Mercer

Mercer Private Wealth

Fall 2022

Optimist

welcome to brighter

Foreword

Welcome to the Fall edition of Mercer Private Wealth's e-newsletter, *Optimist.*

As the leaves turn to those familiar autumn colours and the morning air turns cooler in many parts of the country, it signals fall is finally here. For Canadians, this means turning on the furnace with little thought given to the cost of that much-needed heat. However, for many people living in Europe, the cost of heating their homes will become a serious challenge this winter as energy prices there continue to rise.

On the inflation front, we saw a slight easing in the August numbers here in Canada, but readings still hover at multi-decade highs locally and around much of the world; most central banks are now on a path of raising interest rates in an effort to try to combat surging prices and cool their economies.

Rising interest rates have also had an impact on the real estate market, making borrowing costs more expensive and pulling the plug on the red-hot growth in home prices that we have experienced since emerging from COVID.

Lastly, labour shortages in many sectors of the economy continue to present a challenge to employers, as vacant positions continue to go unfilled. By no means exhaustive, this list paints a picture of several of the major headwinds facing the market at the moment.

In this edition of *Optimist*, we discuss financial planning and the importance of having a solid financial plan to help guide you through your financial journey. We also look at portfolio volatility and how minimizing it can result in a higher terminal wealth. Finally, the government will be rolling out a new type of account in 2023 aimed at first-time home buyers; we explore what this account is and how it works.

As always, we are here to answer any questions that you may have about your financial well-being and wealth management goals. Please do not hesitate to contact us.

Matt Ward
Private Wealth Counsellor
Client Relationship Manager

Planning for security

"If you don't make a plan, presumably nothing will go wrong."

This is a maxim that children might come up with when they want to wing something, in the hope that things will just work out, one way or another. Of course, we all know this is naive in most areas of life, but especially where money is concerned. Indeed, having a financial roadmap plays a key role in achieving personal financial well-being.

Over the course of your life, you will have positive and negative experiences. Negative experiences cause flux and uncertainty. Whether it is the death of a spouse, reduced income, a change in health or any one of the potential myriad of unfortunate life events. It is important to ensure that these issues can be addressed within the context of a personal financial plan.

Today's markets and economic strains are creating uncertainty for many people. Due to the COVID-19 pandemic, global supply chain issues and the conflict in Ukraine, we are dealing with inflation and rising interest rates for the first time in many years (or even decades). As a result, stock markets are capitulating, leading to a feeling of insecurity which many people find unsettling.

Negative returns in an investment portfolio are a normal part of the investing experience and while no one enjoys these events, an investor with a personal financial plan will not be caught unaware. An investment portfolio could be viewed like a great oak tree. If left alone and unmanaged, it would grow haphazardly and without structure, never reaching its full potential. However, as my arborist has told me many times, if pruned and appropriately fed, a tree will grow strong and balanced, to be enjoyed for a lifetime. While pruning can be challenging and may slow growth in the short term, the tree will be stronger as a result. Your financial well-being is similar. While your portfolio may experience challenges from time to time, being prepared for the inevitable negative events and sticking to the "program" will result in better outcomes and enable your wealth to reach new levels over the long term.

In these uncertain times, having a well-diversified and professionally managed portfolio that is aligned with your personal objectives and tolerance for risk will enhance your probability of financial success. Personal financial planning runs in lockstep with your investment experience. You may still get good results without a financial plan, but don't mistake luck for skill. Having a roadmap and the ability to manage unintended detours will ensure a successful financial journey.

Perhaps a more accurate mantra might be:

"If you fail to plan, you plan to fail."

What do bikes and skis have to do with investing?

Global capital markets have been extremely volatile during 2022. Stock markets are experiencing large daily movements that are high relative to history. In addition, most bond markets around the world are experiencing their worst performance in decades.

Over the past several decades, investors came to expect that stocks and bonds would move in different directions. When the stock market experienced large declines in value, it was typical to see bond yields move down; this resulted in bond values moving up and offsetting some of the negative stock performance.

In investing jargon, that relationship is referred to as negative correlation. This means that when the value of one asset moves in a certain direction, a negatively correlated asset would move in an opposite direction. This is a beneficial outcome, as your investing experience is smoothened out and you do not experience extreme highs or lows. Of course, we would all like to have extreme highs, but it is not reasonable to expect that the highs can occur without assuming the risk of the lows. When we are able to own assets that have negative or less than perfect correlation, we expect that the volatility of our overall returns will be lower.

What is volatility and why does it matter?

Volatility is the magnitude of movements in value. In the chart below, the pink line represents a higher volatility experience, the green line a lower volatility experience and the blue line has no volatility. Higher volatility means greater movements and deviations in value. The actual returns of an asset are not determined by its volatility, but in the long term major return benefits can be realized by reducing volatility.

The mathematics of volatility are interesting and may not be intuitive. For instance, if an investment portfolio loses 20% in one period and gains 20% in the next period, the average return of that portfolio is 0%. But unfortunately, the ending value of the portfolio is 4% lower than the starting value (as the worked example below explains).

Period	**1**	**2**
Starting balance	**$100.00**	$80.00
Return (%)	-20%	+20%
Return ($)	($20.00)	$16.00
Ending balance	$80.00	**$96.00**

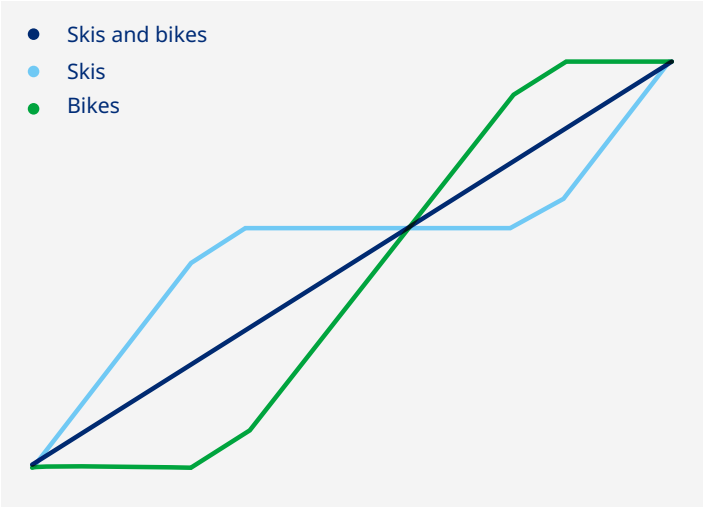
You would have to earn 25% in the next period to get back to where you started. And as the percentage decline worsens, the return required to get even increases: if you lose 50%, you need to earn 100% to get back to even. This is the hidden impact of volatility. The decline of 50% represents a higher volatility outcome than a decline of 20%, so there is definitely a benefit obtained from reducing volatility.

A lower volatility portfolio will generate more ending value than a higher volatility portfolio that earns the same average return. In the chart on the previous page, each line has an average return of 7.3% but the higher (pink) and lower (green) volatility lines both fall short of the no (blue) volatility line with the high volatility line falling extremely short.

But what does this have to do with bikes and skis?*

Well, have you ever noticed that it is more common to see stores that service both bicycles and snow skis than bikes alone or skis alone? That is because a store that services only one or the other will have highs "in season" and lows "out of season." However, a store with both lines of business will have a more consistent experience across all seasons. This is a real-world illustration of the concept of diversifying by combining non-correlated items, with the ultimate goal being to reduce the volatility of a business's profits and activities.

Illustrative ski and bike company cash flows



Takeaways

The key takeaway from this article should be that reducing volatility is a key component in constructing optimal investment portfolios. The most effective method for reducing volatility is to ensure that your portfolio is diversified by combining as many different and non-correlated assets as is feasible. By doing so, you increase your chances of avoiding extreme lows and ideally generating a greater amount of wealth in the long run.

** Concept borrowed with permission from Resolve Asset Management.*

Tax-Free First Home Savings Account

In February 2022, the price of the average Canadian home hit $817,290[1] — an all-time record, as measured by the Canadian Real Estate Association (CREA) — and although that figure has come down over the past several months as the Bank of Canada started raising interest rates, housing affordability continues to be a significant roadblock for many Canadians.

In its 2022 Federal Budget, the Government of Canada proposed a new type of investment account designed to help Canadians save towards the purchase of their first home. The account is called the Tax-Free First Home Savings Account (FHSA) and combines the benefits of both the Registered Retirement Savings Plan (RRSP) with the Tax-Free Savings Account (TFSA). The government has not yet set a launch date for the FHSA but has indicated that individuals will be able to open and contribute to the account in 2023.

The FHSA will be available to all first-time home buyers who are Canadian residents and over the age of 18. To qualify as a first-time home buyer, you cannot have owned a home as your principal residence during any part of the calendar year prior to opening the account or at any time in the previous four calendar years. The FHSA can be open for a maximum of 15 years or until December 31 of the year the account holder turns 71; should either of this stipulations not be met, the account would no longer qualify as a FHSA. Annual contributions are limited to $8,000, with a lifetime maximum of $40,000. Similar to an RRSP, contributions to the FHSA will be tax-deductible in the year of contribution or can be claimed in a future year. Only the individual making the contribution will be able to claim the deduction, but funds can be provided by a spouse without triggering attribution rules. If the full $8,000 annual limit is not contributed in the current year, any unused “room” can be carried forward to future years. Note that carry-forward room starts to accrue only after the account has been opened. Individuals can have multiple FHSAs, but the total amount contributed across all accounts cannot exceed the annual or lifetime limits, with any over-contributions subject to a monthly penalty of 1%. Similar to a TFSA, investment income and growth within the account is tax-free.

As its name indicates, the FHSA is intended to be used for the purchase of a first home, and as such, there are specific requirements that must be met in order to withdraw the funds tax-free. First, you must be a first-time home buyer, as described above. Second,

you will need to have a written agreement to buy or build a qualifying home before October 1 of the year following the year of the first withdrawal. Third, it must be your intention to occupy the home as your principal residence within one year after buying or building it. And lastly, the property must be located in Canada. If all of these requirements are met, funds can be withdrawn tax-free in either a lump sum or a series or withdrawals.

As mentioned, individuals can have multiple FHSAs and transfers from one FHSA to another FHSA are permitted and can be done tax-free. Individuals will also be able to transfer funds from an RRSP to a FHSA on a tax-free basis. These transfers would be subject to the annual and lifetime contribution limits of the FHSA, would not be deductible, and would not restore any RRSP contribution room. Any funds remaining in the FHSA that do not get used to purchase a first home can be transferred to an RRSP or RRIF, or withdrawn on a taxable basis. Funds transferred from a FHSA to an RRSP or RRIF would be subject to the same rules applied to these accounts and would not be limited by available RRSP contribution room or restore the FHSA lifetime contribution limit.

The FHSA will permit beneficiary designations similar to TFSAs, allowing spouses or common-law partners to become the successor account holder upon the death of the original FHSA holder. In order to become the new account holder, the surviving spouse will still need to qualify under the eligibility requirements to open a FHSA. If eligibility requirements cannot be met, funds in the FHSA can be transferred to the surviving spouse's RRSP or RRIF, or withdrawn subject to tax. If the beneficiary of the FHSA is not the surviving spouse or common-law partner of the account holder, funds will be paid to that person on a taxable basis.

This description of the Tax-Free First Home Savings Account does not cover every facet in detail, but instead sets out to provide a general overview of the new account's main feature. A more in-depth explanation of the guidelines can be found on the Government of Canada's website[2] or by contacting your Private Wealth Counsellor.

Endnotes

[1] The Canadian Real Estate Association. https://stats.crea.ca/en-CA/

[2] Department of Finance Canada. https://www.canada.ca/en/department-finance/news/2022/08/design-of-the-tax-free-first-home-savings-account.html

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