Winter 2016

NORTHWOOD FAMILY OFFICE

ALSO IN THIS ISSUE:

Chairman's Message

The Six Values a Good Advisor Provides to Clients

Tom McCullough

The other day, I was reading one of my favourite blogs (*The Nerd's Eye View* by Michael Kitces) and came across an article about the six values a good advisor provides to their clients. It really resonated with me. The article is based on industry pioneer Mitch Anthony's *Return on Life* concept, and I have borrowed heavily from it below.

I thought that sharing these six values were a good way to start the New Year. They are a good reminder to advisors about what they *should be doing*, and a cue for clients about what they *should be expecting*. And if they are consistently absent from a client-advisor relationship, they might also be a catalyst for a conversation, and possibly a change, if the circumstances warrant. Here are the six values, and how we at Northwood think about each of them for our client families.

1. **Organization: We help to bring order to your financial life.** Most families of wealth have multiple advisors, service providers, investments, and products, as well as a range of goals (financial and otherwise), multiple family members and ever-changing circumstances. And all of these components are interconnected. It's hard to manage unless you are on top of it on a full-time basis. A good advisor will bring order to the chaos and give you a sense of confidence.
2. **Accountability: We help you follow through on financial plans and commitments.** We start by determining what your goals are, how much it will cost you to fund them, and what the most sensible plan is to ensure that they actually happen. We also regularly review your progress towards achieving your goals (particularly as financial markets and family circumstances change) and help you stay on track.
3. **Objectivity: We bring clear thinking and independent perspective to each decision.** When stress levels are high due to swings in financial markets or family issues, a good advisor provides balanced, objective counsel, which reduces the risk of costly emotionally-based decisions. We also bring objectivity to the client relationship by ensuring that 'we both sit on the same side of the table' – no hidden fees, no products to sell, no incentives to do anything but what is best for our client.
4. **Proactivity: We work with you to anticipate your major life transitions and be financially prepared for them.** Because we get to know all aspects of your family and financial affairs, and because we have significant experience with other wealthy families, we know what events and requirements will be coming up, and how to prepare for each one. It means that fewer things fall between the cracks and there are fewer unpleasant surprises.
5. **Education: We help you to understand key issues, risks and opportunities so you can make more confident decisions.** Most clients are not experts in wealth management and they don't need to be. But they do need to make choices, and in some cases will need additional education to improve their knowledge. We provide this training and experience, both for the current wealth holders and for upcoming generations as they prepare for independence.
6. **Partnership: We work with you and your family as a trusted partner to help you fulfil your goals and live the best life possible.** We are not just a 'provider' or an 'advisor'. We are invested in the success of your family and committed to walking with you over the long term. Along the way, there will be 'give and take' and 'ups and downs'. We will be there to tell you the truth, remind you of the route you chose, and help you make good choices at each turn.

As a new year begins, I am mindful of the great responsibility we have to our client families and of the privilege we have to be a part of their lives. We are grateful for the confidence they place in us every day. Reflecting on the values listed above reinforces my view that the work we do with families is a calling, and it inspires me (and all of us at Northwood) to be the best we can be. Here's to another great year ahead!

Tom

Maintaining Perspective in Down Markets

Eric Weir, CFA, CFP

By now, pretty much everyone is aware that the beginning of 2016 has been a challenging time for investors. You have also no doubt heard the calls to "sell everything now" from worried economists, as well as the comparisons of the recent equity market selloff to what took place in the credit crisis in 2008, suggesting that we are in store for a similar type of pullback. In times like these, when nerves are frayed and it might be tempting to throw in the towel and run for the hills (to mix our metaphors!) it is helpful to remind ourselves of the importance of maintaining perspective.

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Corrections Will Happen Again and Again and…

The trajectory of US equity markets over the very long run has been upwards, to the tune of roughly 8-10% per year on average. However, the path has been far from a straight line. There have been many blips along the way. Today there is concern over a slowing China and falling commodity prices, in 2011 it was the debt crisis in Europe, in 2008 the global credit crisis, and in 2000 the dotcom bubble. The list goes on and on. For this reason, we should not be surprised by this latest period of market turmoil. In fact, with US markets having enjoyed a nice bull run since 2009, this most recent correction is actually welcomed by value-oriented investors such as ourselves, as it brings a sense of order back to the equity markets where many stocks had been trading at unreasonable valuations relative to their fundamentals.

Ignore Temptation of Trying to Time the Market

While it may be enticing, if you've tried to 'time the market' and move funds in and out over the short term you know it can be a challenging and often perilous exercise. Getting *out* is one thing. Knowing when to get back *in* is another thing altogether, especially when the best time to get back in is usually when the news seems to be at its worst.

And the cost of staying in cash over the long term is very high because you fall behind inflation and your capital doesn't grow to meet future needs. For instance, if you invested $100 in 1900 in the following assets (based on U.S. data), this would be the result in 2014 (*after* the effects of inflation):

Cash/ TBills:	$560
Bonds:	$1,260
Stocks:	$63,600

Quite a difference! This has been the case, more or less, over all long periods of time. There are only two periods (the 1930s and 2008) when the 10 year annualized nominal return on stocks was negative, and then only briefly. As mentioned, the average had been about 8-10%, including all crashes, recessions and corrections.

It is worth noting that we tend to believe that the future trajectory of equities is likely to be somewhat weaker than typical due to slower global growth, lower-than-average dividend yields and a number of other factors, to be covered in a future article. We typically assume equity returns of 6% in our cash flow forecasts to reflect this view and to ensure we are taking a conservative stance.

We help our client families avoid the potential pitfalls of trying to time the equity markets by guiding them to:

1) Limit their risk by concentrating on achieving the returns they *need* to earn from the equity component of their portfolios. This can be done by following a goals-based investing approach.
2) Focus on protecting capital by working with equity managers that have an ability to perform better on a relative basis during periods of poor markets.

Goals-based Investing – Knowing What You Need to Meet Your Goals Will Make It Easier to Stay the Course

Every family has financial goals that need to be met throughout their lifetime. For the majority, the most obvious goal is the desire to have enough liquid capital to meet their daily spending requirements. Families who have an understanding of their cash flows and have done the work to quantify them will be able to structure their investments to have the minimum amount of risk exposure i.e. just the amount of risk they *need* or can afford to take.

In following this approach, the family's lifetime goals will be met with more conservative components of the portfolio, such as dividend paying stocks and fixed income. These types of holdings will be more resilient to market declines and still generate income, which will help to ensure that the family's goals are less likely to be compromised due to a short term market event. Legacy goals, such as bequests, can be met by higher return (and likely riskier) investments like capital gain-oriented stocks. Because of the longer horizon for these investments, the inevitable volatility will be easier to withstand because the need for the capital is not imminent.

The end result is that the family will be able to rest easy and feel comfortable that their goals will still be met no matter the prevailing market conditions, allowing them to stay the course with their investments even during periods of volatile markets.

Focus on Protecting Capital

In our approach to investment management, our primary focus is the preservation of client capital and meeting the target rate of return, rather than aiming for above average returns during each measurement period. Our client families have often taken many years and significant risk to build their capital, and it is our job to ensure that it is protected and meets their future needs. As a result, we only employ equity managers that share the same philosophy for client investments. The managers we select have had very good success over the long term preserving capital in poor markets, which has allowed the portfolio to grow when markets rebound. They accomplish this by the conservative approach they take to investing. Within their mandates, it is common to find some of the following features that have helped our client portfolios outperform during periods of down markets:

1) **They hold high-quality, defensive stocks:** These are typically established companies with significant cash flows and high debt coverage ratios. They have been around for many years and have therefore successfully navigated through times of uncertainty.
2) **They diversify both by region and sector:** Canada's market is

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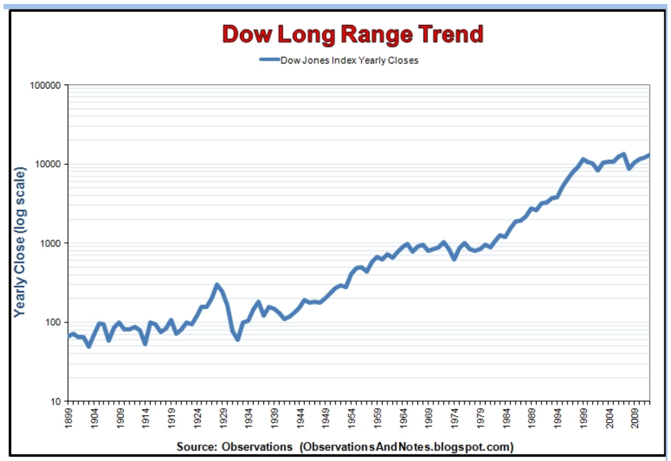
dominated by three sectors, two of which are highly cyclical (i.e. energy and materials). Investing outside of Canada allows for greater exposure to less cyclical sectors such as consumer staples and healthcare, as well as exposure to currencies other than the commodity-dependent Canadian dollar.

3) **They will only buy value and will hold cash if necessary:** If valuations are too high and there are no intriguing opportunities, significant cash positions can be held, which will insulate the portfolio from some of the short term movements in the market and can act as dry powder to take advantage of opportunities when prices eventually fall.

If you look at a historical chart of the major stock markets, the periods of market decline (which feel so significant at the time) seem to disappear in the long term uptrend and it turns out that the periods of turbulence and stock market declines have been good times to enter the market.



Markets will continue to ebb and flow. That is certain. In the long run, we believe that the best way to succeed through the turbulence is to follow a goals-based approach to investing and stick with managers who focus on protecting capital. This will help you structure your portfolio in such a way that you will be able to maintain perspective and stay the course during even during the most tumultuous of times.

Taxing News

Barrett Lyons, CPA, CA, CFP, CIM

Happy New Year to all and best wishes for a happy and healthy 2016 to you and your family! Unfortunately with the New Year comes new tax changes for 2016, which on whole are not favourable for wealthy Canadian families. One of the key Liberal campaign messages was to increase tax on 'the rich' and provide tax-breaks to the middle class. The following is a list of the most pertinent changes we have seen for individuals to begin in 2016:

- Reducing the TFSA contribution limit for 2016 to $5,500 (no change to the $10,000 limit for 2015).
- Introduction of a new federal tax bracket on income over $200,000 – an increase from 29% to 33%, which will put most provinces above the psychological barrier of 50% tax.
- A federal tax cut of 1.5% on the $44K to $89K tax bracket, worth approximately $700.
- Elimination of the family tax cut, proposed by the previous government, that would have saved families up to $2,000 by transferring up to $50,000 from a higher income spouse to a lower income spouse.
- The stock option deduction benefit will be limited to $100,000 on stock options granted after a future date to be determined. Existing options and those granted up to said date will be grandfathered under existing rules, where eligible, allowing individuals to deduct up to 50% of the value.
- Corresponding changes to the corporate tax system to provide for integration between earning investment income personally versus within a corporation.

Further items on the Liberal campaign platform that we may see down the road include the following:

- Changes to the rules of the small business tax program to ensure that "the CCPC status is not used to reduce personal income tax obligations for high income earners rather than supporting small businesses." Details are quite vague on what changes may be proposed, but this may have a significant impact on Canadians with professional corporations.
- Enhancements to the CPP program - likely to mean increased premiums and benefits. Ontarians should also stand by, as changes to the CPP program will surely impact the recently-introduced Ontario Retirement Pension Plan, potentially cancelling it altogether.
- Restoring OAS eligibility to age 65 from age 67.
- Replacing the existing child tax benefit system (a combination of the universal child care benefit, Canada child tax benefit, and National child benefit supplement) with a new streamlined child benefit program that is tied to income.

With promises of increased spending and growing deficits over the next few years combined with the battered price of oil and a majority government, higher income Canadians should not expect any significant tax breaks in the near term. It may be worthwhile to revisit your financial plan to ensure you are taking advantage of tax planning opportunities that may be available to you. One thing to consider for those with a holding company is to evaluate the option of accelerating dividend payments in 2015 to take advantage of the lower rates.

Preparing for the Upcoming Life Insurance Rule Changes

Q&A with Adam Shapiro of Guilfoyle Financial Inc.

Scott Hayman, CPA, CA, CFP, TEP

In his recent article titled "Best Before 2017" featured in the December 2015 issue of CPA Magazine, Adam Shapiro, a partner at Guilfoyle Financial Inc., outlined the changing rules for life insurance that will take effect January 1, 2017. Northwood recently caught up with Adam to find out the details of the rule changes and what individuals can do before the changes take effect.

1. *To get things started, can you provide some insight into what types of life insurance policies will impacted by the changing rules?*

The pending changes to the taxation of life insurance products will be comprehensive. The new rules will impact all the products you and your clients would be familiar with, including:

- Term insurance (e.g. Term 10 or 20);
- Term to 100;
- Universal life; and
- Participating whole life

In addition, there will be changes to the taxation of prescribed annuity contracts.

2. *What is the government's motivation behind the rule changes?*

In general, the upcoming changes are about the government's desire to create consistent measures that can be applied across all products. As a result, the changes will affect certain products more than others. For example, the existing rules have provided product manufacturers with the flexibility to create single premium payment Universal Life policies that have facilitated tax-sheltering of investment capital in excess of what the rules originally intended. In addition, certain manufacturers offer Universal Life products that have the ability to make significant tax-free payouts of policy fund value upon the death of a 'first insured' in a multi-life policy. The new provisions will rein in specific opportunities, like the concepts above, that are commonly associated with universal life insurance contracts.

3. *I know the rules are quite technical, but what are the key impacts of the changes?*

In simple terms, the impact of the new rules can be summarized as follows:

- It will now take longer to fund permanent insurance contracts. Single or short premium payment periods will disappear and 8 years will become the minimum funding period.
- Cash value accumulation will actually increase over the first decade but ultimately decrease until clients reach their 90s.
- Level cost products (think T100 or Universal life) will increase in price (due to increases in the investment income tax).
- The net cost of pure insurance for standard lives will be lower, especially after age 70. This will reduce tax benefits associated with leveraged insurance strategies.
- The adjusted cost basis of insurance products will stay higher for longer period, which will impact capital dividend accounts (in corporate ownership situations).
- More income flowing from prescribed annuities will be subject to income tax, ultimately reducing net yields.

4. *When do the rules take effect and what does this mean for existing policies?*

First, the new rules do not come into effect until January 1st, 2017. Our understanding is that existing products and any life insurance product issued and put into force before this date will be 'grandfathered'. Basically, these policies would continue to benefit from the current taxation regime.

In certain circumstances, a policy would cease to receive this protection, including:

- Any term conversion to a new product after 2016; and
- Generally, any medically underwritten event that increases the insurance amount or net amount at risk.

5. *A common planning practice we see is to hold a life insurance policy inside of a holding company in order to reduce the after tax costs of the premiums, while still allowing the insurance to be paid out tax free to beneficiaries down the line. How will this strategy be impacted?*

Before commenting, let's provide an overview of the concept described above. The strategy involves the acquisition of a life insurance policy by the insured's holding company ("Holdco"). Holdco will also be named as the beneficiary of the insurance contract. This allows policy premiums to be funded with retained earnings that, if originated from a private active business, would have previously been taxed at rates significantly lower than income taxed at the personal level (think 15-27% vs. 50%). The main benefit here is a reduction of the overall cost of funding.

As you alluded, the structure allows for future tax-free payments to beneficiaries. In general, when the insured passes away, death benefit proceeds will be received by Holdco on a tax-free basis. Holdco can then distribute the proceeds as a tax-free capital dividend to the extent that the death benefit proceeds exceed the policy adjusted cost basis. Now, let's discuss the impact of the new rules.

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Currently, the adjusted cost basis of an insurance contract declines significantly after a life insured reaches age 70. From a corporate perspective, this leads to higher capital dividend accounts from the receipt of insurance proceeds at earlier ages.

Under the new rules, the adjusted cost basis of an insurance contract will stay higher for a longer period of time. This ultimately impacts the timing of when 100% of a death benefit can be distributed as a tax-free dividend. Our article examined the case of $5 million level cost Universal Life policy, issued to a 50 year old male, under both the old and the new taxation regimes. The results would look as follows:

- Old Regime: Full $5 million capital dividend by age 73
- New Regime: Full $5 million capital dividend by age 90 (17 more years!)

At age 73, after 2016, Holdco would only receive a capital dividend credit of $4.175 million (in Ontario, tax of $350K to repatriate the remaining $825K of death benefit).

To summarize, the death of a life insured person prior to life expectancy mutes the benefits of corporate ownership in the future, but the strategy is still viable after 2016.

6. *It seems like all of these changes are going to negatively impact the performance of life insurance policies. Is it really all bad news?*

While some benefits have been dulled, we continue to see meaningful opportunities to incorporate life insurance into existing estate and wealth plans. When compared to non-registered investments, tax-sheltered accumulation within exempt life policies will still be compelling, especially considering the state of existing tax rates across the country. The higher adjusted cost basis after 2016 will actually enable policy owners to extract policy fund values on a sheltered or reduced tax basis for longer periods of time. Finally, insurance will continue to play an important role in funding buy-sell agreements, providing liquidity to cost-effectively fund tax on death, enhancing philanthropic activity, and creating estate value to equalize and facilitate family wealth distributions. The changes will reduce some of the benefits available through life insurance, but it will definitely not eliminate them.

7. *With the clock ticking, what would you recommend families and their advisors do to ensure they mitigate the negative impact of these changes? (in terms of existing and new policies)*

I would strongly encourage both advisors and their clients to review existing estate and insurance planning in early 2016. These reviews may lead to meaningful planning opportunities prior to 2017. For insurance plans that involve corporate ownership or the use of tax-effective leverage, there are measurable benefits before 2017. Guaranteed income strategies require a hard look as well.

Estate planning requires the family, its lawyers, accountants, investment counsel and insurance advisor take substantial time to analyze the pros and cons of various planning issues. For many affluent families, the planning process may span greater than 12 months. Insurance underwriting may take 4 – 12 weeks.

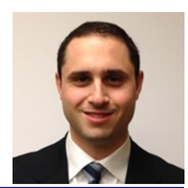
Considering the time required to complete a thoughtfully considered plan, it makes sense to review existing estate plans and insurance contracts immediately, in order to ensure strategies are appropriate before 2017. Finally, planning discussions that need to happen or have been temporarily deferred, should get (re)activated in order to take advantage of favorable existing legislation.

If you would like to read the CPA Canada article in full it can be found here:

https://www.cpacanada.ca/en/connecting-and-news/cpa-magazine/articles/2015/december/best-before-2017

What's Left to Do with Your Fixed Income Allocation?

Dan Solomon, MBA, CFA, CFP



Fixed income has traditionally acted as the stable foundation of investor portfolios, offering predictable income and capital protection. For this reason, it has often accounted for a significant portion of family wealth.

However, in the years following the credit crisis, it has become a frustrating asset class. As yields fell to historic lows in the aftermath of the crisis, many investors elected to hold shorter-term bonds to reduce the potential loss from an inevitable rise in rates. After all, it's not a question of *'if'* rates will rise, but *'when'* they will -- right?

But seven or eight years later (and several percentage points lower), we are still waiting for the 'when' to come! It is now next to impossible for investors who are concerned about the potential for rising rates to construct a high quality and low duration laddered bond portfolio that generates meaningful income. And owning longer-term bonds increases the risk of loss associated with rising rates and, in Canada, doesn't even increase the yield by much (1.14% for 10 year government bond vs. 0.28% for a 2 year bond). The old assumption that bonds will provide investors 4-5% returns a year – their 80+ year historical average – no longer holds water.

The accompanying chart from Vanguard Chairman John C. Bogle helps to illustrate just how poor the return prospects may be for high quality fixed income investments in Canada. This chart points

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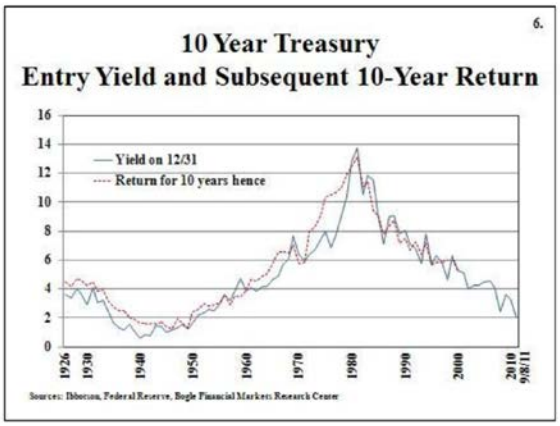
out the extremely high correlation between the current yield on a bond and the return you can expect for the term of that bond. (Bogle uses the 10 year US treasury yield as an example here, but the concept is applicable to government bonds in Canada). For example, if a 10 year Government of Canada bond currently yields 1.14%, and you buy it, this chart suggests you can expect to earn 1.14% per year on your investment, in total, until it matures.

Exhibit 1: 10 Year Treasury Yield Correlation to Return



Source: John C. Bogle

In fact, it is actually more attractive to invest your cash in high interest savings funds than short duration high quality bonds. These funds currently pay only 1%, and while this may not seem like much, consider that the five year Government of Canada bond pays just 0.55%. This means that you get paid 0.45% less each year to take on five years of interest rate risk. It makes no sense! And unfortunately, each time interest rates seems ready to push higher, another issue emerges, such as the latest economic growth concerns out of China, to push them back down.

As interest rates declined, we put in place two key strategies to deal with the problem facing our families.

(1) We introduced a Canadian dividend equity mandate into our portfolios, and
(2) We allocated a portion of our fixed income holdings to a credit manager.

Canadian Dividend Equity Mandate

About seven years ago as rates began to fall in earnest, with the help of a top Canadian equity manager, we built a customized Canadian dividend equity mandate comprised of the highest quality Canadian companies. As a replacement for a sensible portion of their original fixed income allocation, the mandate could offer an enhanced yield to investors, as well as the benefits of tax-efficient dividend income, and the potential for both dividend growth and capital appreciation.

Similar to our approach for screening corporate fixed income investments, companies are selected partly based on the strength and security of their dividend, thereby providing a mechanism for stability. The mandate also provides a similar level of liquidity. The tradeoff, of course, is that the dividend portfolio would experience the volatility that comes along with the equity markets. In constructing the mandate, we understood that this equity market exposure would be the biggest concern. However, given the long term investing horizon of most of our families, we felt that the majority of them could relatively easily withstand periods of volatility.

Credit Manager

Since its introduction, the Canadian dividend equity mandate has become a core component of our families' portfolios, but it has not acted as a complete replacement for their fixed income allocations. To combat the low yields still being earned, we ventured slightly further up the risk curve within the fixed income asset class. We introduced a fund from a top credit manager whose focus is taking advantage of bonds that they believe are underpriced relative to their fundamentals. The manager's sophistication, scale and position in the market afford it the advantage of accessing unique and in some cases exclusive investing opportunities. Interest rate risk here is also managed so that the potential loss from any rise in rates is minimal.

What's Left to Do?

There are still many investors holding cash sitting in high interest savings accounts that only earn 1% or in longer duration bond funds or portfolios. The outlook for any sort of improvement in high quality fixed income returns remains gloomy for the time being. Until the yields on quality fixed income improve, is there a better option for these funds in the meantime? Let's look at the options.

Should You Explore Alternative Investments?

We have spent a lot of time evaluating yield-generating alternatives in areas such as real estate, credit-focused hedge funds, mortgage funds, and private debt. These investments have their merits but they proved hard to for us justify as a substitute for low-risk fixed income, in some cases due to limited liquidity, concentration in one particular industry/geography, performance fees, lack of transparency, and compressed yields. There is a place for alternatives in many client portfolios (including ours), but we don't believe they should play the portfolio cornerstone role, even if they produce yield.

What Now?

We still believe it makes sense to own high quality Canadian dividend paying stocks (even more so as they are getting cheaper), as well as to hold reasonable exposure to a high quality credit manager. Whether a particular investor should add to these allocations in lieu of holding cash will depend, of course, on the unique financial situation of the investing family. If the investor can withstand the volatility of Canadian dividend equities and has a sufficiently long timeframe, the math certainly supports them doing so (see Exhibit 2 on the next page).

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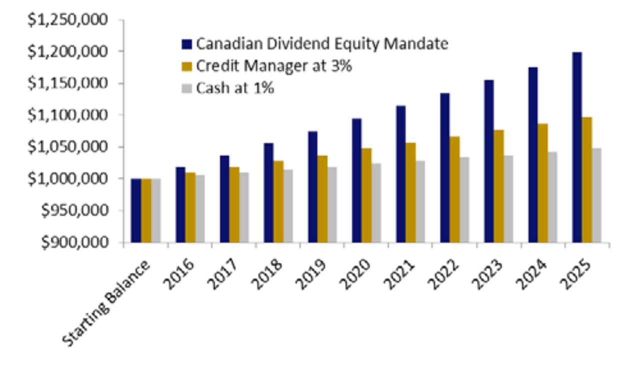
Exhibit 2: Dividend Equities vs. Credit Manager vs. Cash



Investing $1 million in cash over ten years earning 1% annually would generate approximately $47,500 after-tax. The same investment in a dividend mandate (that currently pays an annual yield of nearly 3%) would generate close to $197,500 after-tax, with all the normal assumptions. That's an additional $150,000 of after-tax portfolio income over a 10 year period, without even factoring in potential growth of the capital.

If equity market volatility or a large drop in their portfolio would compromise a family's goals, then adding instead to the credit mandate may be the way to go, the financial benefits of which are also illustrated in Exhibit 2. Taking this approach has the potential to enhance yield without adding equity market risk.

Holding Cash Might Be the Way to Go

And finally, if the situation dictates that the family has reached its limit for its equity and credit risk weightings, then the solution may be as plain as waiting until rates begin to rise again before buying any bonds.

It may also be that no option is perfect in isolation and a mix of the three should be considered. It is a challenging period for fixed income investments and there is no simple solution, but some well thought-out options and a good understanding of each family's financial situation will yield the best possible strategy.

Who is Northwood Family Office?
Northwood Family Office is an independent, privately-owned boutique family office which provides comprehensive Net Worth Management™ to wealthy Canadian and global families. Northwood clients have significant family net worth, typically in the $10 - $500 million range. The firm acts as a Personal CFO or Chief Advisor to client families using a dedicated team of professionals who oversee and manage their integrated financial affairs. Northwood Family Office is Canada's leading independent multi-family office and has consistently been ranked the '#1 family office in Canada' in the *Euromoney* Global Private Banking survey. For more information, see our website at www.northwoodfamilyoffice.com or contact Tom McCullough for a confidential conversation at tm@northwoodfamilyoffice.com.

NORTHWOOD FAMILY OFFICE

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