IN FOCUS

IAIC QUARTERLY COMMENTARY

OCTOBER 2021

IAIC
Independent Accountants' Investment Counsel Inc.™

INFLATION AND INTEREST RATES… THE STORY CONTINUES

In our previous Commentary we focused on inflation -- how inflation is tied to interest rates, why central banks focus so closely on inflation and why we as portfolio managers monitor it so attentively. Three months later, inflation and its impact on our clients' investments continues to be front and centre for our portfolio management team at IAIC, so we thought it best to tackle the issue again in this quarter's Commentary.

In the quarter ended September 30, 2021, we saw:

- inflation rates rise higher than most economists anticipated
- a general decline in stock market values during the month of September
- the Chinese Government become more actively involved in various business segments
- a federal election in Canada
- a 'diplomatic hostages' exchange between China and Canada; and
- a Federal Reserve (the "Fed") meeting outlining how future monetary policy actions may unfold.

Following the Fed's meeting in September, Fed Chairman Jerome Powell provided reassurance that monetary policy will remain accommodative until its dual goals on employment and inflation have been achieved. In essence, the Fed is walking a tightrope, allowing inflation to continue by delaying its policy response under the presumption that some of the inflationary impacts we are observing are transitory. This delayed response allows more time for the economy and employment to recover. Once these transitory impacts have worked through the inflation data, if the economy and employment are nearing full capacity and the recovery is entrenched, the Fed can more safely ease off on stimulus and increase interest rates.

Closer to home, the Bank of Canada ("BOC") may move to reduce the amount of monetary stimulus sooner than the US Fed. In August, Canada's annual inflation rate was running at 4.1%, a rate not experienced for almost twenty years. Add to this the perception that Canada is in the midst of a housing crisis (due partially to cheap credit) and these conditions may lead to the BOC acting before the Fed in removing monetary stimulus. However, such actions can have negative consequences in both government and consumer finances as well as the broader economy. We will be watching these developments very carefully.

Mike Williams, CFA, MBA

Advising Representative

Asset Valuations in an Inflationary Environment

One common question we hear from clients is, "How does inflation tie into the price of the investments that I hold?" Corporate profits and stock

prices are impacted by inflation and interest rates in a number of ways:

Transitory vs. Permanent Inflation

First, it is important to differentiate between the impacts of transitory inflation and inflation that is more permanent and entrenched in the economy. Transitory inflation is usually the result of temporary economic dislocations due to the volatility in the prices of key economic inputs, such as commodities, basic materials and food. While very disruptive, the market often looks beyond the impact of these disruptions. For example, the market is unlikely to materially change its valuation of a grocery store chain due to a sudden, temporary increase in the price of fresh produce. Compare this to inflation that is more permanent and entrenched in the economy that has a longer-term effect. For example, rising labour costs due to a permanent shortage of workers has the potential to be a more permanent source of inflation. Wages increase when businesses compete for scarce labour resources. If businesses are unable to pass through these costs, margins will fall, and profitability will be negatively impacted. However, if businesses are successful at passing through their higher labour costs, this can create a more entrenched inflationary pressure in the economy. The determination of the type of inflation (transitory or permanent) is therefore very important to the market, as is the Fed's assessment of which type of inflation it is fighting.

Interest Rates and the Cost of Capital

Rising interest rates will also negatively impact the cost of capital for businesses. An increase in interest rates will not only increase the interest rate on outstanding debt but can also lead to an increase in the cost of equity capital, all of which leads to negative pressure on stock market valuations.

Interest Rates and Future Cash Flows

Generally speaking, rising interest rates can have the effect of reducing the price-to-earnings ratio investors are willing to pay for stocks. This negative impact is more pronounced for companies that have more of their cash flows occurring further out in the future, such as high growth stocks, like technology companies, where the payoff of high profits is many years away. The valuation of these types of stocks is potentially more sensitive to rising inflation and interest rates despite having higher growth prospects.

Interest Rates and Fixed-Income Securities

Rising interest rates also negatively impact fixed-income assets. The contractual stream of cashflow generated by a bond or any other instrument that provides a fixed payment is discounted in the price of that instrument. In general, the longer the investor must hold the instrument until maturity, the more sensitive the price of that asset will be to interest-rate movements. Some income-producing assets may vary the payments they make based upon prevailing interest rates (floating rate instruments, for example). While the price of these assets may be more volatile, during a period of rising rates they can benefit from higher inflation.

Implications for Our Clients' Portfolios

Even before the pandemic, wealth managers who relied on a mix of fixed-income assets with equities to mitigate market volatility for their clients faced significant challenges. With interest rates at record lows and relatively risk-free assets failing to keep pace with even modest inflation, the economic climate leading into the pandemic produced a widening gap in the spread between traditional fixed-income assets in favour of riskier assets such as stocks. With yields falling to under 1% for many high-quality corporate bonds, the propensity of many asset managers was to shift weighting away from bonds to higher-yielding asset classes including preferred shares, stocks and alternative assets. Of course, each client's unique tolerance and capacity for risk and need for income must be considered before pursuing any such strategy.

With inflation rising in the latter stages of the pandemic, we are watching developments very carefully, including the central banks' actions to keep inflation in check and the impacts of these actions on economic growth and its continued recovery. We continue to focus on mitigating the impact of rising interest rates on our client's portfolios, maintaining the purchasing power of their assets so that the income they require from their

portfolios keeps pace with inflation. All the while, we work to produce a reasonable rate of investment return in conjunction with each client's financial planning objectives.

What strategies are we implementing in this economic environment?

- We maintain a short-term (e.g. generally, a five year maximum term to maturity) equal weight bond ladder to mitigate the negative impact of the potential for rising interest rates. Interest rate volatility has a relatively minor impact on short-term bonds and our strategy is designed so that about 20% of the bond allocation matures in any given year. Our focus is primarily on investment grade corporate bonds that offer yields that are higher than those offered by government bonds. If not needed by the client, the proceeds from maturing bonds can be reinvested back into the fixed-income class at prevailing rates or, where appropriate, moved into higher-yielding alternatives, including preferred shares, REITs and dividend paying stocks.
- We invest in profitable "value-based" stocks in industries that can adapt to inflationary pressures by passing on their cost increases to customers and maintaining their margins.
- We focus on stocks that have a track record of consistently paying and raising their dividends over time, effectively providing their shareholders with a 'raise' every year via the increasing dividend.
- We invest, where the valuation is reasonable, in growth opportunities (e.g. the technology sector) for the long-term. We look for sectors and companies that will benefit from emerging trends and shifts in the composition of the broader economy, providing capital gains despite potential higher volatility and sensitivity to interest rates.
- We invest in strong companies with a dominant global presence. These are companies that enjoy relative competitive advantages with operations that are not denominated in a single currency.
- We provide exposure to some sectors or assets, such as preferred shares and financials, that can benefit from rising interest rates and the economic climate associated with inflation.

Conclusion

We continue to believe that market conditions warrant cautious optimism and a balanced approach. We don't make large, risky bets with our clients' retirement savings that can create a binary outcome – a "big win" or a "big loss." We believe diversification is critical, including exposure to asset classes that can perform well in periods of rising interest rates and inflation.

We believe in the maxim that, "Time in the market, not timing the market," is what will help us build our clients' wealth. We continue to monitor the markets and take actions that we believe will not only produce reasonable long-term returns but will also reduce risk in client portfolios.

Keeping Our Record of Your Personal Information Up To Date

We are required to keep your personal information up to date. It is our practice that if we have not had a meaningful conversation with you in the past year about your personal circumstances, we will reach out to you directly in order to update our records and determine if any investment strategy changes are needed. We may reach out to you by phone, letter or electronically. In these times of identity theft, if you are uncertain at all about the legitimacy of our request for information, please contact us to verify that the request is indeed legitimate and originating from IAIC.

If you experience any type of changes in your life, please inform us directly, either by phone:1-877-291- 3040 or by email: ClientServices@iaic.ca.

We look forward to hearing from you!

How The Markets Performed

Grayson Waechter, CFA

Advising Representative

Equity markets were relatively flat during the third quarter. Canadian investors did benefit from a decline in the Canadian dollar to post returns of 2.9% and 2.0% in US & International markets. Preferred shares also had a positive three months as we saw intermediate interest rates rise towards the end of the quarter. It was a strong start to the second half of 2021, but markets were decidedly negative in September bringing quarterly returns down. Even with the September dip, all regions had strong 12 month returns as the market continued to recover from the 2020 lows.

Key Indicators		Sep-21
90 Day Tbill		0.14 %
CPI (Y/Y) (Aug)		4.1%
$U/$C		$0.79
Major Market Returns	**3 Month Total Return**	**12 Month Total Return**
S&P/TSX Composite	0.2%	28.1%
S&P/TSX Preferred Share	2.8%	26.0%
S&P 500 Composite (C$)	2.9%	23.2%
MSCI EAFE (C$)	2.0%	19.7%
IAIC Equity Sector Benchmarks		
Consumer	-3.5%	19.0%
Financial	0.3%	40.2%
Utilities	-0.2%	12.8%
Industrial	1.1%	23.2%
Resource	-1.9%	23.7%

Source: National Bank Financial

Transfer your wealth to your beneficiaries, not CRA

In our last article, we discussed using a financial plan to help you achieve a state of "retirement confidence." Having certainty about reaching your retirement goals is an important step, but your planning is not yet complete. You also need to plan for how to pass down any wealth not used in your lifetime. One question that can help start this process is, "Who do you want to benefit from your wealth?" For most, the answer includes family members and philanthropic organizations. But without proper planning, more of your estate will pass on to the government through taxes with less going to your desired beneficiaries.

Once you've identified who you want to benefit from your estate, the next step in the process is to ensure the transfer occurs as tax-efficiently as possible. Taxes due when your wealth is transferred to your beneficiaries can be significant.

Here are two potential planning techniques than can minimize these taxes.

<u>Charitable giving using investment securities</u>

Most charitable organizations will accept investment securities as a donation instead of cash. These are referred to as donations in-kind and are eligible for the donation tax credit equal to the market value of the investment securities at the time they are transferred to the charitable organization.

When gifting an investment security to a registered charitable organization, CRA does not require the taxpayer to recognize any taxable gains associated with the donated investment securities.

Oliver Lee, B.Math

Vice President IALIA

Life & Living Benefits

IALIA
Independent Accountants' Life Insurance Agency Inc.™

Using an example to illustrate, let's say an individual wants to donate $10,000 to a registered charity. In order to fund that donation, this individual plans to sell $10,000 worth of stock which she originally purchased for $6,000 and make a cash donation of $10,000. When the donor files her tax return she will need to include the 50% of the $4,000 capital gain – i.e., $2,000 -- in income. With a marginal tax rate of 40%, the act of selling those shares to fund her donation added $800 to her tax bill ($2,000 x 40%).

Alternatively, if the donor in the example above had simply gifted the shares to the charity, she would not have had to recognize the capital gain and saved $800 in tax while receiving a tax receipt for the $10,000 donation.

Using insurance for excess corporate wealth

If you have projected excess wealth trapped in your corporation, consider using insurance to transfer this wealth more efficiently to your beneficiaries. See the chart below for an example of what happens for an individual with $100,000 of excess corporate wealth today. In the first example (see the assumptions noted in the chart), the company owned by our individual simply purchases a GIC which will be held until the time of death and then paid out to the beneficiaries. Taxes are paid within the company on the annual income from the GIC and by the time of death, the GIC has accumulated $145,000 in value within the corporation. In our example, income tax of $53,535 will be paid on the distribution of that cash out of the company to the beneficiaries leaving $91,560 after tax for the family. Alternatively, the company could have purchased a life insurance policy on the individual's life with the $100,000 (again, please see the assumptions outlined in the chart). That policy would pay out $223,319 to the beneficiaries at the time of death of the individual – a significantly higher sum than under the GIC alternative.

Contact your financial advisor to explore if these two planning techniques, along with others, might be appropriate for your situation.

With wealth comes great responsibility and we're here to help you maximize the benefit of your gifting strategy.

	TAXES	FAMILY
Do nothing ($100K invested in 3% GIC grows to $145K at life expectancy)	$53,535	$ 91,560
Use life insurance to more efficiently transfer wealth to family ($100K can purchase a guaranteed $236K death benefit at life expectancy)	$12,803	$223,319 (Equivalent GIC rate necessary to match this option is 9.0%)

Key Assumptions:

Male 73 non-smoker—standard health | female 70– non-smoker– standard health | Joint last to die insurance
Corporate tax rate on passive income 50% | Personal dividend tax rate 47% | UL interest rate 1.5%
See concept illustration for full details | Assumed life expectancy on joint last to die is 21 years.

Conflicts of Interest - What You Need To Know

In October 2019, the Canadian Securities Administrators passed comprehensive regulatory reform, referred to as the Client Focused Reforms (CFRs). Part of the CFRs relate to how Portfolio Managers, such as IAIC, assess, manage, and monitor any existing, potential, or reasonably foreseeable conflict of interest, and how we ensure any potential conflict of interest is always addressed and managed in our client's best interest.

At IAIC, we pride ourselves in always acting in our client's best interest. We address and manage conflicts of interest in many ways – by managing conflicts through internal controls, avoiding conflicts wherever possible, and by ensuring transparency with our clients through continuous disclosure of any existing or potential conflicts of interest.

We have posted to our website a complete list of existing or potential conflicts of interest that may exist between our firm and you, our client. This can be found by visiting www.iaic.ca/COI. The listing explains how each of these conflicts is addressed and managed in your best interest. In addition to posting it on our website, we also distributed the list to you along with your June 30, 2021 IAIC Quarterly Statement.

As always, please contact us by phone at 519-291-2817 (toll free 877-291-3040) or send an email to compliance@iaic.ca with any questions you may have.

Your IAIC Quarterly Statement is now accessible through the IAIC Client Portal

Sign-up for eStatements now and help reduce our carbon footprint

Benefits of electronic statement delivery:

- Environmentally friendly…..no paper. IAIC has already reduced our paper usage by 31,900 sheets
- Receive your statement sooner. We will send you an email to let you know when your statement is ready
- More secure delivery verses an envelope in your home mailbox
- Easier to organize and save electronic copies compared to paper statements

IAIC Disclosures

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