Interest Gained™

Our best insights and updates | May 2018 Issue No.12

COMBINED TO SERVE YOU BETTER

A welcome message from our Board

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"Through the combination of Perron & Partners and Cumberland Private Wealth, we will build on our strengths and offer an expanded range of investment mandates and services."

CUMBERLAND
Private Wealth

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Deep Roots, Stronger Together

By Charles R. Sims, FCPA, FCA
Chief Executive Officer*

On May 2, Cumberland Private Wealth completed the previously announced merger with Perron & Partners. So, how did two successful independent firms separated by 2,100 miles decide to join forces and Go Far Together? Let me tell you.

Both firms have a lot in common. To start with, both were founded by entrepreneurial industry veterans. Both firms were employee-owned with no affiliations to any financial organizations. Both had strong values and believed deeply in the client experience.

Gerry Connor and Gary Perron brought their decades of investment experience and their focus on values and culture to create companies that believed in employee ownership, an entrepreneurial spirit and an unwavering commitment to clients. From this common framework, we have now created one firm that is better able to meet your needs today and tomorrow.

Remaining true to our roots

The new, combined company will build on the strengths of each firm, while remaining true to the principles on which they were founded.

* Cumberland Partners Limited and Cumberland Private Wealth Management Inc.

Gerald R. Connor, Founder
Cumberland Private Wealth*

Investing alongside clients

Gerry Connor has always said "Whatever you recommend to clients, you should be confident in owning yourself." That was the founding philosophy of Cumberland Private Wealth over 20 years ago and it remains true today—we are an investment firm where "our money is managed alongside your money."

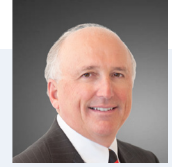
Employee ownership

Our team are owners as well as investors in Cumberland Private Wealth; they are committed, long-term partners for the future.

A unique client experience

Being aligned with our clients creates a unique culture and a rewarding client experience. We understand that clients today want and need to be more actively involved in the management of their wealth. At Cumberland Private Wealth, your portfolio manager is at your side and you can meet the people who manage your money.

"Whatever you recommend to clients, you should be confident in owning yourself."



Gary E. Perron, CFA
Founder Perron & Partners**

"We maintain our independence, innovative approach and drive to always work in the best interests of our clients."

Independence

Gary Perron recognized that larger firms tend to offer clients what's best for the firm, not necessarily what is preferred by the client. When he founded his independent firm, he immediately witnessed what was possible when not inhibited by corporate directives and guidelines.

By merging with another independent firm, Gary ensured that his firm's future would remain free from the influence of a larger financial institution and could remain true to its focus on investment excellence and the client experience.

Unbiased advice

We are able to offer our clients unique wealth management services with objectivity that is not possible at large institutions. You can be confident knowing that our interests are always aligned with your own.

Innovation

As an independent, the firm is free to develop new investment ideas and pursue innovative solutions for our client portfolios and service experience.

* Currently Chairman of Cumberland Partners Limited and Cumberland Private Wealth Management Inc., Director of Cumberland Investment Counsel Inc.

** Currently Vice-Chairman of Cumberland Partners Limited and Cumberland Private Wealth Management inc., Director of Cumberland Investment Counsel Inc.

Joining forces to serve you better

Joining together Perron & Partners and Cumberland Private Wealth ensures that we have the resources to be able to deliver the breadth and sophistication of products and services, as well as the unique client experience, that high net worth clients need and have come to expect.

For example,

- A more holistic offering to meet your life goals, including financial and estate planning
- Broader and deeper investment strategies, with 15 solutions spanning North America and Internationally, including Alternative, Equity and Fixed Income
- Deeper pool of talent, with over 20 investment managers and analysts
- More regional coverage and service

Our promise to you hasn't changed

Whether you were a client of Perron & Partners or of Cumberland Private Wealth, our promise to you hasn't changed.

We remain independent, disciplined and unbiased in our approach. We continue to be invested alongside you; employees of the merged Cumberland Private Wealth will continue to have an ownership stake in the firm. Your success and our success continue to be intertwined.

You will continue to receive exceptional client service from the same people you have come to know and trust over the years, while enjoying new advantages. You now have access to a wider range of wealth management products and services supported by a deeper team of investment professionals.

Your prosperity is our deep commitment.

We look forward to going far together.

World Perspectives and International Investing in 2018

By Sukyong Yang, CPA, CA, MBA, CFA
Portfolio Manager*,
International Equities

The World Stage Today

As we commemorated the fiftieth anniversary of Martin Luther King's passing, we wondered about the progress made in America and the rest of the world in terms of equality and peace. The United Nations, an international organization committed to peace and security as well as social progress, better living standards and human rights, certainly has not been successful in protecting the citizens of Rohingya. It appears that we are witnesses to another case of ethnic cleansing. When we presented on Myanmar post our visit during their first free general election in a generation, we were genuinely hopeful that it would emerge as a better country under the leadership of Aung San Suu Kyi. Her silence on this subject is viewed by many as complicity in crimes against humanity. While discussing this with fellow opinionated industry colleagues, they tried to convince me that she has had no choice but to look the other way if she wanted to stay in power and therefore, we need to accept that acting on principles is simply not a valid choice in the world of politics today.

On a similar note, China is now effectively a dictatorship with its constitution being changed recently to enable President Xi Jinping to lead for the rest of his life. As a result, it appears that we are witnessing a showdown between a potential Asian bully in China going head to head in a possible trade war against an American president who has the propensity to behave like a bully. China, the world's largest exporter with over 13% of the world's total exports, has created prosperity for itself and those with whom it has done business. Over the past decade, businesses around the world have flourished

We need to accept that acting on principles is simply not a valid choice in the world of politics today.

while quite often relying on China's growth for their own growth, albeit on China's terms. However, in doing business in China many companies have been concerned over Beijing's demand for transfer of their core technology to local players in exchange for access to the Chinese market. As China's power has grown, it has come to punish countries by using businesses as a conduit. For example, China boycotted South Korean companies such as Hyundai and Lotte for a year in response to South Korea's plans to deploy a US anti-missile system

* Cumberland Private Wealth Management Inc., Toronto

and Chinese tour groups were banned from visiting South Korea. Retailer Lotte was hit particularly hard and suffered huge losses after China imposed "unofficial" sanctions on the retailer, and Lotte has recently announced its plans to pull out of China's retail market.

Donald Trump is not the first American president to place unilateral tariffs on imports. What is different in his case is the negative view he seems to have of free trade compared to former US leaders and the strength of the opponent he is challenging. And China certainly is a formidable opponent that continues to be eager to flex its muscle on the world stage. In addition, there is tension between the US and several European Union (EU) countries including France, Germany, and the U.K. as a result of the tariffs announced by Trump on steel and aluminum exports. The EU, in response has threatened with retaliatory tariffs on a list of American products such as motorcycles, blue jeans and bourbon whiskey.

We include a chart produced by a sell-side analyst that outlines the tariffs that have been announced in the first two rounds of US/China trade negotiations. China ran a US$375 billion goods trade surplus with the US in 2017. While President Trump has demanded China cut the trade gap by US$100 billion or over 20% of US imports, Beijing has made a request for consultations at the World Trade Organization (WTO) in response. Perhaps China realizes the unfair advantage it enjoys over the US and may even be willing to negotiate. But in our view, Trump's undiplomatic manner has triggered an equally aggressive response from China to enact specific tariffs that would damage the US economy in industrial and farming goods and Trump's political base potentially. China is the biggest market for US soy and its proposed 25% tariff on soybeans would result in a large loss to American farmers. Trump's decision to instruct his administration to implement a plan to protect American farmers and agricultural interests could be reflective of the political pressure he is facing from Republican farm states.

Economists have expressed concern that global economic activity may slow if other governments join the mix with their own import barriers. Generally, a trade war is not in anyone's best interest.

		US Tariffs on China	China's Retaliation
First Round	Date of Implementation	8-Mar-18	1-Apr-18
	Products	25% tariff on steel; 10% on aluminum	15% tariff on steel pipes, fruit and wine ($977 mn of imports involved); 25% tariff on pork and recycled aluminum ($1,992 mn of imports involved)
	Amount Subject to Tariffs	~$2bn	$3bn
Second Round	Date of Implementation	3-Apr-18	4-Apr-18
	Products	25% tariff on Aeronautics, Modern Rail, New Energy Vehicles, Telecom Communication, Machinery and High-Tech Products	25% tariff on Soybeans and other agricultural products, Auto, Chemicals, Airplanes
	Amount Subject to Tariffs	$50bn	$50bn

Source: China and US governments
Credit Suisse

Interestingly, a former Trump administration official expressed the view that the side that wins in a trade war is the side that is most united. We note that currently, there is no choice but to be united on the Chinese side while on the US side, it appears that President Trump does not have a comprehensive, thoughtful strategy and united team.

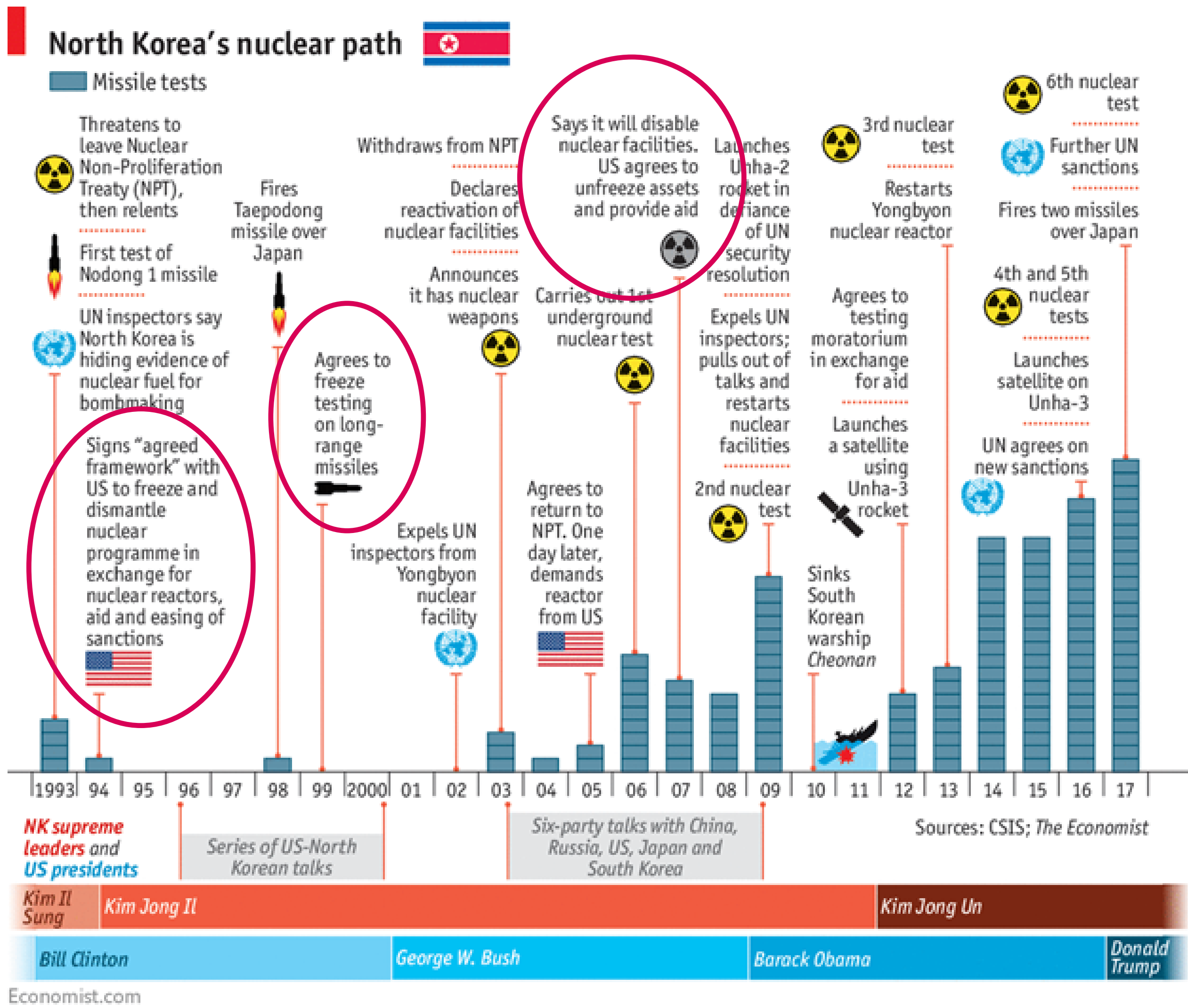
As we stated, President Trump escalated a trade war with an order that a plan be put in place for an additional US$100 billion in tariffs on imports from China. We are not surprised by this tactic since he has said that when he is attacked, he will attack back harder rather than negotiate. So with that, this will definitely not be the last round in the tariff war and therefore, we can only assume an elevated level of uncertainty as a given in looking ahead. We should remember however, that none of the tariffs proposed by either side have been imposed yet and there is still room for both China and the US to back down.

The U.S. dispatched its key economic policymakers led by Steven Mnuchin, Treasury Secretary and Robert Lighthizer, US Trade representative to China last week to be followed by the Chinese delegation visiting Washington in the coming weeks. There is still much uncertainty as to whether these two countries will be able to negotiate and avoid a trade war given their respective views. The dispute has deepened given China's efforts to become a global leader in advanced technologies. Concurrently, the U.S. is attempting to negotiate with the EU over tariffs on steel and aluminum and thereby avoid a trade war over the Atlantic.

President Trump escalated a trade war with an order that a plan be put in place for an additional US$100 billion in tariffs on imports from China.

Ironically, alongside this we may witness peace talks between the two Koreas that have been separated since 1945. In the past, sanctions alone against North Korea have not solved the Korean crisis which today is an extension of what took place 68 years ago, when the US underestimated the role China would take in the Korean War. We should not forget that 2.5 million civilians and 1.2 million soldiers perished in this "Forgotten War". North Korea had China's support back in 1950 and has been able to survive all these years because of it.

A policy of containment of North Korea is rather complicated as it involves negotiations of many countries, namely the US, China, Japan, South Korea and North Korea. One can question whether much has been learned by the past two generations that will lead to a pathway to a full resolution. However, post their show of unity at the winter Olympics hosted by South Korea, North Korea's supreme leader, Kim Jong-Un invited President Trump to a summit. The date and place have finally been confirmed and it will take place on June 12 in Singapore, a location that can be considered as politically neutral. As can be seen in the chart below, we have been down this road before with North Korea promising to freeze its nuclear program a few times over the past twenty five years. Hence, we have tempered our enthusiasm as peace may not be as immediate an outcome although it now appears possible. With North Korea's backing from China, the upcoming summit may be at risk given the strong tensions that have developed between China and the US.



It is also possible that China may be seeking to strengthen its ties with its Asian neighbors as a means of easing the pressure from the Trump administration. The leaders of China, Japan and Korea held their own three-nation summit in Tokyo on May 9, which has been cancelled many times in recent years due to the tensions among these three nations themselves. That said, this year also marks the 40th anniversary of the signing of the Treaty of Peace and Friendship between Japan and China, offering an opportunity for a bolstering of ties prior to President Trump's meeting with North Korea. Furthermore, with all three countries being beneficiaries of global free trade and having been negatively impacted by Trump's policy, it is natural for them to create a closer economic relationship. On the particular topic of North Korea, all three countries have welcomed bilateral talks between Pyongyang and Washington, yet each country's interests differ, which may ultimately prevent a satisfactory resolution.

At the end of April, South Korean President Moon Jae-In and North Korean leader Kim Jong-Un declared in a joint statement a new era of peace in the peninsula and agreed to work toward advancing the reunification of the two nations. As is the case in any deal, post the current optimism and eye-catching photo opportunities lie the details and terms yet to be negotiated and agreed upon. In order for the agreement to succeed, both sides will have to overcome decades of distrust which sceptics do not believe can be achieved. During this period prior to this summit, there is a mixture of hope and friendliness as was demonstrated by North Korea's gesture of goodwill releasing three U.S. citizens. Yet, the underlying distrust still remains given North Korea's cycle of provocation.

International Markets and Our Portfolio Positioning

If you have ever ridden a rollercoaster, then you know how the markets have behaved since the beginning of the year. When the bell rings to signal the end of the trading day, you are just glad to get off the ride, knowing that the bumpy ride may repeat itself the next day. Many of the ups and downs have been a result of Donald Trump's overnight tweets and / or any one of the games being played on the political stage as we described. It is also interesting to note that the Russian and Brazilian equity indices were among the two best performing markets in the first quarter of this year. Given our high quality screens, risk aversion and disciplined approach to investing, it should not come as a surprise that we do not have any exposure to either of these. The FTSE 100, the UK's benchmark index, has on the other hand been the worst performing major index, down more than 8%. Fortunately, our exposure here has also been minimal.

We came across an interesting article examining the recent weakness of the DAX index, Germany's benchmark index, which is dominated by carmakers and the chemicals industry, and has become a proxy for world trade. Investors have certainly been betting against them. While these cyclical sectors helped the DAX perform well in 2017, the broader macroeconomic situation is less favorable now causing the German market to lag every major European market except the UK's FTSE 100. This situation also highlights the downside of buying an index where as an investor you are subject to the larger swings of the market rather than the fundamentals of the underlying companies and stocks. Fortunately, our exposure to Germany is limited to two high quality companies, Fresenius SE and SAP. Fresenius SE, a global, diversified healthcare company with sales of €34 billion in 2017, has been a long-standing investment in our Cumberland International Fund and has served us well with its strong track record of generating profitable growth and good returns year after year. SAP continues to make progress in their S/4 HANA software sales and is performing well. We note that these investments are in two sectors that have little representation in the DAX Index.

Over the years, we have introduced the concept of investing in secular themes into our global and international portfolios which more recently have included rising global wealth, demographics, automation, and big data. We invested in sub-themes within these secular growth areas too, such as the electrification of automobiles within automation.

In the demographics area, we believe that the global trends of falling birth rates and increasing lifespans will continue to impact economic growth in many developing countries around the world. Related to these trends, as an example the needs of the ageing population can be considered as a growth area.

We can also relate our portfolio to the range of common issues that are on most CEOs' minds today, such as:

1. Digitalization
2. Ways to use big data to enhance productivity, drive growth
3. Global growth
4. Blurring industry lines
5. Geopolitical risk

In reviewing our portfolio companies with these trends at the forefront, we feel confident that they will maintain their respective competitive advantages in light of the continuously changing landscape. Companies will either use digitalization to achieve or maintain their leadership while others will use it as a defensive tool to obtain cost efficiencies.

If you have ever ridden a rollercoaster, then you know how the markets have behaved since the beginning of the year.

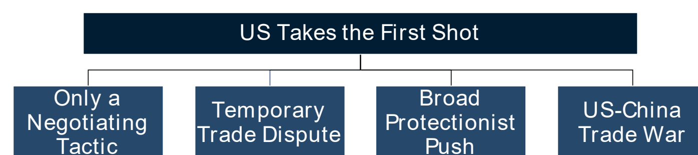
Automation continues to be an important focus for executives to achieve not only cost efficiencies but margin expansion too, especially in today's era of limited high economic growth potential. For example, companies will use big data to get to know their customer base better, understand the threats and opportunities and capitalize on the growth potential the data provides.

Another major business challenge today is the impact of technological disruptions, the mere survival of entire traditional industries and the blurring of lines between different industries. One example is the blurring between media and consulting. Accenture, an investment in our International Fund, has had its growth strongly driven by digital and its expansion into advertising. A critical success factor in this industry is being close to the customer, having the ability to define who the customer is and even being able to define the desires and needs of customers. Ad agencies are currently underweight in high growth segments of the market while Google (a holding in our Global Equity Portfolio) along with Facebook (not a holding), have absorbed most of the global advertising growth. Furthermore, disrupters such as Amazon are simultaneously changing the landscape of the ecosystem. Maurice Levy, Chairman of Publicis has spoken about mobile phones taking the lion's share of digital communications and playing a key role. And it is deep data, not just big data that factors today.

Concluding Comments

Despite all the rhetoric in global politics and the gloomy headlines, leading global companies are still forging ahead with innovation to keep themselves relevant and maintain their competitive advantages. However, most strategists view a trade war and countries going into a protectionist mode as being negative for synchronized global growth and as a result, the bull case for equity markets may now be at risk. Over the past decades, many global companies have been able to improve their margins through innovation and with free trade, they have also decreased input costs, allowing them to successfully sell their products and/or services around the world. If this door starts to close, margin growth will surely wane, and revenue growth will become muted. Therefore, this is a development that we shall monitor closely. Cumberland's International Fund continued to benefit from its exposure to the Information Technology returning +3.9% in the first quarter while its benchmark MSCI EAFE Index had a mere +1.3%. Our Fund's investments in Dassault Systèmes, Nidec and TSMC were the main contributors in terms of stock selection.

Going back to U.S. / China tariff discussions, the chart below, courtesy of our Fixed Income Manager, looks at the different scenarios that can take place post the first shots taken by the U.S. At the present time, our firm's view is that the U.S. is deploying a negotiating tactic although we realize that we cannot be complacent as the whole situation may not remain static. We shall be vigilant in assessing the moving parts and the potential on our portfolios.



To conclude, the volatility experienced during the first quarter and year to date, has largely reflected the fear that synchronized global expansion may be coming to an end. Our conservative stance, both in our stock selections as well as our current allocation to cash (12%), helped us preserve capital during the first quarter. We continue be of the view that maintaining a margin of safety that serves to protect against the "unknown unknowns" that can affect our investments is a prudent strategy, given the global political risks that exist today.

We welcome your questions and invite you to touch base with your Portfolio Manager.

May 11, 2018

International Equity Strategy: Total Returns Summary (From Inception June 2010)

As at: 3/31/2018

	YTD	1 Year	2 Years	3 Years	4 Years	5 Years	Annualized Since Inception June 2010
Cumberland International Fund (Gross of Fees)	3.92%	13.84%	12.61%	8.65%	9.77%	10.61%	10.71%

Changing of Chairs: Styles of Central Banker and Rate Cycles

By Diane Pang, CPA, CA, CFA
Portfolio Manager*, Fixed Income

Jerome H. Powell vs. Janet Yellen

Since the mid 70s the Chairman of the Federal Reserve Board have served at least two consecutive terms (terms are 4 years at a time). The appointment of Janet Yellen, being the first women Chairperson of the Federal Reserve Board, back in 2014 by Barack Obama marks the first break in that trend, serving only one term. Many have asked if this change in Chairs will make a difference in the interest rate hike cycle in the US. Our Short answer: NO.

While Mr. Powell seems a tad bit more hawkish (interest rates rising), we think he will stick to the script of balancing target inflation at 2% and avoid overheating the economy and will continue with gradual rate increases (based on what data dictates).

The expectation is still 2 to 3 more hikes in 2018 if data persists. Major differences (and obvious ones) include man vs. woman, Republican vs. Democrat, Capitalist vs. Socialist but both Chairs are of the view that hikes are required to avoid the economy overheating. The one notable difference is their backgrounds –Mr. Powell has had extensive experience in capital markets. This experience could be a benefit to the investment community as it is well known bond investors scrutinize the FOMC meeting minutes and his speeches in the public for next steps in monetary policies. So far, he has been pretty transparent and consistent, which helps to stabilize the markets…now if only Trump stopped poking dragons.

Many have asked if this change in Chairs will make a difference in the interest rate hike cycle in the US.

Our Short answer: NO.

* Cumberland Investment Counsel Inc., Toronto

	Jerome Hayden Powell	Janet Yellen
Term	Feb 5, 2018 - present	Feb 3, 2014- Feb 3, 2018
Age at start of term	65	67
Education	Princeton University – Bachelor of Arts Georgetown University – Juris Doctor	Brown University - Bachelor of Economics Yale University - Ph.D
Experience	• Lawyer at Davis Polk & Wardwell (1981 to 1983) • Lawyer at Werbel & McMillen (1983-1984) • Investment Banker at Dillion, Read & Co (1984-1990) • United States Depart of Treasury (1990-1993) • Under Secretary of the Treasury for Domestic Finance (1992) • Investment Banker (1993-1997) • Partner at Carlyle Group (1997-2005) • Other Private Equity ventures (2005-2010) • Visiting Scholar at Bipartisan Policy Centre (2010-2012) • Federal Reserve Board of Governors (2011) • Federal Reserve Board Chair (2018)	• Lecturer at University of California, Berkeley (1980s to mid 1990s) • White House Council of Economic Advisors (1997 to 1999) • President & CEO of Federal Reserve Bank of San Francisco (2004) • Vice Chair of Federal Reserve Board of Governors (2010) • First Chair-woman of the Federal Reserve Board (2014)
Nominated by	Donald Trump	Barack Obama
Political Party	Republican	Democrat

Canada vs. the U.S.

The Bank of Canada Governor, Stephen Poloz, came into his seven-year term on June 3, 2013, with an extensive background in Economics and serving at the Bank of Canada for 14 years working towards his final appointment there as Chief of the Bank's Research in 1992 before leaving in 1995 to join BCA research for four years. He then became the Chief Economist at Export Development Canada ("EDC") in 1999, moved into a financing role between 2008 to 2010 and then was most recently President and CEO of EDC before being appointed as the Governor of the Bank of Canada in 2013.

The main notable difference between Poloz and Powell is that Powell has extensive capital markets experience as we have indicated, which shows in his initial public appearances to be consistent in his forward looking statements as the investment community relies heavily on his statements. Poloz on the other hand has shown over the years to change his views drastically rather than phasing in shifts in his views over time which we think has caused more volatility in the bond markets than necessary.

As central banks of the United States and Canada, The Federal Reserve Board and Bank of Canada respectively, each uses a committee of members to vote on monetary policy and hold 8 meetings throughout the year. The members conduct economic and financial reviews to derive what is appropriate from a monetary policy standpoint.

In the US, there are 12 members on the Federal Open Market Committee (FOMC) while in Canada the board is composed of the Governor, the Senior Deputy Governor and then 12 independent directors. Both central banks are targeting a 2% inflation target and continue to be "data dependent" weighing economic factors to ensure inflation stays within their target range without swaying too far.

The table below highlights a few things we need to take note of and some of the anticipation of the next rate hike.

To conclude, our belief is that at this time, Governor Poloz will continue to lag the US in hikes and we expect at least a 25bps gap between Canada and the US before Poloz continues hiking (ie. we will not outpace the US such that our overnight rate will be higher).

To learn more about how we are positioning our income investments in today's environment, please reach out to your Portfolio Manager.

	United States Federal Reserve Board	Canada Bank of Canada
Fed Chair/Governor	Jerome Hayden Powell	Stephen S. Poloz
Overnight Rate (Lower Bound)	1.50%	1.25%
First Hike in Cycle	December 16, 2015	July 12, 2017
# of Hikes in 2017	3	2
# of Hikes in 2018 (YTD)	1	1
Anticipated Hikes for Rest of 2018	2-3	1-2
Next Anticipated Hike	June 2018	July 2018
Next Meeting	June 13, 2018	May 30, 2018
Inflation as at March 2018 (y/y)	2.4%	2.3%

Today's Landscape and Opportunities in Canadian Pipelines and Midstream Companies

By Chris Bolton, CFA
Portfolio Manager*

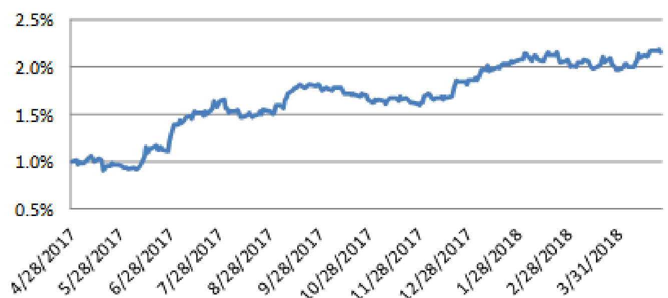
The S&P/TSX Oil & Gas Storage and Transportation Total Return Index is down approximately 14.7% year-to-date (through April 26). Rising interest rates, larger than normal discounts for western Canadian natural gas and crude oil (particularly heavier crude oil), and various delays with new projects have all given analysts, pundits, and the media plenty of material to construct a negative narrative.

We recently met with senior executives of Enbridge Inc., Gibson Energy Inc., Inter Pipeline Ltd., Keyera Corp., Pembina Pipeline Corporation, and TransCanada Corporation. Based on our meetings, we have concluded that some of this external negativity is misplaced and that the sector has been overly punished.

The Impact of Rising Interest Rates

All things equal, rising interest rates decrease the value of most equities including pipeline company stocks. Over the past two years, S&P/TSX Oil & Gas Storage and Transportation Total Return Index and the yield on 5 year Government of Canada bond have a correlation coefficient of -0.212 when measured on a monthly basis, which does indicate that historically lower interest rates have been positive for Canadian oil and gas storage and Transportation equities.

Interest rates have generally been increasing over the last year. For example, the yield on the 5 year Government of Canada bond has increased from a recent low of approximately 0.92% in May 2017 to about 2.19% today.



Source: Bloomberg

Government of Canada 5 Year Bond Yield

All things equal, we expect that interest rates are more likely to rise than fall in the next 12 months. However, we do not believe than another 138% increase is likely in the next year. Furthermore, given

* Cumberland Private Wealth Management Inc., Calgary

the 20% + sell-off in these stocks since last May, we believe some degree of higher interest rates are already priced into their prices.

Existing Operations Running Well

One thing that impressed us throughout the meetings was that existing operations are generally running well. Most pipeline systems originating in Western Canada are at or near full capacity. While this fact has been frustrating for oil and gas producers (as they often have to accept less attractive pricing for their product), it has led to opportunities for the pipeline companies. Increased demand for storage capacity, demand if any capacity becomes available on existing pipeline systems and producer demand for the construction of new pipelines should all be positive for the pipeline industry.

Large, Meaningful Growth Projects to Come

While a lot of focus is placed on projects that face opposition, it is sometimes forgotten that these companies have completed a number of projects and continue to have a large backlog of potential investments. For example, Enbridge placed $12 billion of projects into service in 2017. While the Line 3 expansion is awaiting regulatory approval (a decision is expected in June), construction on projects such as the US$1.3 Billion NEXUS pipeline and the Valley Crossing pipeline in Texas continues on time and on budget. TransCanada placed $5 billion of project into service in 2017 and the US$1.6 billion Leach XPress pipeline went into service in January 2018. In 2017, Pembina Pipeline posted 43% growth in EBITDA (when compared to 2016) thanks in large part to new projects. These companies have been and continue to execute on meaningful growth projects.

Opposition to New Projects

Almost all major infrastructure projects face opposition from at least some party. While natural gas producers may be dismayed at the price of their product in Alberta, consumers of natural gas (such as the petrochemical industry) are incented to maintain the status quo. No one has a crystal ball and can predict if and when the Trans Mountain Expansion, the Line 3 Expansion or Keystone XL get completed. As investors perhaps all we can hope for is a clear, fair regulatory process that is accepted by all parties. In the long run, it seems clear to us that transporting crude by rail is generally more costly and more dangerous than via pipeline. Furthermore, the discounts currently being endured by producers of oil and gas in Canada is currently costing the Canadian economy billions of dollars per year.

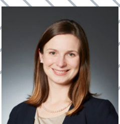
Concluding Comments – Stay The Course

Profitably investing in pipeline companies has been difficult thus far in 2018. However, we would not advise giving up on the sector permanently. While the lack of progress on certain projects remains frustrating, in theory the value of existing pipelines should be higher if constructing new pipelines is more difficult. While much focus has been placed on these delayed "mega-projects", most pipeline/ midstream companies in Canada continue to execute on smaller projects year after year. Some of these "smaller" projects are still multi-billion dollar opportunities.

In addition, the sector is currently trading at less than 17x forecast 2018 Price-to-Earnings (2018E P/E) or and a 5.9% dividend yield according to Bloomberg. In terms of 2019 forecast earnings, the sector is trading at 15.6x forecast P/E and a 6.8% dividend yield. On a forward P/E basis, this is the lowest valuation the sector has traded at in the last six years. The sector was trading over 31x forward P/E four years ago.

We believe the sector generally represents good value and approximately 10.8% of the Kipling Monthly Income Fund is currently allocated to the common equity or stocks of Canadian pipeline companies. These are also represented within the Cumberland North American and Canadian Equity mandates.

Your Portfolio Manager would be happy to review these with you.



Implications of 2018 Budget on Tax for Private Corporations

By Meghan Davis, CPA, CA, TEP*

As many Canadians are aware, the Department of Finance has made major changes to the taxation of shareholders effective for 2018. What used to be known as "kiddie tax" is now referred to as "tax on split income" or "TOSI" and it can potentially apply to almost anyone with residency ties to Canada. The budget also introduced new rules for corporations earning passive income, which will become effective in 2019. As a result, incorporated professionals are more restricted in their tax planning, leading some to ask: "Is it still worth it"? The classic tax-planning answer, of course, is "it depends". This article explains some of the recent tax law changes, and considers some situations where professional corporations ("PCs") may still offer tax and financial planning benefits.

Some Perspectives and Background

For the past decade, many professionals, most notably physicians and dentists, have used PCs for their significant financial and tax planning benefits. Unlike other professions, physicians and dentists are allowed to have family members as shareholders in their PCs, opening up the possibility for tax savings by paying dividends to lower-income shareholders ("income splitting").

For professionals unable to benefit from income splitting, the fact that corporate tax rates are lower than most personal tax rates provides another advantage: a tax deferral. Money saved inside a corporation is subject to corporate taxes (with rates ranging from 10%-31%) instead of personal tax rates (ranging up to 54%), and therefore, a corporate investment account can accumulate assets more quickly than a personal non-registered account. If the corporate shareholder is in a lower tax bracket when the funds are withdrawn, further tax savings are possible.

Tax benefit #1: Splitting Income

For those business owners who used income splitting in the past, the most recent TOSI rules contain some new exceptions which may allow dividends to escape TOSI, including the following:

1) Excluded shares – the idea here is that related persons can avoid TOSI as long as they hold the "right" type of shares (i.e. sufficient value and voting rights) in the "right" type of business (e.g., manufacturing, goods-based). Unfortunately for professionals, PCs and service-based businesses are specifically excluded.

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2) Excluded business – The other exception from TOSI, unlike income from excluded shares, could potentially be accessed by the shareholders of professional corporations and service-based businesses. This exception allows related shareholders that are sufficiently active in the business (in that year or in any of the 5 previous years) to avoid TOSI on their dividends.

3) Dividends paid to spouse of a "source individual" (e.g., the professional) age 65 or older – to allow for income splitting for retirement-age couples, TOSI doesn't apply to dividends paid to a spouse once the individual who actively worked in the business reaches age 65.

With this understanding, a professional may decide to incorporate under the new rules in the following scenarios:

The practice meets the definition of an "excluded business" for a family member shareholder.

For example, it is not uncommon for the spouse of a dentist, family physician, or other professional to have enough involvement in the practice to meet the requirements of these new rules (an average of 20 hours per week in the current year or any of the preceding 5 years). While it is true that an unincorporated professional could pay the family member a salary for their work (and salaries are not subject to TOSI), in order to be deductible to the professional it must be reasonable. Dividends would allow for better income splitting, so a PC might be a good option.

It is also not unusual for spouses to be in the same profession; in that case, combining their practices into one corporation could allow them to equalize their income regardless of their respective level of fees generated, as long as each spouse met the minimum involvement requirements mentioned above.

The PC can be used as a source of retirement income.

Because of the exception from TOSI for professionals age 65 and above, corporate savings can still play a role in funding a tax-efficient retirement. This may be a good strategy when the corporation tax rates are lower than the personal tax rates of the active shareholder, and registered account options aren't enough to meet their retirement goals.

Tax benefit #2: Lower corporate tax rates

There are other examples of when it might make sense to incorporate, because of the increased after-tax cash flow resulting from low corporate tax rates. Here are a few such situations:

Acquiring a practice of significant value: The ongoing decreases to corporate tax rates (and increases to top personal tax rates) make financing the purchase of a business such as a dental practice with a corporate loan much more tax-efficient than a personal loan. Because loan repayments are not deductible from income, corporations have more after-tax funds available that can be used to repay their debt (versus an unincorporated professional using his or her after-tax income). Interest payments would generally be deductible whether the loan is corporate or personal.

To illustrate with an example, consider the pre-tax income required to repay a $500,000 corporate loan (an Alberta company taxable at the small business rate of 12%) vs. a top rate Alberta taxpayer's personal loan (taxable at 48%):

Income Required to Repay $500,000 Business Loan:

Income (Taxes Payable)	Corporation Loan (12%)	Personal Loan (assumed top marginal rate 48%)	Difference
Income before taxes required to repay loan:	$568,182	$961,539	$393,357
Taxes	$68,182	$461,539	
Available to repay loan	$500,000	$500,000	

In this scenario, the self-employed individual would need an additional $393,000 of pre-tax income to repay the business loan, which would clearly significantly reduce the cash flow of the business for a number of years.

Professionals who would benefit from "income smoothing"

Depending on the nature of work and possible leaves (e.g., parental, sabbatical or unplanned), a corporation is beneficial as it is not subject to the quickly increasing marginal tax rates applicable to individuals. A professional can use a corporation to control their personal tax liabilities, keeping a steady salary (or dividend) income from year to year, to ensure that they are maximizing the benefit of lower marginal rates each year. To illustrate with an extreme example, consider a non-incorporated physician resident in Ontario who earns $440,000 in year 1, and then takes a 1-year parental leave in year 2 with no income.

	Year 1	Year 2	Total
Income	$440,000	-	$440,000
Taxes payable	$199,000	-	$199,000
After-tax cash	$241,000	-	$241,000
MPC Salary to shareholder	$220,000	$220,000	$440,000
Taxes payable	$81,000	$81,000	$162,000
After-tax cash	$139,000	$139,000	$278,000
Income tax savings (not including CPP)			$37,000

The non-incorporated physician would pay about 37,000 in additional income tax versus an incorporated physician able to split that income evenly between year 1 and year 2. This strategy could be thought of as "income splitting" between years instead of between individuals. An example of a non-health professional who may realize a significant benefit from this strategy is a litigator that earns contingency-based fees.

Provide additional savings for retirement

Canada pay tax rates ranging from 10% to 31% on active income, generally lower than personal tax rates (which are as high as 54%), so professionals can accumulate business profits more quickly (and therefore produce more investment income and capital gains) inside of a corporation than in a personally-held, non-registered investment account. The exception from TOSI noted above to allow income splitting in retirement further adds to the appeal of corporate investment accounts. The impact of corporate passive income on the access to small business tax rates introduced in the 2018 budget may result in more business owners prioritizing RRSP and TFSA savings, but for savings in excess of the associated contribution limits, corporate investing is an option.

Paying non-deductible life insurance premiums: As was the case previously, for non-deductible business-related expenditures such as corporate-owned life insurance premiums, lower corporate tax rates provide greater cash flow. Therefore, using a corporation to fund a permanent life insurance policy remains an appealing option in estate planning.

Are they worth it?

Using a corporation to operate a professional practice has always introduced additional complexity to one's tax situation. Now, perhaps more than ever, clients will require sound professional advice to navigate the complexity of today's tax laws to find the answer to this question in their particular circumstances. There is no "one size fits all", as the professional's family situation, how the practice is acquired, the anticipated income, and numerous other factors will play a role in this decision. However, even in the current tax climate there continue to be many compelling reasons to incorporate a PC.

For further insights, we encourage you to speak with your Portfolio Manager.

Stay The Course

By Keith Leslie, CFA
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One of my friend and colleague's favourite saying is, "Don't get smart, stay the way you are". Besides being a pretty good insult, I think it is sound advice when it comes to investing.

Too many investors overthink what they read or hear and then try to time the market. We do not believe that anyone or any system can time the market consistently and, as a result, it is a better idea to stay invested. For every analyst or expert that tells you the market is under valued, we can find another analyst or expert that looks at it a different way and claims it is over valued. This also applies to commodities such as oil and gold.

What investors need to remember is that the long-term direction of the market is up so staying the course and remaining invested seems to be the best solution. While trading in and out of the market may add value on occasion, it is human nature to remember when it works and forget when it does not. I suspect that those that think they are good at timing the market will give you examples of when they were right. However, they likely will have forgotten all the times they were wrong. At best, I suspect their calls net out to even.

Don't forget that timing the market requires two decisions in order to be deemed correct: when to get out but also, more importantly, when to get back in.

The best way to combat market volatility is to create a properly diversified portfolio, stay the course, and follow the plan.

If you sell before the market pulls back 10%, you are not right if you are not invested when the market rebounds 20%. This is an important point that is often overlooked.

Another important thing to remember is that if you "go to cash" and the market goes up 10%, it is extremely hard from a psychological point of view to make the decision to enter the market at a higher level. If you stay invested but became more conservative if you were worried about a correction, the decision to get more aggressive is significantly easier.

There are other ways to time the market without going all in. You can buy low volatility funds to give you guarded growth potential or alternative strategies that have the ability to use short selling to provide better downside protection. If you are wrong and the market keeps going, you still participate although likely to a lesser extent. If you are right then you protect a little better, making it easier to recover.

Ultimately, the best way to combat market volatility is to create a properly diversified portfolio, stay the course, and follow the plan. Be a long-term investor, do not chase returns and stick to your well thought out asset mix. Rebalance your portfolio consistently and try to create targets rather than just blindly trying to hit home runs. Design your portfolio to protect first with core positions, and then grow second by adding funds, stocks or other securities for upside. If you own a portfolio of lower risk securities both in Canada and globally, investment grade and high yield bonds, conservative alternative strategies; and then add in securities with strong track records, like small cap funds, reaching your investment goals without excessive risk becomes more palatable.

We have seen the following study many times but thought we would re-create it internally to show what the upside and downside of trying to time the market is. Volatility creates anxiety with investors so we wanted to show the effects of short-term moves in the market, both positive and negative. Once investors understand that they will likely never pick market tops and bottoms and may even be wrong, our hope is that they will stop worrying about short-term returns and look to the long term. The variance of returns by removing a very few number of days is staggering.

In our study, we decided to look at the Canadian and U.S. markets to see what would have happened to investor returns if we removed the best and worst trading days. First, we would like to remind everyone that there are approximately 250 trading days per year so removing one day per year is only excluding 0.4% of the trading days and removing five days per year is only excluding 2% of the trading days. We examined the 28 year period from the beginning of 1990 to the end of 2017 and obtained the following results

TSX	0 Days	1 Day (0.4% per year)	5 Days (2% per year)
Removing **best days** per year	8.1%	5.0%	-3.8%
Removing **worst days** per year	8.1%	12.2%	23.9%
TSX	**0 Days**	**28 Days (0.4% of overall)**	**140 Days (2% of overall)**
Removing **best days** per year	8.1%	3.0%	-7.2%
Removing **worst days** per year	8.1%	14.8%	29.2%

The annualized total return of the TSX over the 28 year period was 8.1% (0.03% per day). If we were to remove the best trading day each year, the annualized return would drop to 5.0% and if we were to remove the worst trading day each year, the annualized return would rise to 12.2%. Even more dramatic is what happens if we exclude five trading days per year. If we removed the best 5 days per year, the annualized return would drop all the way to -3.8% per year and if we removed the worst five days, the return would climb to nearly 23.9%.

You can also see from the chart above that if we removed the best and worst 28 days in the period (average of one day per year) the return would range

from 3.0% to 14.8% and if we removed 2% of the days, good and bad, the range of returns would be from -7.2% to 29.2%. In other words, Canadian market returns are driven by a very few number of days. Trying to pick those days that drive the market is next to impossible. Also, keep in mind that many of the worst days are immediately followed by a best day as the market rebounds. So, to my point earlier, unless you buy back after a bad day, you will likely give up some or all of your paper profit.

Now, let's see if the same holds true in the U.S. market. We looked at the same 28 year period only we used the S&P 500 Total Return Index this time. The annualized return for this period was 10.2% (0.04% per day).

TSX	0 Days	1 Day (0.4% per year)	5 Days (2% per year)
Removing **best days** per year	10.2%	6.3%	-4.7%
Removing **worst days** per year	10.2%	14.6%	27.9%
TSX	**0 Days**	**28 Days (0.4% of overall)**	**140 Days (2% of overall)**
Removing **best days** per year	10.2%	4.3%	-7.9%
Removing **worst days** per year	10.2%	17.2%	32.9%

The results are pretty much the same as in Canada. Removing 0.4% of the trading days or 2% of the trading days will lead to a dramatic variance in returns.

I suspect that investors would take a return of 8.1% or 10.2% over a 28 year period instead of chasing a higher return but potentially ending up negative.

In conclusion, we believe that the best thing an investor can do is to remain invested for the long term and not chase returns.
To combat some of the volatility, introduce low volatility and alternative strategies but for the most part, set a proper asset mix and stick to it. Understand that getting out of the market will, more often than not, end in a mistake as it is not just when to get out but also when to get back in. If an investor wants to act on their belief that the market is over or under valued, we suggest they move around at the fringe by staying invested but in more conservative or aggressive securities rather than being in or out of the market. It will make the transition back to the other direction easier and save face if they are wrong given they will still participate in some of the upside or protect a little better on the downside. If somehow an investor can pick the worst days, they probably missed some of the best days as they are often close together. Investors can alter the risk dynamics of their portfolio without changing their asset mix which protects them in the event the market does not behave as you expect, and it rarely does. The best piece of advice I have for any investor is to take the time to properly create a diversified portfolio and then "Stay the Course".

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