NORTHWOOD
FAMILY OFFICE

ALSO IN THIS ISSUE:

Chairman's Message

Tom McCullough

My colleague Eric Weir and I spent a week in Tokyo and Kyoto this past month. We were struck by the beauty and culture of the country, as well as how pleasant and welcoming the Japanese people are. We met with a range of government officials, portfolio managers, and local business and private equity managers as part of the Wigmore Association meetings (www.wigmoreassociation.com). Here are a few of our observations.

Prime Minister Abe is highly regarded by the population and business community. He is bringing about significant reforms in a number of areas, and he is very central to the success of this project. After Japan's string of five Prime Ministers in five years, the stability of Abe's tenure (2012-present) has been beneficial to the country's economy and stock market. Japan's ability to reform its economy depends heavily on Abe's personal popularity and as a result key man risk is high.

The declining population is a serious challenge for Japan (unemployment is only 3%). They are taking several steps to increase the country's output, including: adjusting labour laws to reduce the amount of overtime employees work, boosting productivity gains through technology in the very inefficient service industry, encouraging female participation in the workplace via daycare, and encouraging workers to stay beyond normal retirement dates. Immigration, a typical solution for countries in this situation, has been uncommon in Japan, although this is slowly beginning to change. They added a million immigrants last year, mostly from regional neighbours such as China, The Philippines, and Vietnam. Despite these recent additions, the resident foreign population in Japan is still less than 2%.

The Bank of Japan has been aggressive in implementing programs to prevent deflation in the economy. Bond buying has been extreme, and Japan has the highest debt to GDP ratio of all major economies. However, most of the government debt is owned locally, by the BOJ and pension plans, reducing the risk of a default or a required restructuring of the debt. In addition, the BOJ has expanded into purchasing equity ETFs and corporate bonds to reduce the risk premium in the market and to encourage companies and individuals to take risk. As a result, the BOJ is now a significant shareholder of many companies.

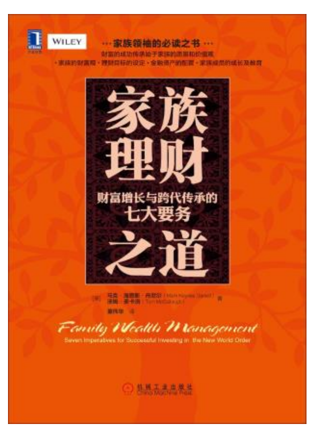
Corporate governance in Japan has historically been poor, however, the government is beginning to make changes. Corporations have not specifically been required to act in the interest of shareholders, which results in some companies trading for less than the value of the cash on their balance sheets. Companies will now be required to report an ROE target which is viewed as a significant change and there is pressure for companies to add outside (vs. just inside) board members.

The stock market has doubled over the past five years, based on the positive changes that Prime Minister Abe has been introducing, but it is worth remembering that the Nikkei has been in a 25 year bear market and is still about 50% below its December 1989 peak.

Japan is at an interesting crossroads due to the challenge of its aging population. The government appears to be aggressively making changes to respond to this challenge, but immigration will remain key to the long term success of the country. From an investment perspective, bonds are not an option due to low interest rates, and equities trade at discount valuations due to governance problems and questionable long term growth outlooks. Japan's economy and stock market have both rebounded in recent years as Abe's reforms and the stability of his tenure have increased economic confidence. If the current reform measures and immigration policies can lead to revived growth and better governance, the recovery may continue.

Tom

FAMILY WEALTH MANAGEMENT BOOK NOW AVAILABLE IN CHINESE



Four years after its initial publication in English, Tom McCullough's book 'Family Wealth Management: 7 Imperatives for Successful Investing in the New World Order' has been translated into Chinese. The Chinese edition of the book is now available on Amazon and can be purchased by readers in China and throughout the world.

If you are interested in purchasing the Chinese edition of the book please click here

Federal Budget Recap

Barrett Lyons, CPA, CA, CFP, CIM

On March 22nd, a year to the day from the Trudeau government's first budget, the government released the 2017-18 edition. Leading up to this date, we heard many rumours about proposed tax changes that could be coming in this budget. However, when the budget was released there were only a small number of income tax changes that will affect private clients. These changes are largely intended to address areas where the government sees the system not functioning efficiently or fairly.

The budget focused on the following four areas related to the government's theme of "Building a Strong Middle Class".

- Skills, Innovation and Middle Class Jobs
- Communities Built for Change (Infrastructure)
- Tax Fairness for the Middle Class
- A Strong Canada at Home and in the World

The budget revealed a **$23.0B** deficit for 2016-17 which was below the projected deficit of **$29.4B**. This is where the good news ends however, as the 2017-18 deficit is now expected to increase to **$28.5B** before slowly falling to a level of **$18.8B** by 2021-22. These numbers are a far cry from the government's campaign promises to run deficits no greater than **$10B** per year and have the budget balanced by 2019. As a result of these changes, the current debt level of **$637.1B** is expected to grow to **$756.9B** by 2021-22 when debt will be 30.9% of GDP.

Although there were no changes to personal or corporate tax rates, the budget did feature some 'highlights'. Several of the most discussed changes are listed below:

- *Eliminating the public transit tax credit*
  - The current credit will continue until July 1, 2017 at which point it will be eliminated.

- *Streamlining the Caregiver credit system*
  - Currently there are three separate tax credits (infirm dependent, caregiver, and family caregiver) and the budget proposes to simplify and combine these into one program called the Canada Caregiver tax credit.

- *Disability Tax Credit Certification*
  - Budget 2017 proposes to add nurse practitioners to the list of medical practitioners that can certify the impact of impairments for Disability Tax Credit applicants.

- *Discontinuing the issuance of Canada Savings Bonds in 2017*
  - In 2017 the outstanding bonds accounted for less than 1% of the total Federal debt market.

- *Preventing the avoidance or deferral of income tax through the use of offsetting derivative positions in straddle transactions*
  - This strategy would be put in place to defer tax that would otherwise be realized and the Budget proposes new anti-avoidance rules to eliminate these situations.

- *Eliminating the use of billed-basis accounting*
  - For income tax purposes a limited group of professionals have been able to defer income on work-in-progress and the Budget proposes to eliminate this billed-basis reporting methodology.

- *Extending anti-avoidance rules to RESP and RDSP plans similar to those of TFSAs and RRSPs*

One thing to note is that the government will be completing a review of tax planning strategies involving private corporations in 2017. This is part of a continuing process to crack down on tax planning strategies that specifically benefit the "wealthy". Within this review, the government has identified three strategies that they will be focusing on:

- *Sprinkling income using private corporations*
  - Reducing income taxes by directing income to family members that are in a lower tax bracket.

- *Holding a passive investment portfolio inside a corporation*
  - Accumulating income in a holding company and earning investment income on undistributed business income.

- *Converting a private corporation's regular income into capital gains*
  - Using strategies and transactions that result in capital gains which are taxed at a lower rate that would otherwise be characterized as another type of income taxed at a higher rate.

It will be interesting to see the results of the government's review of these topics in the days ahead.

Why We Don't Do Macro Investing

Eric Weir, CFA, CFP

The year 2016 will be remembered as a tumultuous one in the history of the English-speaking world. We saw the United Kingdom vote to leave the European Union after 47 years of membership, and the United States elect an inexperienced and controversial person as its 45th president. Both events seemed unthinkable a month before they occurred, and highly unlikely even a day before. This has shaken people's faith in polling, conventional wisdom, and the presumed march toward a more connected and inclusive world.

Both outcomes, unlikely as they seemed, were widely expected to result in large market losses. In the end, after brief panics, the economic prognosticators were proven wrong in both of their predictions. In Britain, the FTSE 100 is now up over 17% since the June 2016 Brexit Referendum, while in the United States the S&P 500 is up approximately 10% in the five months since Donald Trump's election. One can argue that both stock market rallies are built on false foundations, or that the British Pound has lost ~15% of its value against the USD as a result of the Brexit vote, but the key takeaway for us is that the broad economic consensus about how global markets would react to these outcomes was largely wrong.

If you were a macro investor, and went against overwhelming conventional wisdom and predicted Brexit and the election of Donald Trump, you would still have needed to predict the unexpected positive market reaction to both events in order to make money. To be successful as a macro investor you not only need to predict the outcome of the event correctly, you also need to accurately predict the market's reaction to this outcome. This type of multilevel bet is highly complex, notoriously unreliable and not one that makes a lot of sense, from our perspective.
At Northwood, we don't believe in market timing or making investment bets based on geopolitical or macroeconomic predictions. We think it is wiser and more productive to base our investing on the specific goals of our clients and to invest their money in individual companies at prices below their intrinsic value. This straightforward approach has proven itself very successful and much more predictable over multi-year time horizons.

This year brings the promise of more potential peril in the liberal democracies of the West. Although the Dutch election in March resulted in the governing centre-right party winning the most seats, the upcoming elections in France and Germany have the potential to turn Western Europe in a more radical direction. In France, candidates from the far right and the far left are in contention to advance to the second and final round of voting in early May. At Northwood, we will be watching the results with interest, but will be sticking with our tried and true approach of investing based on the goals of our clients and a sound, bottom-up value philosophy.

Successful 3rd Edition of the Rotman Family Wealth Management Program

From April 6th to 9th 2017, 20 members of families of wealth attended the 3rd edition of the Rotman Family Wealth Management Program at the University of Toronto. Over the course of four days the 'students' covered the following topics:

- Family capital and governance
- Goals-based wealth management
- Tax and estate planning
- Family dynamics, communication and succession
- Asset classes and asset allocation
- Investment approaches and the investment policy statement
- Selecting investment managers

Northwood Family Office

Rotman School of Management
University of Toronto

Sessions were taught by the following speakers:

- Tom McCullough (Chairman and CEO, Northwood Family Office)
- Michael Lagopoulos (Consultant - Former Deputy Chairman, RBC Wealth Management)
- Eric Kirzner (John H. Watson Chair in Value Investing, Rotman School of Management)
- Scott Hayman (President, Northwood Family Office)
- Eric Weir (Executive Vice President, Northwood Family Office)
- Trevor Hunt (Portfolio Manager, Leith Wheeler Investment Counsel)
- Michelle Osry (Partner – Family Business Advisory, Deloitte)

Time-Weighted vs. Money-Weighted Performance

Dan Solomon, MBA, CFA, CFP

The Canadian Securities Administrators (CSA) have recently implemented measures to enhance the meaningfulness and transparency of the investment account statements clients receive and review. Investment managers are now required to report complete transaction activity, more detailed statements, a breakdown of fees paid to the manager, and a summary of portfolio account changes.

Northwood and many of our peers had previously been providing much of this information. However, investment management firms have typically reported returns figures that show how the portfolio has done, irrespective of when the client has deposited or withdrawn money. This method of calculating returns is known as the *'time-weighted'* rate of return. Specifically, it shows the compound growth of $1 over the given time period being measured. The new performance calculation displayed on client statements beginning this year is the *'money-weighed'* rate of return. This method accounts for all of the deposits and withdrawals made into the client's portfolio and so is a more appropriate indicator of how the client's invested money has actually done.

Depending on the input factors, applying both return calculations to a portfolio could result in materially different results. Here's a simple example: A client has $1,000 to invest. They decide to use all the funds to purchase just one stock at the beginning of April. To reduce complexity, assume the stock pays no form of income, and the holding period measured is one month. The *time-weighted* return earned in this case would be the percentage change in price over the course of April. The *money-weighted* return calculation here would yield the exact same result. This is because all of the client's money was invested at once, at the beginning of the holding period, and no other deposits or withdrawals were made during the time-frame.

Now let's introduce a scenario where the client intends to use the funds to buy the same stock in April, but perhaps is a little nervous to buy in all at once. Let's assume they dip their toe into the water before diving in, so to speak, and purchase just $100 of the stock at the beginning of the month. After waiting for a couple of weeks, they watch the stock price advance 25% by mid-April, and they decide to put the rest of the money to work the next day and purchase $900 in additional shares. Unfortunately for this investor, the stock flat-lines for the rest of the month and doesn't gain a single additional penny.

Here is where the difference between *time-weighted* and *money-weighted* can become more apparent and relevant. The *time weighted* return for the April holding period is simply the 25% gain in the stock. For the first client who bought up all $1,000 worth of stock on day one, a 25% *money-weighted* return is earned. For the client who chose to wait, the *money-weighted* return is just 4.8%. Of course, there's a flipside to this in that the stock could have declined 25% and the client who waited would have been better off (see the accompanying exhibit).

We believe that both calculation methods have their respective merits. For instance, the *time-weighted* approach is the industry's preferred method of evaluating current and prospective investment managers. This is because those conducting manager due diligence want to judge portfolio performance resulting only from the manager's investment decisions. And so for this purpose, returns should not be skewed to the upside or downside because of client-directed fund flows. On the other hand, a client should know how their cash flow activity and timing of their investments impacts their personal portfolio performance. This is where the *money-weighted* return is very useful.

With its recent introduction in client statements, it is likely that the *money-weighted* method will stoke conversations between clients and their advisors on the topics of client-directed cash flow activity and strategies for the timing of investment portfolio implementation. In our view, a change such as this that can have the effect of encouraging dialogue and cultivating a closer relationship between the client and advisor is a welcome one.

	Stock Gains 25%		Stock Declines 25%	
	Invest $1,000 Now	**Invest $100 Now and $900 Later**	**Invest $1,000 Now**	**Invest $100 Now and $900 Later**
Beginning Portfolio Value	$1,000	$100	$1,000	$100
April 16th Purchase	N/A	$900	N/A	$900
Ending Portfolio Value	$1,250	$1,025	$750	$975
Time-Weighted Return	25%	25%	-25%	-25%
Money-Weighted Return	25%	4.80%	-25%	-4.8%

Finance Grade 1(01) – 10 Years Later

Scott Hayman, CPA, CA, CFP, TEP

About 10 years ago I wrote an article for the spring issue of our newsletter about my six year old daughter Sarah. She asked: “Could I come into her class and tell them about what I do?” My conclusions then were ‘to keep things simple’ and ‘kids really are smart.’ Well, 10 years have passed! My daughter is now 16, driving, and finishing up grade 11. I thought I would look back over the last 10 years and see if there is anything I would change in how I approached my answer to her question if I went into her class today.

In 2007, I said there were only three things you do with money—save it, spend it or give it away. Today, I would refine that to say that there are really only *two* things—spend it and give it away. Saving or investing money is really just to spend it later, or to give it away later. This drives a lot of how we think about managing finances at Northwood. Of course, the implementation of this framework is more complicated than the concept, but it is the simplicity that drives the process. We believe that understanding why you are doing something and what you are investing in is integral to being successful.

This leads to the second concept I talked about: goal based financial management. Understanding what you are trying to achieve makes developing a plan easier. It’s important to plan for what you want, as opposed to having investment returns or your income dictate what your goals can be. Once you have decided on your goals, using facts to make your decisions will lead to greater success. We call this fact-based decision making. This means having the correct data, understanding legal, tax and other issues and what you are allowed to do, and then developing a plan to achieve your goals of spending or giving away. I often hear the words “I think” whereas if we start with the facts we can say “I know”.

Another lesson over the last 10 years is realizing what you can control and what you cannot control. For anyone, even six year olds, controlling spending is vital to long term success. If you know your facts and have clear goals, spending should be easier to control. There are a number of factors that you can control—spending, tax planning, fees, and the risk you take. What is more difficult to control is investment returns.

Lastly, remember that there are four factors that affect long term cash flows:

1. Income - Employment income, investment income, good tax planning
2. Expenses - You need two dollars of income to pay for one dollar of expenses, so this number is very important
3. Time - How long you will work or hold on to your business, and how long you will live
4. Other assets - Assets that currently add to your expense level that could be ‘converted’ to income generating assets (such as selling your cottage or Florida property)

10 years ago I concluded my article by emphasizing that keeping things simple and using facts is a good way to plan. I’ve learned a lot in the ensuing decade, but I still believe that this is an important part of financial planning. If you can keep things simple, and keep the four factors listed above in mind, you are well on your way to building a successful financial plan.

Who is Northwood Family Office?
Northwood Family Office is an independent, privately-owned boutique family office which provides comprehensive Net Worth Management™ for 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, visit our website or contact Tom McCullough for a confidential conversation.

NORTHWOOD FAMILY OFFICE

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