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# The Northwood PERSPECTIVE

## Chairman’s Message

Tom McCullough



This has been one of the busiest periods for Northwood Family Office in a long time. We have welcomed a record number of new families and, of course, continued to serve our existing families. We have also added several new investment managers to our Northwood recommended list, complementing our strong existing lineup, and have hired some additional staff to meet the rising client demand.

In addition, we have been involved in a number of other interesting activities. We recently chaired the Eastern Private Family Office invitational summit in Niagara-on-the-Lake, with an excellent group of family office attendees and expert speakers. In February, we met with our Wigmore Association ([www.wigmoreassociation.com](http://www.wigmoreassociation.com)) partners for three days in Yellowstone, Montana for a fruitful session of information sharing about investment managers and family office best practices. (The next meeting is in Singapore in September 2014.)

We also presented to several groups of wealthy philanthropists at a series of Roundtables across Canada on the topic of ‘Children and Money,’ and we just finished our sixth year of teaching the Private Wealth Management course in the MBA program at the University of Toronto’s Rotman School of Management. And of course our new book, *Family Wealth Management*, came out late last year. So, all in all, it was an active and fulfilling quarter.

The months ahead look to be equally exciting. The annual Canadian Family Office Forum meets again in early May. We will be co-chairing this unique gathering of 40 single- and multi-family offices from across Canada. We will also chair the Western Private Family Office invitational in Banff, with its great lineup of contributors.

We are hosting a special event in Toronto in May for clients and friends of the firm called ‘Preparing the Next Generation’. It features two special guest speakers -- wealth psychologist and author Dr. Jim Grubman and family communication specialist Jennifer East. Topics include:

- \* How to raise financially thoughtful children
- \* Helping heirs develop the financial skills and wisdom they need
- \* Understanding how different generations think about wealth differently

We are also excited to announce a new Family Wealth Management course to be offered through Rotman Executive Education. It will be held October 23-26, 2014 and will be available to members of families and/ or their family office staff. If you are interested, you can check out the website <http://tinyurl.com/od5kr7s>.

Leading and participating in these programs helps to build both our skills in serving families, as well as our network of professionals who we use to help out on specific issues. We are happy to contribute to the cause of better family management and grateful for the support and confidence we receive from our clients, partners and colleagues.

## Three Strategies to Safeguard Client Equity Portfolios

Dan Solomon, MBA, CFA



In the last edition of the *Northwood Perspective* we highlighted concerns that the world’s equity markets are getting stretched, after a very strong showing in 2013. Taking money off the table to crystalize these gains might seem like the appropriate solution; however, as past experience has shown, trying to time the market can be perilous. There is the potential of missing out on additional returns if the equity markets continue to move higher, and of course private investors must be mindful of the potential tax impact associated with realizing capital gains on their investments. In addition, the fixed income alternative remains a relatively unattractive one, with yields near all time lows.

To add an extra layer of protection to client portfolios, our equity investment managers have taken steps to de-risk their equity portfolios. Keep in mind that most of our clients are looking for capital preservation and moderate growth over the long term in their portfolios. We have also found that protecting capital in bad markets and ‘keeping up’ in good markets is a highly successful strategy for long term outperformance.

These are the steps our managers have taken to structure our portfolios for uncertainty:

- Overweight Sectors That Are Less Cyclical
- Invest in High Quality Companies
- Maintain a Meaningful Cash Weighting

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### NEW FAMILY WEALTH MANAGEMENT PROGRAM



Introducing a new 3-day intensive Family Wealth Management program for family members and family office staff offered through the University of Toronto’s Rotman Executive Education department. The course will be held on October 23-26, 2014, and will be taught by Tom McCullough and other key faculty members and wealth management leaders. For more information and to enroll please visit:

<http://tinyurl.com/od5kr7s>

### Overweight Sectors That Are Less Cyclical

The equity markets can be divided into industry sectors based on the common characteristics of their underlying companies. There are sectors that are cyclical in nature (i.e. mining, and energy) meaning that their performance ebbs and flows along with the prevailing economic conditions. And there are less cyclical sectors (i.e. utilities, consumer staples, and health care) that are much more stable because their performance is not as tied to fluctuations in the health of the global economy. By positioning your portfolio to be overweight less cyclical sectors, you are likely to do better in down markets, but might also lag when markets are rallying. This can be a tough sell when markets are rising, but in our years of practice we have found that this approach can lead to outperformance over the long term while reducing volatility.

### Invest in High Quality Companies

Selecting high quality companies can add an additional layer of protection to your portfolio. These are companies that have defensive qualities such as stable cash flows, consistent dividend payments, and low debt. As always, it is important to own companies that have conservative multiples such as low beta, and low price to equity and price to book ratios. You will likely find that

many of these stocks are well-known household names that have been around for years, and have large market capitalizations. The outcome of including high quality stocks in your portfolio is similar to overweighting less cyclical sectors. Because of the defensive features of these stocks, the more of them you hold in your portfolio, the less market downside your portfolio is likely to suffer when the inevitable decline comes.

### Maintain a Meaningful Cash Weighting

Finally, the percentage of cash you hold in your equity portfolio can play an important role in its preservation. Committing a portion of your capital to an equity mandate does not necessarily mean that your capital must be fully invested. Some managers will maintain a cash weighting not only to provide dry powder for potential purchases, but also to act as a natural way to insulate the portfolio from undesirable short term movements in the market.

If your situation merits a long term approach to investing where you expect to remain invested through both good and bad markets, then implementing these strategies will establish built-in mechanisms to help safeguard equity portfolios during turbulent times, and also suppress the instinct to try to time the market. 🌲

## Shaping of the Next Generation of Wealth and Generosity

Tom McCullough, MBA, CIM, CIWM, CFBA

Earlier this spring, Northwood's Tom McCullough participated in a series of roundtable discussions across Canada on the shaping of the next generation of wealth and generosity. We have provided a summary of his comments for each of the topics of the roundtable.

### Why are issues of family and wealth important?

Much attention has been paid to the 'great transfer' of wealth to the Baby Boomers from their parents, which is still taking place today. However, a **second and even larger wealth transfer** from the Boomers to their heirs is starting and will continue over the next 30-40 years (see Exhibit 1). With such a massive movement of wealth yet to come, it is of particular importance for families of wealth to discuss their wealth transition to the next generation.

### How do different generations think about wealth?

Before engaging in a family discussion about wealth and family issues, it is important to understand the views of the people who will be part of that discussion. If four different generations are

sitting at the table as a part of the conversation, then it is very possible that you will also have four different views of wealth. The issues and factors a person grew up with can have a lasting impact on the way that they experience wealth. For example, those who lived during the Great Depression likely have a more 'waste not, want not' attitude when it comes to money than Boomers do. A lot

of what shapes the way you view wealth also depends on *how* you came to money. Did it come as an inheritance or was it earned? Dr. James Grubman, in his book *Strangers in Paradise*, talks about the concept of *immigrants* and *natives* to wealth and explains how the source of your wealth has a significant impact on how you think about your wealth and the way you interact with other people. Understanding how your children think about wealth will help you

effectively plan for wealth transition to the next generation.

Exhibit 1: Great Wealth Transfer Yet to Come



Source: Accenture, The Greatest Wealth Transfer, 2012

Continued

## What are the best practices for the transition of wealth?

There are two streams of wealth transition – ‘Technical Planning’ and ‘Family Development’. Both are extremely important, but they are actually quite different. The purpose of technical planning is to prepare the *wealth* for the *family*, while family development is about preparing the *family* for the *wealth*.

### Technical Planning

Technical planning begins with a clear understanding of the structure of the family’s net worth. We like to think about this as a balance sheet. Just like a company has a balance sheet, so do individuals and families. The difference for individuals is that liabilities are not *debts* but rather *commitments* or *goals* that families establish, such as maintaining their lifestyle or dynastic goals like passing wealth on to the next generation.

When you think about it, there are really only two things you can do with your money – spend it or give it away. Wealth transition involves the ‘giving away part’ of the family capital that is not required to meet your lifetime commitments.

There are three major recipients of this potential legacy money -- children, future generations, and charities. It is extremely helpful in the transition process for a family to identify how much of their capital they want to allocate to each category. However, this can be a tricky process. With respect to children, for example, Warren Buffet famously said that the perfect amount to leave your children is “enough money so that they feel they can do anything, but not so much that they can do nothing”. This of course is easy to say but a challenge to actually decide.

The next step is to ensure that the transfer of wealth is well planned. There are several tools to help determine when and how money should be transitioned. One example is a Milestone Strategy, which

defines the amount and timing of money to give to future generations based on the critical needs that the heirs will have at the time, such as funding for education, weddings, and home purchases.

### Family Development

The second critical element of wealth transition best practices is on the family side. There are three main areas of focus here. The first is the transfer of family values. Essentially, the goal is for the family leaders to help the family develop their values and discuss with the rest of the family how those values can be shared and passed on. This provides a critical foundation for future money behavior and personal well being.

The next area of focus is the development of financial literacy and skills. You can do this with your children at different ages and stages of their lives. For instance, you can guide young children to put allowances in three buckets - spend, save, and share. For young adults, you can teach more specific skills including budgeting, developing a credit record, and working with an advisor. Philanthropy can also be used a key tool to help develop financial skills and family values together, as can taking specific wealth education courses that provide training to family members.

The third area of focus, and a crucial component in family development, is family communication. Frequent communication through family meetings and intentional conversations with family members will facilitate both the transfer of family values as well as financial literacy to the next generation.

Overall, the transition of wealth is one of the most significant worries and concerns of wealthy families, because money can not only add great value but also cause great harm if not managed properly. 🌲

## Weighing the Benefits of Spousal RRSPs

Barrett Lyons, CPA, CA, CFP



The 2013 RRSP deadline is now behind us but if you are keen, you can think about making your 2014 RRSP contributions at the beginning of the year to take advantage of additional tax-free growth throughout the tax year. Compared to making the contribution at the deadline this essentially provides one additional year of tax-deferred growth. If you are considering contributions for 2014 and you haven’t evaluated the benefits of a spousal registered retirement savings plan before, now might be the time.

By way of background, spousal RRSPs were a popular planning tool for splitting retirement income between a high income spouse and a

low income spouse until 2007, when the government legislated the pension income splitting rules. These rules allow a pensioner to allocate up to 50% of their pension income to their spouse’s tax return, lowering the family’s overall tax rate. This, then, begs the question of whether families should still be contributing to spousal RRSPs as part of their overall financial plan.

The answer, as with most financial questions, is that it depends on the facts of your situation. Below we evaluate some of the benefits and disadvantages of the spousal RRSP that you can apply to your family’s situation.

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### Tax Savings

- By making a spousal RRSP contribution, you are splitting 100% of the value of the contribution plus accumulated future earnings with your spouse as compared to allocating only 50% of the income to your spouse with pension income splitting.

### Flexibility

- If one spouse is the breadwinner and the other does not earn an income, having a spousal RRSP plan can allow the lower income spouse to draw income at a much lower tax rate as compared to the higher income spouse drawing funds at the top rate for the family's expenses.
- Couples retiring before age 65 may find a time when they aren't earning income to the top marginal rate and perhaps even at the lowest rate. RRSP withdrawals before age 65 do not qualify for pension splitting and as such all of the income would be taxed in one spouse's hands. If a spousal RRSP was in place, it would allow both spouses to draw income and lower the family's overall tax expense.
- Higher income spouses over age 72 are unable to make contributions to their own RRSP, however they are able to make spousal contributions to a younger spouse below age 72 and receive a deduction.

- For first time home buyers, if one spouse has little to no RRSP savings, the other can contribute to a spousal plan, allowing the couple to double the benefit of the home buyer's plan (from \$25K to \$50K).
- While unlikely, it is possible that the government could cancel the pension splitting regime, eliminating the tax benefit. Starting a spousal RRSP protects your family against future legislation changes.

### Limitations

- If you have multiple RRSP accounts with low absolute values, you may have limited investment options. For example, it would not be appropriate from a commission/fee perspective to purchase an equity mandate with 40 holdings in an account that is only worth \$40,000. In that case, you may be better off replicating the desired style mandate with ETFs, until such time that the absolute value of the account has grown.

These are just a few considerations to help you think about whether a spousal plan might make sense for your portfolio. Your plan should be developed taking into consideration your goals and objectives. As they say, "don't let the tax tail, wag the investment dog". 🌲

## Federal Budget Update

Scott Hayman, CPA, CA, CFP, TEP



On February 11<sup>th</sup>, the government tabled the Federal budget for 2014. The budget continues along the same trend as prior years in closing down some 'loopholes' to help generate revenue for the government. Highlights of the budget provisions that impact high-net worth taxpayers are noted below:

- **Graduated rate taxation of trusts and estates** – Beginning in 2016 and subsequent tax years, trusts established by wills (testamentary trusts) will no longer qualify for taxation at the graduated rates, but will be taxed at the top rate. Two exceptions will apply:
  - First 36 months of a testamentary trust
  - Trusts where beneficiaries are eligible for the Federal Disability Tax Credit
- **Split income** – The definition of 'split income' (also known as the 'kiddie tax rules') will be expanded to include income that is paid to a minor from a trust or partnership if it is derived from a business or rental property. Historically, this definition only included income from corporations.
- **Immigration trusts** – To attract immigrants to Canada, the government had allowed non-resident trusts ('immigration trusts') to be exempt from the residence rules for 60 months, creating a significant tax benefit. After 2014, this exemption will be removed and immigration trusts will be deemed residents and taxable in Canada.
- **Estate donations** – Beginning in 2016, donations made by will, will no longer be deemed to be made by an individual immediately before their death, but instead will be deemed to have been made by the estate at the time the property is transferred to the donee. The estate trustees then have the option to allocate the donation credit to the taxation year of the estate in which the gift was made, an earlier taxation year of the estate, or the individual's last two taxation years.
- **Personal tax rates** – No changes to the existing rates. 🌲

## Words of Wisdom from the Oracle of Omaha

Eric Weir, CFP, CFA



In 1965 Warren Buffett began drafting his annual letter to shareholders. It has now become an icon within the industry and the letters (dating back to 1977) are publicly available on the Berkshire Hathaway website. Over the years, Buffett has shared glimmers of his wisdom and the roots of his success through stories that everyone from the most unsophisticated investors to institutional investment professionals can learn from.

This year Buffett didn't disappoint and delivered a great lesson about stock market volatility. Through his experience as an investor in a local farm, Buffett illustrates the importance of keeping a long term horizon when making equity investments, and avoiding the temptation to try and time the short term "irrational" behavior of the stock market. We've included an excerpt from the letter below and the complete letter is available at the following link, <http://www.berkshirehathaway.com/letters/2013ltr.pdf>.

### Excerpt from Berkshire Hathaway annual letter to shareholders – 2013

There is one major difference between my two small [real estate] investments and an investment in stocks. Stocks provide you minute-to-minute valuations for your holdings whereas I have yet to see a quotation for either my farm or the New York real estate.

It should be an enormous advantage for investors in stocks to have those wildly fluctuating valuations placed on their holdings – and for some investors, it is. After all, if a moody fellow with a farm bordering my property yelled out a price every day to me at which he would either buy my farm or sell me his – and those prices varied widely over short periods of time depending on his mental state – how in the world could I be other than benefited by his erratic behavior? If his daily shout-out was ridiculously low, and I had some spare cash, I would buy his farm. If the number he yelled was

absurdly high, I could either sell to him or just go on farming.

Owners of stocks, however, too often let the capricious and often irrational behavior of their fellow owners cause them to behave irrationally as well. Because there is so much chatter about markets, the economy, interest rates, price behavior of stocks, etc., some investors believe it is important to listen to pundits – and, worse yet, important to consider acting upon their comments.

Those people who can sit quietly for decades when they own a farm or apartment house too often become frenetic when they are exposed to a stream of stock quotations and accompanying commentators delivering an implied message of "Don't just sit there, do something." For these investors, liquidity is transformed from the unqualified benefit it should be to a curse.

A "flash crash" or some other extreme market fluctuation can't hurt an investor any more than an erratic and mouthy neighbor can hurt my farm investment. Indeed, tumbling markets can be helpful to the true investor if he has cash available when prices get far out of line with values. A climate of fear is your friend when investing; a euphoric world is your enemy.

During the extraordinary financial panic that occurred late in 2008, I never gave a thought to selling my farm or New York real estate, even though a severe recession was clearly brewing. And, if I had owned 100% of a solid business with good long-term prospects, it would have been foolish for me to even consider dumping it. So why would I have sold my stocks that were small participations in wonderful businesses? True, any one of them might eventually disappoint, but as a group they were certain to do well. Could anyone really believe the earth was going to swallow up the incredible productive assets and unlimited human ingenuity existing in America? 🌲🌲🌲



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