

Financial Planning Guide



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FOCUS ON INVESTING



Keep your portfolio healthy with a regular checkup

We're heading into the home stretch for 2006. Now is a great time to review your asset allocation and rebalance your portfolio's investment mix.

There are two scenarios that might call for rebalancing your portfolio: when your asset allocation has drifted from your existing target or when your target asset allocation has changed.

Asset drift. Market performance — both good and bad — makes it common for a portfolio to deviate from an established plan. To stay on track, it's necessary to periodically bring it back in line with your optimal asset mix.

Some people rebalance when an asset category exceeds its target weighting by a set amount, often five percentage points. For example, suppose your portfolio has a target asset allocation of 35% for Canadian equities. Given the strong performance of Canadian markets over the past

few years, Canadian equities may now represent 40%, or more, of your portfolio.

Changing needs. Developments in your job, family obligations, and physical and financial health may affect your investment goals or risk tolerance. For example, as you approach retirement, you may want to adjust your asset allocation to reflect your upcoming need for regular income.

Your options. To get back to your target mix, there are two possible options:

- 1. Sell and reinvest the proceeds.** Note, however, that this may trigger a taxable capital gain outside a registered plan.
- 2. Direct new cash injections to underweight areas.** You could direct new money to categories that are below target. This avoids possible tax consequences, but it may take longer to get back on target.

To make sure your portfolio is on track or to rebalance it in the most effective way, it's best to rely on professional guidance. ■

Investing for income?

Compare these mutual funds

Thanks to Canadians' ever-growing demand for income, there is now a wide range of income-oriented mutual funds. In addition to providing monthly or quarterly income, these funds are used for other purposes — from cushioning the volatility of equity funds to generating capital gains to providing international diversification.

Types of funds

Here are brief descriptions of the main types of income-oriented funds:

- **Canadian bond funds** are the most traditional. They hold mainly bonds from Canadian governments and corporations. A few of the funds focus on inflation-indexed “real return” bonds.
- **Canadian short-term bond funds** are a separate category because they tend to be used to “park” cash rather than to invest long term. They invest in government and corporate debt securities that mature in less than three years.
- **Mortgage funds** hold geographically diversified portfolios of residential, commercial, and industrial mortgages.



- **Foreign bond funds** hold bonds from government and corporate borrowers around the world. This has been a growing area since the foreign content limit was lifted from Registered Retirement Savings Plans and Registered Retirement Income Funds.
- **High-yield bond funds** invest in bonds

For parking cash, try the money market

FOR SAFETY AND short-term investing, money market funds have several characteristics that set them apart from other mutual funds:

Holdings. Money market funds invest strictly in highly secure, short-term (less than one year) debt instruments issued by federal and provincial governments and corporations.

Objectives. Their purpose is not to generate cash flow or growth potential, but to provide a secure “parking spot” for the short term.

Distributions. Other funds generate a mixture of dividends, capital gains, and interest. Money market funds distribute interest only.

Unit value. Unlike other mutual funds, whose unit prices fluctuate based on the value of their holdings, money market fund units attempt to maintain a constant level, usually \$10.

Security. Although money market funds are not covered by the Canada Deposit Insurance Corporation, they are considered the most secure of any type of mutual fund.

Because they are highly secure but provide minimal returns, money market mutual funds are considered a “cash or cash-equivalent” asset. Professional advice can help you determine, and maintain, an appropriate cash asset allocation for your mutual fund portfolio. ■



issued by financially troubled companies. The U.S. has a highly developed high-yield market and this too has been a growth area since the foreign content limit ended.

- **Monthly income funds** pay monthly income earned from a mix of holdings that usually include income trusts. Income trusts hold a diversified portfolio of businesses that provide cash flow. Distributions vary depending upon the success of the underlying businesses.
- **Dividend funds** used to focus on bond-like preferred shares, but now tend to hold more volatile dividend-paying common shares plus income trusts.

Fundamental facts

Every income fund investor should understand these concepts.

The teeter-totter. When interest rates rise, existing bonds and mortgage investments fall in value. Say you're willing to pay \$5,000 for a bond that pays 5%. If a new bond offered 5.5% for the same outlay, the price of your 5% bond would have to go down in order to make it saleable, since it pays less interest. Similarly, the unit value of bond and mortgage funds tends to go down when interest rates rise.

The opposite happens when interest rates fall. In this type of environment, the value of existing bonds and mortgages goes up, as does the unit value of funds that hold them.

The longer a holding has to run until maturity, the more pronounced the “teeter-totter” effect becomes. An actively managed fund will try to capture the capital gains opportunities that arise from interest rate fluctuations, which can account for much of an income fund's return.

Income versus market value. A sharp interest rate move can drive an income fund's market value up or down. Its distributions, however, remain unaffected. Market value matters only if you're looking to sell your fund units.

Credit quality. The greater the default risk, the higher the interest rate. A bond from a troubled company yields more than a bond from a sound one — that's the appeal of high-yield bond funds. A sound company's bond may yield more than a provincial government bond. Provincial bonds normally yield more than Government of Canada bonds.

With such a broad range of income-generating mutual funds, it can be difficult to choose the ones that best fit your portfolio. Professional advice can help you make the right choices. ■

TAX PLANNING**Study these potential student benefits**

With a new school year under way, here's a list of some tax breaks aimed at making college, university, and eligible training schools more affordable:

- Tuition and education tax credits that are not needed to reduce the student's taxable income to zero can be transferred to a spouse, parent, or grandparent.
- The full amount of all bursaries and scholarships is exempt from federal tax.
- There's a tax credit for interest paid on education loans issued under the Canada Student Loans Act.
- Students who move at least 40 kilometres from home to attend school can deduct moving expenses from any income earned while at school. ■

**RETIREMENT PLANNING****Canadians recognized for planning ahead**

Canadians are among the world's leaders in preparing for retirement.

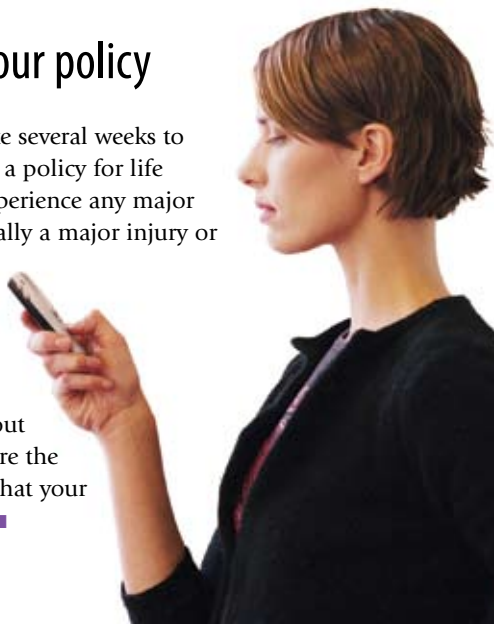
Results from a recent 11-country survey found that 78% of working Canadians aged 25 and over have begun saving for retirement — putting us in third place behind the U.S. (84%) and Germany (82%).



If you've contributed to this honourable score, congratulations! But getting recognition doesn't mean getting to take a break from your retirement planning. Professional advice can help make sure your retirement savings plan stays on track. ■

INSURANCE PLANNING**Honesty is best for your policy**

Insurance companies usually take several weeks to process an application and issue a policy for life or disability insurance. If you experience any major changes during that time, especially a major injury or disease diagnosis, be sure to let the insurer know. Some events could be enough to void the policy you're about to get. It's better to deal with this up-front when you can do something about it than to have your family endure the stress of learning, after the fact, that your insurance coverage was invalid. ■

**WHAT YOU NEED TO KNOW ABOUT...****The RESP carry-forward**

The Canada Education Savings Grant (CESG) tops up contributions you make to a Registered Education Savings Plan (RESP) by 20%. If you skip a year, the CESG entitlement can be carried forward. Here's how it works.

Q: What are the contribution and grant limits?

A: The maximum RESP contribution is \$4,000 per child per year, up to a lifetime amount of \$42,000. The CESG provides a matching contribution of 20% on the first \$2,000 contributed annually, and unused entitlement can be carried forward. The maximum grant in any one year is \$800. The grants are not included in the annual or lifetime RESP limits.

Q: How does the RESP carry-forward actually work?

A: Every Canadian child under 18 accrues a CESG entitlement each year, retroactive to 1998. Suppose your child was born in 2004, but until now you haven't contributed to an RESP. If you were to contribute \$3,000 this year, the RESP would get a \$400 grant for 2006, plus a \$200 grant for the entitlement carried forward from the previous two years when you made no contributions.

Q: Are there any deadlines for making contributions and receiving grants?

A: The annual RESP contribution deadline is the end of the year — there is no 60-day grace period as there is with Registered Retirement Savings Plans. As for CESGs, these are paid out only to the end of the year in which the child turns 17.

Consider letting your business do the investing

An incorporated small business pays far less tax on its profits than its owner does when those profits are taken out as income. This can create a wealth-building opportunity if the company makes more money than it and the owner need in order to meet expenses.

To fully benefit, you'll want to understand how to capitalize on this opportunity, and be aware of any drawbacks.

Make use of the small-business tax rate

Suppose that, thanks to the small-business deduction, your company pays tax at a rate of just 18%. On \$1,000 of earnings, that would net \$820, after tax.

If you paid that \$820 as a dividend to yourself as shareholder, you might have to pay as much as \$250 in personal income tax. (The exact amount would depend on your province of residence and the amount of your other income.) That would leave \$570 available for you to reinvest on your own.

What if, instead of paying the net earnings out as a dividend, the company invested them? You'd be able to put \$820 to work, not just \$570. The \$250 difference remains taxable, but only when withdrawn from the company. That might be many years away, and in the meantime that \$250 can grow.

Remember, you'll be taxed personally only when the money is taken out of the company, providing another potential advantage. You get to control the timing of the payout and also whether it's taken as salary or as a tax-advantaged dividend.

Proceed with caution

There are potential pitfalls. For example, if the investments held by your business grow too large, they may compromise your ability to qualify for the special \$500,000 lifetime capital gains exemption that's available when shares of a small-business corporation are sold or transferred.

Also, this money would be vulnerable to seizure by corporate creditors unless you take steps beforehand to shield it. This might be achieved by interposing an investment holding company or trust between you and the corporation, and transferring investment assets into it by way of a dividend, but it's a complex matter requiring professional advice.

Because companies face very high tax rates on income derived from investments rather than business operations, there could be tax consequences. Focus on investments that appreciate in value, not those that pay out income. There's no advantage to investing in an interest-bearing Guaranteed Investment Certificate — the company would be likely to pay more tax on the interest than you would yourself. But there might be an advantage from investments such as equity mutual funds, corporate-class mutual funds, and growth stocks that can grow in value while making few or no taxable payouts.

For incorporated small-business owners who hold investments personally, investing through their company is one of many strategies that might be beneficial. Seek professional financial and tax advice regarding your specific circumstances. ■

Canada Savings Bonds tempting? Consider all options

EACH OCTOBER THE federal government mounts its sales campaign for Canada Savings Bonds (CSBs). CSBs are highly secure and liquid, and can be held in registered plans. But before buying, consider some of these alternatives.

- **High-yield savings accounts** offer daily access and are protected (up to \$100,000 per account) by the Canada Deposit Insurance Corporation.

- **Guaranteed Investment Certificates (GICs)** offer higher returns than CSBs and savings accounts, but are less liquid. For ready access, choose cashable GICs.

- **Money market funds** typically pay a variable interest rate comparable or slightly better than GICs. Units are redeemable daily.

- **Government bonds** usually offer higher returns than CSBs if held to maturity. Federally backed bonds are as secure as CSBs; provincial bonds are almost as secure. These bonds can be sold before maturity for a capital gain or loss.

- **Bond or mortgage funds** may pay more interest than CSBs. Units can generally be redeemed daily, but not always at the price at which they were bought.

- **Monthly income funds** typically pay a set level of tax-advantaged income monthly, but they fluctuate in value. The monthly payout is likely to be higher than interest earned on a CSB, but the amount is not guaranteed.

With professional advice, you can find the savings solution that's best for you. ■

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