

# Memo

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**Date:** October 26, 2006  
**To:** Financial Security Advisors  
**Subject:** "cash" alternatives for your conservative clients

Hello –

You have asked me to provide some thoughts and comments with regard to possible alternatives for your conservative clients to consider with regard to their cash holdings.

As you know, there are advantages and disadvantages to holding cash. On the positive side, cash is liquid and accessible, offering maximum flexibility for pursuing new business or investment opportunities as they arise. Cash is also an excellent 'hedge' against fixed income and equity market gyrations, as it brings no market risk whatsoever.

Those positives have corresponding negatives – no risk means low gross returns, which indeed become negative when taxes and inflation are taken into account<sup>1</sup>. Cash is therefore typically viewed as a viable asset class only for very "short-term" holdings for which liquidity is the paramount objective – often referred to as a 'parking spot' for money only until it is reinvested.

With regard to conservative clients (and their companies), the relevant facts of these situations are as typically:

- Cash holdings within the related companies typically amount to large amounts representing a significant portion of overall assets/net worth.
- Cash is required periodically to cover annual insurance premiums, etc, but chequing privileges are not required.
- The highest marginal tax rates apply
- While there are expected to be some cash flows in and out of the account, there is a minimum expected holding period of over one year for the bulk of the funds.
- There is no appetite for exposing this money to market risk (absolute loss).

Based on these facts, I would define the portfolio objectives as follows:

1. Security of principal with a real, after-tax return greater than 0% based on a minimum holding period of one to three years.
2. Liquidity and accessibility of capital to provide for periodic cash flows and for eventual investment to a more suitable long-term asset allocation.
3. There is no need to produce regular income, and a desire to avoid short-term market volatility.

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<sup>1</sup> Net return on 30-day commercial paper as of July 31/06 = -0.12% Calculated as 4.33% minus taxes at 45% and inflation at 2.5%. (source for interest and inflation rates [www.bankofcanada.ca](http://www.bankofcanada.ca))

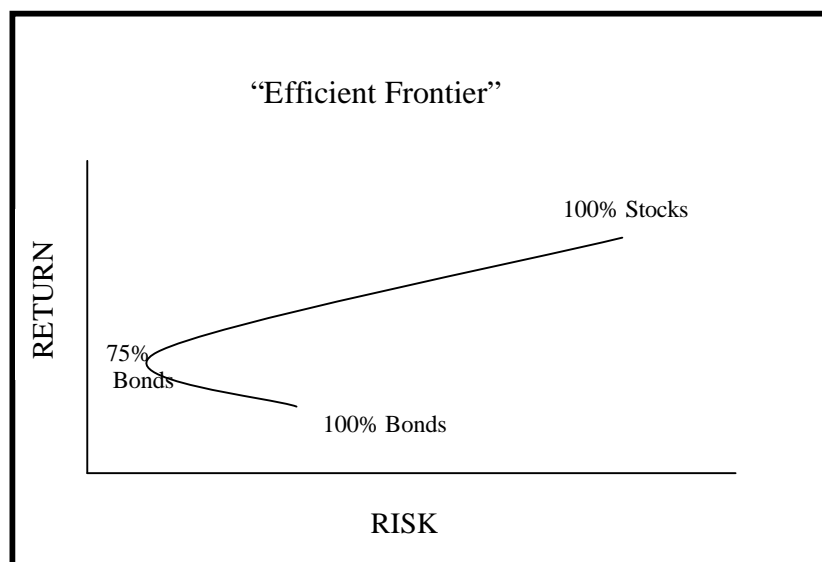
In the current low interest rate environment this set of facts and objectives typically presents a bit of a conundrum for investors.

In order to earn positive (greater than 0%) real (after inflation), after-tax returns in an interest bearing product (such as t-bills, commercial paper, bonds and GICs) the pre-tax nominal rate would have to be 4.55% or greater<sup>2</sup>.

Unfortunately, such yields or rates are not generally available without taking on either credit risk, duration risk/longer maturities, or both. The specter of rising interest rates may seem to offer a rosier picture down the road – unless those rate increases come with rising inflation, as could be expected. Historically, this spread between nominal and real rates on short-term, cash type investments has been very low or even negative, as it is now.

Since the real culprit here is the tax bite, products that offer more tax efficient returns become very compelling. Capital gains (which are only 50% taxable) and dividends (which are taxed at a lower effective rate) are much more attractive tax-wise, but are typically associated with higher risk investments such as stocks and income trusts.

So what's an investor to do? One solution that we have been recommending to our clients can be found in the basic tenets of Modern Portfolio Theory, on Markowitz's "Efficient Frontier".



As can be seen from this graph, a conservatively allocated portfolio with a 25% allocation to higher return, tax preferred equities can actually improve the risk/return efficiency of the portfolio, so long as there is a minimum holding period of one to three years<sup>3</sup>.

While this strategy does bring exposure to market volatility over short holding periods, the statistical chance of loss (nominal return of less than 0%) over one to three year holding periods reduces to 0%.

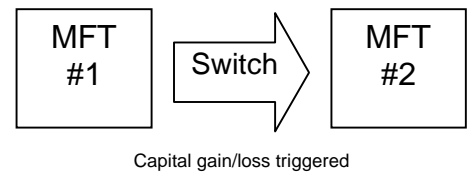
<sup>2</sup> Assuming tax rate of 45%, inflation at 2.5%.

<sup>3</sup> Source: Paltrack, "All Time Periods" report, review of a sampling of funds with "conservative" allocation (75% FI).

Another strategy to improve tax efficiency is to use Corporate Class mutual funds. Especially in contrast to investments that generate fully taxable interest income, such as GICs, or a traditional trust type bond fund, Corporate Class funds offer a structure that has the potential to be very tax efficient.

Mutual fund trusts are treated as separate and distinct entities for tax purposes. Therefore, the income generated by each fund is distributed to unit holders of that fund in the form as received (i.e. interest, dividends, or capital gains). In addition, if the client rebalances their portfolio by switching money from one fund to another (e.g. if they move from an equity fund to a fixed income fund to reduce portfolio risk, or between equity funds to get a better balance of Canadian and foreign holdings, etc.) this disposition triggers an immediate capital gain or loss that could result in taxation.

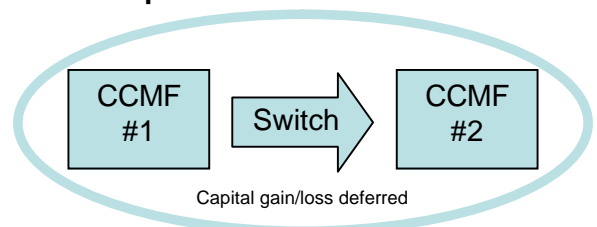
### Mutual Fund Trusts



In contrast, corporate class mutual funds are structured such that individual funds are actually different classes of shares within a single corporation, and therefore:

- The income and offsetting expenses generated by each fund are pooled before being subsequently assigned and distributed to shareholders. Subsequently, the amount of distributions for any given fund may be reduced.
- The nature of the distributions will be tax-efficient (e.g. money market and fixed income funds can only be allocated dividends and capital gains rather than interest income).
- Rebalancing a portfolio by switching money from one eligible capital class fund to another does not trigger an immediate capital gain or loss. Instead, these gains or losses are deferred until the funds are redeemed and subsequently withdrawn from the corporate class structure, thus allowing for a potentially significant compounding benefit.

### Corporate Class Mutual Funds



(There could be many more tax efficiency strategies that you could be employing with regard to your overall financial plan, such as income splitting, or the prudent use of leverage. Please continue to work with your Financial Security Advisor to create and implement your financial plan.)

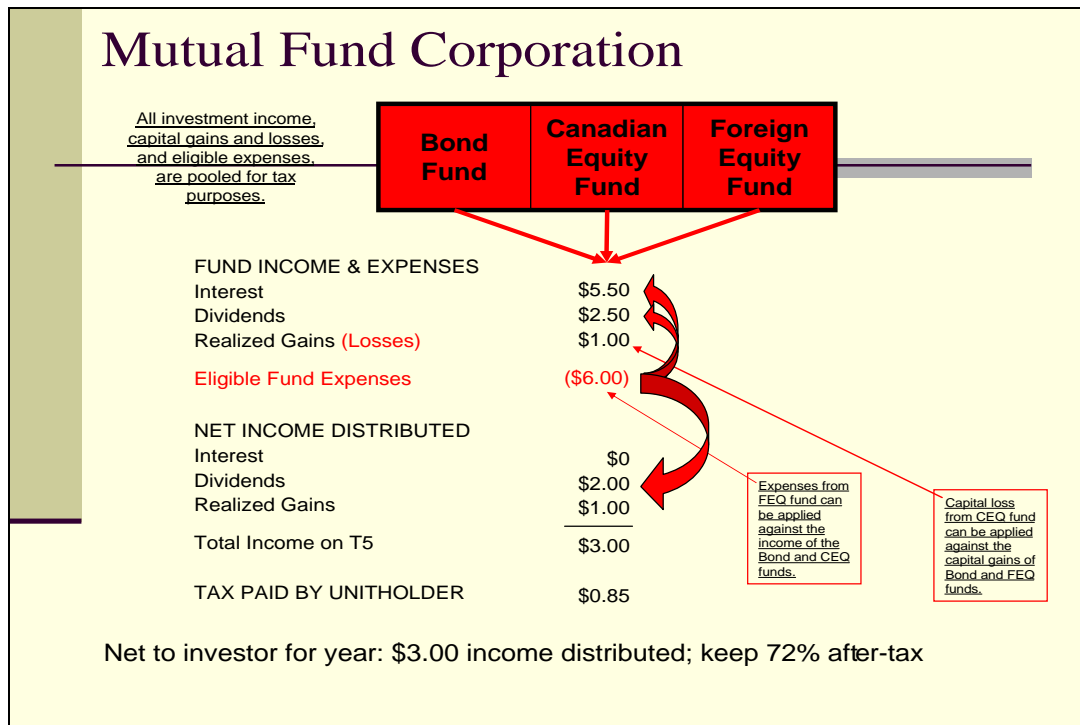
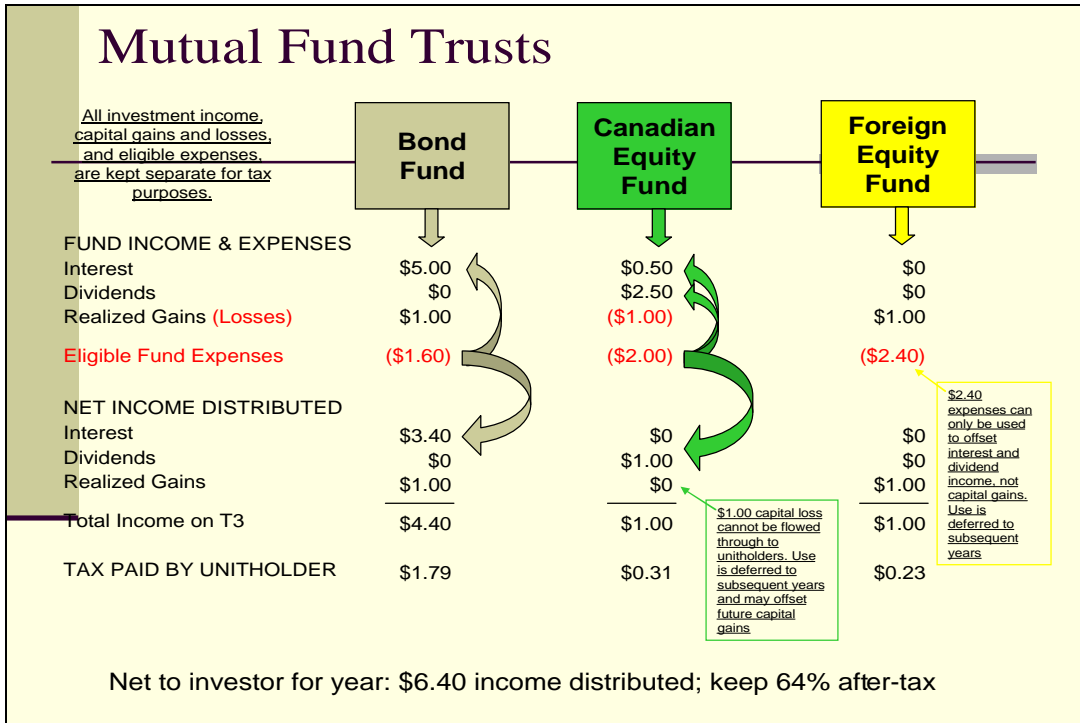
An illustration of the tax savings follows.

I hope you find these comments helpful in your discussion and review of investment alternatives for your conservative clients.

Regards,

Angela

Here is an illustration of the possible tax savings due to the ability of corporate class funds to pool expenses and incomes:



With the same income and expenses, the corporate structure is forced to distribute only \$3.00 of income as capital gain, vs. the trusts, which distribute \$6.40 some of which is interest income.