A PORTFOLIO MANAGER'S PERSPECTIVE

Applying Harbour's investment process to the Canadian Equity Value Pool

WEALTH MATTERS

*As part of our November 11, 2017 Wealth Matters webcast, we heard from **Peter Hofstra**, Senior Portfolio Manager, and **Brian Huen,** COO & Research Director, of Harbour Advisors. Their presentation provided an overview of the team's investment process that prioritizes capital preservation and risk management to deliver consistent returns. **Peter** and **Brian** also discussed their outlook for the Canadian equity market and how they apply their investment approach to the Canadian Equity Value Pool.*

Harbour philosophy

- We are protectors of capital, independent thinkers and bottom-up stock pickers looking for quality long-term partners
- Developed team with a strong breadth of experience and collaborative culture
- Analysts cover their sectors globally and in Canada, have logical coverage universes, as well as both cyclical and defensive sectors
- All analysts follow a common disciplined investment process to produce strong results.

Investment selection

We are bottom-up stock pickers who focus on identifying and investing in individual companies with superior properties. The qualities we look for in prospective Harbour investments are similar to those found in successful private businesses:

- Strong cash flow generation in a range of economic environments
- Conservative capital structure
- Above-average secular growth
- Self-managers to extract more value from the business
- Shareholder-focused management that is transparent and communicative.

How we think about risk

- Manage risk first to enhance return – protect from the big losses
- Capital preservation is paramount
- Understand individual companies to get successful businesses at the rational price.

Macro awareness

- Economic and political environments can affect the overall investment environment and individual corporations in a number of ways
- However, need to consider the "what ifs" and look for the outliers
    - For example; lower interest rates have allowed the relationship between stocks and bonds to break down at a time when the stock market is at near historic highs.

Canadian equity market

- Canadian economy is surprisingly strong, facilitating an increase in interest rates, and the Canadian dollar is at a fair value
- However, debt levels remain historically high and the challenging energy market is here to stay
- Upside: Coordinated global growth is good for commodities and Canada, and stimulus supports job creation and consumer debt levels
- Downside: Possible diminished trade with the U.S., and high debt levels which make the economy potentially fragile.

Portfolio construction

1. Screen universe for companies that meet a minimum quality threshold.
2. Assign quality rating to all potential investments.
3. Follow an independent forecast and financial model to estimate the rational price.
4. Lean on concentration to add value.
5. Strive to deliver consistent returns with a strong team, broad coverage list, rotation to value, and sector and liquidity risk management.

Canadian Equity Value Pool

- Took over the fund in July 2017 and changed how non-Canadian exposure is managed
    - Before, 25% of the portfolio was allocated to U.S.
    - Now use that 25% to gain exposure to sectors and companies not available in the Canadian market
- Use a structured process consisting of quality score and return rank, rotation to highest return ideas, strict sector rules, risk management protocols and actively hedge non-Canadian exposure.

A WEALTH PLANNING PERSPECTIVE

Proposed tax measures of private corporations: How they could impact you

WEALTH MATTERS

*0n July 18, 2017, the Department of Finance released its discussion paper "Tax Planning Using Private Corporations," which included proposed tax measures that would significantly impact the taxation of Canadian Controlled Private Corporations. During the Wealth Matters webcast, **Salman Khan**, Regional Vice-President, Wealth Planning at Assante Private Client, discussed the proposed legislation relating to three tax-planning strategies, what has changed since then, and what this means to Canadian business owners moving forward.*

1. Income sprinkling using private corporations

A. Extension of the tax on split income (TOSI) rules

- Strategy where business owners shift income from an individual at a higher tax rate to one at a lower tax rate
- *July 18 proposal*: Introduce reasonableness test for adult family members aged 18-24, and 25 and older on January 1, 2018
- *October 16 announcement*: Continue with July 18 proposal on TOSI rules and will clarify what is considered "reasonable"
- *Next steps*: Business owners should review their corporate structures, including who their shareholders are, their age, and how they are connected to or involved in the corporation, to determine any potential tax planning opportunities for 2017.

B. Lifetime capital gains exemption (LCGE)

- Exemption of up to $835,716 in capital gains from the sale of qualified small business corporation shares, or $1 million for a qualified farm or fishing property, which can be multiplied among other shareholder family members or through a trust
- *July 18 proposal*: Disallow exemption of gains accrued before the tax year the shareholder turned 18 or through a family trust
    - This could have a significant impact on those planning to pass their business on to the next generation
- *October 16 announcement*: Government will not move forward with measures that limit access to the LCGE.

2. Holding passive assets inside a private corporation

- Assets are taxed at lower corporate rates resulting in deferral opportunities and more after-tax dollars available for investment
- *July 18 proposal*: Implement alternative deferred approaches to curtail perceived benefit
    - Would result in higher tax costs, compliance burden, and impacts to business owners' retirement and succession plans
- *October 18 announcement*: Set a $50,000 threshold of annual passive income and grandfather all past investments (and the income earned from those investments), to allow businesses to save for contingencies and future development
- *Next steps*: Require clarification on how the threshold will be applied and how protected investments will be tracked.

3. Converting a private corporation's regular income into capital gains

- Extraction or "stripping" of funds as capital gains, which are taxed at a lower tax rate, instead of dividends or salaries
- *July 18 proposal*: Introduce rules to prevent the conversion of income into capital gains
    - Could impact tax-free capital dividends, and estate and post-mortem planning such as intergenerational transfers
- *October 19 announcement*: Government will not move forward with measures on conversion of income into capital gains
    - Government will continue to work with business owners to ease the transfer of business to the next generation.

Small business income tax rate

- Federal small business income tax rate will be reduced from the current rate of 10.5%, to 10% after January 1, 2018, and 9% on January 1, 2019, however, the corresponding personal non-eligible dividend tax rate will increase.

Next steps… reach out and speak with your tax advisor as soon as possible to consider any tax planning considerations for 2017.

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