NORTHWOOD FAMILY OFFICE

ALSO IN THIS ISSUE:

Chairman's Message

Tom McCullough

I hope that you had an enjoyable and relaxing summer. Unfortunately, for many investment managers it has not been very relaxing. The prevailing theme for the global stock markets has been *volatility*, and many expect the unsettling conditions to persist into the fall.

At Northwood, we are always thinking about risk (especially in the midst of volatility) and how to take a level-headed approach to guiding our client families through times of uncertainty. There are many things investors cannot predict or control (i.e. investment returns, inflation, black swan events), but there are some things they can. Every family is different, but the exhibit below provides some of the more universal ones. The more of the 'controllables' we can manage and lock down, the less negative impact the 'uncontrollables' will have when things go badly.

Things you can control/ predict (at least somewhat!)

Costs
- Fees
- Taxes
- Turnover
- Complexity/time

Personal decisions
- Spending
- Years of work
- Sale of business
- Amount of debt
- Building a reserve in good times

Investing strategies
- Basic diversification
- Margin of safety
- Rebalancing
- Dividend re-investment/ compounding

Planning/ Behavior mgt
- Reasonable ROR target
- Being satisfied with enough
- Conservative assumptions
- Self control strategies
- Plan / manager consistency

Innate characteristics
- Capacity to handle illiquidity
- Capacity to handle volatility

For instance, as the article on goals-based investing in this newsletter explains, the financial well-being of investors is often better protected from external market shocks if their investment strategy is structured to match their cashflow-related goals, such that they only take on the minimum amount of risk required to meet their goals. A family might not know the return it will earn on its portfolio, but it can more easily forecast its cash needs by taking the time to quantify its more predictable goals, such as the amount it reasonably expects the family members to spend during their lifetimes.

As frequent readers of this publication will know, Northwood is a member of the Wigmore Association, a group of eight single and multi-family offices from around the world. The CIOs of the group meet every six months to exchange views on the outlook for the global economy and markets, share insights on investment strategies and managers, and discuss best practices for serving wealthy families. The next meeting will take place in London, England at the end of September and we are keen to hear insights from our colleagues regarding their experiences through this latest period of market volatility.

We are also excited to once again be participating in the Family Wealth Management course for family members, offered through U of T's Rotman School of Management. The course will be held in Toronto and take place this coming October 22-25. If you are interested in more information on this 3-day course, please check out the website or contact me.

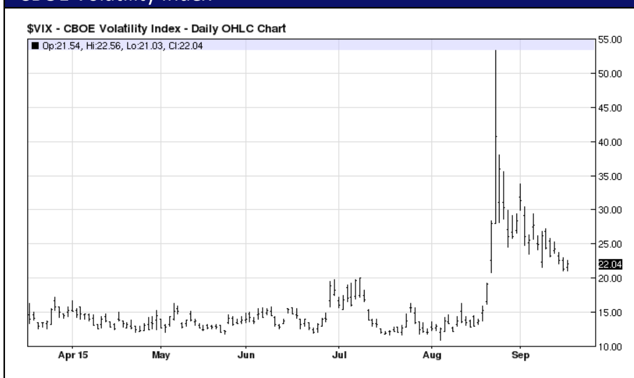
Tom

The Return of Volatility

Dan Solomon, MBA, CFA, CFP

Over the past month, global equities have been on a roller coaster as market uncertainty spawned a decline in valuations along with significant price volatility. Investors have been reacting to disappointing economic readings for China, a lack of clarity over a potential rate hike by the US Fed, and the continued struggle of the world's oil producers.

CBOE Volatility Index



Source: www.barchart.com/charts/stocks/$VIX

Following six years of rising stock prices south of the border, a market correction should not be much of a surprise, and some commentators would argue that markets were long overdue for one. It was not a matter of *if* prices would ultimately drop, it was a matter of *when*. Nonetheless, market turbulence is an uncomfortable time for most investors, especially with a heightened level of volatility. For instance, on August 24 the Dow Jones Industrial Average plunged a staggering 1,000 points during the trading day, before climbing back to close down *only* 588 points. Not for the faint of heart! Daily

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WEALTH EDUCATION PROGRAM FOR FAMILIES – October 22-25, 2015

On the heels of the very successful inaugural Family Wealth Management course in 2014, the University of Toronto's Rotman School of Management is pleased to offer the program for a second time. The 3-day intensive Family Wealth Management program for family members and family office staff will be held in Toronto on October 22-25, 2015, and will be taught by Tom McCullough and other key faculty members and wealth management leaders. For more information and to enroll please visit: http://tinyurl.com/od5kr7s swings of large magnitudes have become all the more frequent in this day and age. Information is more plentiful and investors can react swiftly with the use of products and technological advances such as ETFs and high frequency trading. The result is a more volatile investing environment.

You Cannot Avoid Volatility, But You Can Plan for It

For investing families who subscribe to the philosophy that conservative equity investing can deliver a superior long-term return, we believe that there are ways to provide some protection from the short-term movements in the market, no matter how extreme. As we said, you cannot avoid volatility, but you can certainly plan for it.

The Goals-Based Approach to Investing

Similar to a corporation or institution, every wealthy family has their own set of financial resources (assets) and goals (liabilities), which are reflected on their family's balance sheet. The largest component of the liability side is typically the family's spending goals. These are the expected cash requirements for the family members throughout their lifetimes. The asset side of the balance sheet is the family's capital, which is used to cover its cashflow requirements. Proper planning ensures that the composition of the family's capital is well-matched to its spending goals. This is the *goals-based* approach to investing that is so helpful during times of market uncertainty.

A family that has done the important work of quantifying its goals might find that it only needs a modest portion of its total capital to meet its lifetime spending objectives. In its portfolio, a family will often match these expected cash outlays with offsetting higher-liquidity, lower-risk assets such as quality fixed income and conservative high quality dividend-paying equities. Thus, if the stock market declines in the short-term, the family will still have sufficient capital to ensure that its lifetime spending objectives will not be compromised.

Conversely, the family's longer-term spending objectives, such as legacy gifts, can be met by potentially higher return investments (generally with higher risk) such as growth equities. If there is no need to liquidate these investments for cashflow needs, then the family's equity holdings can weather sustained periods of price pressure and volatility without causing any undue stress to the family.

By taking a goals-based approach to investing, the portfolio will be structured in such a way that the family will take on only the investment risk they need to take and can afford to take. The end result is that people can sleep well at night feeling confident that their needs and goals will still be met, no matter the prevailing market conditions.

Back to School – Time to Review Your Family's Education Funding

Barrett Lyons, CPA, CA, CFP, CIM

The *registered education savings plan* ('RESP') is a government program established to help families save for their children's post-secondary education. We administer a number of these for our clients, and they are a great program for helping families dedicate capital for an important value – education. The RESP is a great vehicle, but it may also be supplemented or replaced with other tax planning opportunities available (e.g. income splitting with a family trust) depending on the facts and circumstances of the family.

Establishing an RESP is quite easy, and there are three primary benefits to the program:

1. The government will match 20% of your contributions (subject to annual limits) up to $7,200 lifetime limit per child;
2. Income earned in the account grows tax-free until it is withdrawn. When withdrawn, the income is taxed in the hands of the beneficiary (and hopefully the majority of it is offset by tuition and education tax credits); and
3. Having a dedicated account allocated to funding your children's education provides the confidence that this goal is looked after.

The lifetime limit on contributions to the plan is $50,000 per child which essentially allocates sufficient capital to provide for one post-secondary education program in Canada. If your child plans to attend school in the US or graduate programs, they will require additional funding beyond the scope of the RESP due to the limit on capital contributions.

Once the RESP is established, the next step is to determine how to best fund it. There are a number of strategies for funding the RESP, and the best option will depend on the family and its specific circumstances. Assuming cashflow is not an obstacle, generally there are two optimal strategies for funding the program:

1. Make the minimum annual contributions to maximize the grant received from the government
2. Funding the maximum $50,000 up front and forego the benefit of the government grants

Funding the RESP with the maximum in the first year may come as a surprise as a possible strategy, but if the return on the portfolio is sufficient, the annual income on the portfolio may surpass the value of the grants. Some families may prefer the 'free money' (in the form of future grants from the government) as a matter of principal irrespective of any financial benefit from front loading the plan. To determine which is more beneficial we ran projections for each

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strategy using the following assumptions:

Funding Strategy 1 – Spread out
- $16,500 contribution in year 1
- $2,500 contributions from years 2-14
- $1,000 contributions in year 15
- Total grants received = $7,200
- Income on uninvested capital held outside RESP until RESP is fully funded is taxed at 30%

Funding Strategy 2 – Front-end loaded
- $50,000 in year 1
- Total grants received = $500

Cost of Education
- Annual cost of attending Ontario university (excluding spending money)

Tuition and Fees	$8,000
Books	$1,500
Food	$4,000
Housing	$6,000
Other	$500
Total	$20,000

- Cost of education is inflated at 2% per year
- Withdrawals for education begin at 18

The results of the projections are summarized in the accompanying table.

RESP Funding Strategy Comparison

	Portfolio Balance at Age 21		
Return	*Strategy 1*	*Strategy 2*	*Difference*
0%	(60,533)	(67,233)	6,700
1%	(50,495)	(57,246)	6,751
2%	(38,288)	(44,712)	6,424
3%	(23,528)	(29,103)	5,575
4%	(5,764)	(9,789)	4,024
5%	15,526	13,983	1,543
6%	40,955	43,104	(2,149)
7%	71,235	78,634	(7,400)
8%	107,193	121,831	(14,638)
9%	149,793	174,179	(24,386)
10%	200,153	237,434	(37,280)

In all scenarios, with returns below 5%, the RESP will have a shortfall in funding, which would then require additional capital outside of the RESP to fund the education. In scenarios where the return is from 0-5%, Strategy 1 is more advantageous but not by a significant margin. In scenarios with an annual return of 6% or beyond, the lump sum contribution is more beneficial as the initial capital will accumulate faster in the earlier years compared to the alternative. The 'best' solution will depend on the circumstances of the family but this provides a general overview.

Existing Plans

For any existing plans, the back to school time is an annual reminder to check-in to review the family's RESP to see if any adjustments are required. Consider the status of the following:

- What is the timeline for your children to attend school?
- Does the asset mix and managers align with the above timeline?
- If your children plan to attend post-secondary school shortly, has a plan been established for withdrawal of the funds (i.e. liquidity, timing, and taxation)?

The benefits of the RESP are significant compared to the alternative and making the incremental investment in time to administer the program is worthwhile – especially to achieve a meaningful goal for most, if not all families.

The Rules are Changing for Some Common Estate Planning Strategies

Andrew Jeffery, CPA, CA, CLU, CIM

Is your will up to date?

Come January 1st, 2016 it might not be, as a number of legislative changes are coming into effect that will significantly alter the tax and administrative treatment of a number of commonly used estate planning strategies.

To assist in identifying whether your estate plan will be affected, we have highlighted the key changes that will soon take effect.

Taxation of Testamentary Trusts

A testamentary trust is a trust created on an individual's death through the provisions in their will. The purpose of this type of trust can vary, but it is most commonly used in post-mortem tax planning strategies to reduce the surviving family's overall tax expense.

Under the current tax rules, a testamentary trust pays tax on its earned income at graduated rates similar to that of an individual. As a result, tax savings can be achieved by holding estate assets in trust for a beneficiary, as opposed to distributing assets directly to them. It has therefore become a common estate planning practice to set up one or more testamentary trusts at one's death with the intent of minimizing the ongoing tax burden of the estate beneficiaries.

The **new tax rules** will eliminate the graduated tax rates for testamentary trusts and impose a flat tax rate on earned income which is equal to the *top marginal rate* applicable to individuals. This will result in the loss of the tax advantages that are currently being enjoyed through the use of multiple testamentary trusts. Some relief from the flat tax will be provided during the period where an individual's estate is being administered, by allowing the estate access to graduated tax rates for the first 36 months following the individual's death.

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Existing estate plans should be reviewed if they include the use of testamentary trusts for the sole purpose of minimizing tax. It should be noted that these changes do not mean the end for testamentary trusts, as there are still a number of valid non-tax driven reasons to include their use within one's estate plan. Some common examples of these uses are: to provide for a spouse, minor children or disabled individuals, and to control the timing of when a large inheritance will be received.

Introduction of New Qualified Disability Trusts

As mentioned above, providing for an individual with a disability is often an ideal situation in which to use a testamentary trust as part of an estate plan. Fortunately, the government realized that the new changes to the testamentary trust rules were going to unfairly punish individuals in this situation and are providing relief in the form of a new testamentary trust named a *Qualified Disability Trust*.

A Qualified Disability Trust will essentially follow the current testamentary trust rules in place (pre January 1, 2016), where income that is earned and retained in the trust will be subject to graduated tax rates similar to individuals. Creation of these trusts can be achieved through provisions included in an individual's will, and there will be an ongoing requirement for the beneficiary to file an election indicating they are still eligible for the disability tax credit. Failure to file the annual election will result in a loss of the trust's preferential status and could trigger punitive tax consequences.

Existing estate plans should be reviewed to determine whether the use of this special type of trust is applicable. As this type of trust is not created automatically, executors of the estate should be aware of the intent to utilize these new trust provisions to ensure the proper elections are correctly filed.

Taxation of Life Interest Trusts – Spousal, Joint-Spousal, and Alter-Ego Trusts

A life interest trust is a trust created to provide income for a living beneficiary, while restricting their ability to access the trust capital. This type of trust is commonly used in situations where an individual wants to provide an income stream to one beneficiary, but would like the capital of the trust to be protected and ultimately passed to another.

Under the current tax rules, a life interest trust is deemed to dispose of all its assets at fair market value on the death of the income beneficiary. The income triggered on the deemed disposition will be taxable to the trust and the trust will be liable for any resulting tax.

The **new tax rules** will still trigger a deemed disposition of the trust assets on the death of the life interest beneficiary, but will now charge the income and any resulting taxes payable to the deceased individual's estate as opposed to the trust. This separates the tax liability from the assets that triggered it, and may create administrative issues if the deceased's estate does not have sufficient assets to cover the liability.

Existing estate plans that include the use of a life interest trust should be reviewed to determine the impact of these changes. Planning may be required to estimate the tax liability, if any, that will be triggered on the life interest beneficiary's death and ensure that their estate will have sufficient assets to cover the bill.

Increased Flexibility of Charitable Gifts on Death

Many individuals allocate a portion of their estate for charitable purposes and receive tax credits to help reduce their tax liability at death as a result. Under the current rules, chartable gifts are claimed on the final tax return of the deceased individual creating a tax credit that can be used to reduce taxes owing on their final return.

The **new rules** will allow for greater flexibility in terms of how donations through an estate are treated. The donation credit will now be able to be claimed on either the individual's final tax return or the estate return, which ever is more beneficial. It is important to note that for the credit to be claimed by the estate, the donation must be made within the first 36 months of the estate's existence.

Existing estate plans should be reviewed to determine the impact of these changes and whether they present a planning opportunity. As always, the appropriate legal counsel and tax professionals should be consulted before making any changes to your will or estate plan.

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