Oct - Dec 2013

Assante®
WEALTH MANAGEMENT

Be well-advised.

MONEY *matters*

FINANCIAL STRATEGIES TO PROFIT FROM RISING INTEREST RATES

Interest rates in the U.S. and Canada seem to have reached a bottom and the end of the 33-year-old bond bull market seems to be looming.

When interest rates drop, bond rates rise and a bull market for bonds is created. Recently bond prices are dropping and bond yields are rising, signalling the start of a bear market for bonds and the start of a cycle of rising interest rates.

Reversal of interest rate trends is a significant event and may happen three times in each person's lifetime. So it would be prudent to take note and put proper strategies in place to protect yourself against the negative consequences of this trend and position your portfolio and your business to profit from this trend.

Since the financial crisis struck in 2008, central banks all over the world have been printing money and pursuing an "easy money" policy with little fear of inflation. While economic recovery rates have been anaemic in Europe and the US, the recent signals from the Federal Reserve Board's Open Market Committee (FOMC) meeting in June, indicating the Fed would start to taper its quantitative easing (QE) program caused significant jitters in North American equity markets, resulting in a drop of 4.8% for the S&P 500 over a four-day period, the worst it has experienced 20 months.*

continued ▶▶▶

Tina Tehranchian, MA, CFP, CLU, CHFC
Fellow of FPSC ™
Branch Manager
Senior Financial Planner

more in this *Issue*

- FINANCIAL STRATEGIES TO PROFIT FROM RISING INTEREST RATES
- YOUR INVESTMENT PORTFOLIO
- CORPORATE PROFITABILITY
- IS THIS THE END FOR TESTAMENTARY TRUSTS? GOVERNMENT CONSULTATION BEGINS
- KEY BENEFIT: GRADUATED TAX BRACKETS
- PROPOSED CHANGES
- THE FALLOUT
- CHALLENGED TO RESPOND

"The end of the 33-year-old bond bull market seems to be looming."

While the Fed did not announce the start of its tapering program in its September 18th meeting, most pundits believe that it is only a matter of months before the tapering will start.

While the markets are very nervous about the end of the Fed's "easy money" policy and bond buying program, when this happens it signals an improving economy that does not need to be kept on life support any longer. A stronger economy is not bad news for the stock markets as it will mean improved profitability for corporations.

The truth of the matter is that we have all become accustomed to stable and low interest rates in recent years. In Canada, interest rates have been unchanged since September 8, 2010 and in the U.S. they have not budged since December 16, 2008. A recent upturn in bond yields is quite clear. While the 10-year U.S. Treasury bond yields dropped to an all-time low of 1.43% last year, the 10-year yield rose to 2.98% on September 5, 2013, the highest since early 2011. Many financial pundits believe that once the 10-year yield rises above 3%, the trend reversal will be conclusive.**

With world economies recovering, the writing is on the wall that short-term interest rates will start to rise soon too. So, rather than being afraid of the start of this trend, you should plan and try to profit from it.

Rising interest rates will affect your investment portfolio, the real estate market, and corporate profitability. You should have strategies in place for all these different areas.

YOUR INVESTMENT PORTFOLIO

While initially the market reaction to rising interest rates may be negative and this may be interpreted as a bearish signal for stocks, in most instances within a few months markets recover and returns improve due to rising corporate profitability.

One bullish signal for stocks and the economy at this point is the widening of the yield curve. This happened in 2007-2008, signalling the bull market that started in 2009. As of September 20, 2013, the difference between 2-year and 10-year Treasury yields in the U.S. has widened to 2.41%, or 241 basis points, signalling a steepening of a yield curve that stood at 121 basis points last year. This is mainly because two year rates have not fluctuated much recently. Of course, the steepening of the yield curve may be short-lived and could change as short term interest rates start to rise. However, if the rise in the long end of the yield curve exceeds the rise in the short end, the steepening yield curve will stay intact.

Interestingly in the last two occasions in the past when interest rates hit bottom after a long secular drop, a secular bull market started in the stock market. These occasions happened long ago in 1942 and 1897.

In 1897, interest rates bottomed out after a 30-year drop. At that time, the start of a rising interest rate cycle coincided with the beginning of a secular bull market on Wall Street that lasted until the market crash of 1929 and the start of the Great Depression. The same thing happened in 1942.

The change of direction in the bond market necessitates new strategies for your portfolio. When it comes to your bonds and fixed income investments you should stick with short-term maturities and roll over your GICs and bonds as they mature. By keeping the maturities short-term you can invest them at gradually higher interest rates as rates rise. You will also avoid capital losses on your bonds that are inevitable in a rising interest rate environment. The longer the maturity of your bond, the steeper the capital losses due to rising interest rates will be.

THE REAL ESTATE MARKET

Rising interest rates usually have a dampening effect on the real estate market. The reason for this is that as interest rates rise, mortgages become less affordable and activity in the housing sector cools down leading to softening prices.

While the recent rise in five-year mortgage rates has stimulated buying fervour in the real estate market, as buyers scramble to lock in their mortgage rates before further increases come along, this could be short-lived and once a consistent rising trend in interest rates starts, we could see a cooling down of activity in the mortgage and real estate markets.

The real estate market has been experiencing a bull run that started in 1996. This is much longer than most previous bull runs in North America. So now is a good time to reassess your real estate holdings and start taking profits from properties that have had good appreciation, unless you are willing to hold on to your properties for the long run and would not mind possible significant short-term drops in their value.

This is also a good time to lock in your mortgage rates at the current low levels before the trend reversal picks up steam.

Reducing mortgage debt is a good idea too, as higher interest rates mean higher financing costs. Since real estate prices are likely to drop in a rising interest rate environment, making it an undesirable time to sell real estate, you should ensure you can afford your current mortgages even if interest rates rise 3 to 4% over and above their current levels. While the interest rate rises in store may be more muted, interest rates did rise 4.25% from June 30, 2004 to August 17, 2007 and they rose 3% from February 4, 1994 to July 6, 1995. (*Source: "The Big Picture August 2013 – Rates will likely rise", Richard J. Wyle, CFA, Vice-President, Investment Strategy, Assante Wealth Management)*

"One bullish signal for stocks and the economy at this point is the widening of the yield curve. "

CORPORATE PROFITABILITY

An improving economy usually means a better business environment, increased consumer spending and more capital spending by businesses, which will lead to further boosting of the economy. That is good news for corporate profitability.

Rising interest rates are a side effect of an improving economy. When interest rates rise, the cost of financing increases and corporations with high debt levels will suffer as a result of the higher cost of financing. As bond yields rise, corporations will have to offer higher and higher interest rates on their bonds to attract investors and this will hurt their bottom line.

Therefore, reducing corporate debt is a good strategy as you get ready for the new rising interest rate environment. Also, if you have plans for financing a new venture, the sooner you act and the longer you guarantee your financing rates for, the more the likelihood that you can secure better and lower rates for your financing.

On the positive side, investing in new ventures could be more profitable when the economy is in growth mode, making up for the higher cost of borrowing.

Taking note of the impending historic change in interest rate trends and making necessary changes to your business, investment and real estate portfolio will certainly pay dividends in the long run.

**Source: "The Big Picture August 2013 – Rates will likely rise", Richard J. Wyle, CFA, Vice-President, Investment Strategy, Assante Wealth Management*

***Source: Web site of the Department of the Treasury http://www.treasury.gov/resource-center/data-chart-center/interest-rates/Pages/TextView.aspx?data=yield*

This article was originally published in the October issue of the Canadian Business Journal and has been reprinted with permission.

IS THIS THE END FOR TESTAMENTARY TRUSTS?
GOVERNMENT CONSULTATION BEGINS

Doug Carroll
Vice President of Tax & Estate Planning with Invesco Canada Ltd.

There was an almost-audible collective gasp from the estate-planning community when Finance Minister Jim Flaherty announced in the 2013 Federal Budget that testamentary trusts would be placed under the tax microscope. While not technically "the end" for such trusts, the budget brought into question whether the key benefit of graduated tax bracket treatment would remain available to them and to grandfathered pre-1971 inter vivos trusts.

This June, the federal government published a consultation paper on the issue, soliciting input from all interested individuals and organizations. As proposed, these changes have the potential to:

- fundamentally change future estate-planning processes and decisions,
- force existing plans to be reconsidered and reconstructed, and
- disrupt existing trusts that may have been in place for years or even decades.

KEY BENEFIT: GRADUATED TAX BRACKETS

A testamentary trust comes into being on a person's death, with the trust terms generally provided for in the person's Will. In fact, an estate itself is a testamentary trust, irrespective of whether a Will exists or what may be stated in it. There's more on estates below within the summary of proposed changes.

A trust is subject to the combined federal-provincial tax rates where it's determined to be resident. As compared with an inter vivos trust (one created during one's lifetime) that is taxed at the top marginal tax rate, a testamentary trust is entitled to use graduated tax brackets. Though it cannot claim tax credits available to an actual human being, a testamentary trust can thus experience a tax-rate reduction of 20% or more in some cases.

PROPOSED CHANGES

Put simply, the proposals would subject these trusts to flat top-rate taxation. In the case of estates, graduated treatment would be allowed for up to 36 months, after which flat top-rate taxation would apply. The measures would apply to existing and new arrangements for the 2016 and later taxation years.

A number of further implications flow from this change:

1. •Tax installments – Instead of being allowed to pay taxes at year-end, quarterly tax installments would be required
2. •Alternative minimum tax calculation – As is the case for existing intervivos trusts, the $40,000 exemption would no longer apply
3. •Year-end – Rather than being able to choose its year-end, such trusts would be subject to a calendar year-end
4. •Distributions to non-residents – The exemption from part XII-2 distribution tax would no longer apply
5. •Tax-deferred distributions – Rather than being automatically a "personal trust" that may transfer assets at cost base to beneficiaries, conditions will now be attached to such characterization
6. •Investment tax credits – These credits will no longer be allowed to be transferred to beneficiaries, and therefore may only be used to calculate the trust's own income
7. •Tax administration – Extended time periods for certain refunds, assessments and filings will no longer be available

"Finance Minister Jim Flaherty announced in the 2013 Federal Budget that testamentary trusts would be placed under the tax microscope."

Doug Carroll

The proposals will not affect capital property rollover rules for spousal and common-law partner trusts, but, otherwise, it appears that the changes will encompass these trusts.

For disabled and minor-age beneficiaries, income will still be able to be taxed to qualified beneficiaries while being retained in the trust. Again, it appears from the proposals that income taxed to the trust itself will be subject to flat top-rate taxation in addition to the other implications listed above.

THE FALLOUT

The government's stated concern is that beneficiaries of these impugned trusts may access more than one set of graduated tax rates, raising questions of "tax fairness and neutrality." With respect to grandfathered pre-1971 inter vivos trusts, I agree that tax planning undertaken almost half a century ago should not continue to provide tax benefits indefinitely. However, in the case of testamentary trusts – where you must die for the wheels to be set in motion, we need to tread far more carefully.

Accepting that the system may be open to abuse by some, there is a much broader swath of the population who, by no fault of their own, find themselves in a vulnerable position due to the death of a key household provider. Juxtaposed with "tax fairness," life itself has not been fair to these widows or widowers, orphans and other dependents. There are valid personal and public policy reasons for the "neutrality" of the tax system to give way in such circumstances.

CHALLENGED TO RESPOND

Wills prepared under the prevailing rules may need to be redrafted and other planning avenues canvassed and undertaken. Apart from the confusion and complication this could introduce, there is obviously a cost. Practically, inaction may be the default result, or if a testator is now incapable, no corrective action would be possible anyway.

And this also affects surrounding estate-planning measures. For example, the quantum of life insurance may now be out of sync, whether those proceeds are intended to flow through a testamentary trust or directly to a beneficiary, on the assumption of existing tax treatment applying to other assets flowing through a testamentary trust. As with Wills, there is the potential for confusion and complication, and a very real possibility that insurability will limit or eliminate maneuvering options.

Existing trusts that were funded based on the premise of graduated rates will now be subject to top-rate taxation. Where a trust is settled in whole or part for a frail beneficiary (e.g., gambling problems, substance abuse, etc.) who falls short of being disabled, trust capital may be eroded sooner than anticipated. Where there are multiple beneficiaries in a trust, it may now be necessary to isolate disabled and minor beneficiaries from others. In either case, drafted trust provisions may no longer be appropriate, particularly calculations based on distinctions between income beneficiaries and capital beneficiaries. In fact, investment policies and past investment decisions may not be optimal in hindsight, and may not comport with continuing needs under the new regime. In all cases, a court application for the variation of a trust is neither simple nor inexpensive.

Wish to comment?

The government has invited public comment. Submissions may be sent in paper to the Department of Finance in Ottawa or via e-mail to *trusts-fiducies@fin.gc.ca.*
The consultation period is open until December 2, 2013.

This article was originally published by Doug Carroll, Vice President of Tax & Estate Planning with Invesco Canada Ltd. Authorization to reprint this article has been granted.

ABOUT THE EDITOR

Tina Tehranchian MA, CFP, CLU, CHFC, is a branch manager and senior financial planner with Assante Capital Management Ltd. Assante Wealth Management is one of Canada's largest wealth management firms, offering integrated financial solutions to create wealth and prosperity for you and your family. Our 900 advisors in 300 offices across Canada take pride in the exceptional service they offer to clients through trusted face-to-face relationships and a level of service excellence second to none. Money Matters is published as a special service for clients of Tina Tehranchian.

15 Wertheim Court, Suite 604, Richmond Hill, Ont. L4B 3H7
Tel: (905)707-5220 | Fax:(905)707-1035
Email: ttehranchian@assante.com
Web: www.tinatehranchian.com

Insurance product and services are provided through Assante Estate and Insurance Services Inc. This material is provided for general information and is subject to change without notice. Every effort has been made to compile this material from reliable sources however no warranty can be made as to its accuracy or completeness. Before acting on any of the above, please make sure to see me for individual financial advice based on your personal circumstances. Services and products may be provided by an Assante Advisor or through affiliated or non-affiliated third parties. Assante Capital Management Ltd. is a member of the Canadian Investor Protection Fund and is registered with the Investment Industry Regulatory Organization of Canada. Please visit www.assante.com/legal.jsp or contact Assante at 1-800-268-3200 for information with respect to important legal and regulatory disclosures relating to this notice.

"Wills prepared under the prevailing rules may need to be redrafted and other planning avenues canvassed and undertaken."
Doug Carroll