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"The smart way to keep people passive and obedient is to strictly limit the spectrum of acceptable opinion, but allow very lively debate within that spectrum".—Noam Chomsky

THE WAY I SEE IT

By SERGIO SIMONE

With the upcoming U.S. Presidential election less than two months away, I'm sure many of you have been paying attention to the polls. I have as well, though the poll I paid the most attention to is the one conducted by Harris for the Guardian.

The reason I was so intrigued with this poll is that it displayed a huge disconnect between overall measures of economic growth and how people feel about the economy. This poll revealed some very interesting insights into public perception of the U.S. economy versus the reality of the U.S. economy.

For example, there was an odd **"Recession Perception"** uncovered by the poll that found that 56% of Americans believe the U.S. is currently in a recession. This perception persists despite expert analysis indicating that the U.S. has not been in a recession since 2020.

The poll also uncovered an **"Unemployment Misconception".** Many of the respondents believed that the unemployment rate was at a 50-year high, when the current unemployment rate sits around 4.1% as of June 2024, which is nowhere near a 50-year high. In fact, the current unemployment rate has been relatively stable in recent years.

Another area of disconnect has to do with **"Stock Market Performance"**. The poll found that a significant number of Americans think the S&P 500 is down year-to-date. However, the actual performance of the S&P 500 can be tracked through various financial sources, and it may not align with this perception. As I am writing this, the S&P 500 has a positive YTD return of 17.7%.

How is it remotely possible that there is such a huge gap between reality and what people believe is reality? I don't believe I am too far out of line when I suggest that the culprits responsible for these misperceptions are the media, personal financial experiences and political narratives. Let's examine this more closely.

THE WAY I SEE IT

Economic indicators like GDP growth, unemployment rates, and stock market performance provide a broad overview of the economy's health. These metrics are often used to gauge economic success and guide policy decisions.

However, these measures may not reflect individual experiences. For example, someone might be struggling with job security or rising living costs, which can lead to negative sentiment despite positive economic indicators.

Income Inequality can significantly contribute to a disconnect between overall economic growth and how people feel about the economy. For example, an uneven distribution of benefits may disproportionately benefit higher-income groups, leaving lower-income households feeling left behind. This can create a sense of unfairness and dissatisfaction among those who do not see improvements in their own financial situations.

As income inequality increases, the gap between different income groups widens. This can lead to more social comparisons, where people measure their own success against others. When people see others thriving while they struggle, it can undermine their sense of well-being and satisfaction.

Economic growth can sometimes be unevenly distributed. If the benefits of growth are concentrated among a small segment of the population, many people may not feel the positive effects. This can lead to a perception that the economy is not doing well, even if overall indicators suggest otherwise.

Taking it one step further, higher income inequality can erode trust in institutions and the belief that the economic system is fair. This can lead to feelings of disenfranchisement and discontent, even if the overall economy is growing.

These are a few of the factors that illustrate why measures of economic growth, such as GDP, might not fully capture the economic well-being of all individuals within a society.

In my opinion the Media is the biggest culprit in shaping public perceptions of the economy, which can sometimes lead to a disconnect between how people feel about the economy and its actual performance.

The fact is that negative news tends to get more attention, which can skew people's views of the economy. Media outlets tend to focus on sensational or negative news because it attracts more viewers and readers. This leads to an overemphasis on economic downturns, job losses, or market crashes, even if these events are not representative of the overall economic situation.

The media often tries to frame economic news in a manner that evokes feelings of doom and gloom in their audience. For example, reporting on rising GDP might be framed positively, but if the same report highlights that the benefits are not reaching the average worker, it can create a sense of dissatisfaction.

Another strategy the media employs is one of frequent and constant coverage of negative economic issues. This has a tendency to amplify public anxiety and pessimism which can make people feel that the economy is much worse than it actually is.

I'm sure everyone has experienced biased and partisanship news at one point or another. Different media outlets may have a political bias that affects how they report economic news. This can lead to polarized views of the economy, where people's perceptions are influenced more by their media consumption than by actual economic data.

I have spent more than 40 years in an industry that is greatly influenced by the economy. What I have learned is that economic issues are often complex and multifaceted. By deliberately leaving out important facts media coverage may simplify these issues, leading to misunderstandings or incomplete pictures of the economic situation. This is a form of lying by omission.

Considering the current political climate, I thought I would save the best for last.

Political narratives can significantly influence public perception of the economy, often creating a disconnect between how people feel about the economy and its actual performance. Here are some ways this happens:

Politicians often frame economic data to support their agendas. For example, a government might emphasize positive economic indicators like GDP growth or low unemployment rates, while downplaying issues like income inequality or rising living costs. Conversely, opposition parties might highlight economic challenges to criticize the current administration, even if the overall economic situation is stable.

As I previously mentioned, Economic issues are inherently complex, but political narratives often simplify them to make them more digestible for the public. This can lead to oversimplification or misleading representations of the economic reality.

Politicians are often guilty of selectively using data that supports their narrative while ignoring data that contradicts it. This selective presentation can skew public perception and create a biased understanding of the economy.

It is very common for political narratives to use emotional appeals to connect with voters. By focusing on issues that evoke strong emotional responses, such as job losses, or tax increases, politicians can influence how people feel about the economy, regardless of the broader economic context.

It is bad enough that the media and politicians can influence how people feel about an economic condition, but when the media blatantly endorses one political point of view they have the ability to amplify political narratives, especially those that are sensational or controversial. This can further distort public perception by giving disproportionate attention to certain economic issues.

The disconnect between public perception and the actual state of the economy is a multifaceted issue influenced by income inequality, media representation, and political narratives. While economic indicators like GDP and unemployment rates provide a broad picture, they often fail to capture the lived experiences of individuals. Media and political messaging further complicate this by framing economic data in ways that serve specific agendas, sometimes at the expense of a nuanced understanding. To bridge this gap, it is crucial for policymakers, media, and the public to engage in more transparent and inclusive discussions about economic realities. Only by acknowledging and addressing these complexities can we hope to foster a more informed and equitable economic landscape.

Unfortunately, the probability of this happening is as likely as finding a single economic policy that benefits everyone equally.

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Canada's economy as measured by gross domestic product (GDP) has increased over the last two quarters. Growth in Canada's GDP came from higher government spending; however, lower export volumes and investment in housing were both detractors of this growth. In plain English, it means Canada's economy is growing. But if the economy is growing, why are so many people feeling like their wallets are being pinched?

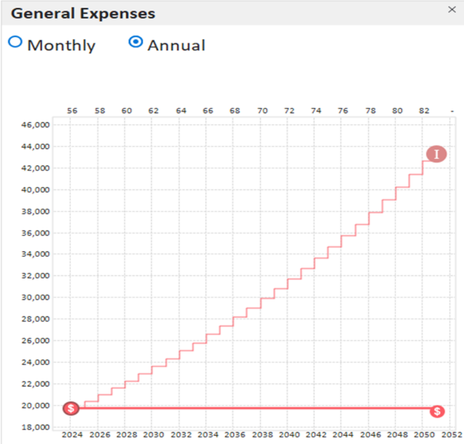
The term "Mecession," has been coined to describe the unique economic situation in Canada where traditional metrics may not fully capture the individual experiences of economic downturn. Despite avoiding a technical recession in 2024, Canada has faced one of the sharpest increases in interest rates in its history, leading to a highly restrictive monetary policy. While the overall economy has shown resilience, business and consumer sentiment remain weak, indicating a disconnect between macroeconomic indicators and personal financial realities. This divergence suggests that while the economy may not be in a recession by standard definitions, individuals and businesses are feeling the pinch of economic pressures in a more pronounced and personal way.

The situation calls for a closer examination of economic policies and their impact on the average Canadian, A significant contributor of the 'Mecession' is the sharp increase in interest rates, which, while stabilizing inflation, has also led to a tightening of monetary policy. This has had a ripple effect on the housing market and consumer spending, both of which have experienced a slowdown. Additionally, the high cost of living, particularly in essential areas such as groceries and housing, has not abated, placing further strain on individuals. The labor market, despite showing growth, has been uneven, with certain sectors feeling the impact of the restrictive economic environment more than others. Moreover, global economic trends, including a slowdown in business investment and exports, have also played a role in shaping the current economic landscape. These factors collectively contribute to the personal financial pressures that characterize the "Mecession," where the macroeconomic picture may not reflect the individual hardships faced by Canadians.

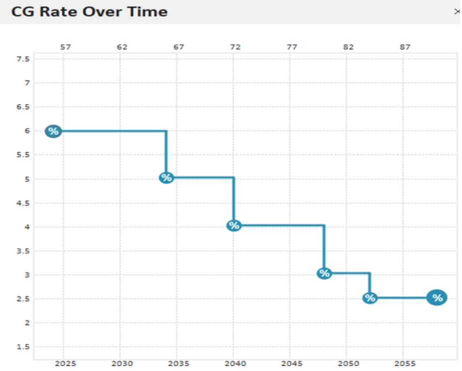
It is in situations like a 'Mecession' that a holistic financial plan becomes a powerful tool for creating ease of mind. This is because holistic planning incorporates inflation assumptions into cash flow modelling using robust and powerful financial planning software. For example, in our own practice, we can forecast a client's general expenses over time in today's dollars and in actual inflated dollars. In the chart below, for instance, I've added the average cost of groceries ($16,800/year), clothing ($2,300/year), and personal hygiene ($700/year) for the average Canadian household and applied an aggressive 3% long-term inflation rate.

Figure 1 Shows cost of groceries, clothing, and personal expenses for the average Canadian household in today's dollars and inflated dollars.

There are two red lines on the graph. The straight line at the bottom shows the cost of these general expenses in today's dollars. The "staircase" line that rises from $20,000 to over $42,000 by 2051 is the inflated number. The numbers at the top of the graph show this person's age, and the years are at the bottom of the graph. So, in the graph, the individual is 56 years old and spends $20,000/year on general expenses. At 3% inflation, this person will spend $30,000 on the same expenses at age 70. By age 80, they are spending $40,000 or twice as much.



Let's assume the hypothetical individual in the above scenario (named Cliff) never decreases his general expense spending. We now know how much Cliff will need at any point in the future to cover his general expenses. But here's the truth. In real life planning, the scenario is far more complex. Consider that Cliff is likely to spend less in some areas as he ages and more in other. He may sell his home and buy a new one. He may decide to rent when he is older and drive less. He may increase his travel expenses between age 65 and 75. His investment returns will also change as he gets older; as he de-risks his portfolio, his return assumptions must also drop. In the graph below, I have de-risked this client's portfolio as he ages.



There are many other factors I'd build into a holistic plan but the end point is to create an easy to understand picture. A simple image that shows cliff whether he can live the rest of his life without financial worry, no matter what happens.

My very simple hypothetical example above has an inflation rate of 3% and $100,000 in an RRSP. Cliff is 56 years old, will retire at 65 and will live to age 90. His only expenses are $19,800 spent on groceries, clothing, and personal hygiene. These expenses never change; neither does his lifestyle. His RRSP has a declining rate of return starting at 6% and ending at 2.5%.

The following image shows my hypothetical example. It will show how much money he is starting with and how much he will have on the day he dies.

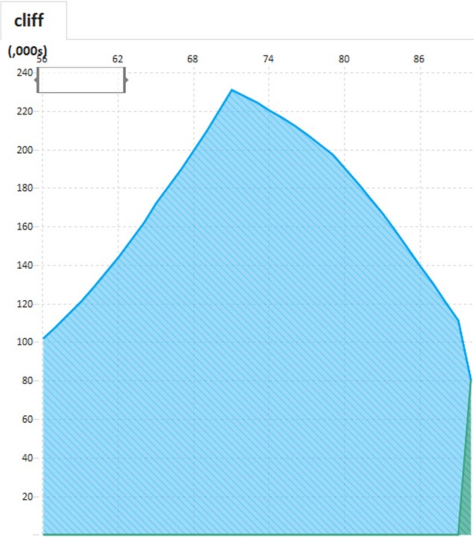
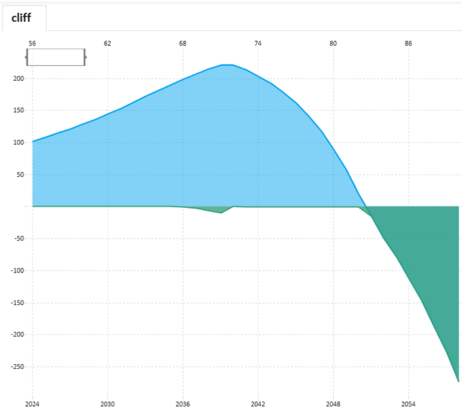


Figure 3 Image shows the amount of money through the examples lifetime.

This image shows all of the money Cliff has throughout his life in the blue area. In this case it is just an RRSP but you can see that he starts with $100,000 and ends his life with $80,000. Somewhere around age 71 he really starts to eat into his money.

In a real-world example, there would be other buckets of money represented in that graph (TFSA, bank accounts, RRSP, etc). But what we do not count is the home and other assets that cannot be easily spent.

Just for fun, I've changed the inflation rate to 5%. To be clear, long-term inflation in Canada is 2.1%, so a 5% long-term inflation rate would be almost apocalyptic. Here is the result from our example.



Sadly, if long-term inflation stays at 5%, Cliff runs out of money by about age 82. This is represented by the green area in the above graph. As such, Cliff would have to make some choices: he could spend less on his general expenses, take on greater risk in his RRSP to try and earn more, or work past age 65. And this is exactly what is happening within the Mecession. Canadians are spending less and working later in life! For younger Canadians, a little extra planning will go a long way in making sure that money as is there when need most.

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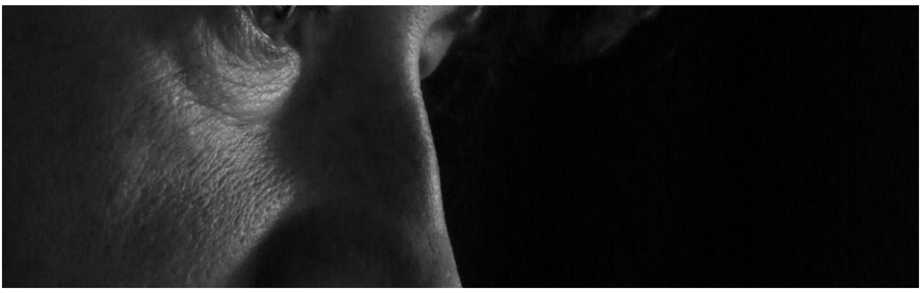
PLAN YOUR FINANCES WITH EASE

UNDERSTANDING THE PSYCHOLOGY OF DECISION MAKING



Given my background, I can't help but feel a surge of excitement when I come across topics relating to psychology and finances. Although the relationship is not always direct, a recent article I came across truly laid it out well. It began by emphasizing the fact that money has no feelings, and the stock market has no emotions. However, the reality is that people experience all that and some.

When helping a client with their finances, human psychology needs to be accounted for, and as a professional, we need to be cognizant of the fact that clients don't always make financial decisions that are in their own best interest. Not all financial professionals need to have a BA in Psychology, but I suppose it's a major advantage that I do. Simply put, we just need to understand that humans are not robots, and emotion can not always be removed from sound financial decisions.

It is our role to act as an intermediary when assisting clients who may make decisions based off greed or panic. We must help shift the focus back to the long-term reasons that a decision is made, evaluate whether they are still valid, and avoid making any impulsive decisions that could impede one's overall well-being.

The key is taking the time needed, not rushing into such decisions, as we often emphasise the need to avoid making impulsive decisions involving high turnover or timing the markets by buying low and selling high; both of which lead to underperformance and not reaching financial goals.

As sound planners, we take the time to help set clients up for success, by implementing certain behavioural concepts that help them make the best decisions. What this often looks like is helping clients better relate to their future selves. By helping clients understand what their future needs are going to be in retirement and help them connect more closely to their future self, it is often easier to choose to save rather than spend.

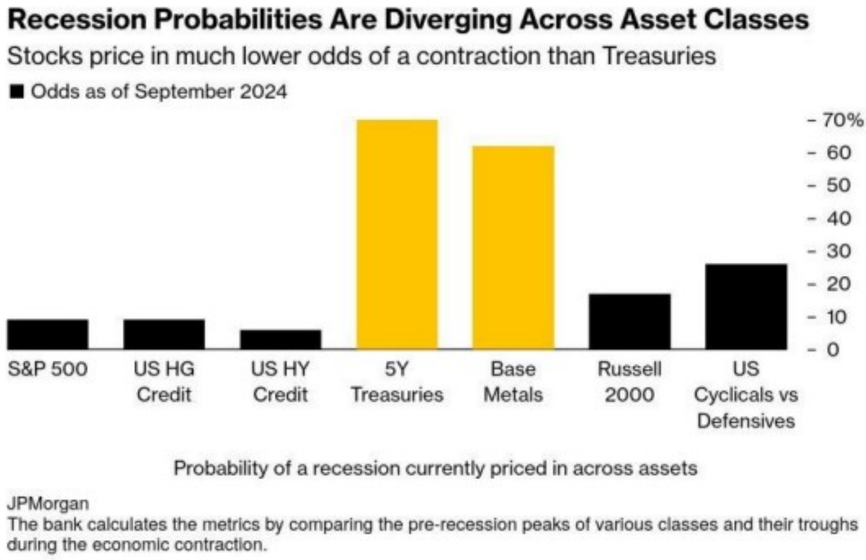
Wealth management has evolved immensely, touching on far more emotional and personal issues than ever before. This is evidenced wholeheartedly in our approach to lifestyle financial planning. The reality is that accepting that money and emotion can not be separated can ensure clients are better served and needs are better met. Honing in on clients values and lifestyle goals, is incredible information for us to have, and ensures not only that we are able to have clients money work for them but that we understand what is truly in the best interest of the client.

In my work as a Chartered Financial Divorce Specialist, I have seen firsthand how often the things that impact money the most are burdened with emotion, such as separation and divorce, job loss, or death of a loved one. In such situations, in our role as advisors we must look beyond the numbers and listen more than we speak.

Everyone must bear in mind that the worst time to make decisions is during times of stress. At the same time, our role is to be sure to ask the right questions. As we often say, we have no business telling our clients what to do with their money if we haven't the first clue who they are. There is no denying the fact that psychology plays a major role in the financial decisions we make and how professionals can collaborate to guide clients to achieve their goals.

In this issue we evaluate some data around recession odds from varying asset classes as well as the yield curve, and the market's current valuations.

1. **Recession probabilities are diverging across asset classes. Treasuries and base metals price a recession as other asset classes, like stocks and credit do not:**



2. Are rate cuts necessarily bullish for stocks? Not if they're associated with an economic downturn and earnings decline. For example like in 2007-2008:

3. Valuation remains a headwind for US equities. S&P 500 is expensive on 19 out of 20 metrics according to the Bank of America analysis. Some metrics are over 100% above historical averages. Shiller P/E and S&P 500 market Cap to GDP are now 101% and 147% above averages:

Exhibit 11: S&P 500 Valuations – shading indicates that metric is statistically expensive relative to history (as of 8/24)

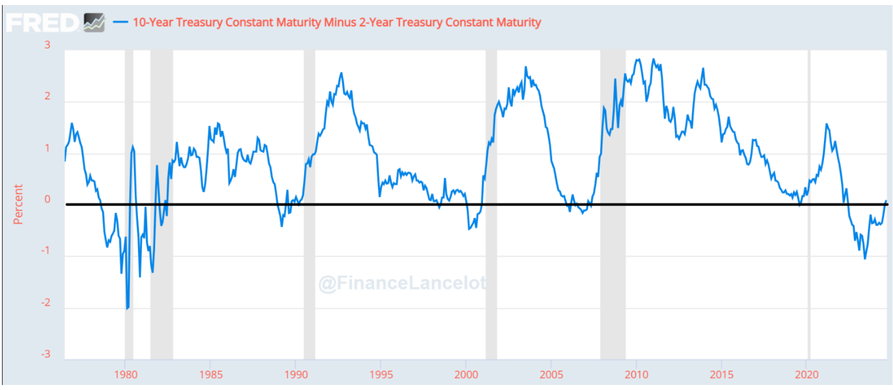
S&P 500 valuation metrics

Metric	Current	Average	Avg. ex. Tech Bubble	Min	Max	% Above (below) avg	Z-Score	History
Trailing PE	24.9	14.9	14.5	5.2	30.5	67.6%	2.1	1900-present
Trailing GAAP PE	28.7	15.2	14.8	4.2	122.4	89.4%	1.6	1832-present
Forward Consensus PE	21.6	15.9	15.1	9.8	25.1	36.1%	1.6	1986-present
Trailing Normalized PE	26.5	19.1	17.9	9.2	34.5	39.0%	1.5	9/1987-present
Median Forward P/E	18.4	15.5	15.3	10.0	21.9	18.6%	1.3	1986-present
Shiller PE	35.1	17.5	16.9	4.8	44.2	100.5%	2.4	1881-present
P/BV	5.09	2.70	2.53	0.98	5.34	88.5%	2.3	1978-present
EV/EBITDA	15.5	10.6	10.3	6.0	17.1	46.0%	2.0	1986-present
Trailing PEG	1.83	1.68	1.65	1.05	3.24	9.3%	0.4	1986-present
Forward PEG	1.59	1.44	1.42	0.93	3.50	10.0%	0.4	1986-present
P/OCF	19.1	11.4	10.9	5.4	19.3	67.3%	2.2	1986-present
P/FCF	32.6	27.9	25.1	12.9	65.7	16.8%	0.5	1986-present
EV/Sales	3.27	2.00	1.94	0.86	3.40	63.4%	2.1	1986-present
ERP (Market-Based)	546	506	522	136	880	7.9%	-0.2	11/1980-present
Normalized ERP	227	382	428	-120	929	-40.6%	0.7	1987-present
S&P 500 Div. Yld. vs. 10yr Tsy. Yld.	0.32	1.23	1.25	0.17	4.20	-74.4%	1.5	1792-present
S&P 500 in WTI terms	74.2	27.3	25.1	2.7	175.3	171.9%	2.4	1960-present
S&P 500 in Gold terms	2.25	1.65	1.44	0.17	5.48	36.0%	0.5	1968-present
S&P 500 vs. R2000 Fwd. P/E	1.38	1.04	1.00	0.76	1.70	32.0%	1.6	1986-present
S&P 500 Market Cap/GDP	1.66	0.67	0.64	0.22	1.66	147.0%	2.8	1964-present

Source: FactSet/Compustat, Bloomberg, FactSet/First Call, BofA US Equity & Quant Strategy

BofA GLOBAL RESEARCH

The yield curve has been inverted for a couple of years now, and a week ago it un-inverted, which could be interpreted as an indicator of a coming recession. The grey bar shows recessions throughout history, and the yield curve is the blue line (2yr—10yr spread):



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PRIVATE WEALTH:
SOLUTIONS FOR HIGH-NET-WORTH INVESTORS

CREATING A LEGACY OF FINANCIAL AFFLUENCE

FAMILY FORTUNES: FAMILY OFFICES WILL MORE THAN DOUBLE OVER THE DECADE

Family offices are expected to add over $2 trillion in assets by 2030, as an increase in wealth concentration and a revolution in wealth management drive rapid growth in new family offices.

The number of single-family offices — the in-house investment and service firms of families typically worth $100 million or more — is expected to rise from 8,000 to 10,720 by 2030, according to a report from Deloitte Private. Their assets are expected to grow even faster, topping $5.4 trillion by 2030, up from $3.1 trillion today and more than doubling since 2019.

In total, the wealth of families with family offices is expected to top $9.5 trillion in 2030, according to the report — more than doubling over the decade.

“The growth has been explosive,” said Rebecca Gooch, global head of insights for Deloitte Private. “It’s really the past decade that has seen an acceleration in growth in family offices.”

The rise of family offices is remaking the wealth management industry and creating a powerful new force in the financial landscape. Projected to have more assets than hedge funds in the coming years, family offices have become the new stars of fundraising, with venture capital firms, private equity interests and private companies all competing to capture a slice of their rising wealth.

The growth is being driven by two broader economic forces. Increasingly, wealth is growing fastest at the top of the pyramid, as technology and globalization create winner-take-all markets and outsized rewards for tech entrepreneurs. The number of Americans worth $30 million or more grew 7.5% in 2023, to 90,700, while their fortunes surged to $7.4 trillion, according to CapGemini.

The population of centimillionaires — those worth $100 million or more — has more than doubled over the past 20 years to over 28,000, according to Henley & Partners and New World Wealth. There are now an estimated 2,700 billionaires in the world, according to Forbes, more than 2.5 times the number in 2010.

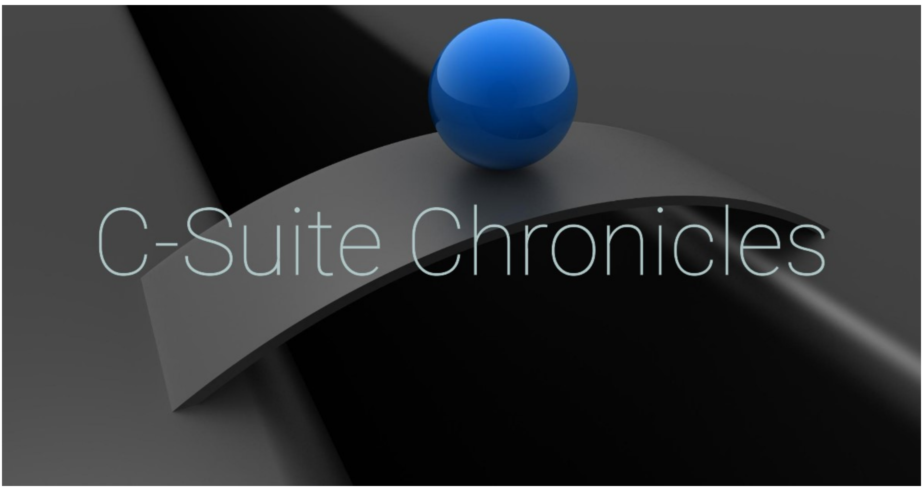
At the same time, the ultra-wealthy are changing the way they manage their investments and financial lives. Rather than handing over their fortunes to a single private bank or wealth management firm, today’s mega-wealthy are opting to create single-family offices to better represent their interests and long-term goals. Family offices are seen as offering more privacy, more customization and more tailored programs for the next generation of the family.

“They want a team that’s entirely dedicated to them, 24 hours a day,” Gooch said. “Not only with investing, but in all the different areas of their life.”

After the financial crisis, wealthy families also want advisors that represent the family’s best interests, rather than private-bank or wealth-management advisors incentivized by the need to sell product.

“There are some organizations that don’t have products to pitch, but a lot of them do,” said Eric Johnson, Deloitte’s private wealth leader and family office tax leader. “And, lo and behold, if you engage them, what you’re going to have to buy is kind of what they’re selling, which might not be the best for the family.”

More than two-thirds of family offices have been created since 2000, according to Deloitte. The largest number (41%) were founded by the original wealth creators, while 30% serve the second generation (inheritors) and 19% serve the third generation.



TAX-EFFICIENT WAYS TO WITHDRAW MONEY FROM YOUR BUSINESS

You've worked hard to build your business and create a profitable company. During the start-up years, you may have forgone paying yourself in favour of reinvesting in your business and growing your enterprise. Perhaps you are now at a point where your business has become more established and you are ready to start withdrawing some of the profits out of your corporation. Maybe you want to bolster your personal cash flow for lifestyle reasons or to fulfill your family's financial obligations. Or instead, perhaps you are concerned about maintaining your corporation's status as a small business corporation for the purpose of one day claiming the capital gains exemption.

Whatever the reason, simply withdrawing cash from your business's bank account will likely result in a significant tax bill. So the question then becomes: how do you take money out of your business in a tax-efficient manner?

Unfortunately, the answer to this question isn't as straightforward as you might think. The way in which it makes the most sense for you to take money out of your company may not be the same for another business owner. Consideration must be given to many factors, including the personal federal and provincial/territorial tax rates where you live, the corporate federal and provincial/territorial tax rates where your business is located, your cash requirements both in the short- and long-term, and whether your company possesses certain favourable income tax attributes that can be utilized to minimize tax.

This article discusses some of the more general approaches that business owners can take to withdraw money out of a business in a tax-efficient manner. Some of these strategies may even allow you to access corporate profits on a tax-free basis. But, keep in mind that recently introduced tax rules add more complexity to the decision-making process, resulting in additional benefits and costs to weigh when determining the most tax-efficient approach.

Let's consider the more general approaches.

Remunerate yourself and family members

Typically, business owners will pay themselves a salary from the business in a way that is similar to an employee being remunerated. If family members work in the business, a reasonable salary (or wages) can be paid to them as well. This is especially beneficial if family members have little or no other sources of income. Generally speaking, a reasonable salary in this instance would be one that approximates what would be paid to an unrelated third party for the same work activities.

From a tax perspective, business owners and family members will be taxed on salary (or wages) at regular personal marginal tax rates that apply based on the jurisdiction in which they live. The corporation will be allowed a deduction for salary (or wages) paid when determining taxable income, but only to the extent the amounts are reasonable.

Note that there is an exception for salary (or bonuses) paid to owner-managers. Under this exception, the Canada Revenue Agency (CRA) will generally not question the amount of salary (or bonuses) paid by a Canadian-controlled private corporation (CCPC) to a Canadian resident owner-manager who is actively involved in the day-to-day operations of the CCPC. The CRA's position allows more flexibility in making remuneration decisions for owner-managers.

Pay a taxable dividend

Dividends can be used to distribute money from the corporation to both you and your family members. This would require that you, your spouse, and your children hold shares of your corporation either directly or indirectly (i.e., through a trust or a holding company).

To ensure this is a tax-efficient method of withdrawing money from the corporation, it will be critical to consider both the tax on split income (TOSI) rules and the corporate attribution rules before any distribution is made.

TOSI rules - Taxable dividends from a private corporation will be subject to the highest rate of personal tax, with restrictions on personal tax credits that offset this tax, unless an exclusion from the TOSI rules is available.

Corporate attribution rules - Transfers or loans to a corporation in order to effectively shift income to another family member may result in additional tax for the individual making the transfer or loan, unless certain conditions are met. Planning will help to avoid any punitive tax result under the corporate attribution rules.

With complex rules in place to restrict income splitting, consult with your BDO advisor before paying any dividends to adult family members (including spouses), as well as minor children.

Optimize your salary versus dividend mix

Remember, active business income of a CCPC is eligible for specially reduced rates of both federal and provincial/territorial corporate tax due to the small business deduction. In order to maximize the potential for this tax savings, it is common for owner-managers of CCPCs to pay themselves a combination of both salary and dividends.

Some time ago, in situations where the active business income of a company exceeded the federal small business limit, it was common practice for a corporation to automatically "bonus down" to that limit. The reason was that the total corporate and personal tax associated with retaining the excess income and paying it out as a dividend often exceeded the personal tax cost when paying the excess income as a bonus. This concept is referred to as the tax integration cost.

However, with changes to the rules governing the taxation of dividends in 2006 and the gradual reductions to the federal and (some) provincial general corporate tax rates, the cost of retaining income within a corporation has declined. As a result, paying a bonus may not always yield the most tax-efficient result. Furthermore, where profits are left in the business (to be distributed at a future date as a dividend), the additional personal tax on the dividend will be deferred.

As a cautionary note, if you decide to retain income in your corporation to take advantage of the tax deferral, and invest in passive assets, this may increase the passive investment income earned by the corporation. If that is the case, it will be necessary to consider the impact of the new passive investment income rules. These rules generally apply to taxation years that begin after 2018, and will restrict the small business deduction that can be claimed by a CCPC where passive investment income of an associated group exceeds $50,000 in the previous year.

Our Incorporating Your Business Tax Bulletin provides further discussion on retaining income within a corporation, along with a chart that illustrates the tax integration costs and potential amounts of deferrals for each province and territory. This Tax Bulletin also provides a more detailed explanation of the passive investment income rules.

Take note that other factors can influence your decision to take a salary versus being paid dividends. Your cash flow needs must be taken into account, since retaining income in your business won't work in cases where you need money for other purposes. Also, bear in mind that drawing dividends alone will not provide you with earned income for purposes of your RRSP contribution. Moreover, on the corporate side, you will want to consider the impact of any relevant payroll taxes, as well as any remittance requirements and filing obligations that may arise.

As you can see, establishing the best possible remuneration strategy can be a complex undertaking. Your BDO advisor can help you determine your optimal mix of salary and dividends.

Convert hard ACB into cash

If you purchased your business from someone else, it is possible that the shares you acquired have "hard" adjusted cost base (ACB), which can become relevant when planning to withdraw cash from your business. Essentially, "hard ACB" is a tax term that represents the amount that you paid for the shares when you purchased them, and it can potentially be converted into cash (or debt that can be repaid later) using a holding company, thereby allowing you to access the capital you invested on a tax free basis.

In simple terms, a holding company would be set up for the purposes of acquiring the shares of your operating company in return for consideration equal to the ACB of your operating company's shares. In this way, you could potentially receive proceeds as cash or debt, in an amount up to the cost base of your shares without attracting any tax. There are additional advantages of incorporating a holding company, as well as a number of issues to consider. Your BDO advisor can help determine if setting up a holding company makes sense for your business situation.

You should note that attention must be paid where you acquired the shares of your business from a non-arm's-length person, such as a relative, who would have either claimed V-day protection (for capital properties owned on December 31, 1971) or the capital gains exemption (CGE) on the disposition of those shares to you. This is because hard ACB on acquired shares does not include the amount of the gain realized by a non-arm's-length person that was reduced either by the application of the V-day rules or the CGE.

If ACB related to a non-arm's-length person's V-day protection or CGE is cashed in, then a deemed dividend could arise. Note that recent changes to the tax rules may allow a non-arm’s length person to transfer their shares of a small business, family farm or fishing corporation to an adult child or grandchild without negative tax consequences. Since these rules can be very complex, make sure you involve your BDO advisor if you're interested in converting the hard ACB of your shares into cash.

Repay outstanding shareholder loans

To help finance the start-up or growth of your business, you may have loaned funds to your company in the form of a shareholder loan. Now that your corporation is profitable, it may be a good time to consider having the company repay all or a portion of this loan. Any amount that you receive in settlement of your shareholder loan will be a tax-free distribution, similar to a return of capital.

Alternatively, you could consider having your company start paying you interest on your shareholder loan. However, keep in mind that while any interest paid would be deductible to the corporation, it will be taxable to you as investment income. It is also important to note that in certain circumstances the TOSI rules will apply to tax interest income earned by individuals from private corporations at the highest tax rate. Therefore, before any interest is paid, consideration should be given to whether the TOSI rules are a concern in order to avoid any negative tax consequences.

Pay a capital dividend

Another potential tax-free distribution to consider is to pay yourself a dividend out of your corporation's capital dividend account (CDA).

In simple terms, the CDA is a notional balance that most commonly represents the non-taxable (currently 50%) portion of any capital gains (or similar receipts) that a private corporation has realized on the disposition of capital assets (tangible and intangible). A positive balance in a corporation's CDA can be distributed to Canadian resident shareholders as a tax-free dividend, ensuring that the non taxable portion of the company's capital gains (and similar receipts) do not subsequently become taxable in the hands of the shareholder.

You should note that CDA is calculated on a net cumulative basis, so the balance will be eroded by any capital losses realized by the corporation. However, capital losses realized subsequent to a distribution of the CDA will not have a retroactive effect on having previously received this distribution tax-free even if the loss is carried back. Accordingly, it is advisable to pay out the balance of the CDA as it becomes available.

That said, calculating the CDA can be complex. There are rules that govern what can and cannot be included in the CDA, as well as timing considerations with respect to the recognition of additions (and depletions) to its balance. Unfortunately, there can be negative income tax consequences when a capital dividend is paid in excess of the corporation's available CDA. Moreover, specific filing requirements must be met when paying a capital dividend. For these reasons, it will be imperative that you speak to your BDO advisor in advance of paying a dividend from your corporation's CDA.

As a planning note: if your corporation currently has no (or very little) CDA, consideration can be given to undertaking an internal sale of company assets that have unrealized capital gains. Triggering the realization of these available capital gains will create CDA that can then be distributed as a tax-free capital dividend. Although tax will be payable on the gain inside the corporation, distributing a combination of taxable and capital dividends may be beneficial when compared with just paying a taxable dividend. An additional complication has been introduced with the new passive investment income rules discussed earlier. If the capital gains are realized by the corporation on the internal sale of passive assets, these capital gains may impact the corporation's ability to claim the small business deduction. Once again, consult with your BDO advisor before effecting this type of strategy.

Deciding on the right course of action for your business

Whether you find yourself in a situation where taking out some cash from your business is a question of necessity or whether this is an issue that has arisen as a matter of course, taking the time to properly plan how you're going to withdraw money from your business will ensure that you'll pay the minimum amount of tax necessary.

However, as we've seen, there is no cookie-cutter approach to taking money out of your company in a tax-efficient way. Instead, there are numerous potential avenues to explore, and many factors to consider, when selecting the most tax-beneficial plan for your unique situation.

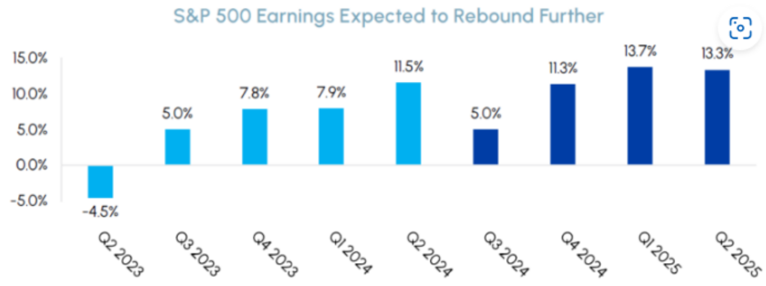
LIFESTYLE FINANCIAL PLANNING BY KPW

MACRO UPDATE

By Dean Orrico, President & CEO and Robert Lauzon, Managing Director & CIO

The S&P 500 Index experienced an 8.5% drawdown between July 16th and August 5th. The sell-off proved to be short-lived, with the Index staging a V-shaped recovery and recapturing nearly all its losses. Although September is historically the worst month of the year, and volatility may return in the weeks ahead, we maintain a constructive view on the market over the medium term. This outlook is supported by three key supports that remain in place: solid earnings growth, goldilocks economic data and expected monetary easing.

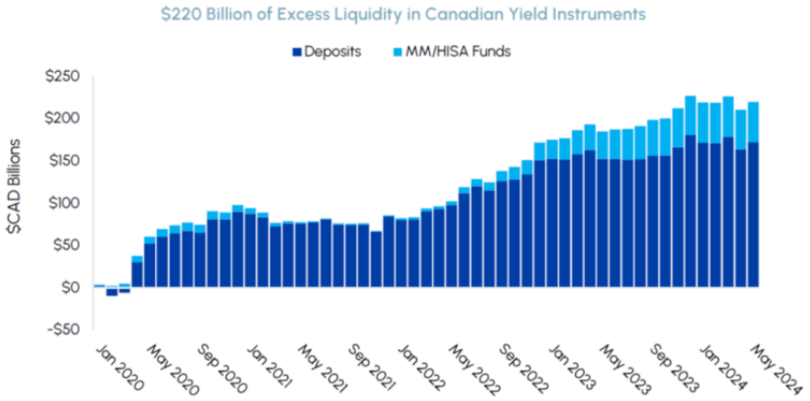
Q2'24 was the best quarter of earnings growth for the S&P 500 in nearly three years. This trend is expected to continue with consensus estimates implying earnings to grow even faster over the next four quarters. This comes at a time when the Federal Reserve faces a challenging task of recalibrating its monetary policy. The risk of either delaying rate cuts or cutting them too quickly could lead to undesirable consequences, such as rising unemployment or reigniting inflation. We are currently more focused on growth statistics than inflation risks. From this perspective, we were happy to see the recent Q2 GDP print show continued economic growth of 3% in the United States driven by strong consumer spending. Ultimately, we expect the Fed to cut rates at a gradual pace starting in September with the magnitude of the first cut to be influenced by jobs data leading up to the meeting.



Source: Middlefield, Bloomberg. As at August 31, 2024.

On the surface, not much has changed in the market over the past 6 weeks – the S&P 500 finished August just 0.3% below its all-time high. Looking closer, it is clear breadth has improved and the market is being led by a new cohort of stocks. Since July 11th, when U.S. CPI came in softer-than expected, the Magnificent 7 has underperformed the other 493 stocks in the Index by over 14%. The equal-weighted Index has outpaced the cap-weighted Index by over 6% and more than 70% of stocks have outperformed the S&P 500. Year-to-date laggards are finally catching up, with the S&P Financials, Healthcare, Industrials, Real Estate, Staples and Utilities sectors all achieving new highs. These recent trends are very encouraging and make it much more likely that the recent strength in the market will be sustainable.

Canadian equities have benefitted greatly from the recent market rotation. The emergence of AI and the spike in borrowing rates have caused capital to flow away from Canada's core sectors over the past two years. CIBC estimates that approximately $220 billion of capital that typically invests in dividend-paying equities has left the equity market for fixed income alternatives such as GICs and HISAs. With the Bank of Canada expected to cut short-term borrowing rates by another 150 basis points over the next twelve months, we anticipate capital will flood back into Canada's high yielding sectors such as Real Estate, Utilities and Financials. Real Estate in particular provides an attractive investment opportunity due to the prevailing supply / demand imbalance brought on by the recent surge in Canada's population.



Source: CIBC World Markets.

A resurgence in M&A activity further validates our view that confidence is building in the Canadian market. The number of deals in Canada has risen for three consecutive quarters with robust activity across multiple sectors. In the first half of the year, there has been over C$80 billion of M&A activity, with nearly $60 billion of that occurring in the second quarter. Several of our portfolio holdings have been opportunistically acquiring assets as the M&A market thaws. Most recently, Tourmaline announced an agreement to purchase Crew Energy for C$1.3 billion in a move that strengthens its position as Canada's largest gas producer. We expect further M&A activity to boost investor sentiment as it is generally viewed as a positive sign of growth, confidence, and potential profitability.

PROTECTING YOUR LIFESTYLE BY KPW

7 BIGGEST MISTAKES INVESTORS ARE MAKING NOW

By FIDELITY INVESTMENTS CANADA

Don't fall for these money-losing traps.

Key Takeaways

- Investment decisions should be driven by a long-term plan, rather than by gut feeling or current events.
- Holding a well-diversified mix of investments has often led to better outcomes, historically, rather than focusing only on the market's top movers.
- Interest rates on short-term CDs and Treasurys may still be high, but holding too much in these investments could hurt long-term growth potential.
- Investors may be focused too much on the risk of a market pullback, and too little on the chance that the market keeps rising.

Every investor can look back on their track record and think of a few things that they wish they'd done differently.

If you see yourself in any of the mistakes below, don't beat yourself up or lose sleep. Instead, remember that investing is a lifelong learning process, and a big part of that process is getting real-world experience and learning from your mistakes. The best anyone can do is try to learn and move on.

And if you read through the list below and don't recognize yourself in any of the mistakes then congrats—you might be a better investor than you realize.

Read on for 7 top mistakes that investors are making now.

1. **Worrying that every market stumble is the start of a crash**

Sudden market pullbacks are always unnerving. And investors who are already anxious about stocks might see every market stumble—such as the ones experienced in April, July, and August of this year—as the potential start of a major downturn.

But the truth is these temporary setbacks are actually routine occurrences in the stock market. "Markets don't go up in a straight line," says Denise Chisholm, director of quantitative market strategy for Fidelity. "Market corrections and steep pullbacks always feel like a panic. But in fact they're very common." Just as a mountain climber needs the occasional break to refresh, the market sometimes needs to take a breather and regroup before it continues its march.

Oftentimes, these pauses or temporary declines signal that the market is processing new information and that investors are recalibrating their expectations. Far from always being bearish signs, sometimes these dips can indicate that the market is coming into better balance. (Read more about why the recent pullback may have actually created opportunity potential.)

2. Avoiding the stock market because it's gone up

Even after the market's recent pullback, US stocks have had a strong year so far. Given the series of new all-time highs it's made in the past few months, many investors may be wondering if it's time to get out, not in.

"After seeing the stock market rise quite a bit, many investors start to wonder whether or not this may continue," says Naveen Malwal, institutional portfolio manager with Strategic Advisers, LLC, the investment manager for many of Fidelity's managed accounts. "Hearing that the market has made an all-time high may even make some investors nervous enough that they avoid investing more or even cash in some of their winners."

Part of the concern may stem from misunderstandings of market history. When investors and analysts describe past market cycles, they often note that the market made a new all-time high before declining, with the all-time high marking the end of a bull market and the start of a bear market.

But this can lead to a misconception that any all-time high will precede a pullback. "If you look back historically, the market making an all-time high is a very common occurrence," says Malwal. Bull markets have often spanned multi-year periods when the market has made one all-time high after another. Investors who took every all-time high as a sell signal would have missed out on substantial gains.

"It's not true that whenever the market has made an all-time high, a correction has come around the corner," says Malwal. "More often, the market has continued to rise."

3. Focusing too much on a narrow group of stocks

The recent bull market has been unusually concentrated, with only a few stocks accounting for an outsized portion of the market's returns since 2022.

This kind of market dynamic can be a recipe for investor distress. Investors who missed the ride can get hung up on regrets. "Many of us end up kicking ourselves for not having invested more in a space that has done remarkably well," says Malwal. Investors who caught the wave may see their portfolios grow increasingly concentrated, and face the fraught decision of whether or when to sell.

But ultimately, trying to make big bets on small groups of stocks may be very risky, and leave an investor vulnerable to a correction. Instead of fixating on recent big movers, focus on formulating a sensible and well-rounded plan for the future.

"Rather than trying to guess what's going to be the next big thing, what we have found helps investors more over the long run is to diversify and invest across a whole host of investments," says Malwal. "Investors who are diversified may not experience so much of the booms or busts that might occur with a narrower set of investments, so they tend to have an easier time sticking with their plan, and they historically have experienced healthy growth."

4. Holding too much in CDs and other short-term investments

Short-term CDs and Treasurys have come into favor among many investors in the past 2 years as rates have risen. Many investors feel comfortable in these investments due to their low risk of default and predictable cash flows.

"There are many wonderful features of short-term investments," says Malwal. "But investors with a long-term outlook have historically often been better off in stocks."

The key challenge with short-term investments is a lack of stronger growth potential. "While it's true that stocks may be more volatile than short-term investments or bonds in the near term, over the long run stocks have provided much higher returns," says Malwal. Although rates on these investments may appear attractive, they may not be providing much growth after accounting for inflation. Moreover, with rates potentially poised to fall if or when the Federal Reserve starts cutting rates, staying in short-term positions could leave investors exposed to reinvestment risk.

Says Malwal, “Investors who have time on their side can typically benefit from having a broader exposure to stocks and bonds, or a combination of the 2, as opposed to staying in short-term investments for a long time.”

5. Not factoring taxes into investing decisions

Investors often think of their brokerage accounts as accounts they should use for trading stocks or pursuing their latest ideas. But because brokerage accounts are not tax-deferred, Malwal says this can lead to one of the top mistakes he sees: generating a bigger tax bill than necessary.

Actions like trading a lot and holding tax-inefficient investments can increase investors’ tax bills. “Generally speaking, in taxable accounts, investing tax-efficiently and making gradual changes may help investors keep more of what they earn before taxes,” he says. Simple actions like choosing a mutual fund that trades less or keeping in mind the potential benefits of lower long-term capital gains tax rates may help investors keep more of what they potentially earn.

6. Letting the perfect be the enemy of the good

Analysis paralysis can be a problem for any investor.

Even if you’ve come up with a solid investing plan, it can be easy to get hung up on “what if” questions. What if I’m missing out on an even better investment option? What if the market crashes tomorrow? What if my plan just doesn’t work out?

The reality is that investing is inherently uncertain. Even the most experienced investors can only work off estimates, not certainties. While investors might worry about the “right” answer to any given investing question—like what investment to buy or when to get into the market—the fact is there may be a range of reasonable solutions.

But one thing has been true time and again historically: Over long periods, investors have done better by being in the market than being out of the market. If you’ve got a well-rounded, suitable plan that’s sensitive to your financial needs, then don’t let hangups about the perfect investment or the perfect time derail you from your goals.

7. Focusing too much on news headlines and politics

There’s no shortage of worries or risks in the world right now.

Malwal says he sees many investors staying out of the market in the hopes that the landscape will look more stable at some future time. “Some investors feel like they should wait because there’s an election happening. Or maybe they want to wait until their candidate is in the Oval Office, or until Congress is favoring their preferred issues,” he says. Others may worry about the tense state of global affairs, or risks to the economy.

Rather than using news headlines or gut feeling as indicators on the market, Malwal suggests investors go deeper into the economic data that actually helps drive the stock market—like corporate earnings, economic growth, stock valuations, and consumer spending. This data may not paint as sensational a picture as news headlines, but may be a better guide to market potential. (Read more about the vibecession,” or why investors may feel the economy is weaker than it is.)

After all, the world has always been perilous. “It’s very rare for me to sit back and think, ‘There’s nothing to worry about right now,’” says Malwal. And yet, through decades of uncertainty and challenging news headlines, the market has still made big strides.

PROTECTING YOUR LIFESTYLE BY KPW

August was a rollercoaster month for equities, with the confluence of various macro currents temporarily inducing a significant downward lurch.

In the case of Japan, the decline was of a magnitude not seen since the Black Monday Crash of 1987. The seeds of this turbulence were partly sown by the near certainty of a cut in the US interest rates in September, which would mark an end to the tightening cycle that began in March 2022. But the prime source of the market tempest was the Bank of Japan's (BoJ) end-July interest rate hike.

End of an era?

While the Federal Reserve is on the verge of cutting interest rates, Japan's central bank is gradually bringing to an end a nigh-on 20-year-long era of monetary experimentation. This was a period characterized by a yield-suppressing bond buying programme, and ultra-low interest rates. Indeed, from January 2016 to March this year, the central bank's key overnight call interest rate was kept at negative 0.1% as it sought to stoke growth. But breaking away from the gravitational pull of deflation has been difficult.

Weak is good, until it isn't

Throughout the Covid-19 pandemic, the BoJ stuck to its monetary guns. Japan initially eschewed the full-on, lockdown approach to handling the pandemic. Nonetheless, the economy saw a 4.6% decline in GDP in 2020 in the wake of the global growth meltdown with deflation in Japan intensifying. However, the exit from the Covid period solicited a different response by the BoJ compared to its G7 peers. Supply chain issues and rising energy prices lit the blue touchpaper for global inflation, and consequently brought about hikes in interest rates in the US and Europe. With Japan not following suit, the yen embarked on a sustained period of weakness, falling over 30% against the US dollar from March 2022 to July this year.

Viewed as 'benign neglect', the BoJ's policy seemed to be tacit approval of yen weakness as a means of improving the country's competitiveness, with the side benefit of enhancing foreign exchange translation gains for Japanese corporate profits. The Bank also got what it wanted - rising core inflation, which reached a peak of 4.2% in January 2023, and sat at 2.7% in July this year, marking the 27th consecutive month it has been above the target 2% rate.

The problem is that inflation has been of the cost-push rather than the sought-after demand-pull variety. It has raised costs for companies and the public alike and stifled domestic consumption, as evidenced by the quarter-on-quarter economic contraction in the first three months of this year.

A New Hope

Having shifted away from negative interest rates in March, July's rise to 0.25% and plans to halve the amount of bond buying indicated a further attempt to return to a semblance of monetary normalisation. GDP estimates for the second quarter, released shortly after the rate hike, painted a mildly better picture, with the economy expanding 0.8% on the previous quarter, although that still translated into an 0.8% year-on-year decline. A key issue for the economy has been the lack of real wage growth, although Japan has not been alone in that regard. However, there are signs that this is improving, as for the first time in 27 months, real wages rose 1.1% year on year.

The BoJ cautiously expects the economy to grow 0.6% this fiscal year and 1% next year. Core inflation, meanwhile, may recede to 1.9% for this fiscal year and 2025 as the impact of rising import costs wear off. However, given the tentative state of the economic recovery, more than a few economists and politicians are questioning how much the BoJ will need to tighten.

Market maelstrom

Nevertheless, with the Fed trumpeting interest rate cuts and the BoJ going in the opposite direction, this was sufficient to propel the yen upwards, and prompt concerns about the impact of a stronger currency on corporate export earnings. From the end of July to 5 August, Japan's broad TOPIX stock index fell 20%.

The extreme reaction to interest rate realignments was also attributed to the unwinding of the 'carry trade'. Given favourable interest rate differentials between Japan and just about everywhere else, a longstanding macro trading wheeze has been to borrow 'cheap' yen in a low interest rate environment and invest in higher yielding asset classes elsewhere, or, for example, harder-charging sectors of the US market. Consequently, the perceived unwinding of this trade induced a temporary sell-off in many US growth names, including the Magnificent Seven, although a rebound in markets since suggests a more measured view of interest rate differences and growth prospects. This possible shake-out of loose 'macro' money is good news, tempering exuberance, and reminding investors of the importance of fundamentals.

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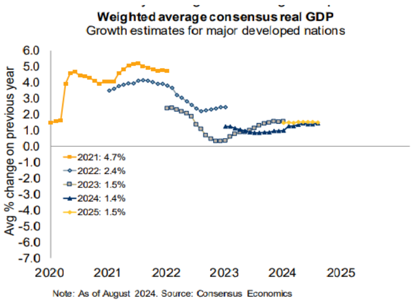
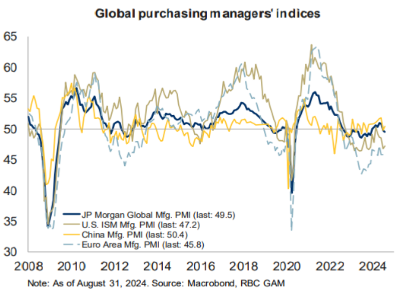
The Economy

Leading indicators of economic growth suggest the economy is decelerating but the outlook still tilts towards a soft landing rather than recession. The moderation in growth experienced over the past couple years was consistent with rapidly rising interest rates. The economy is now set to feel relief as the pressure from prior restrictive monetary conditions rolls off and as policy rates fall over the months and quarters ahead. We recognize that pockets of financial pain do exist, particularly outside the United States, delinquency rates have been rising and unemployment rates have been ticking higher. As such, there is a possibility that some of these metrics could worsen over the months and quarters ahead and as a result we place a 40% chance of recession over the next 12 months with Europe, the United Kingdom and then Canada most vulnerable. But the more likely outcome, in our view, is that the U.S. and global economy will continue in moderate expansion, particularly as the interest-rate backdrop becomes more supportive.

A variety of risks complicate the outlook. Escalating tensions in the Middle East threaten geopolitical stability, with potential impacts on the price of oil and ultimately inflation. In the U.S., the presidential election in November is a key risk given that the race is likely to be tight, and the two leading candidates have massively different platforms related to taxation, spending initiatives, global trade and immigration policy. Looking further ahead, significant fiscal stimulus during the pandemic stretched sovereign debt loads to levels likely to weigh on future growth potential. All these factors are sources of uncertainty and volatility for both the economy and capital markets.





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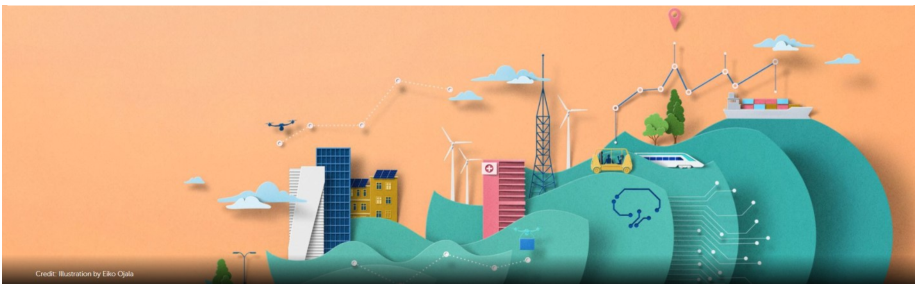


Sustained Economic Growth Hinges on Productivity Gains as Populations Age

A productivity slump is eroding living standards and imperiling financial and social stability.

Gina Bhatt

“Productivity isn’t everything,” Paul Krugman wrote in his 1990 book, The Age of Diminished Expectations, “but in the long run it is almost everything.”

Productivity is a foundation of prosperity. The only way a country can raise its standard of living sustainably is to produce more with existing or fewer resources. You cannot do that without improving productivity. It’s that simple.

Everything else about productivity is surprisingly complex, however. It is difficult to explain, difficult to measure, and, as the past couple decades show, difficult to improve.

We know that productivity must play a more important role in driving sustained growth as our societies age. But there’s no consensus on how to reverse the broad slowdown in productivity growth seen across almost all countries over the past 20 years.

Especially vexing is the sluggish growth of what economists call total factor productivity—a way of measuring how efficiently businesses turn capital and labor into output—the part that basically captures innovation and technology.

Slower gains in total factor productivity account for more than half the deceleration in economic growth since the global financial crisis, IMF analysis shows. Another decade of weak productivity growth could seriously erode living standards and threaten financial and social stability.

Economic dynamism

This issue of F&D brings together leading researchers to help explain the withering of productivity gains, how to counter these trends, and how to spark economic dynamism.

Yale economist Michael Peters sets the stage by delving into the causes of slowing productivity growth in the US. Declining dynamism in the world’s largest economy threatens to reverberate around the globe. Greater immigration to offset a shrinking workforce and stronger competition rules to encourage innovation by smaller, younger, hungrier enterprises could be part of the solution, he concludes.

These small companies can drive productivity gains, writes the University of Chicago’s Ufuk Akcigit, who explores why increased US spending on research and development isn’t necessarily boosting productivity. He shows how small firms are more innovative relative to their size, suggesting that they use R&D resources more efficiently. As companies grow and dominate their markets, they often shift to protecting their market position, rather than fostering innovation.

But while innovation is exactly what's needed to revive productivity growth, it is not sufficient on its own. New technologies and digital transformation, notably artificial intelligence, have the potential over time to underpin a major surge in productivity, writes Nobel laureate Michael Spence. For AI to achieve its full economic potential, however, it must be accessible to all sectors of the economy, and to companies large and small, he notes.

Policies matter, too. Here our contributors suggest that measures should encourage more effective reallocation of resources away from low-productivity firms and support smaller businesses and start-ups—not just large incumbents. This could include targeted tax credits, grants for early-stage innovation, workforce retraining, and policies that encourage competition and reduce barriers to entry for new players.

Understanding productivity growth more fully is crucial because it plays such an outsize role in economic growth—which, as Daniel Susskind of King's College London writes, also demands a renewed approach to help improve people's lives. Ultimately, as Nobel laureate Edmund Phelps writes, a productive society should allow people to enjoy "mass flourishing" from the grassroots up.

STACKING IN A HIGHER INTEREST RATE ENVIRONMENT

By Corey Hoffstein, Rodrigo Gordillo & Team, Return Stacked Portfolio Solutions

This article explores the relevance of leverage in investment strategies amid higher interest rates. The decision to use leverage should be based on the expected returns of assets rather than current interest rates. By emphasizing the importance of understanding risk premiums, the article highlights that leverage can remain beneficial even in environments with higher interest rates.

Introduction

Coming out of a decade-long low interest rate environment, many investors are questioning whether utilizing leverage remains a prudent idea now that interest rates are meaningfully above zero.

Our answer is that the level of interest rates should not impact the decision to utilize leverage. If leverage makes sense in a low-interest rate environment, then it should make sense in a high interest rate environment.

Risk Premiums and the Risk-Free Rate

At the foundation of any discussion about return is the risk-free (RF) rate, which is the rate of return earned for investing in a theoretical, riskless asset. Although the risk-free rate doesn't actually exist, a typical proxy is the yield of U.S. Treasuries, since those are as close to "risk-free" as an investor can get.

Intuitively, for any investor to make an investment in anything that is not riskless, they would require the expected return on that investment to be higher than the risk-free rate (this is not strictly true, as insurance instruments offer an obvious counter-point, but is sufficiently true for most investments). Put simply: the investor expects to get paid to be willing to bear the risk. As we have been known to say, "No Pain, No Premium". Generally speaking, if a risky asset has an expected return lower than the risk-free rate, the price of that asset should come down such that the expected return goes up and properly compensates the investor.

For any asset, the expected return above the risk-free rate is called a "risk premium." For example, in equities we have the "Equity Risk Premium" (ERP) and in bonds, we have the "Term Risk Premium" (TRP) (there are many other risk premiums that we could list, but to keep this article succinct, we will focus on the ERP and TRP).

Expected Return = Risk-Free Return + Expected Risk Premium

In Figure 1, we provide a stylized decomposition of expected returns of equities and bonds into their individual components.

Figure 1: Expected Returns on Cash, Bonds, and Equities

Source: Newfound Research. For illustrative purposes only. Consult your financial advisor before making any financial decisions.

From Figure 1, we can see that the expected returns for bonds and equities are composed of both the risk-free rate, as well as their respective risk premiums. These risk premia are defined as the expected excess return of the asset above the risk-free rate.

Applying Leverage to an Asset

If an investor wants to gain exposure to the S&P 500 index, most investors will operate in the cash market, using cash to purchase a share of the SPDR S&P 500 ETF Trust (ticker: SPY) or the underlying stocks themselves.

Another method, however, could be to borrow money (using leverage) to purchase the exposure. If we borrow the money, we will have to pay back the borrowed amount plus the interest accrued, but we would keep whatever we made in excess of that amount. So, if the S&P 500 returns more than the interest we must pay, we came out ahead by borrowing. In this scenario, the excess return of the S&P 500 is what we expect to make by borrowing, so long as the investor can borrow close to the risk-free rate.

This latter method is effectively how a S&P 500 futures contract works.

One minor difference that we would be remiss to mention is the interest rate. If an investor goes to a bank to borrow money, the interest rate charged would likely be significantly higher than the yield on U.S. Treasury Bills, while futures contracts embed an interest rate remarkably close to the yield on 1-3 Month U.S. Treasuries.

Taken together, an investor who purchases an S&P 500 futures contract expects to earn the equity risk premium of equities and their realized return will be equal to the return of the S&P 500 minus the risk-free rate (assuming the embedded borrowing cost in S&P 500 futures equals the risk-free rate).

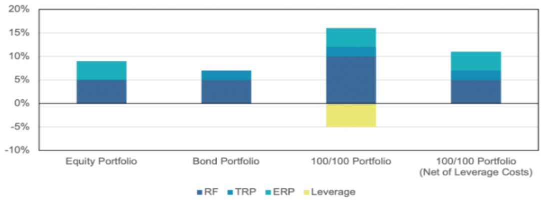
Why Does That Matter

Since return stacking inherently uses leverage (typically via futures contracts) to stack returns into a portfolio, the risk premium of the assets in the portfolio is of great interest to investors. However, what the section above hopefully illuminates is that the actual level of interest rates does not.

In fact, since the return of every asset can be decomposed into the risk-free rate and its excess return, and futures contracts effectively isolate the excess return, the choice whether to use leverage based upon the level of the risk-free rate implies that there is a relationship between the level of the risk-free rate and the size of the expected risk premium. In other words, it's a market timing decision!

To further illustrate this, in Figure 2, we build a 100/100 stock/bond portfolio to analyze how the expected returns change as we introduce leverage to the portfolio.

Hypothetical Expected Return Decomposition of a 100/100 Portfolio



Source: Newfound Research. For illustrative purposes only. All expected returns are hypothetical and should not be relied on for investment decisions. This depiction assumes that the interest charged on leverage is equal to the risk-free rate which may not be realistic. Consult your financial advisor before making any financial decisions.

From Figure 2, we can surmise, that stacking bonds on an equity portfolio leaves the portfolio with three things: the risk-free rate, the ERP, and the TRP. Even though we are implicitly incurring borrow costs by applying leverage, we clear that hurdle so long as the ERP and/or the TRP are positive. Since we would expect risky assets to have a positive excess return, a logical conclusion is that the level of interest rates is inconsequential to applying leverage.

Do We Even Need to Talk About Leverage Here?

While we tend to apply the lens of leverage due to our affinity for return stacking, does this conversation even require the application of leverage?

The short answer is "no," but the long answer utilizes a concept that we already applied earlier in this article.

If we assume that the risk-free rate is 5%, for us to hold any allocation to a risky asset then we need to have the expectation that that risky asset will return greater than 5%, or at least properly compensate the investor for the risk taken.

To further develop this intuition, let's detail two potential investments:

An investment that will return 5% in one year, guaranteed.

An investment that will return a maximum of 5% in one year, with a 50% probability of losing 5%.

No rational investor would select the second option, as the first is guaranteed and provides the same maximum gain.

Without even applying leverage, the investor is better off allocating to the risk-free asset, since it is irrational to allocate to the second choice.

If an investor has the view that equities or bonds will underperform cash (i.e. the ERP and TRP are negative), then that investor should allocate to cash. This decision is true regardless of whether the position is levered or not.

If, however, the risk-free rate goes up and we believe that it is no longer prudent to use leverage, what we're actually saying is, "because the risk-free rate went up, we believe the risk premia of our assets has gone down." Again, this is inherently a market timing decision based upon the level of the risk-free rate. (That is not to say that there isn't a potential relationship between the risk-free rate and levels of risk premia due to aggregate investor risk preferences, but they should be contemplated explicitly.)

Conclusion and Tying it All Together

To concretely summarize this post, we posit the following:

- Levered exposures should earn (approximately) the excess return of the asset class.
- The choice of whether to invest in an asset should be driven by its expected risk premium and potential benefit to the portfolio as a whole.
- For higher interest rates to imply that leverage is no longer attractive, it must mean there exists a relationship between the level of interest rates and expected risk premiums. In other words, we must believe we can use the level of interest rates as a market timing signal!

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