything when a stock pays a dividend. And you pay more tax too.

If stock A and stock B have the same business prospects and same expected future earnings, but stock A pays a higher yield than stock B, investors should prefer stock B because it is more tax advantageous. It is more likely to grow quicker and the eventual sale will result in capital gains tax treatment instead of dividend income tax treatment. If everything else about the two companies is the same, you would have a higher total return at the end of the investment period if you choose the stock that pays lower dividends.

So far we have made the argument that choosing stocks because they pay higher dividend yields should not be the focus. However, investing is a set of trade-offs. In real life you are never faced with the theoretical example where one company pays a dividend and the other does not but everything else about the companies are equal. If it was, you should choose the company that does not pay the dividend. But since it is never this simple, dividend yields are one attribute that can make one company more attractive than another.

A total return investment perspective looks at the full picture. Modern portfolio theory teaches us to look at all investment decisions through the lens of return versus risk. We analyze the potential return to be achieved and evaluate and contrast the potential return vs the amount of loss that may occur if the investment does not go as planned.

If you need a specific amount of cash flow each year from your investments then use this as an opportunity to make some shifts in your portfolio like rebalancing, while considering tax implications. When you invest with this total return approach you are more likely to maximize your overall wealth and have greater purchasing power for your future.

Please call us if you have any questions or would like more information on total return investing.

Sincerely yours,

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