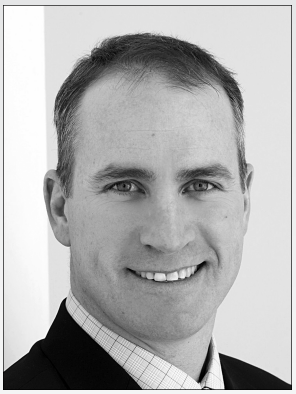

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If building your savings is top of mind for 2014, remember that the New Year also starts with a clean slate for anyone able to contribute to a registered savings plan, such as an RRSP or TFSA.

Not only does the amount of the annual contribution room reset with the calendar year, you can also carry over any allowable room you didn't use in past years. This could present a great opportunity to power-up savings.

If you have questions about how to maximize registered plan contributions, or any other concerns about the year ahead, we can help. Once again, a sincere thanks for your confidence in us, and for your business.

WealthBuilder

Winter 2014

A third of Canadians are missing out on RRSP benefits

Only 63% of Canadians contributed or planned to contribute to their Registered Retirement Saving Plans (RRSPs) in 2012, according to a survey conducted by a major Canadian financial institution.[1] And while that's a healthy increase from the 38% who planned to contribute the year before, it still suggests that a large number of Canadians are not taking full advantage of this valuable vehicle.

Conflicting financial priorities stemming from the weak economy, such as everyday expenditures and paying down debt, were cited as key reasons for the shortfall, and for the fact that the average contribution fell by $1,100.

The good news is that a gradually improving economy, strong job growth, and firming equity prices may make it easier for you to refocus on your financial future this year.

RRSPs remain an excellent way to defer taxes and build up a pool of assets for retirement. Topping up contributions is especially important for baby boomers (the first of whom turned 65 in 2010), who are now increasingly under the gun to get their finances in order before they retire. The years they have remaining in which to build up their RRSPs are running out.

If you haven't yet contributed your maximum for 2013, contact us immediately. The deadline to contribute and claim the deduction for 2013 is March 3, 2014.

In addition to topping up your RRSP for 2013, we can set up a contribution plan for 2014 and revisit your RRSP investment strategy to make sure it continues to reflect your investor profile. ■

1 Survey conducted by market research firm Pollara on behalf of BMO, February 2012.

HollisWealth™

MUTUAL FUNDS

Are equity funds a good inflation hedge?

The U.S. Federal Reserve has been following an ultra-low interest rate policy since the 2008 financial crisis. Many fear that the resulting cheap credit could lead to rising prices down the road — in other words, inflation.

Warning younger Canadian savers about inflation these days is hard, because few have witnessed its pernicious effects as price increases dilute hard-earned buying power. These effects can be significant, especially for seniors living on fixed incomes. For example, inflation of just 3% a year would cut the purchasing power of a senior's annuity payments by close to half (46%) over two decades.

Historically, gold has long been considered an effective inflation hedge. However, equity mutual funds may fill a similar role.

Jeremy Siegel, a professor at the Wharton School and author of Stocks for the Long Run, notes that the businesses that mutual funds invest in are "claims on real assets, such as land and plant and equipment, which appreciate in value as overall prices increase."[1]

Although there can be significant short-term fluctuations, Siegel says over 30-year periods "the return on stocks after inflation is virtually unaffected by the inflation rate."[1]

Picking individual equity winners in the inflation hedging game is hard, because price increases can be volatile; some industries are more vulnerable than others. Statistics Canada even keeps two measures of inflation to account for this disparity. The Consumer Price Index (CPI) targets a broad basket of goods, but the core CPI excludes food and energy prices, which tend to be more variable.

The upshot is that investors who want an effective inflation hedge may be better off investing in a professionally managed mutual fund, rather than trying to figure out which individual companies will outperform.

One especially effective option is to invest in an international mutual fund that has heavy allocations in countries with a history of stable money. That way, if inflation rises in Canada, you stand to be compensated, as this would cause the Canadian dollar to fall and your foreign-currency fund units would then be worth more when converted back into local funds.

Equity mutual funds offer significant advantages over bond funds in an inflationary environment, because the earnings of the companies that they invest in will rise in such an environment; however, the interest that previously issued bonds pay will not.

In late 2013, the urgency of considering possible inflation hedges increased, with the announcement that Janet Yellen will be taking over as the U.S. Federal Reserve chairwoman in early 2014. She is thought to place priority on job creation over keeping inflation low, which could significantly heighten inflation risks.[2]

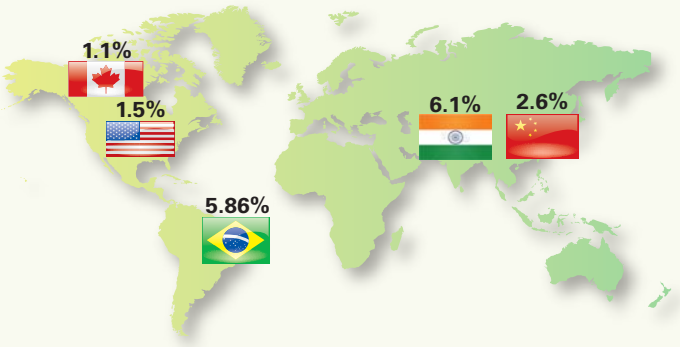
As if that were not enough, inflation pressures from China are showing signs of spreading into Western economies. Low Chinese wages have long been a key factor in keeping prices low for many of the goods that Canadians import, ranging from textiles, to toys and iPhones. However, Chinese wages have been rising[3] and the effects risk spilling over into Canada.

In short, savers need to think ahead. While phrases such as "the risk of inflation," may seem tame, they need to be taken seriously. Talk to us about how to position your mutual fund portfolio to hedge against possible inflation down the road. ■

1 Jeremy Siegel, "Stocks: The best Inflation Hedge," Kiplinger.com, June 9, 2011.
2 "Janet Yellen will stick to her predecessor's expansionary policies," *The Economist*, Oct. 12, 2013.
3 "Manpower CEO Joerres Says Wage Inflation May Aid China Economy," *Bloomberg News*, Sept. 12, 2013

Could inflation spread here?

In a global economy, there is a danger that inflation could spread to North America from countries where it is higher. This chart provides a snapshot of current inflation rates around the world.*



* Monthly inflation, Nov. 1, 2013. Source: WallStreetDaily.com, trading economics

Investing in 2014

Entering the final quarter of 2013, the economic and investment outlook for 2014 was guardedly optimistic. But there remained a sense of risk, with fiscal policy hamstrung in many countries by large deficits. Here's a look at the current situation and prospects for major global regions in 2014.

Weakness in the yen

Late in 2012, Japan elected a new government with policies intended to end deflation. Although both monetary and fiscal policies are more expansionary than under previous governments, the key shift thus far has been a much weaker yen.

Initially this has been good for exports and related equities, and the rise in imported fuel costs has indeed resulted in inflation rising somewhat. But it remains to be seen whether the improvements can be sustained.

Little change in Asia

In other key parts of Asia, things have not changed dramatically since 2012. China is still contending with weak growth but the source of weakness is shifting from weak exports to a slowing of labour force growth. The government has undertaken new infrastructure projects to boost growth but is also contending with a growing pile of bad debt.

Inflation has remained excessive in India, prompting the new central bank governor to raise interest rates even though the economy has been struggling. India's best hope is that a majority government will be elected in the spring and make the needed economic reforms. But even if this can be achieved, there are still the cantankerous state governments and the red-tape bureaucracy to be dealt with.

Modest improvement in Europe

Europe moved out of recession in mid-2013 but growth has been very modest. Fiscal troubles continue, the euro has strengthened, and inflation is threatening to turn into deflation.

The European Central Bank has saved the banking system from collapse and the return to growth has produced a major stock rally from oversold conditions. But just how some of the major European banks will fare in the forthcoming stress tests remains a worry.

Growth slowing in Canada

Canada, like other industrialized countries, faces a gradual deceleration of growth as the baby boomers age and eventually retire. Consumer spending growth can be expected to slow, and investment is unlikely to be strong.

Will Canada see continued strength in natural resource investment? Good question. Production of oil and natural gas has risen considerably in North America in response to a long period of unusually high prices, and global copper production appears to be on the verge of catching up with supply. The supply of most foodstuffs has also risen considerably. Would-be investors in the commodity patch in 2014 need to contemplate the implications of growing supply before committing new funds.

Uncertainty in the U.S.

The U.S. economy is expected to grow by about 2% or slightly more in 2014, although further fiscal wrangling could be a depressant. The issue of tapering (both when and how much) was far from being resolved as this article was being written.

Should quantitative easing end, the result would likely be a further whipsawing of bond yields, with the 10-year yield eventually settling near 2.65%. The U.S. dollar would likely reverse course and strengthen against most currencies, and stock markets would likely resume an irregular upward climb. Baby boomers facing retirement have to put their money somewhere, and well-managed companies should be able to continue to grow and increase their dividends, which compare favourably with government bond yields in many cases. ■

William Tharp, Senior Economist

EQUITIES

Time to rebalance Canadian and U.S. exposures?

In recent years, the benchmark U.S. S&P 500 Equity Index has frequently outperformed the S&P/TSX.

For example, in 2012 and the first nine months of 2013 (to September 30, 2013), the Canadian benchmark S&P/TSX Composite Index rose 4.0% and 2.84%, respectively. Over the same periods, the S&P 500 index rose 13.41% and 17.91% (in local currency terms, excluding dividends).

This unequal performance between the U.S. and Canada may mean that you are over- or under-invested in one of these markets and your portfolio needs to be rebalanced.

Trimming U.S. equities and investing more in Canada, to account for the differing performances, is one possibility. However, doing so could have tax consequences if your holdings are in a non-registered account.

A better option may be to rebalance your positions gradually. Disciplined savers contribute regularly to their investment accounts on an annual, quarterly, or even monthly basis.

There are, of course, no hard-and-fast rules. We can provide sound guidance regarding your particular circumstances. ■

1 Addenda charts (addenda-capital.com).

INVESTING STRATEGY

What to do when markets hit new highs?

Stocks have been rising in value fairly steadily since the 2008 recession. Many investors have thus been wondering whether they should take some profits.

Those who are in it for the long haul may want to think twice. While registering gains may make you feel good, excessively trading assets is generally not the most effective investing strategy.

Let's admit it — when investment holdings increase in value (the S&P 500 hit a record high in late 2013),[1] it's tempting to book profits. However, the short-term pleasure you get may have a downside. For one, sales equities outside of registered plans could spark tax consequences. Any increase in the value of the securities since purchase may trigger a taxable capital gain.

Furthermore, the most effective investment strategies are longer-term in nature and rely on a proper balance between asset classes. These strategies are founded on the dictum that you can make more money through "time in the market, as opposed to market timing."

When seasoned investors sell a particular stock or mutual fund, they know they need to replace it with another or shift those assets to fixed-income investments.

Attempts to "time" the market, however, can be costly. Market timers try to sell off equities at or near market highs, move into fixed income, and then re-enter the market when equity prices have dropped, in order to profit from the next upswing. It's generally not considered a viable strategy. History shows that upsurges in equity prices and mutual fund valuations happen suddenly. Those who shift too often risk missing out on key upwards movements.

The other problem facing investors who want to take profits when markets hit new highs is to figure out where to "park" the proceeds. Right now, returns on major fixed-income instruments are generally unattractive, because interest rates are so low. Furthermore, the Bank of Canada has been signaling that its policy interest rate, which is currently at 1%, is likely to remain low for the foreseeable future.[2]

That does not mean you shouldn't hold any fixed-income assets — quite the contrary. Maintaining a balanced portfolio is crucial. It just means that there are few compelling reasons to shift funds from the equities portion of your portfolio right now — unless you are underweight in fixed-income holdings.

If you feel that stock valuations are getting frothy and are temped to book profits, talk things over with us. Remember, we are always available to act as your "sounding board." We can review your portfolio, calculate gains to date, explore the income tax implications of taking profits, and look at where you might reinvest gains if you do decide that it's time to sell. ■

1 CNN Money, October 17, 2013.
2 Bank of Canada press release, October 20, 2013.