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2015 Performance Reports and year ahead review

Enclosed is your performance report for the one-year and five-year periods ending on December 31, 2015. The report shows the value of your accounts on a combined basis.

'Inflows' is defined as how much money came into your accounts, including amounts transferred from other CIBC Wood Gundy accounts. 'Outflows' is defined as funds withdrawn from an account, including transfers to other CIBC Wood Gundy accounts. The difference between 'inflows' and 'outflows' is the net amount you saved (or took out) from your accounts.

Revenues are defined as total distributions, dividends and interest paid into your accounts (and does not include any change in share prices.) Performance is a combination of revenue and change in security prices. The performance on a five-year basis is the average annualized (per year) return for the past five years.

The report also shows a comparison of how your accounts performed against various indices. The first index is the Canadian bond index. The second is the global stock market index (currency adjusted.) The third is the Canadian stock market index.

This past year saw returns below what we have been experiencing in recent years and as we write, markets have had a rough start to 2016. Most stock markets around the world (particularly Canada) had an off year in 2015 and as is often the case, weakness can spill over into certain areas of fixed income. On the surface, the bond market performed well

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at a return of 3.52% (see FTSEUBOND rate of return on your performance report). What helped bonds over past years has been declining interest rates. The longer the term of the bond, the more it goes up in price. As one third of the bond index is 20- to 30-year bonds, good performance there helped the bond index perform due to the move downward in interest rates. In the past few years, we have not been buying very long-term bonds due to the risk of a fall in price if interest rates rise. Additionally, our average client who is 65 years old these days does not typically want a bond with a 20-year maturity date.

With risk-free short-term to medium-term fixed income investments paying a paltry one to two percent, we have to take some risk on fixed income to have any hope of generating our target return of about 4.5% on the fixed income portion of portfolios. Going into 2014 and 2015, we tried to minimize fixed income risk by continuing to buy quality investment grade corporate bonds, decreasing our overall exposure to high-yield (below investment grade) bonds, and establishing a position in PIMCO Monthly Income Fund, which takes a reasonably low-risk approach. We maintained our position in ACM Commercial Mortgage fund (which continues to perform well). As high-yield bonds had a poor year in 2015, decreasing exposure there helped but as we still have some exposure to this asset class, that cost us a bit. Going forward, high-yield bonds pay an average of about 7% so the spread of what they pay above the risk-free rate of return is high enough where we will probably see better performance here in 2016.

As said, we wanted to avoid longer-term bonds which can decline in price substantially if interest rates increase. This is where things did not work out as planned. Due to the 70% fall in oil prices and overall slowness of the Canadian economy, the Bank of Canada reversed its stance of preparing us for higher interest rates, and instead cut interest rates twice during 2015. Lower Canadian interest rates hurt the price of the remaining fixed income asset class we buy, and that is preferred shares.

We purchased various preferred shares where we locked in guaranteed yields in the 4% range for an average of five and a half years, but preferreds in general have backfired so far pricewise. Here is why. If at the end of the five and a half year period, if interest rates are higher than they were at the issue date of each preferred, the eventual new yield would be greater than 4%. However, as interest rates have moved lower, the share price of these preferred shares is now pricing in the potential for a lower renewal yield than previously expected, which in turn has resulted in price weakness on preferred shares. Today, we can get a high 5.5% on new issues of preferred shares, which is great for new purchases, but not great for the current trading of preferred shares, which have decreased in price to reflect higher current market yields. Market prices average about $20, for preferred shares previously issued at $25.

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Going forward, we feel preferred shares represent good value at these lower prices. In a continued world of low interest rate alternatives, we like quality issuers like Royal Bank that are paying these high guaranteed preferred share yields; and as said, we don’t have to worry about interest rate risk as these preferred shares should increase in price if interest rates do finally start to increase (as the yield will eventually reset higher than 5.5% if interest rates increase from where they are today).

Unless your taxable income is very high, the net amount of tax you pay on Canadian dividend income earned from preferred shares is close to tax free. Most clients would need to earn about 7.5% in interest income to earn the equivalent after tax amount of 5.5% in dividend income; and the odds of safely earning 7.5% interest income in the foreseeable future is about as probable as Stephen Harper making a comeback as an NDP candidate.

Another area we like that generates good cash flow is real estate investment trusts (REITs) where weakness share price wise in the past couple of years means we can get cash distributions as high as 9% off of today's market value. Many REITs are currently trading below net asset value so we also obtain a discount of close to 10% on the current market value of the real estate they hold (typically office buildings, shopping centers and industrial properties).

Regarding the stock market, Canada, Europe, Asia and emerging markets have all been weak, with U.S. markets, close to break-even in 2015 return, continuing to beat other countries. The only positive here was our exposure to the U.S. dollar, which helped us in 2015.

With corporate earnings growth of 15% in 2015 on European companies, a cheaper Euro vs. U.S. dollar, and very supportive Euro Central bank monetary policy vs. just 2% corporate earnings growth in the U.S. and a tightening U.S. central bank, we look for better relative performance on European stocks going forward. In our index and stock strategy, clients own European stocks through an indexed based ‘ETF’.

Our typical client has reasonably good exposure to U.S. stocks. As valuations from both a price-to-earnings and currency standpoint, are now cheaper in non-U.S. equity investments, we will look to decrease U.S. stock exposure in 2016. Canada outperformed the U.S. for many years up until 2009, but the opposite has occurred for six years in a row. In historical terms, it would be unusual for this trend to persist much longer, so stay tuned as we are getting close to targets we have set to make this switch.

Regarding Canadian equities, 2015 saw carnage in both oil and gas and mining stocks. We have a bit of exposure here, but percentage wise it represents a fairly small part of client accounts. We could talk at length about all the supply issues that are driving commodity prices (and Canadian dollar) down but if past history repeats, share prices on these stocks will eventually surprise on the upside. Market sentiment wise, very few analysts and advisers are willing to jump in right now, as buying these stocks at the moment seems like trying to catch a falling knife (ouch).

Resource companies will have an even tougher year financially in 2016 due to expiring forward contracts, where they had locked in previously higher commodity prices. Specific to oil companies, any material increase in oil price can be met with a quick increase in supply due to significantly increased drilling efficiency (because of fracking and improved seismic testing), and the ability of Saudi Arabia and soon Iran, to increase production.

Eventually though, basic economics tell us that these low oil, natural gas and base metal prices are not sustainable at levels we see now. The nice thing about owning a company through its stock is that as shareholders we are entitled to all of the company's future earnings in perpetuity, and share prices are very 'forward thinking,' so any hint of a turn around in commodity prices should see a quick reaction upward in share prices.

As is always the case, ask ten analysts, and you will get ten different opinions as to when a bottom on these resource stocks will occur; and if anything, consensus opinion is usually wrong. Today, the consensus is 'they look cheap, and may start turning around in a year or so', where the reality is no one really knows with certainty when they will turn around. Our guess is anywhere from now to two years from now. It is tempting to increase exposure now as these resource stocks are very cheap, but we need to very much control for risk in everything we do, so our stance (for clients in our index and stock strategy) is to time our way into an increase in broad Canadian equity exposure (though an increased position in the TSX index, which is about 28% resource stocks) funding same by decreasing the US S&P 500 index. Getting the timing exactly right is close to impossible, but what this approach does do is stay within our discipline of 'buy low, sell high', staying diversified into quality investments, and doing appropriate re-balancing when one part of the portfolio gets too high. Tax wise, there is an advantage to having more Canadian exposure as dividend income, from Canadian stocks, is taxed more favorably than foreign dividend income.

Two other areas that look good at current trading prices are good dividend paying Canadian pipeline and bank stocks. You earn a safe average dividend of about 4.5% with companies in each of these sectors typically earning about double the amount required to pay their dividends. Pipelines had a very poor year in 2015 due to the markets concern about the impact of lower oil and natural gas prices. As pipeline companies operate on what are called 'take or pay' contracts, they earn the same amount regardless of the commodity price, so valuation wise they look quite interesting at these levels. Bank stocks are a good hedge against increasing interest rates as they will benefit if this occurs.

New Tax-Free Savings Account (TFSA) limits

The limit is officially back down to $5,500 per year.[*] Goodbye $10,000 limit, it was nice knowing you, albeit for a short period of time. If you are not fully contributed, you can continue to catch up on unused contributions (including the full $10,000 limit for 2015) anytime.

We have recorded your wishes for how you wish to fund your TFSA contribution (in terms of automatically contributing by using an investment in your non-registered account, or instead by making new cash contribution). We will proceed with the automatic contributions this month. We will try and get this all done by the end of January.

For any client wishing to make cash contribution, please let us know at your convenience. We continue to set clients up for inbound electronic contributions directly from your bank account, so if that's been done, your TFSA contribution can be done without the need to send in a cheque.

Updated Registered Retirement Savings Plan (RRSP) maximums

The RRSP deduction limit for 2015 is 18% of trailing income to a maximum of $24,930. The deadline for 2015 contributions is at the end of February.

For the early birds, the 2016 maximum deduction is $25,370.

New Registered Retirement Income Fund (RRIF) minimums

Good news as new rules allow for lower minimum payments. This will decrease your taxable income, and lengthen the life of your RRIF. The changes reflect longer life

[*] The annual TFSA dollar limit between 2009 and 2012 was $5,000. In 2013 and 2014 the annual dollar limit was $5,500. In 2015 it increased to $10,000, and has been reduced back to $5,500 starting January 1, 2016.

expectancy and lower interest rates. You can always take out more than the minimum payment if you wish. Clients who are coded for minimum RRIF payments will see these payments decline this month. If you wish the old higher payment rate to continue, please let us know. We can email you a letter of authorization that can be faxed or scanned back. If you have chosen no withholding tax, CRA rules mean we will have to start deducting some, if you take out more than the new RRIF minimum payment.

Free $1,200 for B.C. kids born 2007 or later

The B.C. government will contribute $1,200 to Registered Education Savings Plan (RESP) accounts for children who are B.C. residents born 2007 or later, through the B.C. Training and Education Savings Grant (BCTESG). You can apply for the grant as long as your child is at least 6 years old. So for kids born 2007-2009 (ages 6-8 already), we can apply now. For kids born 2010 (turning 6 in 2016), we can apply on or after their 6th birthday.

In order to take advantage of this grant, we will have to open a separate off-book RESP account. Please call Cheryl, Melanie or Sylvia to coordinate this. Alberta just cancelled a similar grant, so best not to wait too long.

Scientist in Residence program

Part of our earnings continues to fund the Scientist in Residence program which brings a scientist from the University of British Columbia into an inner city school, to work with the science classes for a full year. This year, we funded the program at Lord Selkirk in East Vancouver. Thanks very much for your support of this valuable and unique initiative.

Our commitment to you

On behalf of the whole team, we also want to thank all clients for your business. Some of our client relationships go as far back as 28 years. It has been a pleasure and honor to work with you. We often work with many generations for client families, our record being five generations for one family. We feel lucky to do the job we do. While my team works very hard, we all enjoy the freedom and flexibility of this industry where we work for clients and not ‘the boss upstairs.’ In fact, as a former Branch Manager, I can attest to the fact that the managerial set up in our industry is that Investment Advisors work for their clients, and our bosses work for us, to in turn help us service our clients. This may sound corny, but it is true. Not many industries are set up that way, and we feel fortunate to work in an environment like this.

Throughout all the ups and downs of markets, we promise we will do our best to generate a decent long-term return as well as give good client service and advice. In this new world of almost no return on risk-free investments, we need to take some risk on virtually all investments in order to make a decent overall return. This means we have to put up with the volatility that comes with financial markets; and volatility also applies to any fixed income investment that is not deemed ‘risk free’ so at times it is not just the stock component of portfolios that will fluctuate, it will also be the fixed income component. Sometimes, your fixed income pricing will stay the same or even go up a bit in price when stock markets are falling, other times will see your fixed income prices decline, particularly when financial markets are very weak. Our objective of course is to find a good balance between risk and return.

From early 2009 to mid 2015, we had remarkably low volatility (in historical terms). We commented in the past couple of years that at some point, normal and at times higher than normal volatility will return, and as of late, we are experiencing same. This is part of the investing process. Our best advice is to refrain from checking account values daily, try to take a long-term view and be confident that you own a very diverse number of household name companies that sell products and services our world needs combined with fixed income investments that pay a defined cash flow that is guaranteed by each company behind it.

Another commitment is that we will always keep your CIBC Wood Gundy money management costs below industry average levels and strive to eliminate or minimize any additional fees that apply to products we use from outside managers. This does not mean much to returns in the short term but is an important factor towards any client’s long-term rate of return.

Thanks to our clients, our practice continues to grow, and this past year, we welcomed 24 new households. Welcome to all new clients; and we thank all clients who mentioned us to friends or family members.

Introducing a new addition to our team

The growth of our practice requires another person on the advisor side so I am very pleased to welcome Susan Christie, Associate Investment Advisor, to our team. Susan has a very interesting background.

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After graduating from Queens University with a major in Political Science, she took a role as an assistant at a major brokerage firm. She then transitioned into a Financial Advisor role and at the young age of 28, was offered a management position in White Rock. After working in management at a few branches of that firm, Susan left the industry to raise her two children. She then rejoined the work force as a fundraiser for St. Paul's hospital, and from there, took a role as co-manager of the administration team that support our large 140-person CIBC Wood Gundy downtown branch. Susan is very highly regarded by staff. Personally I would have lasted about two days in that role as the first person to ask me a question would have been met with, "Please ask Cheryl, Melanie, or Sylvia how to do that."

Suffice it to say, Susan has great experience in our industry. She was looking to transition back to what she enjoyed most, and that is working with clients directly. Welcome Susan!

All the best in 2016!

Regards,
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Disclaimers

Securities

Royal Bank of Canada	2a,2c,2e,2g,3a,3c,7

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