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Perspective

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Battered but Resilient

Economic conditions and market behaviour have been uncertain for some time. Even though we have seen a marked improvement since earlier this year, economic headwinds remain and virtually no one is unequivocally bullish. Longer term, the global imbalances that triggered the financial crisis must be addressed. Deleveraging of the household and business sectors is underway, and financial services regulation will no doubt be tightened. But the key imbalance remains: the extraordinary trade and budget deficits in the U.S. (and now in much of the G7) that accompany the huge and mounting current account surplus in China and other countries where their currencies are purposely undervalued.

To be sure, the budgetary red ink explosion at all levels of government in the U.S., Canada and elsewhere is the necessary result of the credit crisis and its ensuing deep and long recession. What's more, fiscal authorities and central banks will maintain a stimulative policy stance as long as the risks of a double-dip recession remain. Without these support measures, the global economy could well have plunged into depression. But, as the economy recovers, any upward pressure on interest rates arising from a rebound in private sector credit demand would meaningfully increase the costs to government of financing its debt. This would mitigate the positive effects of a turnaround in deficit reduction.

The odds favour a gradual and orderly further decline in the U.S. dollar that will continue to boost American net exports and contribute to moderate growth. Corporate profits have risen sharply as businesses cut costs and massively retrenched in terms of employment, inventories and capital spending. Finally, we are beginning to see some top-line growth as revenues rise gradually from their collapse just over a year ago. This should, in time, lead to stepped up business investment in machinery, equipment and software, as well as a gradual improvement in labour markets. Nevertheless, the caution displayed by companies burned badly by the crisis will keep this a jobless recovery for some time, and the U.S. unemployment rate is not likely to peak until we are well into the coming year.

Things may be getting better, but it would be naïve to think that the depth and brutality of the crisis-driven recession would leave no lasting damage. While housing markets in Canada have bounced back with a vengeance, bank foreclosures in the U.S. will rise sharply this year as an estimated 23% of homeowners have mortgages that are larger than the value of their homes and refinancing possibilities have been limited. Although, most homeowners who can make their payments would prefer to stay in their homes, some will likely walk away if the mortgage gap is too wide. This is particularly the case for those whose income has fallen sharply.

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Reduce your Taxes with a Prescribed Rate Loan

Under our tax system, the more you earn, the more you pay in income taxes on each incremental dollar earned. With this in mind, it makes sense to spread income among family members who are taxed at lower marginal rates in order to lower your family's overall tax burden. However, the income attribution rules can prevent most income splitting strategies where there has been a transfer to a spouse or minor child for the purpose of earning investment income. The attribution rules transfer the taxation of investment income (and capital gains in the case of a gift to a spouse) back to the person who made the gift regardless of whose name is on the investment. While there are significant restrictions, there are still a number of legitimate income-splitting strategies available to you.

Prescribed Rate Loan

A simple, yet effective income-splitting strategy involves transferring income-generating assets (ideally cash) to a lower-income spouse (or other family member) and taking back a loan (equal to the fair market value of the assets transferred) at the Canada Revenue Agency's (CRA) prescribed interest rate in effect at the time of the loan. Given the decline in the CRA's prescribed rates over the past year, implementation of this strategy now presents a very compelling opportunity. For loans made to a family member, the rate necessary to avoid the income attribution rules is only 1% effective for loans made in the first quarter of 2010 – this continues to be an all-time low for the CRA's prescribed rate. Most importantly, if structured properly the prescribed rate in effect at the time of the loan will continue to apply until the loan is repaid, regardless of future changes to the prescribed rates. For loans made after March 31, 2010 (i.e. the end of the first quarter of 2010), the CRA's prescribed rate at the time of the loan will apply.

How it Works

Briefly stated, an interest-bearing loan is made from the person in the higher marginal tax bracket to a family member (such as a spouse) in a lower tax bracket for the purpose of investing. To avoid the income attribution rules there are a number of requirements that must be met. Some considerations are as follows:

- Interest must be charged at a rate at least equal to the CRA's prescribed rate in effect at the time the loan is made, as previously outlined.
- Interest should be charged annually at this rate and must be paid by the following January 30th each year.
- In order for there to be a net benefit, the annual realized rate of return on the borrowed funds must exceed the annual interest rate charged on the loan, which is included in the income of the transferor and should be deductible to the transferee family member, if used for investment purposes.
- By locking in this strategy at this low rate, long-term benefits of income-splitting can be achieved to the extent future investment returns exceed this low 1% threshold.

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- The impact of increased income to the transferee family member (e.g. loss of spousal tax credit) should also be considered before employing this strategy.
- Consider the possible recognition of capital gains or capital losses, which may be denied, when assets other than cash are loaned or transferred to a family member.

Given the complexity of the income attribution rules, you should consult with your tax and legal advisors to review and structure any income splitting strategies to ensure that the strategies are implemented and documented correctly and achieve the desired results without any unanticipated implications ■

The Importance of a Personalized Retirement Plan

If you were like many investors last year that saw their investments suffer a major set back, you may be evaluating whether or not you could have sheltered yourself from the severe market correction.

A recent study conducted by Benefits Canada investigated Capital Accumulation Plan members' behaviour. Results from this recent study revealed some interesting insights. For example, 87% of the respondents agreed that financial markets always experience periods of volatility and that they weren't overly worried about short-term decreases in the value of their investments. On the other hand, over 60% of the respondents indicated that they didn't have a good understanding of asset allocation or what changes were required to their portfolio to cushion themselves against market instability; with about 19% indicating that they considered their investment knowledge to be very or somewhat poor. In fact, around 19% of the respondents turned to family and friends for advice on their investments.

Unfortunately, for individuals who were planning to start withdrawing from their registered plans in the near future, this lack of appropriate investment understanding might have some in for an unexpected surprise.

Let's consider the following:

The Magnitude of Investment Losses versus Time Horizon until Retirement

Obviously, a 62 year-old person who experienced a 30% drop in their $400,000 account balance will be in a different position than a 35 year-old with 25 plus years until retirement. However, regardless of your age, the goal of proper diversification to achieve the best returns with the appropriate amount of risk for your investor profile is critical.

Glide Path until Retirement

The glide path or asset allocation of your investments also plays a big part in your investment returns but as noted from the survey, 60% of the respondents didn't have a good understanding of asset allocation. This strategy also becomes a little more complicated as you approach retirement since investors typically become more risk adverse but are tempted to maintain an aggressive equity exposure too close to their retirement date. Choosing the specific asset classes and the percentage of your total portfolio is the first step, but investors should not forget to incorporate their specific risk tolerance based on their time horizon.

> Having a completed financial plan that anticipates the bumps along the way is essential.

Getting Clarity Through all the "Noise"

Not surprisingly, 28% of the survey respondents between the ages of 55 to 64 indicated that their risk tolerance has decreased due to the market volatility. It appears that even as investors have access to more information and investment education, it is not translating to a higher level of investment understanding or knowledge.

Do I Really Need to Save for Retirement?

Here's an interesting thought – consider the cost of having three square meals a day at an average total cost of $40/day. Now assume your retirement will last

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25 years – that works out to over $350,000 that you will spend just on meals alone during your retirement years. And you can double that if you have a spouse!

Having a completed financial plan that anticipates the bumps along the way is essential to preparing for your retirement needs. The fact that the survey revealed that 50% of the respondents didn't change or weren't planning to change their spending habits due to the recession, highlights the need for personalized investment advice to help you achieve your retirement goals.

Speak to your BMO Nesbitt Burns Investment Advisor to ensure that your financial plan is positioned to meet your retirement needs ■

Making a 2009 RRSP Contribution?

- Investing in a Registered Retirement Savings Plan (RRSP) is one of the soundest ways to ensure you enjoy a financially secure retirement. Your RRSP contributions are tax deductible and continue to grow on a tax-deferred basis until they are withdrawn from the plan.
- You have 60 days after the end of the year to make your RRSP contribution for the previous tax year. The 2009 RRSP contribution deadline is March 1st, 2010.
- While many people wait until close to the deadline before making their annual contribution, it does pay to contribute as early as possible. For example, a $5,000 annual RRSP contribution made on January 1st of each year for 25 years and earning a 7% rate of return will be worth over $25,000 more than if the same contribution was made 14 months later at the RRSP deadline.
- The easiest way to find your RRSP deduction limit is to look it up on the Notice of Assessment that the Canada Revenue Agency sends back to you after you file your annual income tax return. If you would like to verify this amount, here's how to calculate it for yourself. For 2009, your RRSP contribution amount is based upon your carry forward amount from 2008, plus your current year's contribution amount which is the lesser of $21,000 or 18% of 2008 earned income. If you are a member of a Deferred Profit Sharing Plan (DPSP) or Registered Pension Plan (RPP), you have one and possibly two more steps. You must deduct your pension adjustment and, if applicable, your net past service pension adjustment (PSPA).

Chasing Performance can be like Running in Reverse

Your Portfolio Could Grow Nowhere... Fast

In certain market conditions some investors are tempted to make abrupt decisions – such as selling their current holdings and buying hot stocks, mutual funds, or the latest and greatest investment tip or strategy that has recently outperformed its peers. This can be true with any market but especially true when the markets are struggling. However, using short-term trends to support a long-term strategy can be a mistake. So before you start jumping from one hot investment strategy to another, consider the following:

No one has a crystal ball. Trying to predict future performance, based on past market activity, isn't a consistently reliable method of investing. Quite possibly, you could find yourself selling when you should be buying, and vice versa.

Control what you can. You can't influence how the economy, or the financial markets, will behave. What you can control is your commitment to a disciplined investment plan – crafted with the help of your BMO Nesbitt Burns Investment Advisor.

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Periodically rebalance your portfolio. While making frequent, emotionally driven decisions can diminish the performance of your investments, the swings in the markets make it necessary for you to rebalance your holdings among various asset classes.

Reversals of fortune

Foreign stocks – from red-hot to ice cold[1]

- From 1985 through 1988, foreign stocks went UP 322%
- From 1989 through 1992, foreign stocks went DOWN 17%

U.S. stock market soars – then tanks[2]

- For the six years ending December 31, 1999, domestic stocks ROSE 255%.
- Over the next three years, domestic stocks FELL 38%

U.S. Bonds – from the doghouse to the penthouse[3]

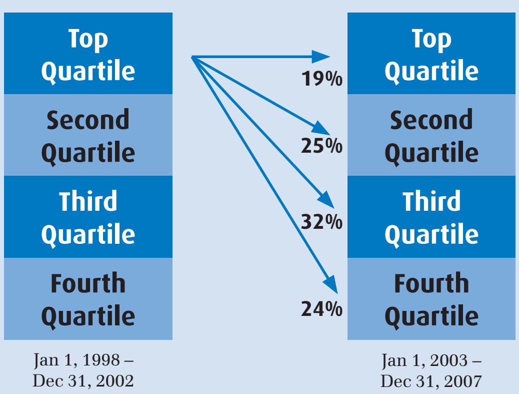
- From 1994 through 1999, bonds TRAILED stocks by 217%.
- From 2000 through 2002, bonds TROUNCED STOCKS by 75%

Source: SEI Investments

Investors can inflict damage on their investment portfolios by chasing supposedly hot investments. However, as the following chart illustrates, making decisions based on past performance alone can be a mistake.

XYZ Fund is Doing Well, Why Not Invest?

Lipper Rankings: Manager Performance is Unpredictable



History has shown that fixed time periods are inadequate to predict a manager's performance

Source: Lipper, Inc., 2007. Rankings are based on 296 large cap core domestic equity managers with returns available over the entire 10 year period from Jan 1, 1998 through Dec 31, 2007. Returns are net of fees.

Source: SEI Investments

This chart follows the performance of U.S. funds that were ranked by Lipper, from 1998 through 2002. These were Lipper's top-ranked funds. As we often say, past performance does not guarantee future results. For the next five years, from 2003 through 2007, 56 per cent of these formerly top funds fell below the median in Lipper rankings.

In conclusion, investors may feel that it is necessary to make moves during volatile or poor-performing time periods. But as we can see from this information, taking action just to take action can lead to significant underperformance.

Your BMO Nesbitt Burns Investment Advisor is committed to:

- Showing you how volatility plays an essential role in the market's long-term history of wide price fluctuations
- Helping you avoid making impulsive decisions. Emotion-driven investors make poor choices – often by selling at market lows
- Encouraging you to adopt a measured institutional approach to investing in the markets

Please contact your BMO Nesbitt Burns Investment Advisor to ensure you are reaching your financial goals.

Important Information

- All figures are in U.S. dollars.
- Diversification does not eliminate the risk of experiencing investment losses.
- Index returns are for illustrative purposes only and do not represent actual fund performance.
- Index performance returns do not reflect management fees, transaction costs or expenses. Indexes are unmanaged; an investor cannot invest directly in an index. Past performance does not guarantee future results.
- Commissions, trailing commissions, management fees and expenses all may be associated with mutual fund investments. Please read the prospectus before investing. Mutual funds are not guaranteed, their values change frequently and past performances may not be repeated ■

[1] The Morgan Stanley Capital International Index (MSCI EAFE) serves as a benchmark of the performance of major equity markets in Europe, Australasia and the Far East. From 1985 through 1988, the MSCI EAFE Index rose 322%. From 1989 through 1992, the Index fell 17%. Returns are cumulative and dividends and capital gains were reinvested. Source: Callan Associates, Inc.
[2] The S&P 500® Index is one of the most commonly used benchmarks for the overall U.S. stock market. It is a market capitalization weighted index of 500 widely held equity securities, designed to measure broad U.S. equity performance.
[3] Lehman Brothers Aggregate Bond Index is made up of the Lehman Brothers Government/Corporate Bond Inex, Mortgage-Backed Securities Index, and Asset –Based Securities Index, including securities that are of investment grade quality or better, have at least one year to maturity, and have an outstanding par value of at least $100 million. From 2000 to 2002, the S&P fell 42%, while the LB Aggregate Bond Index rose 33% Returns are cumulative and dividends and capital gains were reinvested.

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The toughest thing about this recession for Americans has been the rapid rise in long-duration unemployment. Canadians, as well, have suffered job losses and those in manufacturing (particularly in the automotive sector) have been especially hard hit by the strong Canadian dollar. Nevertheless, the loonie will likely rise further on balance over the next couple of years. Canada's previous record trade surplus has been driven down to a record trade deficit as the recession swept through the U.S. and commodity prices fell worldwide. Even so, Canada's rate of structural unemployment is far lower than in the U.S.

The average duration of unemployment south of the border is a record 27 weeks and the broadest measure of joblessness, which includes those who are involuntarily working less than full time, is now a record 17.5%. This has been particularly painful for older Boomers who have been knocked out by the double whammy of wealth destruction from falling stock and home prices as well as the gut-wrenching loss of employment. Hiring in the U.S. remains extremely low, and while layoffs have slowed, prospects for the unemployed appear pretty bleak for now. Many will never find a job that pays as well as the one they lost.

One sign of coming labour market improvement, however, is the rise in temporary employment. Clearly, sustained economic recovery will eventually trigger a boost in hiring. But for now, most businesses are willing to wait cautiously for a confirmation of a sustained upturn.

There is only so long, however, that the jobless can wait before they fall behind on their mortgage and credit card payments. Even for those that have jobs, the decline in household wealth has generated a necessary rise in savings and frugality. Retail sales are certainly stronger than they were a year ago, and Christmas sales will undoubtedly beat last year's very weak numbers, but people are looking for bargains and we will not see a redux of the free-spending days of the bubble era.

In time, governments will be forced to raise taxes and cut non-essential services. While it is highly unlikely that the U.S. will lose its reserve currency status, it will be coerced to tighten its belt. I am not suggesting that the U.S. will be confronted with failed auctions or an inability to finance its debt, but a much-needed revaluation of the Chinese currency will ultimately mean that China's financial spigots will finally be turned down a bit, leading to higher interest rates if the U.S. neglects to sufficiently tighten fiscal policy. Politically, these are very difficult issues and would be daunting for any President. But, it is especially worrisome today, as the degree of cooperation between the two political parties appears to be at a modern-day low.

Compounding the challenge, the aging population of the industrial world was already pointing toward a marked slowing in potential growth unless productivity gains and skilled immigrant inflows were large enough to offset the declining labour force. Ultimately, this will solve the structural unemployment problem in the U.S., but it will also manifest itself in a reduction in living standards.

The strength of the American economy is innovation and invention. It may be that the iPod is produced in China, but the bulk of the profits generated by this device land in the U.S. There are countless examples of this kind of impetus to growth and more are likely on the horizon. Moreover, with the weak greenback, the United States is now beginning to see a return of manufacturing jobs. We have even seen recent examples of foreign manufacturers that are, for the first time, opening U.S. operations. The states with the lowest tax structures and lowest cost of labour will attract the most new businesses.

I am confident that the equilibrating mechanisms of price adjustment—be it through the change in exchange rates, wage rates or product prices—will gradually reduce the imbalances and return the global economy to a sustainable pace of expansion. This pace, however, will likely be well below the 5% level of the bubble era. Tthe recovery is likely to be halting and subpar, especially in the U.S. Downside risks remain, but the clouds are gradually parting. Those who suffered the worst consequences of this maelstrom remain bruised and weary, but new opportunities will emerge as the excesses of the past are painfully whittled away ■

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