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Perspective



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As of September 15, 2011

Moderate Rebound Likely

With all of the gyrations in financial markets, this was not a quiet summer. But, as we move into the back-to-school season, we will see if the synchronized global economic slowdown was a soft spot or a portent of another recession. My money is on a soft spot, with a moderate rebound over the fall and winter months. Don't get me wrong—it won't feel so great, particularly in the U.S. and Europe, but Canada will remain a relative haven of stability. Growth is likely to resume at about a 2¼% pace in North America, which isn't enough to reduce the jobless rate by more than a touch. The U.S. housing market will continue to weigh on confidence and spending plans. Canadian housing construction and sales are far stronger and prices, on average, remain firm. However, don't expect the booming gains we saw in recent years in Vancouver and Toronto. Indeed, at the higher-end of the housing market, foundation cracks are already beginning to show in both cities where affordability among domestic residents is stretched, as incomes have not kept up with house prices.

On the other hand, strong underpinnings for the North American stock markets remain. Corporate earnings are still growing and multiples are reasonable, so there are buying

opportunities after the summer selloff. Interest rates are extraordinarily low and dividends are rich in comparison. There is also a huge volume of cash on the sidelines waiting to jump back in when confidence improves.

To be sure, risks remain. The European sovereign debt crisis will continue unabated this fall, and the U.S. deficit drama will go into full swing as the special bipartisan congressional committee on deficit reduction is scheduled to report before U.S. Thanksgiving. As well, President Obama's proposed jobs plan is ripe for a collision with the House Tea Partiers who don't want any fiscal stimulus.

In the meantime, the Federal Reserve and the Bank of Canada will remain on the sidelines. In any event, the Fed would be shooting blanks now that it has committed to near-zero short-term interest rates for the next two years, and the Bank of Canada has no reason to ease or tighten through the rest of this year.

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The fall in oil prices is welcome relief to many cash-strapped consumers. The U.S. dollar is likely to remain relatively weak, providing an impetus to continued improvement in the U.S. trade balance, as the Canadian dollar remains above parity. Before we know it, all eyes will be on the Christmas shopping season and by then, we could well see evidence that the soft patch is over.

The Benefits of Style Diversification

A diversified portfolio increases investors' potential for achieving superior returns and for reaching investment goals at decreased levels of investment risk by offering two forms of diversification:

- Diversification across asset classes, through the use of asset allocation;
- Diversification within each asset class, through strategically structured combinations of different investment styles.

While the importance of asset allocation is generally well known and accepted by most investors, the importance of style diversification is less well known but equally important to long-term investment success.

Understanding Investment Styles

To understand the beneficial effect of style diversification on portfolio returns, one must first understand the meaning of style as it relates to investing. In the investment world, style is defined as an identifiable and consistently applied approach to investing. A manager's investment style describes the method by which he/she generates investment ideas, conducts investment research and makes purchase and sell decisions.

Many investment managers have an investment process or style which leads them to invest in securities with particular characteristics or in a particular area of the market. These investment managers are not generalists but are specialists in one type of investment style.

Investment management styles in North American equity markets can be divided into five distinct categories:

- A *Value* manager looks for securities which are bargains and seeks to purchase a security which is trading at a level which is less than their assessment of its worth. They are often focused on the current price and whether it remains a good value or is over-priced relative to its worth.
- A *Growth* manager looks for securities on the move and seeks to purchase securities which are expected to grow at a rate which is faster than that implied by its current price. Their focus is on the expectation of what the future price of the security will be.

- A *Large Cap* manager specializes in companies which have a large market capitalization. Typically, these companies have a long established record and consistent revenue. These companies would be the top 100 companies which constitute most of the S&P/TSX Composite Index market capitalization.
- A *Small Cap* manager specializes in smaller sized or emerging companies. Small market capitalization companies can have explosive growth since they are starting from a small base and can achieve this growth in a short period of time. However, with the potential for explosive growth comes more volatility and overall investment risk. Canadian small cap stocks have a market capitalization of \$250 million or less.
- In Canada, a *Market-Driven* manager is a combination of both a value and a growth manager who is looking for the right market segment to be in.

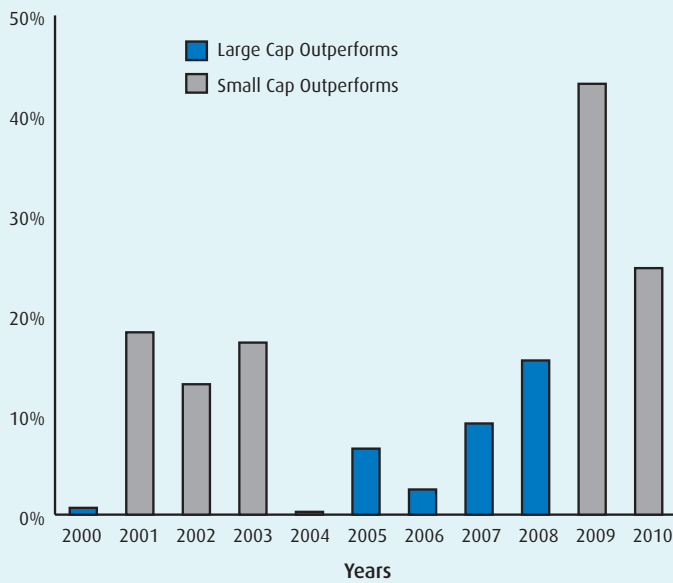
Identifying and categorizing the various investment styles of money managers enables us to compare and analyze managers of the same style against one another and against their own style indices. These style indices, as provided by Standard & Poor's, MSCI and Wilshire for example, have a low correlation – the movement of one index, up or down, does not forecast the movement of another index, up or down. This differentiation and the relatively low correlation between the styles are desirable characteristics for building well diversified portfolios.

By comparing managers of similar investment style, it is possible to identify the best managers in the world in each of the style categories. Once the top investment managers are selected from each style group, style-neutral portfolios can be constructed using the complementary money management styles of the investment managers. Style-neutral portfolios are ideal in that they help to reduce investment risk.

The Danger of One Investment Style

To fully guard against underperformance and limit exposure to unnecessary investment risk, an investor's portfolio should be diversified beyond one style.

The impact of investment style on manager returns and the reasons why exposure to different investment styles is so crucial to an investor's portfolio is demonstrated in the following chart. This chart illustrates the difference in return between the value and growth styles and the

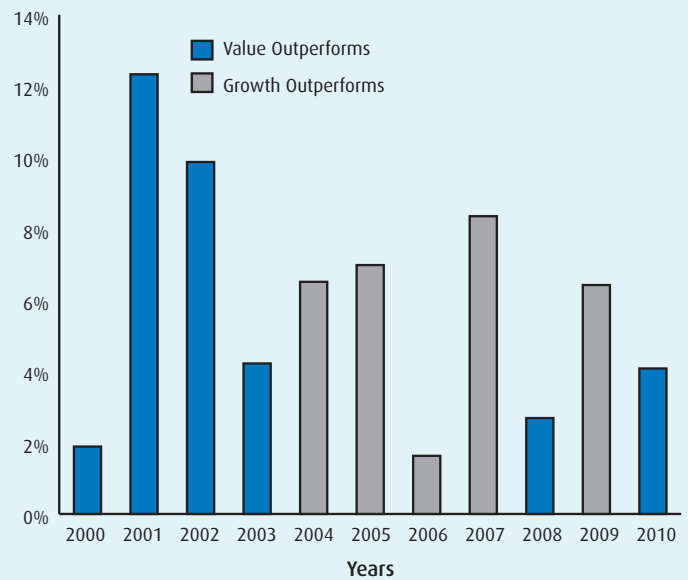


difference in return between the large cap and small cap styles.

In the first chart¹, the blue bars represent the years when large cap securities outperform small cap securities. And, the grey bars represent when small cap securities outperform large cap. The actual bar measure represents the relative degree of outperformance of the one investment style over the other.

In the second chart¹, the blue bars represent when value styles outperform growth and the grey bars represent the years when growth styles outperformed value styles. Once again, the bar measure itself actually represents the relative degree of outperformance.

Several conclusions can be drawn from these charts: first, we can conclude that there is a tendency for investment styles to show relative outperformance as well as



underperformance; second, there is a consistent lack of pattern or lack of predictability with which the various styles move in and out of favour.

Further, as you can see from these charts, growth, value, large cap and small cap investment styles each have their own day in the sun. The difficult question to answer, however, is when do you invest in each of the styles? In reality, successfully timing investment style over the long run has proven to be even more difficult than timing the market as a whole.

The volatility and associated investment risk of being invested entirely in growth or entirely in large cap can be virtually eliminated by investing in both styles at the same time. By building a portfolio with multiple managers and with all investment styles, an investor greatly reduces investment risk and portfolio volatility.

¹ Source: Standard & Poor's

US Citizens living in Canada – Update

As was reported in our Spring edition of Perspective, non-US financial institutions will be required to identify and report on accounts held by US persons. This requirement, as well as the recent IRS focus on uncovering US persons (US citizens/residents/Greencard holders) with undisclosed foreign (non-US) accounts and those who may not have reported their income to the IRS through individual income tax returns, has received widespread media attention. Subsequent to our earlier Perspective article, the IRS announced that the actual reporting requirement by financial institutions has been

delayed until 2014. However, financial institutions are still required to begin their enhanced due-diligence process to identify account holders who are US persons by January 1, 2013.

Given the recent increased IRS focus on US persons with foreign financial accounts, now is the time to ensure that you are compliant with all US tax reporting requirements. Therefore, US persons who have not reported their foreign accounts or filed annual US individual income tax returns should seek the advice of a US tax advisor to determine their best course of action.

Financial Decision-Making: Who Will Manage Your Money When You Can't?

In their quest to prepare for a comfortable retirement without financial worries, Canadians generally understand that they need to grapple with these risks – market volatility, inflation, longevity (which brings along the risk of outliving one's assets) and high health care expenses. They are often less inclined to consider a different threat to their financial health - the decline in their financial decision-making ability that accompanies the aging process. One reason why baby boomers, whether already in retirement or approaching retirement, may be overlooking this risk is the prevalent “sixty is the new forty” mentality.

A recent BMO Retirement Institute report indicates that many people hold the belief that the older you are, the wiser you are. However, many recent studies have concluded that:

- Handling financial matters is an “advanced” activity of daily life, which requires a relatively high level of cognitive ability; and
- As a person ages, their cognitive abilities tend to decline; as a result, the quality of their financial decisions may deteriorate.

The decline in or loss of financial decision-making ability will be even more dramatic in cases where dementia strikes. Dementia refers to a class of disorders - of which the most common form is Alzheimer Disease - characterized by the progressive deterioration of thinking ability and memory as the brain becomes damaged. While dementia is not a part of the normal aging process, aging has been established as one of its most significant risk factors. Studies show that:

- After age 60, the likelihood of dementia doubles every five years; and
- In the case of Alzheimer's disease, one in 20 Canadians over 65 years old are affected; while for those who are over 85 years old, the ratio rises to one in four!

The potential risk of financial mismanagement in later life should not be underestimated. As Canadians live longer and increasingly rely on their own resources for their financial well-being, prudent financial management of their retirement nest-egg throughout retirement is essential. Moreover, the stakes are highest at just the time when one starts to experience declining cognitive ability - at around the age when you are ready to retire, you are



Everyone should make incapacity planning a vital element of their overall financial plan!

likely at the life phase when your net worth has reached its peak. For this reason, it is crucial to plan ahead to ensure that your financial matters will continue to be properly handled in the event of loss or decline of your financial capacity.

For most people, the most appropriate planning tool in this regard is the continuing power of attorney or CPOA. Different terminologies may be used in different jurisdictions to describe a CPOA (such as enduring power of attorney, mandate or durable power of attorney), but they all refer to a legal document in which a person (the “grantor”) appoints one or more persons (the “attorney(s)”) to act in all matters relating to the grantor's financial affairs. Two key things you need to remember are:

- The CPOA must be prepared and executed at a time when you are in full command of your mental faculties.
- Choose your attorney(s) carefully, since there is potential for misuse if the wrong candidate is selected.

Everyone should make incapacity planning a vital element of their overall financial plan! To obtain more information, please have a discussion with your Nesbitt Burns investment advisor.

For further information about the BMO Retirement Institute, visit us at www.bmo.com/retirementinstitute.



Tax Planning for the Family Business

The Capital Gains Deduction provides Canadian small business owners with an opportunity to shelter up to \$750,000 of capital gains on the sale of shares of a qualifying small business corporation. The potential tax savings from accessing this deduction represents one of the most compelling tax planning opportunities for Canadian small business owners. The rules are very complex and only a general discussion is provided in this article. As with all tax planning, professional advice is critical to understand the specific implications to your situation.

The Capital Gains Deduction is available only to Canadian-resident individuals and can be claimed on an actual transfer of shares, or upon a deemed sale of shares, such as the deemed disposition that takes place on death. As it is only available to an individual on the sale or transfer of shares, a business divestiture undertaken as a sale of the business assets will not qualify for the deduction. The amount of \$750,000 is the cumulative limit of qualifying capital gains that can be sheltered during the lifetime of each individual. In order to qualify

for the deduction there are many criteria at the company level that must be met, as outlined below. In addition, an individual's personal tax situation must be considered as a history of investment expenses resulting in a cumulative net investment loss may restrict access to the Capital Gains Deduction. Alternatively, the application of Alternative Minimum Tax may result from claiming the deduction, thereby reducing its benefit.

The following requirements must all be satisfied in order to be considered qualifying small business corporation shares.

Active Business Test

The deduction is available on shares in a Canadian-controlled private corporation which carries on an active business primarily in Canada. For purposes of the Capital Gains Deduction, earning income from property (eg. rental or investment income) generally does not qualify as an active business unless the activity is conducted as a business.

Asset Test

There are also tests which must be met at various times concerning the value of the assets of the corporation that are used in the active business. For example, generally at the time of a sale, at least 90% of the value of the assets must be used in the active business. There is also a 50% asset test throughout the 24 month period prior to the sale. It is therefore critical to monitor the corporation's qualifying status and to consider purification strategies to remove inactive (passive) assets from the corporation when appropriate in order to meet these threshold tests.

Holding Period Test

Generally a shareholder must have owned his or her shares in the corporation throughout the 24 months immediately preceding the disposition. However, there are exceptions where the shares were acquired from a related person or in the course of incorporating an existing business.

Many tax planning strategies are available to obtain optimal benefit from the Capital Gains Deduction. It may be possible to re-organize share ownership of a qualifying corporation to multiply access to the deduction by making it available to other family members in the future. It may also be possible to immediately trigger the use of the deduction without any change in beneficial ownership in a transaction called a Crystallization, which would have the benefit of creating an increased tax cost base in the shares thereby reducing a future capital gain. Sound tax planning advice by professionals who have specific expertise and experience is recommended to explore opportunities to utilize the deduction during one's lifetime, or as part of a tax-efficient estate plan, since the rules are extremely technical and complex.

For more information regarding the Capital Gains Deduction, please ask your BMO Nesbitt Burns Investment Advisor for a copy of our publication *Tax Planning for the Family Business*. Your BMO Nesbitt Burns Investment Advisor can also help you to identify your needs and refer you to the appropriate professional(s) for further assistance in your particular situation.

The comments included in this publication are not intended to be a definitive analysis of tax law or trust and estate law. The comments contained herein are general in nature and professional advice regarding an individual's particular tax position should be obtained in respect of any person's specific circumstances.

Changes to Ontario's Probate Rules

The Estate Administration Tax Act (the "Act") governs probate tax in Ontario. Probate tax is charged to the estate of a deceased Ontario resident at a rate of approximately 1.5% and is based on the deceased's worldwide assets (except real estate located outside Ontario).

While the amendments to the Act do not change the rate of probate tax, they may bring about, indirectly, an increase in probate tax payable by an estate. Effective May 2011, amendments to the Act give authority to the Ministry of Finance to require the Estate Trustee (Executor) to file with the Minister a separate form, when submitting an application for probate to the court. It is not known yet what information the Minister may request on that form, however, the amendments also give the Minister authority to audit and verify the declared value of an estate. This means that the Minister may assess the values declared in the probate application and, based on new information requested, charge additional probate tax.

The Minister has four years from the date of the initial filing to request the information for purposes of assessing and charging any additional taxation. This may result in the Estate Trustee delaying the distribution of the estate for up to four years. Effective January 1, 2013, the changes to the Act carry with them potential penalties of a minimum of \$1,000 or as high as twice the value of the estate, for non compliance.

For more information on the potential impact of the amendments, please consult with your estate lawyer.



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