The Stan Clark Financial Team's

PERSPECTIVES

In this issue...

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If you believe the media, things look pretty bad. However, as I suggest in this month's behavioral finance piece, looking at clear, objective data gives a brighter, more realistic view of the world – and helps in making good investment decisions. In our Quarterly Economic Update, Michael Chu and I argue that, while stocks had mixed results, overall the economic fundamentals remain strong. And with changes to tax rules in the 2018 federal budget, Sylvia Ellis explains why an Individual Pension Plan might just be right for you.

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Behavioral finance

The future is better than you think

By Stan Clark - Senior Investment Advisor

Sometimes it's hard not to feel pessimistic about the future. After all, bad news surrounds us – and in our modern, connected world, that news seems to hit us in an endless stream. There are the concerns about climate change destroying our planet, threats of nuclear war, continued inequality and sexual harassment and intolerance of people of different races or religions or those with different lifestyles. The list goes on. And on...

But is our world as bad as it seems? Are things really getting that much worse?

Let's step back, take a clear look at objective data and a longer-term view of history. Far from getting worse, the world has actually been getting better in almost every area of human endeavour – from life expectancies, poverty and equal rights to safety, quality of life and the environment. Now let's consider the coming advances in so many areas, such as alternative energy, food production, health technology and water purification. From all the above, we should have every expectation that future progress will continue, and even accelerate, into a world of abundance.

Why, then, this disconnect between our perceptions, "our feelings," and more objective assessments of the past and the future? Unfortunately, human nature and the way our brains are wired make *negativity bias* nearly inevitable. Our ancestors survived by paying extra close attention to fearful things. That makes us naturally more attuned to the negative than to the positive.

The media are well aware of this predisposition. They cater to our instinctive bias for their own profit. The time-proven rule in the news business is: "If it bleeds, it leads." Put simply, bad news sells. Not surprisingly, an analysis of the media revealed that the majority of news reports are negative – and this negativity has been increasing over the last several decades. The news media's greater focus on the negative, in turn, leads our subconscious minds to do the same.

Media reports also focus on the unusual and the novel, which appeals to another human predisposition. Through our *availability bias*, we naturally feel that what the news highlights is more common than it really is. With all this in mind, no wonder our perceptions are more negative than reality!

Is this negative distortion good or bad? There are certainly good aspects. To some extent, having a negative outlook helps us avoid modern "tigers in the bushes." Negativity can prevent us from incurring some injuries or losses. And keeping the world's attention focused on negatives motivates us to fix the problems that still exist. So, there's a case to be made that our negativity bias deserves credit for much of the progress we've seen in the world.

But negativity also has a downside. It can be unpleasant, even downright depressing. As well as potentially making our lives miserable, negativity can also, if exaggerated, become demotivating. Why bother trying to fix things if they're too bad to be fixed? Further, we may become so negative that we lose faith and backtrack in the very areas that have contributed to our progress. This last effect seems to be happening to some extent with our current political atmosphere.

So, while we shouldn't be too negative about negativity, maintaining a healthy balance is important. The Stan Clark Financial Team will do our part to maintain that balance. We'll devote our next issue to a more thorough review of the positives in the world – and reasons for optimism about the future. We'll send this next *Perspectives* to you in early December, just in time for the holiday season. ■

Stan Clark is First Vice-President, Portfolio Manager and Senior Investment Advisor for the Stan Clark Financial Team at CIBC Wood Gundy. Stan has direct responsibility for the team and oversees all areas of financial planning, investment selection and investment management.

Team Talk:

Michael Chu
Investment Advisor

Ride to Conquer Cancer 2018 finish line

How was your summer?
Great! I took part in the two-day Ride to Conquer Cancer. This year the ride was out to Hope. Going into the weekend, smoke from the forest fires was a big concern. But then it rained – a lot – throughout both days of the ride. Those two days were the only days it rained in all of August. So, not the most comfortable ride, but at least the rain chased the smoke away. Whatever the conditions, I was glad to spend time with the team and raise money for cancer research.

Plans for the fall?
I'm excited that our ice-hockey nights have started up again. I usually play once or twice per week. I'm also looking forward to a European holiday in October, taking in the south of France and Bordeaux, and then over to Spain. I've only been to Paris and Barcelona before, so the trip will give me broader experience of these two countries.

Quarterly Economic Update:

Mixed results for stocks, but economic fundamentals remain strong

By Stan Clark, Investment Advisor, and Michael Chu, Investment Advisor

2018's third quarter saw mixed results from stock markets around the world. At home, the TSX was down 0.6%. Although U.S. stock markets continued to hit new highs, returns were hampered by a rising Canadian dollar. As a result, U.S. markets were up 5.9% in Canadian dollars. The World Equity Index, a gauge of stocks around the world, was up 3.2% (in C$).

Reserve may raise interest rates too much or too fast, potentially hurting the economy. Growth outside of the U.S. has stalled; other concerns include trade wars and deficit spending.

Guiding these collective fears is the flattening yield curve. To recap, when the curve inverts –that is, the difference between the 2-year and 10-year interest rates is negative – it signals an upcoming recession. Currently, the spread is positive 0.22%, just above a recent low. The reason for so much talk about the curve is that since 1980, every time the curve inverts, a recession follows. However, keep in mind than an inverted curve is just a potential signal, not a cause of a recession.

	3rd Quarter 2018	Year to date 2018	Trailing P/E	Trailing Earnings Yield	Dividend Yield
Canada	-0.6%	1.4%	17.8	5.6%	3.0%
U.S.	5.9%	13.5%	22.8	4.4%	1.9%
Europe	-1.1%	1.4%	16.2	6.2%	3.5%
Japan	4.2%	9.4%	14.1	7.1%	2.1%
EAFE (Europe, Australia, Far East)	-0.4%	1.2%	15.4	6.5%	3.2%
Emerging Markets	2.8%	-5.2%	13.3	7.5%	2.7%
World	3.2%	8.3%	19.4	5.2%	2.4%

Source: Bloomberg

Time flies

It's been 10 years since the beginning of the 2008 financial crisis. In September 2008 Lehman Brothers filed for the largest bankruptcy in U.S. history. The main culprit involved bad real estate debt which resulted in financial panic. In a span of two months, the S&P 500 fell 40%. Based on history, a bear market of such massive proportions implies a bull market of equally historic proportions to follow. Since the bottom 9½ years ago, the market has more than recovered, up over 330%.

In a recent discussion of the Great Depression's psychological effects, the *Wall Street Journal* noted some parallels affecting the current generation as a result of the 2008 financial crisis. The *WSJ* characterized Generation Z – those born after 1996 – as "sober, driven by money, saving more and spending less. They don't want huge college debts and don't drink, drive and party as much." Crises are unavoidable, but we can change how we handle them. From now on investors may be more cautious and save more, with the future generation taking more precautions against future crises. This seems a positive reaction, making another bubble situation less likely.

Recession watch

The U.S. economy is on a roll: Robust factory production, low unemployment and business investment continue their positive trend. Overall, the economy is expected to continue to grow at around 4%. So, all appears to be well. But let's look at some leading concerns. For one, there is a belief that we are in the late innings of a historically long expansion. Also, the U.S. Federal

We've previously discussed arguments why an inversion might not be as relevant in today's world. These include: suppressed long-term rates; using a 3-month yield instead of a 2-year one; and the existence of many other indicators nowhere near sounding an alarm. Even if the inversion does happen, it still wouldn't mean a recession is just around the corner. There have been five recessions since 1980, typically occurring around one to two years (18 months on average) after the inverted yield curve. Of course, the stock market would try to adjust beforehand. But with U.S. stock indexes near record highs, there seems to be a sense that the narrowing spread won't invert; or that if it does, the consequences won't be that bad. So it seems that the U.S. recession risk is not as high as the curve suggests.

Strong fundamentals

The latest economic and market indicators point towards a healthy economy and positive stock market. U.S. GDP has grown by 4.4%. Consumer confidence is at its highest since October 2000, which should support healthy consumer spending.

For U.S. companies, revenues are at an all-time high, up 10% last quarter compared to a year ago. According to top economist Ed Yardeni, normally this far into an expansion, revenue growth tends to only be around 4 to 6%. Profit margins are also at an all-time high. Earnings are up 25%

last quarter compared to a year ago, with revenue growth and tax cuts being big components of that.

Because of these strong fundamentals, U.S. stocks have fared well. But stock markets around the rest of the world did not: Canada, Europe, Asia and Emerging Markets have had negative returns. Part of this is due to fundamentals, but also to a fear of trade wars, Emerging Markets' debt and Brexit.

Growth vs. value

We mentioned above that U.S. stocks have been doing well this year. Usually, that means the stocks in your portfolio are also doing well. So far, this year has been a bit different, as our U.S. strategies have been underperforming. The main reason is growth vs. value. Stocks can be classified as either *growth stocks* or *value stocks*. Growth stocks are expected to have better earnings growth – which is fine, but these stocks are typically more expensive, pay little or no dividends and are riskier. Value stocks are companies that are cheap compared to their fundamentals, therefore usually less expensive and less risky.

Year to year, growth and value stocks perform differently. That's normal. But this year the difference is significant. U.S. growth stocks are up 16.5%, but value stocks are up only 1.6%. Our strategies look at both value and growth, but definitely lean towards value – and that is being reflected in our U.S. performance. Our research indicates that value investing still makes sense, but this year the growth companies, with their higher valuations, are actually meeting/exceeding their lofty expectations. Perhaps in the future we will see some mean reversion, i.e., value catching up with growth.

The new NAFTA

Regardless of what we call it, the successor to the North American Free Trade Agreement (NAFTA) is good news compared to what could have happened in an all-out trade war. The biggest wins for Canada in the new United States Mexico Canada Agreement (USMCA) are avoiding punitive auto tariffs and preservation of the dispute resolution mechanism. One notable concession we made was the loosening of dairy supply management, but this could lead to lower prices for Canadian consumers. Overall, the new agreement is not quite as good for Canada as the outgoing NAFTA, but it's likely good enough as it will not be a huge game changer. Although steel and retaliatory tariffs are still in place, as they were enacted under national security concerns, progress here seems likely given warming trade relations.

The Canadian economy has come a long way since the financial crisis and subsequent oil price collapse. The economy continues to grow while inflation remains low, putting less pressure on the Bank of Canada to aggressively raise interest rates.

Too much debt

We're constantly exposed to media headlines about what might derail the stock market: flat yield curve; cyclically low unemployment; and age of economic recovery/bull market, to mention a few. One the media doesn't often mention is the amount of debt. Most postwar recessions are caused by rising interest rates because borrowers lose their ability to make interest payments at higher rates. Not all debt is bad. But whether it's companies or countries, having too much debt in a rising-interest-rate environment can be a dangerous thing.

Howard Marks of Oaktree Capital recently discussed one of his big worries. Marks cited a main cause of the 2008 financial crisis as the financial engineering surrounding sub-prime mortgages. His big worry today is mainly the increased popularity of public and private corporate debt, combined with the hunt for yield without regard for higher risk. Marks isn't saying there's an imminent risk; still, risky behaviour with debt could be a problem when there is serious economic weakness.

Mid-term euphoria

In the past we've discussed the presidential cycle. To recap, stock returns tend to be below average in the first two years of a presidential cycle and then above average for years three and four. The theory is that presidents and Congress do all the dirty work in the first two years. Then, in the final two years, they try to boost the economy to help get re-elected. The U.S. mid-term elections coming up in November 2018 mark the half-way point of the current presidential cycle.

Additionally, the nine months surrounding the mid-term election have been consistently above average for stock market returns. The basic reasoning is "hope and change." The election cycle is so powerful because the public looks forward to political change as a positive, and the market anticipates these positives in advance. Once the mid-term elections are over, the market then looks forward to the presidential election in two years. While the current presidential term has been anything but typical, and we're not really into making short-term predictions, history indicates we should have positive markets in the near term.

Looking forward

Overall, stock valuations are on the higher side – but are still reasonable, especially when compared to bond interest rates. We remain cautiously optimistic about the future. However, we can never be sure of what will happen in the short term. As we repeat in all our reviews, it's important to have a time-tested financial plan, based on long-term data, that also provides a custom asset mix for your investments. For your individual stocks, we continue to invest in companies that have strong characteristics of doing well in the future. ■

Financial Planning

Individual Pension Plans

By Sylvia Ellis, Senior Estate Planning Advisor

The 2018 federal budget included tax measures that may impact you as a small business owner or professional. In this issue, we'll focus on the tax measure that affects passive investments within a private corporation and the Individual Pension Plan.

Let's start with the reason for the new tax rules. The government's concern is that under the current rules, a "tax-deferral advantage" exists because the tax rate on active business income (ABI) earned in a corporation is generally much lower than the top marginal tax rate for individuals earning business income or employment income directly, especially if the income is taxed at the lower small business deduction (SBD) rate. If this after-tax corporate business income is not needed for a shareholder's living expenses and is retained in the corporation, there is more after-tax income to be used as capital for investment than there would be if the business income was earned directly by an individual. Over time, this may yield more investment income within the corporation.*

The budget proposed a measure that impacts the eligibility for business income to be taxed at the SBD Rate. The SBD Rate currently applies federally on the first $500,000 of qualifying active business income. Under the new rule, when a corporation earns more than $50,000 of certain types of passive investment income in a year, the amount of active business income that is eligible for the SBD Rate in the following year is gradually reduced. The SBD Rate reduces to zero at the $150,000 threshold of passive income*

What this means is that, going forward in some situations it will take longer to build up retirement savings within a corporation. But, there are alternatives, one being an Individual Pension Plan (IPP), when investment income exceeds $50,000.

An IPP is a defined benefit pension plan, generally for individuals 40 plus and earning in excess of $147,000 annually in T4 income**. It is similar to an RRSP in that it uses an investment account to accumulate assets over time as retirement benefits. However, unlike the RRSP, an IPP allows for accumulation of greater assets and allows owners to make contributions for service prior to the set-up of the plan. No other plan or individual investment can offer this benefit.

Other key benefits include:

- Tax-deductible contributions to the plan for the corporation, along with all associated costs.
- Predictable retirement income.
- Creditor protection for assets held in the IPP on condition that the pension plan was set up in good faith (e.g. not due to a looming bankruptcy).
- Ability for succession planning when family members work for the corporation.
- The possibility of terminal funding, which could allow for large contributions at retirement. While, the CRA restricts the benefits that can be pre-funded, at retirement, the pension plan can be amended to include full indexing, an early retirement pension with no reduction, as well as bridge benefits.
- Income earning in the IPP will not be included in the investment income that could reduce the SBD.

When you retire or sell your business, you can either receive a monthly pension plan from the IPP, buy an annuity or transfer the commuted value to a registered account. The rules are similar to RRSP's in that you must begin taking income by the end of the year you turn 71.

You should also consider some of the potential negatives. There's the paperwork and cost to create and maintain an IPP and your funds are locked-in, allowing less flexibility.

If you are interested in obtaining a personalized quote to see if an IPP can benefit you or would to learn more, please let us know. We'll be happy to help. ■

**Source : Jamie Golombek and Debbie Pearl-Weinberg, Tax & Estate Planning, CIBC Financial Planning and Advice, 2018 Federal Budget Review*

***Source: https://www.canada.ca/en/revenue-agency/services/tax/registered-plans-administrators/pspa/mp-rrsp-dpsp-tfsa-limits-ympe.html*

SCFT Trivia

Play our trivia – support the cure!

For every correct entry we receive in our trivia contest, the Stan Clark Financial Team will contribute $1 to CIBC's "Run for the Cure" to raise money for breast cancer research. Each correct entry will also be entered into the draw for this month's prize. Email or phone in your entry today.

Answer all four questions to be entered into the draw for this month's prize. Hint: You can find the answers inside this newsletter.

1. The media tends to skew negative in presenting news to us. This is because:

   a) By self-protective instinct, humans pay more heed to negative information.

   b) Bad news sells.

   c) With our availability bias, we believe that what media reports in one place is happening everywhere.

   d) All of the above.

2. According to The Wall Street Journal, one effect of the 2008 financial crisis is that Generation Z, or those born after 1996, are:

   a) Determined to enjoy money while they have it, so spend and party a lot

   b) Generally depressed about their prospects

   c) Sober, driven by money, saving more and spending less

   d) Suspicious of anyone over 30

3. The U.S. economy is on a roll thanks to a continuing positive trend in robust factory production, low unemployment and business investment:

   a) True b) False.

4. An *Individual Pension Plan* is a defined benefit pension plan, generally for:

   a) Younger people just starting out in the workforce

   b) Individuals 40-plus and earning in excess of $147,000 annually in T4 income

   c) All ages and incomes, as an IPP's tax advantages apply to everyone

   d) Only retirees

Email answers to: **stanclarkfinancialteam@cibc.ca**
or call (604) 641-4361

One prize winner will be chosen by a draw from all those who submit correct answers. The draw will take place on November 30, 2018.

Trivia challenge runs Nov. 1 - 29, 2018. No purchase necessary. There is one prize to be won. Simply complete the trivia questions correctly to be entered in the draw. Limit 1 entry per person.

Chances of winning depend on number of eligible entries and whether you correctly answer the trivia questions. Open to adult Canadian residents (excluding Quebec). For full challenge rules, write to: The Stan Clark Financial Team, CIBC Wood Gundy 400-1285 West Pender St, Vancouver, BC V6E 4B1. © Stan Clark 2018

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