

Notes

Nexus Investment Management Inc.
Portfolio Management & Financial Counsel

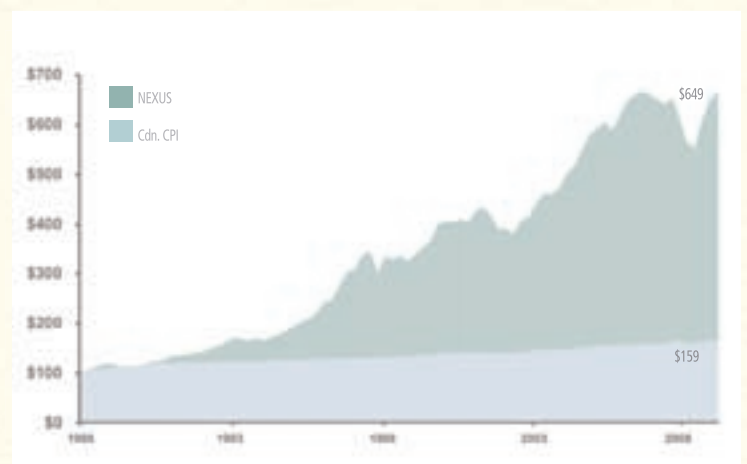
Inside Articles

OH CANADA!
A WORLD IN REHAB
TRUST WORTHY
PEARLS OF WISDOM

Building Value for Clients

Since its establishment in 1988, Nexus has pursued an investment approach which concentrates on real growth in client wealth over the long term. The chart illustrates the impact of this long-term investment thinking – a \$100 investment in a balanced portfolio in 1989 has grown to \$649 at December 31, 2009.

\$100 Investment with Nexus in 1989



Oh Canada!

With the success of the winter Olympics behind us and with spring in the air, it seems Canada continues to garner attention beyond the hockey rink. I am not referring to boisterous singing of the national anthem at whim, but about Canada as having a new global financial presence.

What makes Canada so attractive? According to an article in the *Globe and Mail* in early March, some of the reasons include:

- Canada has the commodities that the rest of the world wants.
- Our banks and financial sector have been deemed “best in class”.
- Our currency is strong and may hit parity with the U.S. currency again in the near future.
- Canada will be the poster child for fiscal health over the next five years compared to other major economies.
- Canada boasts strengths in diversity with a high proportion of foreign born workers with strong market ties.
- Canada offers a highly educated work force. There is no risk of defaulting on sovereign debt.
- Canada has little political risk.
- Our regulatory environment is relatively favourable.

While those points make a good case for a bright Canadian future, we should still maintain a Canadian attitude and remain cautious. One would be remiss

if they didn't consider the health of the rest of world when considering Canada's financial future. Therefore, this rosy outlook may only be on a relative basis and there are still good reasons to remain cautious about the future. In this issue of Nexus Notes there is an article entitled 'A World in Rehab', which considers the implications of the growing global debt burden. The article identifies Canada as enviable because it is one of the only OECD countries where the IMF predicts a decline in indebtedness. However, the rest of world's debt, in particular U.S. debt, will have an impact on future economic growth. This means Canada will still face considerable headwinds. The U.S. just happens to be Canada's key export market. South of the border, rising interest rates, a stalled housing market, and the end of government stimulus spending are expected to have a negative impact on growth.

One of the ways governments tackle the issue of paying off their debts is by increasing taxes. Income taxes in Canada are already significant, so any ideas to reduce the taxes we pay are of interest. As a result, there is an article in this issue of Nexus Notes about how trusts can be used for income splitting.



DCW

A World in Rehab

The stunning collapse of financial markets in 2008 and the deep global recession which followed presented a challenging predicament for governments and policy makers around the world. The credit binge that fuelled speculation in housing and other asset classes had finally collapsed.

In the heat of the moment, there was little choice but to try and stabilize economies through massive government intervention, primarily in the form of spending. Unfortunately, rather than confronting the issue and enrolling in a rehab program, governments instead chose to take the edge off a hangover by having another drink.

Of course, such an approach is not without consequence, and we now face a worrisome rise in the levels of government debts. *Forbes* magazine recently highlighted the work on this subject of Carmen Reinhart of the University of Maryland and Kenneth Rogoff of Harvard.¹ Reinhart and Rogoff found that a ratio of 90% government debt to GDP was a tipping point beyond which economic growth suffered. Simplistically, once a country's debt burden becomes the same size as its economy, then all the increased tax revenue resulting from economic growth is allocated to paying interest on the debt. Nothing is left to actually pay down the debt, other than as a result of strict austerity measures such as tax increases and drastic spending cuts, which in turn reduces growth. A vicious circle quickly becomes apparent: debt depresses growth, which slows the increase in government revenues, which makes paying down federal debt an impossible task.

In figure 1 below, we have provided a forecast of federal government debt levels prepared by the International Monetary Fund. As you can see, debt-to-GDP is near the 90% level in the U.S. already, and is forecast to move well through it by 2014. In the U.S., total federal debt has

ballooned by over 50% from 2006 levels. Around the world, national governments will issue an estimated \$4.5 trillion in debt this year, almost three times the average for the last five years.² By comparison, Canada's position is enviable among OECD countries as the IMF actually predicts a decline in indebtedness. Considering the fact that Canada was a financial basket case as recently as the early 1990s, this is a remarkable achievement.

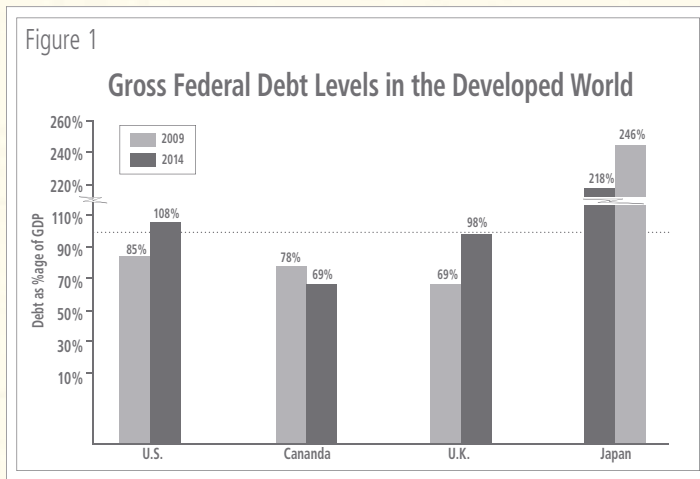
Currently, Greece's fiscal problems have captured the attention of the investment world. However, its pressing issues pale in comparison to what might befall Japan, the 3rd largest economy in the world, and the clear outlier on this chart. Since the collapse of its economy in the early 1990s, Japan's government has spent at levels far exceeding its tax revenues in order to stimulate its economy. Debt-to-GDP rose from 50% in the mid-1990s to over 200% today. Most countries rely on foreigners to finance a large component of the national debt, and in those cases a debt crisis would long since have been a reality. Yet Japan hobbles along under this crippling debt burden for two reasons: interest rates are so low that debt service remains manageable, and that virtually all of its debt is held by its own citizens. Household savings in Japan totals two-thirds of household savings in Germany, France and the UK combined, and much of this savings is invested in Japanese government bonds. While this situation seems unsustainable, there is no obvious near-term catalyst to cause a crisis.

Continued on next page...

¹ Reinhart and Rogoff, *This Time It's Different: Eight Centuries of Financial Folly*, (Princeton University Press, 2009). Quoted in *Forbes*, February 8, 2010.

² "The Global Debt Bomb", *Forbes*, February 8, 2010.

A World in Rehab cont.'d



Source: International Monetary Fund

Of course, federal government debt is not the only debt an economy must support, and the world looks a little different when one adds private debt to the equation. On this measure, the U.S. situation does not look quite as ominous as some others. Based on the fact that banking assets often get financed with the public purse in a crisis, *Forbes* concocted a broader measure of indebtedness by looking at sovereign debt plus the assets of a country's five largest banks compared to a country's GDP. On this measure, the U.S. burden of bank assets plus sovereign debt totals 200% of GDP. This is much less than that in the UK, where it exceeds 500%. Ireland, at over 800%, and Iceland, at over 1,200%, are the leading offenders.

While many lesser developed economies have grappled with debt crises regularly in the past, the situation in the U.S. is a fairly recent phenomenon. In the U.S., debt levels spiked in the early days of the "New Deal" during the Great Depression, but were quickly brought back to normal a few years later. Other than this brief episode, *total* U.S. debt-to-GDP stayed very constant in a band of 130% to 150% of GDP for much of the 20th century. It wasn't until the 1970s that aggregate debt started to grow quickly and it recently reached a level of about 400% of GDP³. Between 2000 and 2007, total credit

grew five times faster than did the nominal GDP in the U.S. This situation, mirrored in so many other countries around the world, clearly is not sustainable.

Historically, individual countries in these sorts of situations have, in addition to austere fiscal measures, lowered interest rates and devalued their currencies. This had the effect of increasing their competitiveness and lowered the cost of their debt burden. In a sense they grew their way out of their problems by relying on economic strength elsewhere in the world. The present situation is notable in that almost all developed economies suffer some degree of the same problem. Interest rates are at record low levels already and, by definition, currencies cannot all devalue at the same time.

Thus, as the saying goes, much of the world finds itself between a rock and a hard place. Over the last several decades the world has become addicted to debt. Just like addicts in more prosaic societal situations, many nations must now embark on a program of rehab. It will not be pleasant. At present, the pain is minimized by the extraordinarily low levels of interest rates around the world. However, interest rates cannot remain at these low levels forever, and as they rise, so will the burden of debt service. The unavoidable consequence of the global debt burden is slower economic growth ahead, and tough decisions by policy makers to raise taxes and cut spending.

We have enjoyed several decades of strong global growth and unrivalled prosperity. We now see that some of this prosperity was borrowed from the future, and we now face the unpleasant task of nursing one nasty hangover.



³ Mark Faber, "Where is the Light at the End of the Tunnel?", *CFA Institute Conference Proceedings Quarterly*, December 2009.

Trust Worthy

In a world where income taxes are still the biggest obstacle to creating and maintaining wealth in Canada, one of the most frequent questions asked is “how can I reduce my tax burden”? Under current tax legislation, there are limited ways to reduce income tax within a family group by income splitting.

Income splitting is a technique whereby income earned in a family is evenly distributed for income tax purposes. This is to ensure that tax benefits that are allowed for each family member – such as low tax brackets, personal tax credits and the small business capital gains deduction – are utilized. One of the methods available for income splitting is through a formal trust, often referred to as a ‘family trust’.

A family trust is an arrangement whereby an individual can allow family members to share in the growth and value of certain property such as an investment portfolio, real estate or a family business, without the individual losing control over that property. Typically, an individual (the “trustee”) will hold property “in trust” for the benefit of family members (the “beneficiaries” of the trust). Title to the property is now in the name of the trust and to the extent income earned by the trust is paid to the beneficiaries, then that income can be taxed in the beneficiaries’ hands. Often the trust is structured such that the trustee may pay the income to any or all of the beneficiaries at the trustee’s discretion. This kind of arrangement is documented in a written agreement outlining the powers of the trustee and terms of the trust. It also means a separate tax payer is created and an annual trust tax return must be prepared.

There are a number of tax planning strategies that utilize a family trust. This article outlines two income splitting strategies.

A FAMILY TRUST FOR ADULT CHILDREN

A trust for adult children (aged 18 and over) may be used in an estate freeze of a holding company (the company holds a portfolio of investments) or an operating company (active private business). Assume in this example that mom and/or dad are the original shareholders and have been receiving all the dividend income from the company. An estate freeze using a trust allows the dividends and growth to be split among more family members.

In this situation, the company’s shares are reorganized such that the current value is frozen in the hands of mom and/or dad and the shares that participate in future growth are held by the trust. The adult children are beneficiaries of the trust. All the reorganized shares can be structured to participate in dividends. A Canadian resident adult child with no other income may receive up to about \$30,000 a year in dividends without having to pay tax.

Due to specific rules in the *Income Tax Act*, income splitting using this type of estate freeze doesn’t work for minor children. Any dividends allocated to a minor child would be subject to tax at the top marginal rates with no personal credits applicable – these specific rules are referred to as the “Kiddie Tax” provisions.

However, no matter what the age of the children, if the company qualifies as a small business corporation and is subsequently sold, then each child trust beneficiary may be able to shelter their portion of the resulting capital gain up

Trust Worthy cont.'d

to a maximum of \$750,000 by using their lifetime capital gains exemption. The “Kiddie Tax” mentioned above on dividend income does not apply to capital gains and therefore minors can participate in capital gains splitting in this scenario.

A FAMILY TRUST FOR MINOR CHILDREN

Despite the “Kiddie Tax” mentioned above, a trust can still be formed for the benefit of minor children and income splitting can be achieved. There are two ways a trust can be used to split income with minor children. The first is where mom and/or dad gift (or loan at 0%) money to the trust and the trustee invests the money in publically traded stocks. Any capital gains realized will be taxed in the minor child’s hands; however, for tax purposes, any dividends and interest will be attributed back to the originator of the gift. The other way is to use a prescribed rate loan (the current prescribed rate is 1%) where mom and/or dad loan money to the trust to create an investment portfolio that is invested in stocks and bonds. All of the income from the investment portfolio can be allocated to the minor child after the trust pays the 1% interest on the loan each year. The interest on the loan must be paid by January 30th following the calendar year for which the interest is due, to avoid tax attribution.

The benefit of setting up a trust for minor children is that they are unlikely to have any other income, so their low tax brackets can be utilized to reduce overall family taxes. In addition to the tax savings, the income that must be paid or payable to the beneficiary can be used to cover expenses that are for the child’s benefit. Some examples of expenses recognized by the CRA as clearly benefiting the child over and above basic necessities include: education and tuition expenses (including private school fees), sports programs, sports equipment, camp fees, vacation costs and allowances paid in cash to the child. If you are a parent looking to get reimbursed for some of these expenses, it is important to keep a record of the expenses.

Trusts are an important vehicle for a variety of tax planning strategies - income splitting is just one example of the use of trusts. Trusts are often also used to reduce U.S. estate taxes, to reduce probate fees at death or even by immigrants to limit taxes on foreign investments. If you are considering the use of a trust in your circumstances, ensure you contact a professional advisor as trust tax planning is complex.



Pearls of Wisdom

Reading is one of the principal occupations in our profession. As the group of us digest a wide range of material, interesting ideas and surprising facts – some serious and some light-hearted – rise to the surface. We attempt to share a few of those with you in each of our issues of Nexus Notes.



- Thanks to recent articles in *The Wall Street Journal*, we were reminded that the technology bubble peaked ten years ago this month. At that time, investors concluded that technology would change the world. They were right. Too bad so many of them lost so much money in the process. On March 10, 2000, the Nasdaq Composite Index closed at a record level of 5,049. It had risen 24% to that point in 2000, after rising 86% in 1999. ‘Money for jam’, as the British like to say. Always the party pooper, your favourite Nexus portfolio manager bet a colleague in the business shortly after it crossed the 5,000 mark that the Nasdaq would hit 4,000 before it hit 6,000. Of course, the bet was won as the Nasdaq collapsed, eventually falling to 1,114 in October 2002 (a fairly noticeable 78% decline). Today it stands at 2,340. The moral of the story is simple – in all times and in all places it matters what you pay for something. Moreover, never underestimate the value of common sense or the madness of crowds. (*The Wall Street Journal*, March 10, 2010.)
- It’s fun to try and imagine what might succeed the Internet as the next great growth opportunity. A number of observers believe it will be the re-development of America’s electric power grid. The current grid was designed more than a century ago and is ageing badly. Who will forget what they were doing at the time of the great blackout in 2003 when a faulty line in Ohio shut down power in much of eastern North America for several days. Utilities are already rapidly expanding their spending on a “smart” grid that uses metering and monitoring devices, and communications technology to help utilities and consumers communicate with each other and better manage energy flow. Currently, spending on these technologies is about \$10 billion a year in the U.S. This is expected to expand to \$40 billion a year by 2015, and to \$100 billion a year by 2030. Recently, a senior Cisco executive surprised listeners when he declared that power networks were a bigger opportunity for his company than was the Internet. (*Barron’s*, March 1, 2010.)
- Andrew Lawrence, research director of Dresdner Kleinwort has developed a skyscraper index. It holds that the effort to erect the world’s tallest buildings often precedes major economic downturns. The planning of the Singer and Metropolitan Life buildings foretold the Panic of 1907; 40 Wall Street, the Chrysler and Empire State Buildings, the Great Depression; the World Trade Centre and the Sears Tower, the 1970s stagflation; and the Petronas Tower in Kuala Lumpur, the East Asian crisis. As it happens, what is currently the world’s tallest building, the Burj, is in the financially crumbling Emirate of Dubai. Next on the skyscraper list: Shanghai World, scheduled for completion in 2012. Mr. Lawrence thinks it may be time to reduce exposure to China. (*Barron’s*, December 7, 2009.)
- Over the last half century, many academics argued that stock markets were perfectly efficient economic mechanisms that discounted all available information instantly and accurately in stock prices. Others see it differently. As Michael Santoli recently wrote in *Barron’s*, “The stock market is essentially an argument over the future, staged over six-and-a-half hours each weekday, among people who can’t even agree what’s most important to be arguing about at any given moment.” Reminds us a little of Bernard Baruch’s quip from many years ago: “The purpose of the stock market is to make fools of as many men as possible.” (*Barron’s*, March 1, 2010.)



NEXUS

Portfolio Management & Financial Counsel

Nexus Investment Management Inc. provides discretionary investment management and financial counselling services to private clients, trusts, estates and foundations.

- Exceptional client service and objective advice:** tailored to the client's individual needs.
- Superior investment performance¹:** long-term record of superior after-tax returns and capital preservation.
- Disciplined investment approach:** "Growth at a Reasonable Price" philosophy, using research and patience.
- Alignment with clients' interests:** as the Firm is wholly owned by its principals, we are committed to your financial success.
- Cost-effective management:** our services are accessible directly, without the costs of branding and distribution.

Nexus Investment Management Inc.
120 Adelaide Street West, Suite 1010
Toronto, Ontario M5H 1T1

William W. Berghuis
R. Denys Calvin, CFA
Geoffrey J. Gouinlock, CFA
Fergus W. Gould, CFA
John C.A. Stevenson, CFA
Dianne C. White, CA, CFP, TEP

Tel: (416) 360-0580 or 1 (888) 756-9999
Fax: (416) 360-8289
email: invest@nexusinvestments.com
website: www.nexusinvestments.com

The Nexus Notes newsletter is published and distributed by the principals of Nexus Investment Management Inc. for the purpose of providing relevant information to our clients and other interested parties. For additional copies, or to be removed from our mailing list, please contact our office.
Publication Mail Agreement 40033917.

¹ A composite of Nexus accounts, managed to a balanced mandate, has earned 7.0% per annum, pre-fees for 10 years. A composite of notional returns from a weighted average of the following indices: T-Bill (5%), Bonds (35%), TSX (35%) and S&P 500 (25%) earned a return of 3.8 % over the same period.