EPISODE 76:
Risk Parity, Rental Properties, and the Smith Maneuver

[INTRODUCTION]

[0:00:05.7] Benjamin Felix: This is the Rational Reminder Podcast, a weekly reality check on sensible investing and financial decision-making for Canadians. We are hosted by me, Benjamin Felix and Cameron Passmore.

In our last episode, Cameron and I – Cameron read some recent iTunes reviews. After having done that, one of the people who wrote the review that we read e-mailed us very excited.

[0:00:27.0] Cameron Passmore: I think it's safe to say that we don't feel great about doing this, but this feels awkward. It feels really weird. Maybe the last time we do this, but anyways.

[0:00:34.3] BF: Maybe not. Depends if we get a good reaction again, I guess. Anyway, this one person e-mailed to say that they were really excited to see that we read the review out, so we thought we would do the same thing again, because we do get frequently new reviews each week.

MilZ322 wrote, "Great podcast since the Canadian Couch Potato Podcast stopped releasing new content. I had been searching for something to fill a void. The Rational Reminder Podcast has done this and more with its more advanced content. Thanks, guys." Thank you MilZ.

[0:01:02.3] CP: Then also HadidCanBeX, "Amazing podcast. I love listening to it every week, and has helped me be smarter and more informed as an investor. I recommended this podcast to all my friends and everyone I work with. An absolute must for all DIY investors. Great job, guys. Thank you."

[0:01:19.3] BF: Thank you, everyone.

[0:01:20.1] CP: Then also a shout out to Club Racer 6, who left a nice review.

[0:01:23.8] BF: On the US iTunes Store. They said that even though it's for Canadians, they're in America, but they still appreciate the content.

[0:01:30.5] CP: As many other podcasts are doing, people are starting to do live, or recorded questions. We've set up a system where we're going to welcome your recorded questions. Just record it on your device, your –

[0:01:42.9] BF: Audio recordings.

[0:01:43.5] CP: Audio recordings. Yes. Record your question, keep it brief. Say your first name and location. Record on your device and e-mail it to Ben at bfelix@pwlcapital.com and then we'll read it out on an upcoming episode. We'll play it on an upcoming episode, not read it out.

[0:02:00.0] BF: We wouldn't be reading it if it's coming in as a voice recording. We do often answer the listener questions, so it would be maybe interesting to play the person's voice for the question. That's what other podcasts do, I guess. We're going to try it out. You can even just write the question as if you're going to e-mail it and then speak it. Maybe that would be a good idea.

[0:02:17.2] CP: Sure.

[0:02:18.0] BF: On that topic of listener questions, we had three that were quite good this week. They're always good, but there were three there were media enough that we actually replaced the investment topic with the listener questions. Instead of the investment topic, we just had three beefy listener questions.

[0:02:32.1] CP: Then we also have a great story. Rob Carrick talked about the greatest personal finance success story of the century, I think he called us. That's one of the stories today as well. Other than that, next week or in two weeks, we got a special year-end show. Again, that's the thing I guess in the podcast world is we're going to take a crack at doing a year-end best hits.

[0:02:49.6] BF: That's a thing too? I thought that was your idea?

[0:02:51.5] CP: I think it's a thing. Someone must have thought that. Not this whole idea of a podcast was an original idea anyways.

[0:02:58.5] BF: That's true.

[0:02:59.6] CP: Anyways, anything else?

[0:03:00.2] BF: No, let's go to the episode.

[0:03:01.6] CP: All right. Enjoy it.

[EPISODE]

[0:03:07.9] BF: Welcome to episode 76 of the Rational Reminder Podcast.

[0:03:11.4] CP: Two weeks to go before Christmas and here we are. Kick off the top with a recently discovered content that I found. Had some luck sharing the fire movie a couple weeks ago. This week, I've got a podcast that I discovered recently called The Happiness Lab with Dr. Laurie Santos. Have you heard this podcast?

[0:03:30.0] BF: No.

[0:03:31.1] CP: I discovered it when I was listening to Malcolm Gladwell's Revisionist History Podcast. Anyway, she had an episode on that was released September 23rd, called The Unhappy Millionaire. Very sad story. I won't give it away what happens, but the point of this episode is how bad we are as humans at predicting what will make us happy in the future. Many of us predict we'll be happy if we get more money by all kinds of different means. It just does not turn out that way very often.

[0:03:58.9] BF: What's that old saying of money just makes you more of whatever you already were.

[0:04:03.0] CP: Exactly. We've talked about this in the past with the researcher Daniel Kahneman, talking about how once you get above $70,000 US of income, you don't get a lot

happier as you earn more. By the way, that's talked about in Michael Lewis's book called *The Undoing Project*. Have you read that?

[0:04:19.3] BF: No.

[0:04:19.8] CP: I'm reading that now too. What a great book. It might be brought up in a future podcast. Anyway, so Dr. Santos talks about how people always run these simulations in their head about how great, or not great things will be. Usually, things aren't as great as you expect, nor as bad and to expect when things turn out. The bottom line is that as humans, we adopt to stuff and we have this hedonic adaptation as we spend more lifestyle increase, we just keep spending more and we just get into these cycles. We end up going back to some baseline level of satisfaction. It’s a great, great podcast, great story, lots of great research.

[0:04:57.5] BF: That's a concept of human adaptability. Does the podcast talk about – I remember there was some research about people who won the lottery and people who became disabled in a car accident or something like that. Right after each thing happened, the people – the lottery winners felt really happy and the people who became disabled felt really sad. Then six months later, they were both back to normal.

[0:05:19.0] CP: Exactly. Or people that have for example, I read in a book once about, but even one of Gladwell's books talking about learning challenges. Dyslexia was the example, I remember in this book and how people saw it’s terrible that I’ve got dyslexia. Where's actually, that's not the case. People with dyslexia and I'm having this challenge to overcome, which they find more fulfilling, which is interesting. Anyways, great podcast. Worth listening to. On to listener questions?

[0:05:43.5] BF: Yeah, we had a bunch this past week. We picked out three that were – I thought worth talking about. The first one, I'll read the question out. I've been hearing a lot about Ray Dalio and his all-weather/risk parity strategy. I would be very interested in your take on whether the strategy is valid, or if there are some issues with this approach compared to your factor investing approach. It's not our factor investing approach.

[0:06:07.4] CP: The factor investing approach. This is a question we got a lot a couple years ago, I think when Tony Robbins book called *Money Master the Game* came out. Haven't had that question in a while though.

[0:06:17.4] BF: I still get it quite a bit actually, most in YouTube comments like, “What do you think Ray Dalio's all-weather portfolio?” That portfolio is it's a risk parity portfolio, which is very different from and it makes that question of how does this compare to factor investing very relevant.

Risk parity and mean variance optimization are two approaches to portfolio construction. Mean variance is where I think factor investing would fall into. It's trying to optimize returns for a given level of risk. The higher your risk adjusted returns are, or expected returns are, the better the portfolio is. Adding in assets like small stocks and value stocks to a portfolio increases your risk adjusted returns, which makes everybody happy in a mean variance world.

[0:06:58.7] CP: Even those factors on their own are riskier when added to portfolio, you get better unit of return pretty good at risk.

[0:07:05.8] BF: Even on their own, they have value stocks have a better risk adjusted return than the market, which is why they were an anomaly at one point. In a risk parity world, you don't think about expected returns at all, which in itself is interesting and we'll talk more about that in a second. It's really more about allocating to assets based on their individual level of riskiness. For example, a 50% stock, 50% bond portfolio is obviously half stocks and half bonds. In terms of the amount of risk contribution from each asset class, stocks completely dominate.

In a risk parity world, you would have less stocks in the portfolio. Then the other implication is that you start looking for other assets that are going to be hopefully diversifying assets and then allocating to them based on their level of riskiness.

[0:07:53.1] CP: You’re saying with risk parity, you're trying at the same amount of risk in each of those buckets?

[0:07:56.6] BF: Based on the allocation, yeah. A riskier thing would get less allocation in the portfolio, because you want each thing to – an equal risk contribution.

[0:08:06.3] CP: Each thing being not just stocks and bonds, but other asset classes as well.

[0:08:08.7] BF: You're still looking for other asset classes. We see for example and you want uncorrelated asset classes too. You see in the Dalio all-weather portfolio example, the one that Robbins had in his book was 30% stocks, 15% intermediate bonds, 40% long-term bonds, 7.5% gold and 7.5% commodities.

[0:08:27.5] CP: On risk parity, each one of those buckets should have the same level of –

[0:08:30.8] BF: It should contribute the same amount of risk to the portfolio.

[0:08:33.1] CP: Fascinating.

[0:08:34.4] BF: The problem, I think, is that we're by definition in a risk parity world, we're ignoring expected returns. We don't care about that if we're making a risk parity portfolio construction and correlation. We want assets that have low correlation with each other, or no correlation.

[0:08:50.6] CP: Which gold and commodities do have low correlation, the likewise have low expected returns.

[0:08:55.9] BF: This is the problem, from my perspective, I mean, we think about things through the mean variance world. I mean, who's to say what's right and what's wrong? I think with stocks and with different types of stocks, like stocks with higher expected returns that we often talk about, there's a good theoretical basis to have a positive return expectation. You start getting into stuff like golden commodities, they look really good in a back-test in risk parity portfolio construction, they can look really good, but there's no reason to expect a positive long-term outcome.

Now people who are taking a risk parity approach to portfolio construction would say, "Well Ben, you have no idea what future returns are going to be. How can you have an expectation?" I mean, on some level, I get that. At the same time when there's a good theoretical reason to

believe certain types of assets will have positive expected returns, completely ignoring that seems irresponsible.

[0:09:40.3] CP: What do you think about the heavy-waiting to long bonds? There's 40% in 20 to 25-year treasuries.

[0:09:45.9] BF: I think this gets tricky when we start talking about the whole risk parity concept is that a lot of it we're betting on – I mean, you can say in mean variance we're betting on future returns, but in risk parity we're betting on future volatility. You look at long bonds in the example, they've been not crazy volatile over the history that we have available to us and they've actually had really good returns and low correlation. It looks fantastic in a back-test. Should you expect the same characteristics going forward?

[0:10:13.5] CP: Well, we've had decades of falling interest rates, which is very good for long bonds.

[0:10:17.8] BF: I think this is the challenge is in a risk parity framework, you can build a portfolio that looks really, really good in a back-test, but what's the basis for your expectation that it's going to do well in the future? I mean, people got excited, or still get excited about the Dalio all-weather portfolio, because it looks really good in the back-test. It beats a 60/40 portfolio and with less volatility. We're isolating a period of time particularly, I mean, 40% in long-term bonds. Of course, it can look good with that asset class and –

[0:10:42.2] CP: Tough to replicate those returns though.

[0:10:44.2] BF: You even see it in model ETF portfolios, like a 60/40 ETF portfolio and the historical data with an allocation to aggregate bonds might be to 90% equity portfolio for the last 20 years. Does that mean we should put all of our money in the 60/40 portfolio, because it has better risk adjusted returns? I don't think so.

Because you're giving up your equity exposure in favor of bond exposure, which historically looked really good. Again, we come back to that theoretical basis. Is there any reason to believe long bonds are going to have – or aggregate bonds are going to have the same returns over the

next 20 years that they had over the last 20 years? I mean, probably not, because we've had this unprecedented fall in interest rates.

I think the thing that I'm saying now with bonds, ties right back into the whole concept of risk parity. You find an asset with low correlation and pretty good risk adjusted returns historically, but if there's no basis for that to occur in the future. I mean, it's tough.

[0:11:33.0] CP: That's the key. Keys have a robust theoretical basis for the expected returns.

[0:11:37.9] BF: As opposed to betting on correlations and volatilities being telling in the future. Now Larry Swedroe has done a lot of work on this recently. None of it that were implementing in portfolios, but it is still interesting. I should have looked it up. I can't remember the asset classes he's been looking at, but I think reinsurance is one and there might be a couple of others. There are these other asset classes that Larry is saying based on the research do have expected returns and they can be used in a risk parity framework. That maybe starts to become more interesting. The gold commodities, I don't know.

[0:12:07.7] CP: Maybe a topic for another show.

[0:12:08.8] BF: Maybe get Larry on to talk about it. Sure he’s love to.

[0:12:10.6] CP: Next question?

[0:12:12.6] BF: You read this one.

[0:12:13.7] CP: Just like your 5% rule with renting versus owning, is there a rule or math that people that want to own properties as rentals can fall back to – If I have $350,000 for down payment and buy a $900,000 property that has 60,000 of yearly rental income, would that be a good investment?

[0:12:31.9] BF: I don't have a hard and fast rule for this one, but I think that when you're investing in real estate, you're looking at the cap rate. How much yield are you getting for the asset? You might demand a different cap rate, or hope for a different cap rate and maybe you're be willing to pay the price for the property based on the cap rate depending on how risk you

think it is. If you're certain that you're going to get a good capital return and perfect tenants, you might be willing to accept a lower cap rate.

That ends up being very geographically dependent and even investor dependent. The example I just gave, if you're certain about a good outcome for a property, you might be willing to accept lower rents. I think that's actually something that we're seeing in the marketplace now, where I read an article maybe a year ago or a couple of years ago about how a lot of landlords are buying properties and renting them out at a loss after costs.

[0:13:22.8] CP: Just to get the capital appreciation.

[0:13:24.4] BF: Because they're betting on the capital appreciation. Again, that's why I say there can't be a rule in this case, because some investors are willing to accept a negative cap rate after costs.

[0:13:33.3] CP: That's why my question to you was if it makes sense to rent as opposed to buy if the cost of renting is less than 5% of the value, is the opposite also true if the rental yield is above 5%, does that then make the property a good investment? Forgetting about cost of friction, trading and whatnot of selling and buying.

[0:13:51.6] BF: I think in that 5% rule framework, that was based on property taxes, maintenance costs and the opportunity cost of equity. This is not including any leverage, which we're going to have to talk about in the context of rental properties for sure. Let's say you pay cash for a property, you've got 1% roughly property tax, 1% roughly maintenance costs. Then between the expected capital appreciation on the property and the expected return on stocks, you've got 3%. That's where 5% comes from.

To your point, if you can as a landlord get more than 5%, then yeah, the expectation would be that you're getting a better outcome than investing in stocks. The challenge is I think having expectations about, like if you find a property, say it meets that test, great. There's a big difference between buying one property and having an expectation and buying all the stocks in the world and having an expectation.

Now we just talked about risk parity. Some people say you can't have an expectation in either case, but it comes back to expected returns. I think the expected returns on stocks are reliably higher expected. Who knows what's going to happen? But expected.

[0:14:54.7] CP: Much less dramatic downside risk. Things can go very bad with a single property. Yes, things can go bad temporarily in the market.

[0:15:01.3] BF: That's important too is that real estate as an asset class, even if it's not – it has had really good risk adjusted returns. If it's not a volatile asset class, that does not mean that your real estate investment is not going to be a volatile asset, because you can have all sorts of asset, specific things go wrong, like things in the specific area. I know you heard a crazy story recently about a house close to an Airbnb that was causing problems in the neighborhood, stuff like that. That's asset specific risk that can drive down property values.

[0:15:30.0] CP: Others had soil contamination they didn't know about when they bought it.

[0:15:32.9] BF: When we're talking about real estate investing. Again, we've talked about this in the podcast in the past. It's really hard to diversify. If you can globally diversify with hard asset real estate, you might get a good outcome, but then you start getting into the realities of managing properties. Multiple properties in one city, but how about multiple properties around the world? It's not feasible for most people.

Now the thing that we haven't talked about yet, which is very important when we're talking about investing in real estate is leverage. You can borrow money to invest in a property. That can be really attractive, because if it goes well, it goes really well. That works – it can work against you.

[0:16:02.8] CP: Go very bad as well.

[0:16:04.9] BF: Yeah. I have a good friend who for a while was a professional real estate investor and he's a real estate agent. He's a mortgage broker and now he's actually working for another company doing similar real estate analysis and acquisition type work. He was explaining to me that you can make good money in real estate. I believe that, because I don't think the market is as efficient as the stock market. The guy that I'm using is the example, he's a CFA charter holder, he's a real-estate analyst, so he knows exactly how to look at properties.

While he was doing the real estate investing on his own, this was the only thing that he was doing.

If you don't have the knowledge and in his case, the infrastructure, because he was able to do his own real estate deals as the agent and the mortgage broker. The time, he said, there's no way you're going to be successful.

[0:16:45.7] CP: I'm also assuming he's adding value to the properties.

[0:16:48.4] BF: Yeah. That's –

[0:16:49.3] CP: It’s like a business.

[0:16:50.3] BF: That's part of it too. His comment to me – We chatted about this for a while. It's actually the guy that I was on the East Coast trail with me, talked about it then. He said he thinks he's been able to generate alpha, but it's because of the specific skillset and setup that he had. For an individual person doing this as part of their investment portfolio while they've got another full-time job, he says the outcome is going to be driven by luck. We didn't get a rule for investing in real estate, but –

[0:17:11.8] CP: Gave insights.

[0:17:12.1] BF: We gave context, I guess.

[0:17:13.4] CP: All right, so here's the next one. “I'm curious to know your opinion on the Smith maneuver for high-income professionals. Is it too good to be true?”

[0:17:19.5] BF: It's not too good to be true. It's turning yourself into a leveraged investor basically.

[0:17:24.1] CP: You better explain what it is. A lot of people might not know what the Smith maneuver is.

[0:17:27.5] BF: The Smith maneuver was pioneered by a guy named Fraser Smith. Interestingly, we actually have his son, Robinson Smith, coming on the podcast in March of 2020. They've got a consulting business. I'll have to prepare for the interview. I don't really know him. They do something related to educating advisors and individuals about the Smith maneuver.

Anyway, it's the process of paying down your mortgage and then immediately re-borrowing against the equity in your home to invest. Instead of paying down your mortgage over time, you're changing your mortgage loan into a line of credit and you're using that line of credit to invest in a portfolio, in a taxable investment account. The reason that you would do this is to build wealth, I guess. It's making the decision to be a leveraged investor. You had the mortgage anyway, so you're not taking on more debt, but what you are doing is each time you pay down some of the mortgage debt, you're re-advancing it.

[0:18:22.8] CP: You're paying down on one side and borrow on the other side.

[0:18:24.8] BF: Right. You use what's called a readvanceable mortgage, which is a traditional mortgage that also has a line of credit. Every time you make a principal repayment on the traditional mortgage side, you readvance that debt on the line of credit side. Your level of debt is remaining constant over time.

The difference is that the debt that you're taking back out from the line of credit and then investing, the interest is tax deductible, because you're taking a loan to invest with the intention of earning income. I mean, it's a way to turn your mortgage over time into tax-deductible debt. It's a way to build up a portfolio more quickly than you would have done otherwise. You're doing that by borrowing money. It is making the decision to be a leveraged investor and not pay down your mortgage.

[0:19:09.3] CP: Because your mortgage effectively is not going away. It's just shifting from being attached to your house, to being attached to your portfolio.

[0:19:13.9] BF: Correct. Your level of debt is staying the same. I think people have the idea that this is a way to pay down your mortgage, but also build a portfolio, but you're maintaining your level of debt.

[0:19:23.2] CP: The big issue is if the market collapses, how are you going to behave when you've got that debt? To me is a largely behavioral question.

[0:19:31.9] BF: Oh, it's a 100% behavioral.

[0:19:33.7] CP: Perhaps as you get older, you might want less debt. For someone starting out, high-income.

[0:19:38.3] BF: I think on the topic of this being an aggressive strategy, like on the behavioral topic, one of the other pieces is that if you're borrowing to invest, you probably don't want to be boring to invest in bonds. You're boring to invest in stocks. That behavioral factor is really being tested. If you're comfortable being a 100% equity investor, great. Are you comfortable being a leveraged 100% equity investor?

[0:19:59.1] CP: Remembering that the past 11 years have been good to equity investors.

[0:20:03.1] BF: I think for a lot of people, the answer to that question is no. It is an interesting approach for sure. It's not too good to be true, given that you're comfortable being a leverage investor.

On the topic of being a leverage investor, I was doing some research over the weekend for another discussion. There's a paper that came out in 2008 by a couple of Yale professors and they wrote a book about it in 2010. It's called *Lifecycle Investing*. There's another component of the title. I can't remember what it is. They are actually arguing that young people should invest in stocks with leverage. It's based on Paul Samuelson's and Robert Merton's lifecycle investing research, which said something along the lines of you should hold a constant proportion of the present value of your future wealth in stocks.

These Yale professors, they're basically arguing that because young people don't have enough capital to maintain that proportion in stocks, they should borrow as much as they reasonably can to increase their equity exposure while they're young.

They call this intertemporal diversification. It's time diversification for equity ownership, which makes sense. If you think about a normal investing lifecycle, you have very little in stocks, even if you're a 100% equity, you have very little in stocks and dollar terms when you're young. Then even if you make your portfolio more conservative later on in life, the magnitude of your equities in dollar terms is much higher. They're arguing that you should try and increase your equity exposure as much as possible when you're younger, so that you're diversified across more time periods.

[0:21:24.6] CP: Interesting.

[0:21:25.5] BF: Being a leverage investor maybe isn't so bad. Well, behaviorally it is, but –

[0:21:29.6] CP: You have to make sure you know what you're getting into.

[0:21:31.1] BF: Yeah.

[0:21:31.9] CP: Okay, current topic number two, this is a paper that you put on our feed for us to look at. A paper from Stats Canada released December 5th. It's called Home Ownership, Income and Residential Property Values. What they did in this paper is they analyzed income characteristics of residential property owners in three provinces; BC, Ontario and Nova Scotia. I don't know how they chose those three provinces. I couldn't see. That's a 2018 data. What it does, it gives insights into first-time homebuyers, so those people who either did, or did not use a homebuyers plan and the relationship between the owner's income and the property values.

They've looked at the distribution of income levels in those three provinces for those two categories. Some of the findings are pretty interesting. Owners earned on average two times more than those who did not own homes overall. Buyers who use the first-time homebuyers plan earn higher income, but owned lower value properties than all others in Ontario and BC. The median property value to income ratio was highest in Vancouver at nine times.

[0:22:39.8] BF: Makes sense.

[0:22:40.3] CP: You expect that. Your property is nine times your income property value. The bottom 20% of income earners at Vancouver, get this, had a property value to income ratio of 32 times. Or it could be people that have owned it for a long time.

[0:22:53.6] BF: Wow. Yeah, true.

[0:22:54.4] CP: Got to say first-time homebuyers, right? Property's owned by the lowest income earners were more likely to be co-owned by non-residents of Canada. These properties had higher valued income ratios and properties owned by residents. Here's some other neat facts that came out of this study; housing prices of growing faster than household incomes. The Teranet-National Bank house price index shows that house prices have increased 69% the decade ending 2017, but median income increased 27%.

[0:23:27.2] BF: Wow.

[0:23:27.5] CP: In Q1 2019, Canada's housing price to income ratio was the highest across OECD member nations.

[0:23:36.1] BF: We talked about this in the podcast a while ago. Remember that?

[0:23:38.8] CP: Yeah. Overall, the owners' median age is 55, non-owners are 37. 75% of homeowners are married. For first-time homeowners, in Ontario and BC, the first-time homebuyers who use the homebuyers plan purchased houses that were significantly cheaper than those who did not claim the homebuyers plan. I guess from a policy standpoint, that is –

[0:24:00.4] BF: Is this the homebuyers plan, or that new program that helps to increase the –

[0:24:02.8] CP: Yeah, it's that. They use that plan. Does this mean that that program is working, getting people that may not have the assets but have the cash use in the market? A mean age of those claimants was age 32 more than 20 years younger than the median homeowner. Here's some other observations, come some stats can, which is why it's full of stats here; the interesting observations of value to income of owners. Vancouver, the highest ratio of 9.1. 9.1 times income. Whereas in West Van, it was over 20. Toronto was 5.7 times.

[0:24:33.1] BF: Wow. I wonder if that speaks to just higher incomes in Toronto? Or price is that much higher?

[0:24:37.5] CP: The next one does. Ottawa, where we are is 3.1 times. That's really low due to the highest median income level of owners.

[0:24:46.1] BF: Wow.

[0:24:47.0] CP: Yeah. I was really surprised at that.

[0:24:48.5] BF: That is surprising.

[0:24:49.8] CP: Nova Scotia is 2.1. One thing I did look up, because they break down income levels by quintiles. I looked at if you're in the middle quintile in these three areas, so the third quintile of family income. If you're in the Vancouver census metropolitan area, the middle quintile of income is 75,000 to a 111,000 of income. The ratio for the home value to income was 8.6.

Just doing some very simple math, that means if you're in that middle income and you're a first-time homebuyer, you're buying a house around 800,000. In Toronto, that income level for the middle quintile, so between 81 and a 118 thousand, the ratio is 5.5. In a simple math, 547,000. I'm just guesstimating that just to get a sense of what the middle income earner is paying for a place in these three cities.

[0:25:37.4] BF: Intuitively, the numbers seem reasonable though.

[0:25:39.9] CP: Because it's pulldown, these are condos. People buying houses in Toronto, they're paying a lot more, but perhaps the condos is a bit cheaper. At Halifax, income level is very similar between 83 and 113, but the ratio is 2.3. Again, puts you about $225,000 house.

[0:25:54.8] BF: It's crazy. When you look at other – I guess other cities even, because Ottawa's not cheap either to buy a place. You start looking at other cities, you can buy nice houses for what in Ottawa would get you a teardown, or a condo?

[0:26:06.5] CP: Yeah. Let alone Toronto or Vancouver.

[0:26:08.4] BF: Yeah, that's right.

[0:26:09.6] CP: There you go. Just some interesting data points. Okay, so you're good to move on to the next topic?

[0:26:13.0] BF: I'm good.

[0:26:13.9] CP: This one's planning topic of the week, I just thought we throw it a quick refresher on tax-free savings account, the TFSA. Lo and behold, the next day Rob Carrick puts an article in The Globe and Mail on December 5th calling the TFSA the greatest Canadian personal finance success story of the century so far. That's a pretty big buildup. Currently, there's 90 and up million TFSA set up in Canada worth 277 billion dollars at the end of 2017, up 19% year-over-year. 14 million Canadians have a TFSA right now.

[0:26:45.6] BF: Wow.

[0:26:46.3] CP: Did you know that more Canadians have a TFSA than an RRSP? 57% of population versus 52% having an RRSP. That's according to the 2019 iteration of RBC's financial independence retirement poll conducted by Ipsos. The average TFSA balance is $42,000. The average RRSP balance is 96,000. Nearly half of Canadians, 43% believe that TFSA's are good for saving money, but not growing it.

[0:27:15.4] BF: That's a big insight.

[0:27:16.8] CP: Well, I remember when it came out, a lot of people complained about the name tax-free savings account. A lot of people thought it was just for saving, not for investing. The most common holding in TFSA is get this, is cash short-term savings and GICs, 57% of the holdings are in that.

[0:27:32.4] BF: Crazy. That speaks to the last point. I guess something that this doesn't capture is that a lot of those people putting the savings in the TFSA might not have other investments.

[0:27:43.2] CP: Quite possible.

[0:27:44.1] BF: If that's true then sure, use the TFSA to shelter your interest. Ideally, all of your less tax efficient long-term investments, like stocks and bonds are going to go on the TFSA.

[0:27:52.9] CP: Basic rules, after tax money goes in gross tax-free, comes out tax-free. Any money you pull out of the TFSA can be replaced, that limit gets add back to your limit the next year.

[0:28:03.6] BF: Replace the following year.

[0:28:04.5] CP: The following year. Make sure you follow your limits closely, because the penalties can be brutal. You name a beneficiary, except in Quebec, including a contingent beneficiary, so it continues on to the surviving spouse.

[0:28:14.6] BF: Lost successor holder.

[0:28:15.9] CP: Holder. Yes.

[0:28:17.1] BF: That's a bit important distinction, because if you name a spouse as a beneficiary –

[0:28:20.2] CP: They get the money.

[0:28:21.0] BF: They get the money.

[0:28:21.7] CP: The tax-free benefit. Correct.

[0:28:22.7] BF: Right. Your name in the successor holder. If anyone has a TFSA, it's important to make sure that if you have a spouse, it's important to make sure they're coded as successor holder and not beneficiary.

[0:28:32.2] CP: Not beneficiary. The limit as of – they just announced a limit for 2020, an additional 6,000. That puts a lifetime limit at $69,500. Only 10% of TFSA holders have actually maximized their limits.

[0:28:46.1] BF: I believe that.

[0:28:47.0] CP: The average amount of unused TFSA room is 31,000. Things to watch for and make sure you watch for any over contributions, the penalty is 1% per month of the over contribution. Also watch if you're contributing an investment has a capital loss, if you contribute that security to the TFSA in-kind, the loss is denied.

[0:29:05.4] BF: Superficial loss.

[0:29:06.4] CP: A lot of people don't know that. If you trigger capital gain, the gain is triggered on that contribution.

[0:29:11.6] BF: I think a big one in terms of what to watch out for with a TFSA and I did a one of my earlier YouTube videos was on this topic, is that if you're going to pick stocks, fine. Don't pick them in your TFSA.

The reason is one, we know the data on individual securities is not very good. You're far more likely to lose money than make money, and you have a pretty significant chance of a permanent substantial loss. I can't remember the exact data points, but some large proportion of securities historically had, I think it was a 60% lost they never recovered from. I can't remember what percentage of securities, but it was a big number. If that happens inside of your TFSA, so say in the example what was the total room? 60 –

[0:29:48.1] CP: 69,500.
[0:29:49.1] BF: Say you put $69,500 into your TFSA, first contribution ever, and you invested in a stock and that stock goes to zero, what's your TFSA room now? Zero. Because there's nothing in the account, you've got nothing to withdraw. Room's gone. Then the other thing is that you don't get to claim the capital loss. If you're going to pick stocks, you're probably going to lose money, you may as well do it in your taxable account where you can at least claim the loss

when you do lose money. I think people think about the big gains are going to make tax free in the TFSA.

[0:30:14.8] CP: I know some listeners have had that experience. We know a few.

[0:30:18.5] BF: Don't pick stocks on your TFSA. If you must pick stocks, pick them in your taxable account.

[0:30:22.8] CP: Lots of good reasons to use a TFSA. I mean, basic rules of thumb, all things being equal once your RRSP is fully contributed.

[0:30:29.1] BF: That's a tricky one though, right?

[0:30:31.3] CP: For most people.

[0:30:32.2] BF: If you have a higher income, then RRSP, like the order of use would be RRSP first. If you have kids, maybe our RESP second. Then TFSA would be last. We talked about that in the podcast. Alexander McQueen tweeted about this a while ago. I think we talked about in the podcast. If you have a low income, you probably want to use the RSP at all.

[0:30:49.6] CP: Nobody would do a TFSA and that could help you preserve your GIS.

[0:30:53.1] BF: If you have low income now, you put money in the RSP. You don't get much benefit from any tax savings. Then the future when you would draw it, it increases your taxable income, which like you said, can eliminate GIS. Once you're 18, you start creating room. I know I told my kids, maximize. They're both over 18 and if you keep maximizing based on that limit, if you can, appreciate if you can. It's a good limit to strive for, the $6,000 per year.

[0:31:16.0] BF: We've had a few clients send their kids once they turn 18 to come and see us and open up a TFSA and get started getting their feet wet with investing.

[0:31:23.1] CP: Yup. 84% of TFSA holders age 18 or 19 have maximized.

[0:31:28.5] BF: Well, they've got no room. Come on. That's easy.

[0:31:30.8] CP: Well still, your 18-years-old, six grand. That's $500 a month, right?

[0:31:33.3] BF: Yeah. That's impressive.

[0:31:34.4] CP: It's impressive. It's a good limit to encourage them to follow. Anything else you want add to TFSAs?

[0:31:39.1] BF: Well, you had a couple other things in your notes I think on asset location. Do you want to talk about that for TFSAs?

[0:31:43.5] CP: I think we talked asset location enough, but –

[0:31:45.6] BF: What were you thinking?

[0:31:46.5] CP: Just in general about asset location.

[0:31:49.0] BF: I think the big one in the TFSA is that you can get caught on is a double withholding tax. If you're holding a Canadian listed ETF that owns a US listed ETF of international stocks, you're going to get hit with two levels of withholding tax that think you're losing about 70 basis points.

Then the TFSA is if you're going to hold international stocks, you're going to want to hold that Canadian listed ETF that holds the stocks directly. Still eating withholding tax, but it's only one level instead of two. We don't want to go back into the bigger picture asset location discussion.

[0:32:13.5] CP: No, no.

[0:32:14.4] BF: Okay. You shouldn't have written asset location.

[0:32:15.8] CP: I know. I'll make that – These are my rough notes here. Anyways, it's great program. I agree with Rob Carrick.

[0:32:22.3] BF: TFSA is awesome. If you gift assets to a spouse and they invest them in their TFSA, there's no attribution. In a taxable account if you give assets to spouse and they invest it, the income is attributed back to you, not through a TFSA. If you have a spouse – if one person has a high income and a spouse that's say, is working as a lower income, you can give the money to match their TFSA.

[0:32:42.4] CP: Okay, bad advice of the week from The Globe and Mail article, entitled Investor Advocates Impatient with Lack of Reform and Mutual Fund Sales Charges. This is a story that never goes away. It's about deferred sales charges. Those are the funds that pay a larger commission upfront and then charge you, happen to leave in the first five or seven years. It's the usual schedule. The commenting on how slow the regulators are to ban them.

You remember last year, almost a year ago after a six-year review, the Canadian Securities Administrators proposed a prohibition on DSEs, back-end loads. From the same data, until the government released a statement opposing the ban. They also proposed that discount brokerages not collect trailer fees and the Ontario government killed that proposal as well.

[0:33:23.4] BF: I didn't know that one was killed. Oh, I didn't know that.

[0:33:25.8] CP: That's what the article says. The question is where is this issue now? The article quotes that the OSC is still reviewing its next moves. "We are taking our time and we know that our decision is going to be a very important decision for investors in the market," said the director of the investment funds product branch at the Ontario Securities Commission. Of course, investor advocates are to say the least not very happy as this process has been underway for six years and there's been so much debate.

I mean, DSC debate goes back I think 20 years. Ken Kivenko who would be a great guest on the podcast some time, who is an active investor advocate suggested that if there is no outright ban, then at least DSC should be banned in RRIF counts and perhaps, reduce the backend schedule to three years.

[0:34:07.1] BF: For sure. We still see. I know investors group got out of the DSC game, what, last year. We still see when we're onboarding new clients, it's still probably 10% or 15% of the time, they're coming in with a whole bunch of recently DSC.

[0:34:21.8] CP: Oh, it's the recent ones. In today's day and age, there's really no need. I was astonished when the entire government was against the ban.

[0:34:29.0] BF: I was talking to somebody earlier today and they said that they figured that the market for financial advice is probably somewhat efficient. Meaning if you're not paying explicitly for advice, you're probably still paying about the same amount as you would pay a fee-only planner in implicit costs, like DSC fees.

[0:34:43.6] CP: No doubt.

[0:34:44.3] BF: I thought that was an interesting comment.

[0:34:45.6] CP: Anything else?

[0:34:46.7] BF: I think that's good.

[0:34:47.6] CP: Great. Thanks for listening.

[END]