

# Wealth & Wisdom

Your quarterly guide to investment success from your TD Waterhouse® Investment Advisor

Fall 2007

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## What the sub-prime lending in the U.S. will mean to Canadians

BY RICHARD KELLY, SENIOR ECONOMIST, TD BANK FINANCIAL GROUP<sup>1</sup>

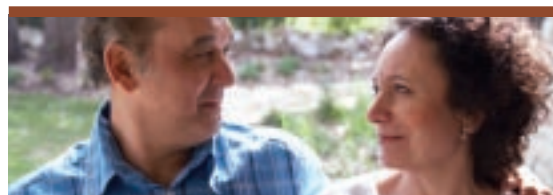
While investors were awed by some financial fireworks at the end of the summer, the show has proven to be rather short. By the end of September, the U.S. S&P 500 was up more than 8% from its trough in mid-August and had regained nearly all of the losses it sustained in the wake of the sub-prime financial crisis.

While several more months of volatility in financial markets and a greater level of economic uncertainty are likely, the immediate fallout has been overdone. The complex debt instruments that precipitated the current market turmoil make up just 2% of U.S.-dollar financial assets, and the ones specifically linked to sub-prime housing debt make up just one-third of 1% (see chart on Page 2).

### The origin of the crisis

The crisis had its origins in the U.S. housing market. Some short-sighted mortgage lenders thought they could combine lax lending standards and innovative financing to fuel a never-ending housing boom. An increasing share of U.S. mortgages was sold off into financial markets through asset-backed securities, which meant the burden of any eventual defaults would fall on the investors holding these exotic investments, rather than the original lender.

Lenders were increasingly detached from having to worry about the credit quality of those they lent to, and investors were increasingly unaware that the value of these financial products — which they were buying at an increasing rate — was rapidly eroding. By the time financial markets woke up to the risks in mid-July, U.S. sub-prime



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debt had been spliced and diced all over the world into long-term debt and short-term financial products like commercial paper.

It will take several more months to develop plans to restore order to financial markets and probably several years before these debts are cleared from the market.

### Reasons for optimism

In spite of this, there are several reasons to be optimistic that the wider economic repercussions will continue to be limited. The U.S. corporate sector is maintaining a high level of cash, which permits companies to wait out a short period of weaker economic growth. At the same time, the falling U.S. dollar and ongoing global economic expansion are driving U.S. exports, helping to offset weaker domestic demand. U.S. labour markets remain resilient, with a steady unemployment rate and ongoing wage gains.

*Continued on Page 2*



## Crisis, what crisis?

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New-home building is likely to continue to contract over the next year, and home prices at the national level will probably continue to fall on a year-over-year basis for the next year as well. Moreover, falling home prices may limit homeowners' ability to tap home equity by refinancing.

But as long as they continue to have their jobs and paycheques, the overwhelming majority of U.S. borrowers should be able to pay their monthly bills and wait out the current weakness in housing.

While those who bought their new homes with adjustable rate mortgages may see their interest rates go higher over the next year, the total cost of these resets is likely to come in at just one-half of 1% of total annual U.S. consumer spending.

The engine of growth for the U.S. economy is expected to slow but should remain very much alive and kicking, especially with the Federal Reserve easing interest rates as needed to offset any unexpected weakness.

### Recession unlikely

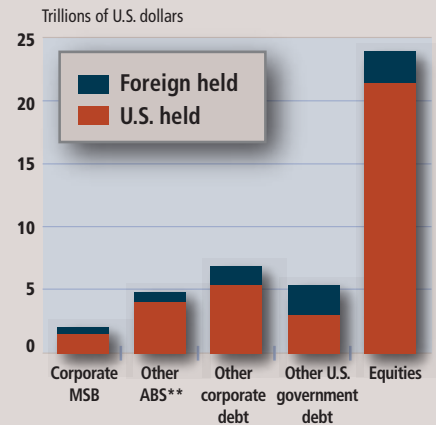
This summer's financial turmoil revealed some vulnerabilities within the U.S. economy. But vulnerabilities need not be exploited. The most likely scenario for the U.S. economy is a modest 2% economic growth, with further weakness in the housing markets. Cautious business investment should be offset by continued consumer spending and demand from overseas.

This is now the fourth U.S.-centred financial crisis in the past 20 years. In none of the previous episodes did financial volatility lead to a recession. There are no indications that events will play out any differently this time. ■

## Sub-prime exposure is minimal

Sub-prime mortgage debt, the key driver of recent market volatility, actually represents only a fraction of U.S.-dollar long-term financial assets.

### U.S.-dollar long-term financial assets\*



\*As of June 2006; \*\*MBS=Mortgage-backed securities and ABS=Asset-backed securities. Source: Federal Reserve Bank of New York.

## What the BCE takeover means to you

As most investors are probably aware, a consortium led by the Ontario Teachers Pension Plan Board is in the process of purchasing all outstanding BCE Inc. (formerly Bell Canada Enterprises) common shares for \$42.75 each. The proposed deal was approved by a majority of BCE common and preferred shareholders on September 21, 2007, and is expected to close in 2008.

### The implications

Common shareholders could feel the effects in a number of areas, including the following.

**TAXES IN 2008.** If you have owned BCE shares for an extended period of time, chances are that the purchase of your shares may result in a significant capital gain. Fifty percent of net capital gains (total capital gain less total capital losses) realized in a year are included as income for the year and subject to tax. In

other words, you may have a significant tax bill in 2008.

The size of the capital gain (or loss) will depend on the average purchase cost of the BCE shares, which will be affected by stock splits and other events, such as the spin-off of Nortel shares in 2000 and the creation of the Bell Aliant Regional Communications Income Fund last year.

**GOVERNMENT BENEFITS.** Higher taxable income means not only higher taxes, but a potential reduction in available tax credits, such as the age amount and the spousal amount, as well as income-tested government benefits such as Old Age Security and the GST credit.

**DIVIDEND INCOME.** If you have been relying on the regular dividend income received from your BCE shares to supplement your cash flow, you may need to consider other investments to replace this income once the transaction closes.

### Planning opportunities

Given that the transaction is expected to close next year, it may be possible to spread out the anticipated capital gains liability over two years by disposing of some BCE shares this year. Other planning opportunities include:

- ▶ Decreasing the income drawn next year from registered and non-registered investments;
- ▶ Utilizing capital losses realized next year and any capital losses carried forward from previous years;
- ▶ Donating the BCE shares in-kind to a registered charity. There would be no capital gains tax on the donated shares and you would receive a charitable tax receipt for their market value.

*Your Investment Advisor, together with your professional tax advisor, may have other ideas to help you reduce your taxes and/or replace the income you derive from you BCE shares. Contact them today. ■*

## Your year-end tax checklist for 2007

The year is about to draw to a close. Here's a checklist to help you make sure you've covered all the bases:

**CONSIDER TAX-LOSS SELLING.** If you're holding non-registered assets that have gone down in value since you bought them, selling them will trigger a capital loss that you can use to offset capital gains realized this year. Excess losses can be used to offset capital gains reported in any of the three previous years or carried forward for use in future years.

In order to claim the loss for 2007, the trade must settle by December 31. That means your trade must be made on December 24 for Canadian exchanges, and December 26 for U.S. exchanges.

**MAKE CHARITABLE DONATIONS.** To be eligible for 2007, the donation must be made by December 31. Where possible, you should consider donating qualified securities in kind instead of cash to a registered charity. There will be no capital gains tax on the donated securities and you would receive a charitable tax receipt for their market value.

**MAKE TAX ELIGIBLE TRANSACTIONS.** Charitable and political donations, medical expenses, child support payments, alimony, eligible accounting and legal fees, professional fees, union dues, and so on must be paid by year-end if you want to claim the related tax credit or deduction for this year.

**CONTRIBUTE TO AN RESP.** Make a Registered Education Savings Plan contribution of up to \$2500 before December 31 to receive a government-sponsored Canada Education Savings Grant equal to 20% of the contribution. The maximum annual grant is \$500, however, if you have unclaimed grant room from previous years, consider increasing your contribution to up to \$5000 to receive up to an additional \$500 in grant.

**PENSION INCOME SPLITTING.** You might be able to allocate up to 50% of your



Are all of your bases covered for this year's tax season? This checklist should help you go into the new year with confidence.

qualified pension income to your spouse or common law partner.

**PAY INSTALLMENTS ON TIME.** If you're required to pay income tax installments throughout the year, your final 2007 payment is due on December 15.

**RSP AGE LIMIT INCREASE.** And finally, if you turn 69 in 2007, you are no longer required to convert your RSP this year. This year's federal budget increased the age limit to the end of the year you turn 71:

- If you are 70 or 71 and have already

converted your RSP to a Retirement Income Fund (RIF), you can transfer the assets back to an RSP so long as you convert it back to a RIF by the end of the year in which you turn 71.

- If you have a RIF, the minimum RIF withdrawal rule is waived for 2007 (if you are 71 years old in 2007) and for 2007 and 2008 (if you are 70 years old in 2007). ■

*Your Investment Advisor can provide you with guidance specific to your investment situation.*

### BOOK REVIEW

## *How: Why HOW We Do Anything Means Everything... in Business (and in Life)*

PATRICIA LOVETT-REID REVIEWS THE BOOK BY DOV SEIDMAN

In today's business environment we are all looking for the competitive advantage. What could we do differently to help us stand out in a crowded space? In Dov Seidman's *How: Why HOW We Do Anything Means Everything... in Business (and in Life)*, the qualities that were once thought of as the softer aspects of business become the focal point.

Seidman talks about trust, integrity, values, reputation, and transparency, with loads of practical examples that make us question past behaviours,

refocus our energies, and adjust to the changing rules of the game.

As Seidman says, "it's no longer what you do that sets you apart from others, but how you do what you do." This book explores how we think, how we behave, and how we might do things differently in the 21<sup>st</sup> century.

*Patricia Lovett-Reid, host of MoneyTalk on the Business News Network (BNN), is a leading authority and sought-after speaker and commentator on wealth management.*

# Diversification is the best protection against stormy markets

So far this year, Canadian stock markets have continued to perform well, while in the U.S., the picture has been decidedly grim. During periods of volatility, where we see surges as well as dramatic “downs,” investors are reminded of the protection that a well-diversified investment portfolio can provide against risk.

A portfolio that can achieve your goals over the long term is one in which assets are spread — or diversified — among different types of investments.

## How diversification works

Looking at the way markets have performed this year and over the decades, we can see that equity and bond markets behave differently, which is why an investment portfolio needs components of both, plus a measure of secure investments.

The proportions of each type of asset in your portfolio, including equities for growth, bonds for income, and money market securities for safety and liquidity, depends on your investment goals, your time horizon, and your tolerance for risk.

For example, while equities tend to be more volatile than other types of financial assets, they have usually provided the highest returns over time. Bonds are not as volatile and tend to have less growth potential, but offer more predictable returns over the long term. Money market securities are much more secure, but deliver modest returns.

Diversification makes a portfolio significantly less vulnerable to downturns

in any one group. Downward movements in one can be offset by positive results in another.

## Opportunities for growth

A portfolio that is too concentrated in one type of investment, geographical region, or sector carries a risk beyond failing to protect the investor from downturns. It's missing out on other opportunities for growth.

Including investments from different asset classes, regions, and sectors in a portfolio allows investors to take advantage of the sometimes significant growth potential they may offer.

## Prepared for the long term

Over the long term, a diversified mix of



In a diversified portfolio, downward movements in one asset class can be offset by positive results in another.

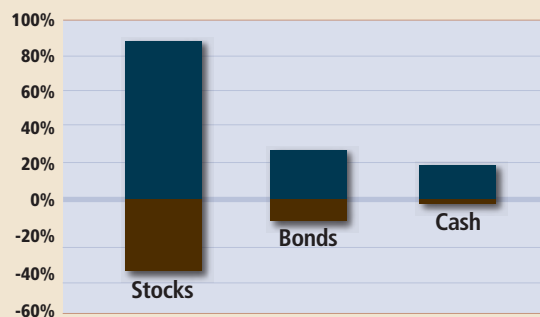
assets will generally offer growth along with protection from turbulent markets.

*Working with your Investment Advisor, you can keep your portfolio in line with your time horizon and risk tolerance in order to achieve your goals. ■*

## Annual range of returns over time

A portfolio weighted heavily in equities would be more volatile compared to one which has a more balanced asset allocation. Diversification across various asset classes will help reduce the volatility of the portfolio.

Maximum/minimum rates of return for various asset classes 1935–2006



Source: Global Financial Data, Bloomberg, TD Waterhouse Research Marketing Group.

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