LIBERTY
International Investment Management

MARKET UPDATE

Q1 | January 1 to March 31, 2022

IN THIS ISSUE:

1 **What happened in the markets during the first quarter of 2022 and what we anticipate for the rest of the year**
5 **Investing for Millenials:** Invest conservatively first, then take risks after you've made money
6 **The Relationship between Risk & Volatility**
8 **Fun with Math:** The Cash Conversion Ratio identifies quality companies
10 **Tax Treatment for Estate Planning**
12 **Client Q&A:** David Driscoll answers your questions

When my 2-year-old granddaughter drops something on the floor, she usually says, "Uh-Oh". In the first quarter of 2022, investors had their "Uh-Oh" moment. It was the first quarterly loss in two years for investors who were invested all in equity, all in bonds or in some combination of stocks and bonds.

More than $3 trillion was erased from markets because the Federal Reserve raised interest rates for the first time since 2018. As a result, parts of Treasury yield curves inverted, with long-dated rates falling below short-dated ones. Historically, this is often seen as a warning that we may be headed toward a recession.

Few equity markets did well in Q1 2022

Positive equity returns were made mostly in resource-based economies such as Canada (the TSX Composite total return was 3.84% - see the table below), Brazil (up 15%) and Mexico (up 6%). Commodity prices spiked because of supply chain interruptions and the war in Ukraine.

Total Monthly Equity Index Returns for First Quarter 2022 (in Canadian dollars with dividends re-invested)

	MONTHLY RETURNS			Q1 2022
STOCK INDEXES	JANUARY	FEBRUARY	MARCH	TOTAL RETURN
TSX 300 Composite Index (Canada)	-0.40%	0.27%	3.97%	3.84%
S&P 500 Index (United States)	-4.81%	-3.08%	2.03%	-5.86%
MSCI Global Index (World)	-4.90%	-2.52%	1.13%	-6.29%
MXEF Index (Emerging Markets)	-1.90%	-2.79%	-2.30%	-6.99%
Russell 2000 Index (U.S. Small-Caps)	-9.28%	0.93%	-0.40%	-8.75%
Stoxx600 Index (Europe)	-4.86%	-3.12%	-1.61%	-9.59%
Nasdaq Index (U.S. Technology)	-8.61%	-3.43%	1.80%	-10.24%

Data Courtesy of Bloomberg L.P.

© 2022 Liberty International Investment Management Inc.

Brent Crude oil prices jumped 35%, gasoline prices spiked 42% and Henry Hub natural gas prices leapt 51%. It wasn't, however, limited to energy prices. Nickel was up 54%, iron ore rose 30% and corn, cotton and soybean prices all increased over 20%.

The S&P 500 Index suffered a peak-to-trough slide of 13% at its worst, while the tech-heavy Nasdaq 100 and the small-cap Russell 2000 index each entered a bear-market decline of 20%.

With the belief that stocks would perform as a better investment against inflation than regular bonds, those markets rebounded in the quarter's last two weeks.

I remain skeptical, however, because an entire generation of new portfolio managers have known only to buy the dips and haven't had to suffer through lengthy recessions such as 2007-08 and 2000-03.

In the former, there were seven corrections of 10% or more in just 15 months as the financial system was rocked to its core because of bad mortgage loans (Bear Stearns and Lehman Brothers went bankrupt).

In the latter, the tech bubble burst in March 2000, terrorists struck in September 2001 and the market went into recession and stayed down for three years until a recovery began in March 2003.

Meantime, a rise in interest rates in Q1 sent bonds into a tailspin as prices reacted negatively to an expected overall jump in US and Canadian rates in 2022 of about 2%. See the bond performance table to the right.

The acceleration in price declines occurred because both Canadian and U.S. central banks indicated they may have to raise rates by 0.50% instead of a planned 0.25% in future months because of higher inflation expectations.

While many investors would be concerned about price declines, I'm not, for two reasons:

First, if the economy falls into recession, the yield curve would invert. The economy would slow, jobs would be lost, consumers would reduce their spending, stock prices would drop with a fall in sales and profits and inflation should ease. Bond prices should stop falling.

In this scenario, central banks would then have to cut rates to stimulate the economy and bond prices would then rise, ending the drop in prices.

On page 3 is a current chart of the U.S. yield curve. The blue curve indicates where current yields are; the orange line is the yield curve at the beginning of 2022. Note the following:

- Short-term rates (3-months to 1 year) have risen from 0.44% for 3-months to 1.19% for 1-year.
- Longer-term rates (2 years to 30 years) have jumped by 1.63% for 2 years and by 0.58% for 30 years.

Total Monthly Returns for Various Fixed Income Indexes (in Canadian dollars with interest re-invested)

	MONTHLY RETURNS			Q1 2022
BOND INDEXES	JANUARY	FEBRUARY	MARCH	TOTAL RETURN
Canadian 10-30 Year Bond Index (ZCM)	-3.03%	-0.95%	-3.34%	-7.32%
Canadian 30+ Year Bond Index (ZLC)	-5.65%	-2.67%	-2.12%	-10.44%
U.S. 30+ Year Bond Index (VCLT)	-4.65%	-3.21%	-4.34%	-12.20%
Canadian Real Return Bond Index (ZRR)	-6.83%	-1.07%	-1.74%	-9.64%
PREFERRED SHARE INDEXES				
Canadian Rate Reset Index (ZPR)	0.22%	-2.74%	0.27%	-2.25%
U.S. Perpetual Index (ZUP)	-3.34%	-1.87%	-1.45%	-6.66%

Data Courtesy of Bloomberg L.P.

 © 2022 Liberty International Investment Management Inc.

At the beginning of the year, the orange line showed the yield curve sloped upwardly to the right, indicative of a growing economy.

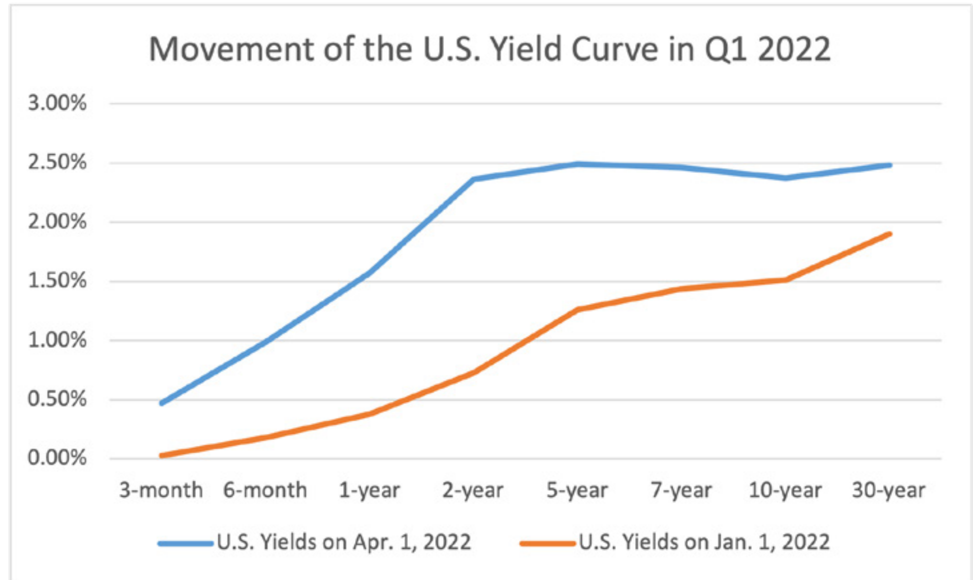
With the subsequent rise in interest rates (the central banks only control short-term rates), the blue curve has risen sharply at the short end and flattened out at the longer end.

This indicates that the bond market believes three things:

- Inflation is temporary. Otherwise, long-term rates would be much higher than they are today.
- The hump in the yield curve, especially in the two-year term, is the combination of hedge funds shorting the US 2-year T-note on the expectation that rates won't rise beyond 2024, and the Federal Reserve ending its Quantitative Easing policy of buying Treasury bonds and, instead, letting those bonds mature.
- Higher rates could lead to an inverted yield curve and a recession. Evidence of a slowdown in consumer spending has begun with 30-year U.S. mortgage rates now over 5%. This has led to a decline in home buying but also a reduction in spending as consumers must allocate more of their take-home pay toward debt repayment, leaving fewer funds to buy "stuff".

The second reason why we're not concerned about a drop in bond prices is because they are tied to the bond's par value at maturity. The prices may move around positively or negatively based on movements in interest rates during their term but, at maturity, the borrower still has to pay back the full value of the bond.

U.S. Bond Yield Curve



Data Courtesy of Bloomberg L.P.

Below is a chart of a 7-year bond issued by Cominar REIT in 2015 and called recently prior to its June 1, 2022 maturity date.

If you bought 5,000 par value in 2015, it would have cost $5,000. On November 2, 2016, it hit a high of $104.048 or a value of $5,202.40. By July 25, 2017, the bond had fallen to $97.617, or a value of $4,880.15 a drop from peak to trough of 6.18%

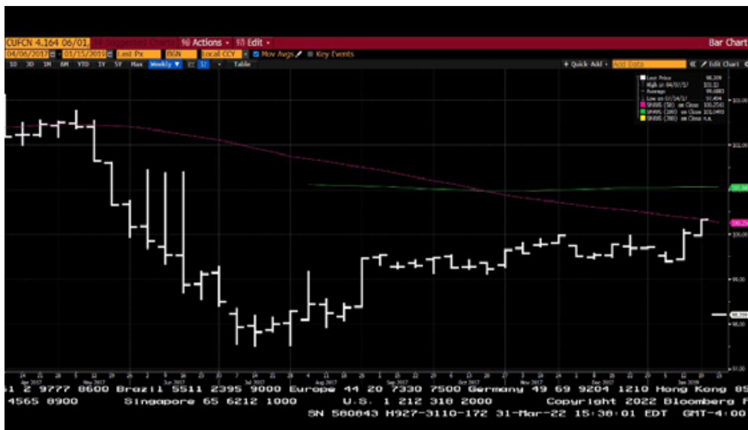
However, the bond was recently called at its $100 par value, meaning the movement in price during that 7-year time horizon was irrelevant. The company made its annual 4.3164% payments and it didn't go bankrupt during the holding period.

The same argument can be made for all bonds. The movement in price is irrelevant unless the company goes bankrupt. They could currently be down 11% or so but that unrealized loss will disappear when the bond matures.

Finally, while some investors would want to sell their bonds because of the unrealized loss, I see it more as an opportunity to pick up more of the same bonds or other bonds at higher yields. I see the world through opportunity, or as Warren Buffett has said, "Be greedy

© 2022 Liberty International Investment Management Inc.

Price chart of the Cominar REIT 4.3164% bond due June 1, 2022.



Data Courtesy of Bloomberg L.P.

when people are fearful." That axiom doesn't just apply to the stock market. It applies to bonds, too.

What many pundits have missed are the following opportunities in the market:

→ Short-term yields of bonds maturing in 5 years or less are reaching 4% and trading under par. For example, a corporate bond issued by Reliance LP (they rent water heaters to homeowners and carry an investment grade of BBB-Low) has a 3.75% coupon and trades at $99.036, providing a yield of 4.0161%.

  If the price falls in the next 6 months as rates rise and inflation eases, the yield could reach a level that would provide a real return greater than the inflation rate.

→ Some bonds with low coupons trade below $90. This could be a good investment for taxable accounts as the higher-taxed interest income is low, say 2% while the potential capital gain is larger, say 10%.

  Granite REIT offers a 2.19%, 7-year fixed rate bond rated BBB maturing August 30, 2028. The current price is $89.126 and yields 4.1493%.

  On a $1000 investment, the annual interest income would be $21.90 and taxed at a 50% rate but the capital gain over the life of the bond would be 12% and taxed at a rate of 25% or less.

→ If we get another 1% or more rise in interest rates, investment grade corporate bond yields should range between 4.50% and 6% depending on maturity. At those levels, they should provide positive real returns after inflation and also offer competition to stock yields.

  While pundits have proclaimed in the last year that the 60% stock / 40% fixed income asset mix is out-of-date, the narrative could change quickly.

Market Summary

→ If rates continue to rise, we see bonds as an attractive investment. For new accounts, we'll be picking away after each central bank rate increase. For example, if we have to buy 20 bonds for a new account, we could buy 3 bonds after each rate increase and dollar-cost average our way into the full position with a potential yield of 5%.

→ If inflation remains an issue, the market could fall into recession. This makes value stocks attractive. Those with above-average dividend increases and the ability to raise prices quickly without a drop-off in client demand should be the winners.

→ If inflation ebbs, there could be a rotation out of commodities into growth stocks. If you own commodity names in the agriculture, mining or oil and gas spaces, you may wish to lock in some profits along the way.

Remember, these names are cyclical and they make money in the good times but lose it all during the bad ones. Manage your cash appropriately. More on that in the Q&A below.

 © 2022 Liberty International Investment Management Inc.

INVESTING FOR MILLENNIALS: IN THE BEGINNING, INVEST CONSERVATIVELY

By James Coman

Given the high stock market returns of the past five years, many young investors have been attracted to the stock market like moths to the light. Just think, if you make 30%, 40% or more in Crypto ETFs, junior mining stocks or high-risk tech start-ups, you could make a lot of money and retire early. While a tempting thought, it's probably the worst strategy for younger investors.

For example, say you have $20,000 to invest. For investors in their 20s, the risk of losing that money in the types of stocks listed above are very high. If they lose all that money on high-flyers, how long will it take on their current salaries to save another $20,000?

That's why it's important for first-time investors to think differently. Instead of investing in an emotional dream world, they should make their first investments with purpose and a focus on time and compounding.

That means investing in solid blue-chip, or large-cap stocks to build a stable portfolio and use the income, if they wish, to later gamble in the stock market with higher risk, speculative investments.

Large-cap companies are defined by those with a market capitalization (number of shares times the share price) of greater than CAD $10 billion. They tend to be mature firms where revenues may only grow at the average 2.0% rate of GDP (Gross Domestic Product) but they consistently pay out an ever-increasing dividend.

While these companies have likely transitioned through the explosive growth phase into a steadier pace of expansion, they tend to be run by seasoned executives and have superior access to financing options which allows them to better weather downturns in the economy.

TD Bank (TD CN), a long-time Liberty holding and one of Canada's largest banks, is an example of a large-cap stock. At the end of February, its stock price was up 5% even though the overall S&P/TSX composite index was down 0.45% during the same period. Conversely, a more speculative stock such as Lightspeed Commerce Inc (LSPD CN) was down 33%.

It's important for new investors to consider two things:

- Two-thirds of all performance comes from rising dividends and the re-investment of dividends
- Managing downside risk is of ultimate importance, especially if your salary or income is low

Increased stability in a company's finances allow for better forecasting of future cash flows, which in turn permits a stable or even rising dividend.

For example, TD Bank has increased its dividend payment from $1.45 a share in 2012 to $3.56 in 2022, an annualized growth rate of 15 per cent.

If a first-time investor had purchased 100 shares in 2012, the annual income would have grown from $145 to $356. The accumulated dividends for the decade would be $2,711, allowing the investor to use the dividend proceeds to buy another dividend-paying stock for the portfolio and to diversify it.

In contrast, Lightspeed doesn't pay a dividend so total return comes from capital appreciation. To raise

© 2022 Liberty International Investment Management Inc.

money to buy another stock, the Lightspeed shares would have to rise in value and a portion sold to raise the proceeds for the next stock purchase.

The second issue of managing risk is simple. As dividends grow, the share price has to follow or the yield (dividend divided by price) will be too large. This should attract buyers and send the price higher.

In Lightspeed's case, a drop of 33% in value is like watching $1 turn into 67 cents. To get back to breakeven, Lightspeed shares must now rise 49%. It may take years just to return to breakeven.

By building out your portfolio with multiple stocks paying dividends, you can create a steady stream of income. This dividend stream creates cash flow to provide for the future purchase of new stocks, which leads to higher income from higher dividends – a positive feedback loop that grows the portfolio.

While it may sound more appealing, chasing speculative stocks puts your long-term financial goals and retirement at risk. Instead, we recommend that when starting out to invest, be conservative in your decisions: Buy blue-chip stocks first and speculative stocks later.

This strategy should go a long way to achieve your long-term goals such as purchasing a home and growing income for your retirement.

THE RELATIONSHIP OF RISK AND VOLATILITY

By Brett Girard CPA, CA, CFA

Risk, used as a verb, is defined as exposure to danger, harm or loss. Translating into an investing context, we would extend the definition of loss to a permanent impairment of capital. Ex ante, it is almost impossible to determine whether capital will be impaired permanently.

The investment industry uses volatility as shorthand for risk. Volatility, often expressed as standard deviation, comes to us from statistics and measures the dispersion of returns for a given security or index – or, how much the price of a security changes over a specific period as compared to the average price change over the entire period.

A higher standard deviation tells us that in the past, annual returns differed from the average (prices moved up or down a lot). Here's an example:

HYPOTHETICAL SECURITY ANALYSIS	SECURITY A PERFORMANCE	SECURITY B PERFORMANCE	SECURITY C PERFORMANCE
Year 1	+4%	+21%	+15%
Year 2	+3%	-18%	-2%
Year 3	+5%	+15%	+13%
Year 4	+3%	+25%	+18%
Year 5	+4%	-19%	-4%
Average return (Mean):	**3.8%**	**4.8%**	**8.0%**
Standard Deviation:	**0.74**	**27.21**	**9.14**

Above are three securities with 5 years' worth of annual return data. Security A consistently returned 3% - 5% during the period. The standard deviation of Security A, due to the consistent annual results, is very low. If an investor optimized just for standard deviation, Security A would be preferred. The risk-adjusted returns are better than Security B or C.

© 2022 Liberty International Investment Management Inc.

By contrast, Security B had large swings in performance - annual returns ranged from -19% to 25%. This resulted in a significantly higher standard deviation, although the average return over the 5-year period was not meaningfully better than Security A. From a volatility perspective, this could be seen as a lot of risk with little reward.

Security C was in the middle of the road in both dispersion of results (-4% to +18%) and standard deviation (or volatility).

If given the choice, a rational investor using past performance would select Security C for the average return. As per below, this decision would be reinforced by looking at the cumulative growth of $100 invested at Time 0.

CUMULATIVE GROWTH OF $100 AT THE END OF:	SECURITY A PERFORMANCE	SECURITY B PERFORMANCE	SECURITY C PERFORMANCE
Year 1	$104.00	$121.00	$115.00
Year 2	$107.12	$99.22	$112.70
Year 3	$112.48	$114.10	$127.35
Year 4	$115.85	$142.63	$150.27
Year 5	$120.48	$115.53	$144.26

While Security B had higher returns in certain years, the greater volatility vis-a-vis negative returns ended up destroying value and resulted in the worst ending investment out of the three securities.

While volatility in a portfolio can be alarming, especially when prices are falling, focusing too much on this metric can lead investors to make poor and often emotional decisions. Volatility is not risk.

Further, business growth and stock performance does not occur in a straight line. All businesses, good and bad, will have variability in operating results. By finding companies that can consistently perform within a range, in a host of economic environments, investors should focus on avoiding permanent impairment of capital, not minimizing volatility.

© 2022 Liberty International Investment Management Inc.

FUN WITH MATH: CASH CONVERSION – HOW TO FIND LONG-TERM STOCK WINNERS

By David Driscoll

Many do-it-yourself investors don't spend time to do their homework and actually learn what makes a company good.

When I'm at a cocktail party, I find that everybody wants to blather on about their latest stock investment that made thousands or how their day-trading style can't be beat. Instead of helping inflate their egos, I always ask them to tell me about their biggest losers. Within minutes, I'm usually standing in the corner drinking a glass of wine by myself.

"Before you buy any stock, please do your homework and focus on cash conversion rates. Those firms that can consistently turn net income into free cash flow at a 100% rate are rare and worth investigating."

We've written in past newsletters about the importance of free cash flow but we're going to put a little twist on it by showing you the importance of cash conversion. This ratio essentially makes or breaks a Chief Financial Officer's career.

Free cash flow conversion ratio

In your own life, free cash flow is the amount of money left over after all your bills are paid. With this excess, you have financial flexibility. You can save it, spend it or invest it.

It's the same with a corporation. If the company has free cash flow, it can raise the dividend, pay down debt, buy back shares, upgrade plant and equipment to stay modern, allocate funds to research and development to continue to evolve and be relevant or it can make acquisitions to increase its market share and pricing power.

Simple free cash flow is calculated as Cash from Operations (CFO) minus Capital Expenditures (CE) minus Cash Dividends (CD), or **FCF = CFO – CE – CD.**

The Cash Conversion ratio is simply Free Cash Flow (FCF) divided by Net Income (NI), or **FCF / NI**.

A Chief Financial Officer's (CFO) ability to turn profits into free cash flow is not an easy task. Of the 30 stocks on the Dow Jones Industrial Average, only one company, Salesforce.com, has consistently been able to convert 100% of its net income to free cash flow. That's not surprising, given it's a software company, where costs are low and operating margins and cash flows are high.

© 2022 Liberty International Investment Management Inc.

Rarely does it happen at a manufacturing company. But when it does, the results can reward investors hugely. Dividends, profits and share prices can rise more than the average company. That's why it's one of the first metrics we consider when investing in a stock.

To illustrate, let's compare two industrial firms, 3M Co. (MMM US), with one of our Liberty names, Littelfuse Inc. (LFUS US).

3M is a diversified company that operates in four segment categories: Safety & Industrial, Transportation and Electronics, Health Care and Consumer. Some of its more recognizable brands include Post-It notes, Scotch tape, Scotchgard fabric protectors, Filtrete air filters and ACE bandages.

Littelfuse is one of the world's largest custom-design makers of fuses. It also offers LED lighting and sensors. With the move to greater electrification in the economy, Littelfuse is well-situated to benefit from higher demand.

The table below shows the cash conversion trends of each company over the past 10 years.

Cash Conversion Trends (Littelfuse Inc. vs. 3M Co.)

LITTELFUSE INC.	10-YEAR AVERAGE GROWTH RATE	3M CO.	10-YEAR AVERAGE GROWTH RATE
Revenues	21%	**Revenues**	2%
Cash From Operations	21%	**Cash From Operations**	4%
Capital Expenditures	41%	**Capital Expenditures**	2%
Cash Dividends	24%	**Cash Dividends**	12%
Free Cash Flow	16%	**Free Cash Flow**	0%
Cash Conversion	107%	**Cash Conversion**	47%
Total Stock Return (Dividends reinvested)	21%	**Total Stock Return (Dividends reinvested)**	10%
vs. S&P 500 Index (Dividends reinvested)	16%	**vs. S&P 500 Index (Dividends reinvested)**	16%

Data Courtesy of Bloomberg L.P.

From a financial standpoint, Littelfuse should continue to perform better than 3M in the future. Revenues and cash flows are growing significantly,a sign that it's in the right business. The free cash flow growth has also provided the company with the financial flexibility to make acquisitions, devote more dollars to research and development to stay relevant and keep shareholders happy with above average dividend growth.

And as the dividends grow, the share price ultimately follows. On a compound annual basis over the past decade, Littelfuse's share price has grown 21% per year and has outperformed the S&P 500 Index by 5%.

Before you buy any stock, please do your homework and focus on cash conversion rates. Those firms that can consistently turn net income into free cash flow at a 100% rate are rare and worth investigating.

© 2022 Liberty International Investment Management Inc.

TAX TREATMENT FOR ESTATE PLANNING

By Scott Kerkhof CPA, CA

When planning for your future, think about the impact of tax on your life's work, investments, and other assets. With all the types of accounts and investments available, often with different tax and probate rules, it is hard to know where to start. Let's explain the details you need to understand by breaking down four key terms:

Adjusted Cost Base (ACB):

This is an accounting term for the amount you originally paid for the asset. For example, if you bought 100 shares of a stock for $10 a share, your adjusted cost base would be $1,000. This also works for multiple purchases; 100 shares at $20 ($2,000) a share then another 150 shares at $25 ($3,750) a share would result in a cost base of $5,750.

Fair Market Value (FMV):

This is another accounting term for the amount an unrelated third-party would pay you for an asset. If the same 100 shares above were trading on an exchange for $30, your Fair Market Value for those shares would be $3,000.

Capital Gain:

This is the difference between your Fair Market Value and your Adjusted Cost Base.

Deemed Disposition:

For tax purposes, you treat assets as if you had sold them on the day you die, also known as a deemed disposition. Using the examples above, if at death your 100 shares were trading at $30, then you would have deemed to have disposed of them for $3,000, resulting in a capital gain of $2,000 (FMV of $3,000 – ACB of $1,000).

Next, let's discuss the treatment of each type of account from the perspective of both income and probate – two sources of taxes on an estate at passing. Income taxes arise from the deemed dispositions of certain accounts as well as the inclusion of other accounts in income at death (more below). Probate, also known as the Estate Administration Tax, is applicable in varying degrees depending on the province, and is levied against assets that are probated.

Non-Registered "Cash" Accounts and Joint Non-Registered Accounts:

Tax: Upon the first spouse's death, the value of the account will "roll over" to the surviving spouse on a tax-free basis. When the surviving spouse dies, the investments will have a deemed disposition, creating a taxable capital gain.

If the investments are jointly held between individuals who are not spouses, the portion of the account held by the deceased person will be deemed to have disposed of their share in the joint account at fair market value and any resulting gains will be taxable in that person's estate.

Probate: These investments are subject to probate based on the fair market value when the last surviving spouse dies. When investments are jointly held between individuals who are not spouses, and one owner passes away, if the intent of the transfer was to ease estate administration and not to gift or change beneficial ownership, then the assets may be subject to probate fees, depending on the provincial legislation and related legal interpretations.

Registered Retirement Savings Plans (RRSP)/Registered Retirement Income Funds (RRIF):

Tax: The general treatment of RRSPs and RRIFs is to have the total fair market value of the account included in income in the year of death. However,

 © 2022 Liberty International Investment Management Inc.

a tax deferral is possible by designating a spouse or common-law partner as a successor annuitant or financially dependent children under the age of eighteen as a beneficiary of the RRSP/RRIF.

For a successor annuitant, the RRSP/RRIF continues, and the surviving spouse becomes the annuitant. There is no tax reporting required and the account will have a name change.

For a beneficiary, in rare instances, the RRSP/RRIF is deregistered, and there will be a rollover of all assets to the spouse on a tax deferred basis. This will result in the spouse having to report the fair market value of the transfer in their income but will also receive a corresponding RRSP contribution slip to claim an offsetting deduction.

Probate: These investments are subject to probate (depending on the provincial legislation) based on their FMV if there is no surviving spouse named as a successor annuitant or a beneficiary or if the beneficiary is anyone other than a financially dependant child under the age of eighteen.

Tax Free Savings Account (TFSA):

Tax: There are no taxes on TFSAs at death. However, the treatment of the TFSA going forward will depend on whether one makes a designation of a survivor as a successor holder or as a beneficiary.

For a successor holder, the Income Tax act only allows the passing of the tax-exempt status to a spouse or common-law partner. If the spouse is the successor holder, then the spouse becomes the holder of the TFSA, keeps the tax-exempt status of the TFSA, and this will have no effect on their own TFSA contribution room.

For a beneficiary, it differs from a successor in that they would receive the value of the TFSA on a tax-free basis but would not receive its tax-exempt status. Unless the beneficiary has their own available TFSA room, they would incur taxes on any investment income or gains going forward.

Probate: If a TFSA has a named beneficiary, this excludes it from the estate, and thus will not be subject to probate.

Registered Education Savings Plan (RESP):

Tax: For parents and guardians, RESPs would not be subject to tax on death if they name a successor subscriber. If the beneficiary is not expected to use the RESP before their parent or guardian's death, then a trusted successor subscriber who can care for the RESP and ensure that the original beneficiary receives the benefit of the RESPs assets should be named.

However, if it is not possible to name a successor subscriber (in specific circumstances), this will result in the wind up of the RESP and will be subject to tax.

Probate: Like the tax treatment of a TFSA, if a successor subscriber is named, the account will not be subject to probate. However, if it is not possible to name a successor subscriber (in specific circumstances), this will result in the windup of the RESP, and it will be part of the estate and subject to probate depending on the provincial legislation.

Principal Residence (Home):

Tax: On death, a principal residence is not subject to income tax. However, the estate will have acquired the home at the FMV on the date of death. If there is any increase in the FMV when the estate sells the home (after a reasonable period), then the increase (less any selling expenses) would be subject to capital gains tax.

Probate: The last surviving spouse of the principal residence will be subject to probate based on its FMV depending on the provincial legislation.

Other Real Estate Property:

Tax: On the death of the last surviving spouse, real estate property other than the principal residence will be subject to a deemed disposition and capital gains tax will apply on the date of their death.

© 2022 Liberty International Investment Management Inc.

Probate: When the last surviving spouse passes away, any real estate other than the principal residence will be subject to probate (depending on the provincial legislation) based on its fair market value.

Conclusion

We understand that this a complicated topic and that you may have questions about how this applies to your specific assets and situation. We also know that governments and their budgets are constantly changing. The guidance here notes the treatment of these items currently but may be subject to change.

We welcome any questions or concerns you may have.

CLIENT QUESTIONS

I have big profits in my resource investments. Should I hang on for even greater profits or do some selling?

This is the flipside of the Warren Buffett quote noted earlier. This one is, "Be fearful when people are greedy."

Resource investments are elastic businesses. They make all their money when commodity prices are high and lose it all when commodity prices are weak. As a result, these cyclical stocks also have high betas, meaning they're more volatile than the average stock on an index.

For example, Vermilion Energy (VET CN) is an oil and gas firm that trades on the TSX exchange. Its beta is currently 2.48. This means that for every $1 dollar the TSX composite index moves up or down, Vermilion's stock price moves up or down $2.48, or about 2 ½ times the index. The greater the price spread, the greater the volatility.

In fact, we have observed during many markets that stocks with betas greater than two are often opportunities for short-sellers. Currently, about 4% of Vermilion's stock float has been sold short.

Over the past 12 months, Vermilion's share price has risen 194%, almost tripling in value. That's great, except that the company cut its dividend in 2020 from 92 cents a share annually to its current 24 cents. It's bonds are rated BB-Minus, known as "junk" bonds or non-investment grade securities.

What, then, should an investor do if they own the stock? Rather than speculate about the future, it's wiser to manage the investment like a professional gambler in Las Vegas.

The gambling pros are well aware that the odds are in the casino's favour, as the "house" wins about 88% of the time. While most visitors to Vegas get aggressive and increase their bet sizes when they're on a roll and winning, the professional gambler does just the opposite. They control their bet sizes.

For example, if they show up in Vegas with $2,000, they'll put $1,000 in their safe and take the other $1,000 with them to the casino to bet.

If they double their money, they'll then take their $1,000 profits and put it back in the vault and gamble again with the original $1,000. If they double their money a second time, only then will they double their bet size to $2,000 because they know that if they lose it all, there's still $2,000 in the vault and they're no worse off than when they arrived.

Stock investors should consider the same thing, especially with cyclical names. If they double their

 © 2022 Liberty International Investment Management Inc.

money in a stock, they should sell half of their shares and keep the remaining shares invested. If the stock goes to zero, they've already made back their money with the original profits.

At Liberty, we do the same thing. If a stock's percentage weight starts out at 3% (30 stocks in the portfolio and an equal weighting in each) and becomes a 6% weight, we automatically sell half. This takes the emotion out of the situation.

A company we still own for clients is Shopify Inc. (SHOP CN). We first bought it at $83 a share and, because of its high volatility, sold half at $166 and then pared the holding again every time it doubled at $325, $650 and $1,300 a share. The company reached a price high of $2,228.73 on November 19, 2021 and currently trades at $824.21, down 63%.

It's not a concern to us because most of our clients have made their money back many times over.

How come you don't outperform the market every year?

In the history of the stock market, nobody has ever outperformed a stock index every year. While an investment style (value, growth, momentum, "bottom-up", "top-down") may be successful for a few years, economies change and will impact the fortunes of any particular strategy.

As proof, let's compare the performance of Warren Buffett's investment vehicle, Berkshire Hathaway (BRK.B US) versus the S&P 500 Index for the past 22 years, or from calendar 2000 to 2021. This provides a good time frame as there were a number of market collapses during this time. Below are the compound annual returns (with dividends re-invested).

Berkshire Hathaway performance vs. S&P 500 Index (calendar 2000 to 2021)

INVESTMENT VEHICLE	SYMBOL	COMPOUND ANNUAL RETURNS				
		22-YEARS	15-YEARS	10-YEARS	5-YEARS	1-YEAR
Berkshire Hathaway	BRK.B	10.01%	8.55%	14.30%	10.79%	30.05%
S&P 500 Index	SPX	7.52%	11.02%	16.79%	17.59%	28.68%

Data Courtesy of Bloomberg L.P.

Since the beginning of 2000, Berkshire Hathaway has outperformed the S&P 500 Index by 2.49% on an annual basis, so Buffett has done his job for investors. Note that Berkshire doesn't pay dividends while the S&P Index does. This makes the outperformance even greater.

However, Berkshire underperformed the S&P 500 Index over a five, ten and fifteen-year period, with the 5-year period underperformance of 6.8% notably bad. What do these numbers suggest?

- A 22-year outperformance of 2.49% is huge. Put in numeric context, if you invested $1,000 on December 31, 1999 in Berkshire shares, they'd today be worth $7,414, a seven-fold increase, compared to the S&P 500's value of $4,584.
- During those 22 years, Berkshire beat the index only 12 times, a win rate of only 54%. It means that in the years when Buffett beat the S&P, he really beat it. In Year 2000, for example, Berkshire shares were up 28.6% while the S&P Index was down 9.1%, a difference of 37.7%.

The moral of the story is this: Let time and compounding work in your favour by investing in businesses over economic cycles rather than try to trade your way to great fortunes.

© 2022 Liberty International Investment Management Inc.

I don't understand why we own rate-reset preferred shares in our portfolio. Can you please explain further?

Both central banks in Canada and the United States plan to raise rates by up to two per cent this year. Rate-reset preferred shares perform best when interest rates rise. Here's one example of the benefit of owning rate-reset preferreds.

Capital Power Corp. is a utility company that originally issued a rate-reset preferred share in 2013 with a 4.60% coupon. Five years later, in 2018, the company reset the coupon from 4.60% to 5.45% based on the following formula: 323 basis points, or 3.23% plus the 5-year Government of Canada (GOC) bond yield. At the time, the 5-year GOC rate was 2.22%.

This preferred share will reset again on December 31, 2023. If it reset today with the 5-year GOC at 2.55%, it would reset at 5.78%, higher than today's coupon. This is good for investors because they'll earn more dividend income than they had during the previous five years.

And based on the current $24.60 price and annual dividend of $1.363252, the current yield is 5.54%, or 7.75% on a pre-tax basis.

This type of security helps offset inflation to some degree and earns income greater than vanilla bonds or stocks. It is in client portfolios for income purposes only, not for capital appreciation.

IN OTHER NEWS:

Liberty is a teaching institution and we're happy to announce that the following three staff members passed their recent exams:

James Coman and Alice Park passed the Canadian Securities Course's second exam, while Sharang Arora passed his Compliance Officer course.

We believe that teaching staff more about the investment business provides a better level of service to our clients. That's why we're happy to pay for all the courses they take, whether or not they pass. We haven't been disappointed yet.

If you have any questions, let us know.

David Driscoll CIM
President & CEO

Brett Girard CPA, CA, CFA
Portfolio Manager & CFO

Annie Bertrand CIM
Portfolio Manager

The commentary in this newsletter should be considered general commentary only. The above language is intended for informational purposes only and is not intended to constitute accounting, legal, tax, or investment advice. You should consult directly with a Liberty professional before acting on any information in this newsletter.

© 2022 Liberty International Investment Management Inc.