TD Wealth

July 2017

Market Update

Important Topic: Taxation

When evaluating any investment, it is always critical to consider the **after-tax** and **after-inflation** return. This final result is what matters.

Taxation

Simply, taxation is the percentage of your investment return that goes to the government. If a bond returns 4% and taxation is 53.5% then the government takes 2.14% and you get to keep only 1.86%.

Since the rate of taxation is so important and since it is different dependent on the form of the return – interest, dividends, capital gains, return of capital – understanding the type of return you receive from an investment is critical.

Tax Rates

- Interest is taxed at the same percentage as income – 53.5% for the highest income earners in Ontario (income over $205,000).
- Eligible dividends are taxed at roughly 3/4 of this rate – 39.3% for the highest income earners
- Capital gains are taxed at half this rate – 26.75% for the highest income earners
- Return of capital is not taxed at all when received, but lowers one's cost basis resulting in a capital gain when sold. This can therefore by described as a deferred capital gain.

The following investments, therefore, all have the same after tax return of 4.00%:

- Interest of 8.60%
- Eligible dividends of 6.60%
- Capital gains of 5.46%
- Return of Capital (sold - deferred - after 10 years) of 5.14%

Conclusion

Focusing on minimizing taxation matters. This can have a significant effect on your net worth over time and on your ability to meet your goals.

TD Wealth Private Investment Advice
5140 Yonge Street, Suite 1600
North York, Ontario M2N 6L7
T: 416 512 6689

Meir J. Rotenberg, MBA, CFA
Vice President & Investment Advisor
meir.rotenberg@td.com

Adam D. Shona, B.Comm
Assistant Investment Advisor
T: 416-512-7645
adam.shona@td.com

Nelson Gordon
Client Service Associate
T: 416-512-6813
nelson.gordon@td.com

Market Update – July 2017:

July proved to be an average month - average for the capital markets. It began with the markets continuing the decline seen in June, but then it reversed course and regained all that it lost. Much of the reversal was due to strong corporate earnings. Note that overall, positive earnings, a rise in oil and strong economic data all combined to push markets back up to its highs.

So let's take a moment to consider where we are – are markets fairly priced, cheap or expensive?

A simple indicator is the Price-Earnings (P/E) multiple. This is simply the Price of a stock divided by its Earnings per Share. For example, if a company's stock trades at $16 and it earns $1 per share, then the P/E = 16. Historically, the average P/E is 16. And therefore, in general, markets are cheap at 10x, inexpensive at 13x, fair at 16x, expensive at 20x and very expensive at above 24x. I say "in general" as different industries shift these goal posts depending on profitability and growth.

Currently, the overall market is trading at a P/E level of 22x – an expensive level. If the P/E ratio were to return to its average of 16x then the market would have to fall 27% (22-16/22).

However, consider the effects of earnings' increases: If earnings rise 30% to $1.30 then a 16X P/E ratio would put the price at $20.80 (1.3 x 16) reflecting a 5% decline from $22. At present, earnings' growth (as measured by the Forward P/E) is expected to grow by 30% over the next twelve months.

Conclusion

Markets are expensive but earnings are increasing and exceeding expectations. The expectation is that the P/E ratio is justified by the fast growing P. I expect earnings to increase but I do wonder if they can increase this quickly.

So let's continue being careful. Avoid the market as a whole (indices), steer clear of companies trading at the higher multiples, and focus on the undervalued prudent opportunities.

Looking forward, the economy is performing just fine by most measures, political uncertainty has increased but market volatility has decreased, and inflation remains benign. We hold our positions and continue to invest cautiously.

For the month the bond market was down 1.8%, the Canadian market was flat, and while the US market was up 2%, International markets were up 2%, the Emerging markets were up 1%, the large downward movement of the US dollar negated these returns when presented in Canadian dollars.

Have a great month and let us know if there is anything we can do for you,
Meir