QUBE COMMENTARY

January 2021

TIME TO CELEBRATE UNCERTAINTY AGAIN?

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Letter From The Editor
Ian Quigley

While 2020 was an undeniably terrible year, it was not so for your investment accounts with Qube. Posting 20% gains with our stock market models, leaves us thankful for something (especially in light of the paltry 5.6% gains provided by the Canadian stock market). Thank-you to our hardworking and passionate research team.

As with many of you, Qube spent much of the past 12 months working physically in isolation from each other. We took the opportunity to begin rebuilding our office, with renovations expected to finalize by summer. Unfortunately, 2020 also brought us some losses, as we decided to abandon our passion project, the affordable housing investment fund. Nonetheless, I was repeatedly amazed at the creative and worthy advice our client relations staff generated for clients. Seeing this has been a highlight of my career. I also saw our operations team respond to an onerous compliance audit by the Alberta Securities Commission with success. We saw two new team members in 2020, Olesia Tsareva (Operations Manager) and Mark Pekar. Mark joined us to spend two years training as an investment counselor, while building a new endeavor for Qube, called QubePD, a website offering financial and tax literacy seminars produced by our staff.

In this edition, I ask you to boldly consider 2021. Our capital market expectations indicate ample upside potential in numerous regions and sectors to, once again, deliver strong investment returns in the year ahead. We also present articles on various tax planning topics including TFSA/RRSPs, charitable giving and potential changes to capital gains taxation. We have an article on value vs momentum investing, as well as updates on some of our current holdings. Finally, as always, we have our research tables showing what valuations were completed in recent months and how we felt about them.

We all eagerly look forward to the spring/summer, when we can reunite together not just as a team, but also with you. It remains our privilege to earn your trust and to serve your wealth management needs in 2021 and beyond.

Ian Quigley, MBA
Senior Portfolio Manager

Kaleo Portfolios: Past Performance

	2020	2019	3-Year	5-Year	Inception
Kaleo A	19.8%	20.2%	12.2%	11.2%	13.3%
Kaleo Full	20.6%	19.6%	12.8%	12.3%	14.1%
MCSI World Index	14.0%	21.6%	11.2%	10.4%	12.6%
S&P TSX	5.6%	22.9%	5.7%	9.3%	5.8%
50% TSX/ 50% MSCI World KALEO Benchmark	9.8%	22.2%	8.5%	9.9%	9.2%

Note: All returns reported above for periods in excess of 1-year are reported as annualized returns. Composite returns represent past performance and should not to be treated as an indication of future results. All returns are reported as net of trading costs, but do not account for management expense fees. All rates reported above correspond to the period ending December 31, 2020. Kaleo inception of January 2011.

Kaleo

Kaleo consists of a portfolio of stocks that are selected using an investment approach that applies company-specific fundamental analysis, and strategic macroeconomic positioning. The model invests in a mix of both domestic and international equities, with geographic weighting subject to change intermittently.

Our Kaleo Full model is composed of 35 stocks + 5 index ETFs. For clients with invested funds in the $250K to $1M range, we offer a subset 22 stocks + 5 index ETFs subset of this model (Kaleo A) in order to reduce brokerage fees. Returns since inception for each of our Kaleo models are similar by design.

We currently aim to hold a stock for 3-5 years in our Kaleo models. This means that we have an average portfolio turnover of 25%.

We purposefully chose our benchmark to more accurately represent the broad geographic diversification of our holdings in Kaleo. Our benchmark for Kaleo is defined as 50% of the MSCI Index and 50% of the S&P TSX Total Return Index.

Ready to Celebrate Uncertainty in 2021?

By Ian Quigley

2020 is now behind us.
It is fair to assume that you are eagerly anticipating less complicated times with less uncertainty. Permit me a few minutes to challenge you to reconsider.

You see, risk and uncertainty are critical ingredients to growing your wealth. Competitive management of your investments allows you to not just play bingo in retirement but also a game or two of golf. I love using the golf analogy because it is so close to the heart for many of us. When you arrive in retirement at the golf course, you, in theory, have to bid against other retirees for the right to play a round. Those with the most dollars in their wallets, get the chance to play more golf.

Various options exist to stretch your wallet, including finding better-paying work, a wealthier spouse, a delayed retirement, or a more competitive return. I spend much of my time seeking and thinking about a competitive return, and I believe 2021 could be a fantastic year to bank a few extra golf games using this strategy.

For a competitive return, you actually need more than just risk. You also need uncertainty. While risk can be managed and diversified, one cannot determine uncertainty with the probable outcomes calculated in advance. Numerous risky assets have little uncertainty; government debt and bonds are great examples. The return on these investments will compensate for the risk, but it will be predictable and likely non-competitive.

Another example is an equity index fund (like the S&P500), which passively holds all stocks trading in the market. It also compensates for market risk, but little for uncertainty. Again, the return, in this example, is limited to the average of what all investors received. The only way to outcompete your fellow investor/golfers is to accept some uncertainty, and that uncertainty is what we call "active risk."

The more risk you accept, the more return you can expect.

It is the investment counselor's role (Qube) to help each client determine their optimal level of risk and uncertainty. We do this based on your required return (if applicable) combined with your capacity and tolerance for risk. This process is standard practice and something every investment advisor should do every day.

Why Not Take on Infinite Risk?

If returns increase with risk, why not take on infinite risk? Couldn't you then become as wealthy as Bill Gates or Drake?

This question represents the **St. Petersburg paradox**, first published by the Swiss mathematician Daniel Bernoulli in 1738. Bernoulli developed the idea while discussing two games with his cousin Nicolaus: first a dice game, and then, a coin flip gamble. In both games, the payoffs are not obvious, and Bernoulli missed it the first time (as did I). With both games, one can win more the more they bet. While both offer an infinite trade off, however, many are unwilling to bet unlimited amounts! Hence the paradox. While Bernoulli posed the question in 1738, it took until 1768 for the math to catch up. The paradox remained, if compensation stands ready - why are we not taking more risk?

An American mathematician revisited this paradox in a 1954 book that challenged the very foundations of statistics. His name was Leonard Savage, and Milton Friedman called him a genius. He proposed a solution to the St. Petersburg paradox: starvation. It doesn't take a genius to see that humans can only risk so much. We have limits, particularly those we experience near dinnertime every day. These human limits are integrated into our investment decision making. Humans, rational or not, have evolved as biological creatures with built-in mechanisms that aid our decisions and increase our chances of survival.

The mechanism captured by the St. Petersburg paradox is called Risk Aversion. Thanks to their will to survive, humans are only interested in modest amounts of risk. Risk management is a primal urge.

Unfortunately, just because humans are interested in risk management does not mean that we are good at it. In an essay published in Foreign Affairs last November,[1] Peter Scolic and Philip Tetlock contemplated the many unplanned events that we have endured over the years (including COVID-19). These, despite the US$1.25 Trillion spent annually on national security. Money spent with the sole purpose to manage and modernize our anticipation of bad things.

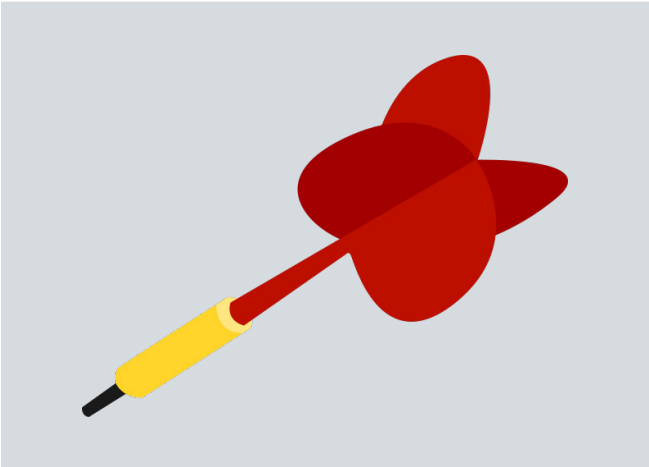
According to the authors, modern decision making has a long history with predictions made as far back as WWII that were considered sound at a tactical level but proved farcical at the strategic level. Recommendations like overwhelming the Soviet air defenses by deploying a fleet of aging bombers (with no available bombs), blatantly disregarding the pilots and crew's lives. These were decisions made using mathematical analysis and game theory. Thankfully, few Generals listened to the mathematicians in those years.

That was until Herman Kahn came along. Kahn became the inspiration for Stanley Kubrick's character in "Dr. Strangelove" (a 1964 black comedy film) by tossing out the math used at that time and creating what we term today "backcasting."

[1]Foreign Affairs Nov 2020 "What are we Missing? Predicting the Next Crisis". A Better Crystal Ball, The Right Way to Think About the Future by J. Peter Scoblic and Philip E. Tetlock.

Kahn used various scenario forecasts while working as a US Air Force Strategist to develop and imagine creating multiple possible future worlds. He still used math in this work, but the process was reversed by predicting the unknown values of the independent variables that might have existed to explain the known values of the dependent variable. Whether that makes sense or not to you, his new approach worked. Using reverse engineering, mathematicians could gain more accurate predictions.

Philip Tetlock also captured this risk evaluation evolution in a 2005 study where he demonstrated that political experts couldn't beat "dart-tossing chimpanzees" when predicting significant global events. This was a call back to Burton Malkiel's claim in 1973 that "monkeys throwing darts could outperform most portfolio managers."[2]



Tetlock believed experts were infected with classic decision-making biases, including overconfidence and conservatism bias.

Tetlock was confident enough that he assembled a team of untrained amateurs and entered a "forecasting tournament," competing against career CIA analysts with access to classified information. Using his team's diverse perspectives, he trained them to decompose the issue into smaller parts and then seek similar or analogous events.

They forecasted multiple possibilities and backcasted using Kahn's approach. Tetlock had his team adjust the odds based on the situation's uniqueness and then continually update the forecasts as new information emerged (now called Bayesian decision making). The results were phenomenal. Tetlock's team scored higher than the CIA agents, and the experience formed the core of a 2004 best-selling book (and a favorite of mine) by James Surowieki called, "Wisdom of the Crowds."

The task here is to convert uncertainty into measurable risk. This is precisely what our research team at Qube does every day. Taking a potential investment, measuring its obvious risk, and then seeking its "uncertainties." Our analysts build a narrative that forecasts potential future states and then "backcasts," highlighting the variables required to justify the projected future state.

While some of the variables and inputs are available to the analyst for narration, others are set by our Portfolio Steering Committee.

[2]A Random Walk Down Wall Street, by Burton Malkiel. W.W. Norton & Company Inc. 1973.

For example, our collective vision for long-term corporate growth rates, inflation, and risk premiums remain constant amongst all narratives, leaving the analyst empowered to cast variables specific to the company under consideration.

Variables include the viability of the current business plan (short-term growth rates), changing profit margins, and decisions related to reinvestment and reinvestment success.

The Elephant in the Room: Why the Recent Stock Market Success?

For starters, I think this much-touted perspective is misleading. The past decade has been more fruitful for sure, with market gains averaging 13.6% per annum, when the long-term returns have been closer to 10% (1965-2020) on average. I don't believe the recent excess is all that excessive (3.6%/yr), but it does deserve some explanation.

Year	S&P 500 Annual Return
2010	15.1%
2011	2.1%
2012	16%
2013	32.4%
2014	13.7%
2015	1.4%
2016	12%
2017	21.8%
2018	-4.4%
2019	31.5%

In the past 20 years (see T-Bill chart below[3]), interest rates plummeted to unprecedented lows, which helps explain the favorable equity returns because interest rates place a price on time. This is obvious if you want to borrow money, as your loan's cost is the interest charged by your lender. The longer you plan to pay back the loan, the more expensive (most likely) the rate of interest is charged, thereby compensating the lender as the more time you take to make the repayment, the more time you have to consider defaulting on the loan.

[3]Chart and data from Yahoo Finance

We also use interest rates when investing in stocks, but the relationship is less obvious. Like the lender, an investor also needs to assess whether a dividend or productive reinvestment may not happen as anticipated. To "price" this risk, we start with interest rates. Interest rates form the base compensation, to which we then add what are called risk premiums. As the US stock market has delivered returns averaging 10%/annum (13.6% over the past ten years), interest rates have averaged only 4.4% but fell to near zero in 2020.

[3]Chart and data from Yahoo Finance (finance.yahoo.com).

The value of a stock is the present value of its expected future dividends, discounted back to today at these prevailing rates. As interest rates have fallen to near zero, the discounting becomes more favorable to a stock's valuation. As interest rates have fallen, stock valuations have increased with little to no change in the business plan, competitive position, or profitability required. This creates a very tricky situation, with any increases to interest rates significantly harming our valuations. To compromise, we have assumed modest interest rate increases in our valuations for 2021 and beyond. For example, US 10yr T-Bills at the time of writing had just bumped to 0.92%, but Qube uses 2% in our valuation models. We believe this is more consistent with reality and provides a safety reserve for our investors.

Inflation - 2021

Although the chances are low that we will see anything other than a bump in inflation in 2021 as global industries restart and pent-up demand is realized, we see inflation as a real threat to monitor closely. Low inflation also has allowed governments to buy their debt, with Canada now owning 46% of its debt market (with a self-imposed ceiling at 50%). I realize that many might now take low inflation for granted, forgetting the "Margaret Thatcher" days and its war on inflation.

The developed world's aging populations require proactive immigration policies that import young workers to support their economies. We cannot rely on potential productivity gains in 2021. So, immigration reform will be an important development to monitor going forward.

In light of this, and respectfully, we do not see inflation as a concern for 2021. There are armies of unemployed workers with ready access to raw materials. For example, in November, Abu Dhabi announced a massive 24-billion-barrel oil discovery, and Alberta remains ready to deliver our heavy oil that nobody seems eager to purchase. Inflation is an issue for sure, but not until, at least, we see global recovery from the COVID recession.

Region	5YR Avg	3YR Avg	2020 Forecast
US	1.57%	2.13%	1.20%
Canada	1.77%	1.98%	0.70%
Europe	0.89%	1.49%	0.30%
China	2.00%	2.20%	2.70%
Japan	0.89%	0.65%	0.00%

[4]Bloomberg Inflation Data

[4]Data from Bloomberg Finance L.P. as of Dec 2020. Used with permission of Bloomberg Finance L.P.

Other Potential Disruptors in 2021

COVID Vaccines are the most significant wild card in 2021, but assuming they work as advertised, vaccine coverage is high in all OECD member states. We will have to hope COVAX can help the less fortunate. Speaking of the less fortunate, income and justice inequality and climate change will undoubtedly integrate into many trends in the year ahead.

Further, we need to see the current "deglobalization" trend stop in 2021. Trade wars, nationalism, and onshoring harm the global economy, but despite these concerns, Bloomberg Economics estimates deglobalization trends to only shave 0.1% off long-term US GDP growth. The US re-entering the CPTPP (Comprehensive and Progressive Agreement for Trans-Pacific Partnership) would reintegrate the US into the Asian region and is a globalization advance to anticipate in 2021. For Canada, Bloomberg Economics is less optimistic about "deglobalization" with a potential hit to our GDP of 0.5%.

Heading into 2021, monetary policy is exhausted and will be of little help in managing potential storms ahead (unless the negative interest rate experiments continue). So, much will rest on fiscal policy (with some countries like Canada having little left here). Either way, watching finance ministries will be more important than central banks in 2021, and for those that dream of less economic intervention, 2021 may be the year for you! On a positive note, there is much discussion about the acceleration of the digital revolution and associated productivity gains, which could be the most exciting thing in 2021 and would directly support equity valuations.

Stock Markets - 2021

After a year like 2020, there are understandable concerns when investors saw the US stock market post double-digits gains amidst a global pandemic, societal shutdowns, and a dictatorship run by the outgoing US president. Not just in 2020, but over the past five years, the US market has certainly gone faster and further than any other global option as measured by market returns, corporate sales, and/or corporate earnings[5]:

	Cumulative Market Return 5 yr	2020 Market Returns	5YR Sales Growth	2020 Sales Growth	5YR EBITDA[6]	2020 EBITDA
USA	73.9%	9.7%	1.9%	-5.1%	0.4%	-12%
Canada	34.2%	-2.3%	-0.4%	-15.1%	-2.6%	-22.8%
Europe	8.32%	-11.4%	-3.6%	-14.9%	-3.8%	-21.3%
China	6.7%	12.7%	-1.2%	-7.7%	-4.5%	-22.4%
Japan	32.9%	2.2%		-11.5%		-16.0%

Here, you can see that market returns have had at least some underpinnings of support, based on economic fundamentals. Also, using monthly data over the past five years, we continue to find meaningful diversification with exposure to Chinese markets[6] (see correlation table below):

	USA	Canada	Europe	China	Japan
USA	1.00				
Canada	0.85	1.00			
Europe	0.82	0.83	1.00		
China	0.57	0.40	0.44	1.00	
Japan	0.73	0.62	0.79	0.45	1.00

US Region

Coming into 2020, the USA was at the peak of its business cycle with substantial stock market gains, low unemployment, and high consumer confidence. Such was a business cycle that lasted 11 years and came to a clear ending with COVID-19. A growing economy typically lasts closer to 4 years, and the subsequent recession, 1-2 years. In the year ahead, we have an unusual situation. We have a clear catalyst that will end the US recession and restart another expansion phase: the vaccine.

Thanks to our analysts' work[7], we now see the US as in a "pre-expansion" stage of the business cycle with profit expectations still to be fully priced into its stock market. While American health has not faired competitively during the pandemic (4% of the world population has 20% of the recorded COVID deaths), the American economy has. Consumer spending returned late in 2020 to near pre-COVID levels, and corporate sales were only down 5.05% in the past 12 months (best results in the world). US corporations have the strongest, by far, EPS (earnings per share), supporting why they produced the best stock market in 2020.

[5]Data from Bloomberg Finance L.P. as of Dec 2020. Used with permission of Bloomberg Finance L.P.

[6]EBITDA – Earnings before interest, taxes, depreciation and amortization.

[7]Much thanks to Nick Riemer and Austin Glenn (Qube student analysts) for their work updating our Capital Market Expectations again this December.

US productivity is needed to offset an aging population in the years ahead, but slower long-term US growth is a reality, with immigration reform being unlikely. Increases to the US population were projected at only 0.2% under Trump, increasing potentially to 1.6% under Biden (putting it much closer to Canada's population growth). A Biden administration will undoubtedly reverse the aggressive corporate tax breaks Trump handed out, with a potential corporate tax increase of 21-28%, which will negatively impact earnings.

However, the move hinges on Democrat control of the Senate. Other Democrat policies like clean Energy, domestic R&D spending, and infrastructure investments, combined with the aforementioned corporate tax increases, pro-trade positions, and potential immigration reform, would have a combined negative impact on the US economy in the coming four years, as they are generally investments in the future (as politicians are expected to do).

We forecast a 6.5% dividend growth in our US market valuation in the coming five years, with long-term growth stabilizing at 2%.[8] Since our last US market valuation in July, we have become more positive on the US market's prospects, deeming it undervalued by 12% heading into 2021.[9]

Canadian Region

The March OPEC-Russia oil price war hurt Canada, with WTI Crude holding well below $50/barrel in 2020 (Alberta production requires oil above at least $60). This, combined with an overheated housing market, has reduced international interest in Canada. Fiscal intervention is tight, with the federal government now owning 46% of its debt with little room for more. Corporate Canada has shown weak investment in all business sectors, not just in oil and gas. Nonetheless, significant spare capacity still exists in the economic system, and a recovery in Canada is not expected in 2021. We would describe Canada in 2021 as "recessionary."

Despite the gloomy outlook, our team does anticipate some opportunities to invest in Canada, with plans to seek companies with integrated supply chain systems (metals, natural gas) in particular. We forecast a 7% dividend growth in the next five years with long-term growth stabilizing at 1.7% in our Canadian Market Valuation[10]. Since our last valuation in July, we have remained neutral on the Canadian market, deeming it slightly undervalued by 2% today compared to 3.2% last summer.

[8]Other assumptions include a risk-free rate at 1.24% and cash yields at 3.42%. Equity risk premiums falling to 5.02% from 5.63% last July.
[9]We deemed it 6.3% undervalued last July.
[10]Other assumptions include a risk-free rate at 1.03% and cash yields at 4.41%.

European Region

Brexit continues to dominate the story in the European markets with significant economic impacts from the disrupted trade relationship. Thanks to a deal announced at the time of writing, we can more accurately assess damages for 2021 but could best describe Europe as "recessionary."

In our European Market Valuation, we forecasted 6.5% dividend growth in the next five years, with long-term growth stabilizing at 1.7%.[11] Since our last valuation in July, we have seen a shift in Europe from being overvalued by 17.6% to "fair value" entering 2021.

Asian Region

Like the US, China also appears in an "early expansion" state, but with a more flexible consumer product and inflation friendly economic base. The recently consummated Comprehensive Economic Partnership Trade Agreement is like a reverse Brexit for the Asian region. Numerous new investment opportunities have surfaced in recent years, bringing plenty of investment-worthy options to consider in 2021, including Huya, Tencent, Alibaba, Weibo, ZTO, JD.com, China Mobile, Baidu, NetEase, and EDU.

Japan has, in particular, positive reinvestment and also participates in regional trade agreements with China. Constrained by monetary policy and deflationary dynamics, Japan, unfortunately, is further from an early-expansion phase but closer to it than Europe.

There is no doubt China will see GDP slow as their economy matures, but GDP growth in 2021 will likely hit an impressive 8%. We hope to see events in 2021 that demonstrate political maturity, as well. Significantly, China needs to maintain positive trade relations outside of Asia with the USA and Europe, as Bloomberg Economics projects this issue to be the difference, by 2030, of 4.5% GDP growth vs. 1.6%. Exposure to China could provide meaningful diversification. In the last five years, China has been only 57% correlated to the USA when Canada was 85% and Europe 82%.[12]

Our China valuation had to shift to a "free cash flow approach" from the dividend approach used in other regions as China has a low payout ratio. We see Chinese stocks in a similar position to the US, with a potential 11.2% undervaluation. Using a dividend valuation approach for Japan, we find it also undervalued by 15.9% heading into 2021.

[11] Other assumptions include a risk-free rate at 1.24% and cash yields at 3.77%. Equity risk premiums falling to 5.02% from 5.63% last July.
[12] Data from Bloomberg Finance L.P. as of Dec 2020. Used with permission of Bloomberg Finance L.P.

Sectors Analysis 20201

The US stock market is now subdivided into 11 sub-sectors with relative weights and recent returns as follows:

Sector Returns:	5YR Total	2020	Market Weight
Information Technology	219%	50%	27.6%
Healthcare	63%	19%	13.4%
Financials	44%	0%	10.3%
Consumer Discretionary	129%	35%	12.7%
Telecommunications	62%	27%	10.8%
Industrials	54%	15%	8.5%
Consumer Staples	52%	13%	6.6%
Energy	-53%	-31%	2.3%
Utilities	58%	1%	2.7%
Real Estate (REITs)	28%	-5%	2.4%
Materials	50%	25%	2.6%

Sector rotation is not considered a successful strategy, but a strategic selection of sectors in recent years was key for ensuring active risk placement. Further, material diversification was found but limited to Utilities, Consumer Stapes, and, to a lesser extent, REITs (see correlation table below).

	IT	Health	Financials	CD	CS	Energy	Utilities	REITS	Materials
IT	1.00								
Health	0.64	1.00							
Financials	0.69	0.67	1.00						
CD	0.85	0.76	0.77	1.00					
CS	0.62	0.64	0.56	0.68	1.00				
Energy	0.58	0.56	0.76	0.72	0.47	1.00			
Utilities	0.23	0.25	0.19	0.24	0.55	0.19	1.00		
REITS	0.48	0.59	0.48	0.59	0.71	0.49	0.68	1.00	
Materials	0.74	0.72	0.79	0.82	0.54	0.77	0.16	0.45	1.00

Technology Sector

There is much anxiety with the Technology sector in 2021, as its 5YR growth has crushed all other options. It is potentially the only sector truly aided by COVID, with all of its subsectors offering revenue growth narratives in 2021. Big data is forecasted to double every two years. We have a proliferation of new technologies, and everyone continues to participate in the digitization revolution. The technology sector has healthy reinvestment, coupled with high Return on Invested Capital (ROIC).

Our valuation assumes dividends and buybacks will return to pre-pandemic levels by 2022, a cost of equity at 6.2% and long-term growth at 2%. We find Technology, in general, undervalued entering 2021 by 15.8%. It takes courage to remain active in this sector, but nonetheless, we remain confident that our research time spent here is well spent.

Financial Sector

Financials have shrunk their relative position in the markets significantly since 2008. Disinterest by investors combined with low-interest rates (poor for banks) has hurt. Our valuation of the banking subsector places it 30.3% undervalued, and we see potential pricing on bank stocks as plausibly irrational entering 2021.

Within the financial sector is also Asset Management, a sector also beat in 2020 but for different reasons. As "COVID fear" entered the system, investors moved investments toward lower margin "safety assets." We see this subsector poised for inevitable growth, and at a tempting discount. Our valuation puts it at 19.7% undervalued.

Finally, we looked at the Insurance subsector and from poor macroeconomic conditions saw its growth in revenue & earnings contract. Unlike the other subsectors, our valuation places this industry 12.3% overvalued, even with a financial rebound post-COVID included in the narrative.

Health Sector

Our valuation of this sector puts it overvalued by 3.7%, likely a reflection of investors' intense interest here in 2020. While the sector's aggregate sales and EPS growth has decelerated, growth remains in the mid-single digits. However, we find investors have pushed market prices in pace with increased market valuations in 2020.

Consumer Discretionary Sector

There is little doubt about COVID and its impact on luxury goods. This sector saw its economic profile hammered in 2020, as we would expect. However, after considering a bullish but plausible rebound, we see the sector as modestly undervalued by only 5.2%.

Communications Sector

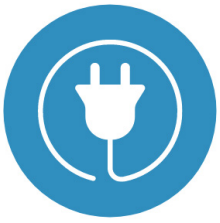
While this sector is one of the few that will benefit from the work-at-home economy, the market has priced an improbable growth narrative for the sector, and we find it fully valued going into 2021 (-0.2%).

Industrial Sector

Despite forecasts illustrating a rebound and continued growth for a variety of sub-industries within this sector, it appears that investors have already priced the probable rebound with improbable growth rates. We find the sector overvalued by 19.1%.

Consumer Staples Sector

The Staples sector did not perform as well as previously anticipated, as companies cut dividends even with stable revenue growth. However, increases in potential tax and interest expenses pressured this sector's bottom-line. A "flight to safety" by investors pushed prices and, in our opinion, moved the sector into a 21% overvalued position.



Energy & Materials Sector

We would anticipate interest in energy and material companies to pick up with an economic recovery in play, especially considering the brutal devaluations seen in share prices in recent years. It is particularly challenging to value these companies accurately, as the future value is driven mainly by future energy and commodity prices. Indeed, both will become valuable again as the global economy will restart. For the moment, they appear to be appropriately valued (+0.27% for Energy and +0.1% for Materials).

Utility Sector

Utilities are another "safe" market sector, despite their exposure to interest rates. While this sector has accelerated its' sales, EPS, and EBITDA growth in 2020, investor interest has priced in an improbable narrative for the sector. We find it 23.1% overvalued heading into 2021.

Real Estate Sector (REITs)

REITs are real estate investments pooled together and unitized like a mutual fund. Debate continues about the diversification real estate offers, with appraisal time lags potentially creating more of an illusion of diversification than reality. Either way, the pandemic hit them especially hard with unexpected vacancies and business closures slamming rent collections. The pandemic will end, and demand for this sector will rebound in the coming forecast period (5-years). A period where low-interest rates will help (REITs use leverage) more than with other sectors. We find REITs to be undervalued by 7.1%.

Conclusion

Capital market expectations, such as these, guide our research dollars. While we have grown a competitive research team, we only have so much time available to seek and secure undervalued positions for our Kaleo model. These expectations guide us to the regions and sectors that we feel have the most potential, but they are only a guide as we are often surprised by discovering undervalued stocks in overvalued sectors. The game is competitive, and these positions form the active risk that should reward our clients with thicker wallets and more golf games in retirement. As we exit a COVID induced recession, we can be optimistic about 2021, particularly about the potential returns within our investment accounts.

A Little from You, A Lot for Charities

By Noah Clarke, MA

As I write this article, the holiday season is fast approaching. It's a time of year when many of us may look to step up our charitable giving. Could this be because we're all anxious about the end of the current tax year? …Probably not.

A recent study published in the "Nonprofit and Voluntary Sector Quarterly" identified that the key considerations for making charitable contributions, listed in order from most important to least, were:

- **Altruism,**
- **Trust,**
- **Social Norms,**
- **Financial Constraints,**
- **Egoism, and**
- **Tax Benefits.**

So, it seems tax (more specifically, the ability to reduce it) only weakly drives our decision to make charitable contributions. Often the tax savings are just an added benefit. Putting moral purity aside, might we choose to give more if tax savings on donations were higher? Quite possibly. After all, financial constraints are number four on the list.

I propose that with some intelligent planning, those with corporations can reduce their after-tax cost of donating by an additional 50%. For those with corporate-owned and appreciated securities (e.g., stocks that went up in value), this planning would allow one to donate at least double the amount they would otherwise. For the most part, I find that too few are taking advantage of this opportunity, and tax advisors need to do a better job promoting corporate donations.

Let's start with the basics. With regards to the tax treatment of donations granted from corporations:

• Tax Deductible.
When a corporation donates, it receives a tax deduction (versus a credit). The deduction reduces corporate taxable income and, subsequently, taxes payable. This is the standard tax benefit that most owners recognize is available.

• In-Kind Donations.
Thanks to a 2006 change in Canadian tax law, there is no capital gains tax incurred on appreciated securities' disposition if they're donated in-kind to a registered charity. This tax break is offered on both personal and corporate donations. Again, this creates parity, leaving a taxpayer somewhat indifferent to their corporation's donations or by themselves personally.

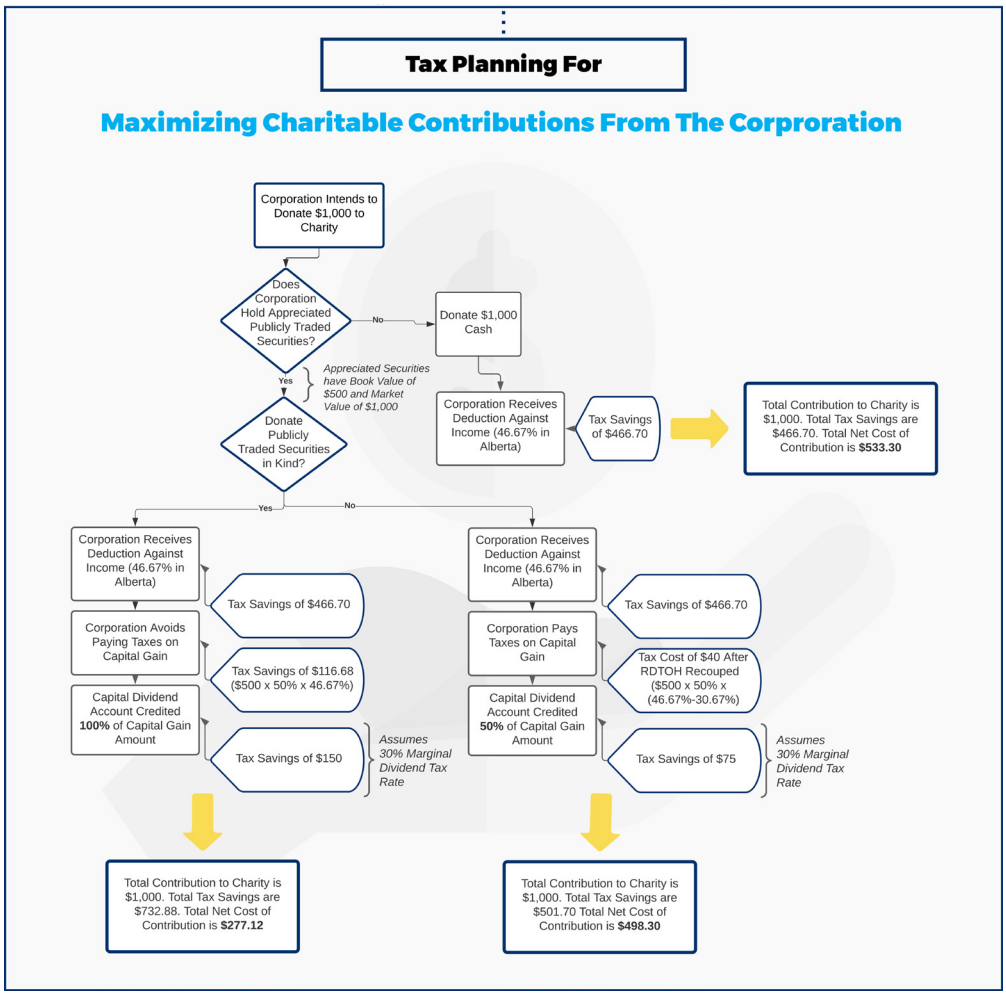
Moving on beyond the basics is where things get interesting.

• Every corporation has a 'Capital Dividend Account' (CDA). While it does not appear on a corporation's balance sheet, it is detailed in the financial statements' notes. The CDA is a notional account that is used to record the non-taxable portion of any realized capital gains. If we realize a capital gain through the sale of a security, only 50% of the capital gain is taxable, and the non-taxable portion is credited to the CDA (the other 50%). Dividends from the CDA account are tax-free. Again, this has traditionally created parity between donations made personally or from a corporation.

• With the 2006 tax law changes, a corporation can donate appreciated shares in-kind to a charity with no taxable capital gain realized. So, in this case, 100% of the capital gain is considered non-taxable and credited to the CDA account.

We are not certain if this was intended in the 2006 changes, but this peculiarity of the tax code can be very, very powerful! In our example below and using an in-kind donation of appreciated securities, a donation of $1,000 would save the corporation/shareholder $732.88 in taxes. In other words, it would only cost $277.12 to donate $1,000 to charity. Conversely, if one donates by selling the securities first and then donating the cash (which most people do unwittingly), the total cost would range between $498.30 and $533.30 depending on the specific method employed. A shameful loss of efficiency and unnecessary wealth destruction!

See Appendix for a larger version of this chart.



How Exactly Can We Do This?

The process for making an in-kind donation of appreciated securities is fairly straightforward! One of our clients recently asked that we process a donation of $10,000 to the Mustard Seed,[1] which would enable the charity to provide 2,850 lunches for those in need. This generosity level deserved a correspondingly high level of care when determining the most tax-advantaged method for contributing. We reviewed the client's account and found that at the time, their shares of John Deere (DE) had the highest unrealized capital gain, and with this information in hand, we then:

1. Used "CanadaHelps.org" to **initiate the in-kind transfer** from the invest ment account to the charity;
2. Issued a **charitable tax receipt** for the full market value of shares donated;[2]
3. **Sold the securities** after the transfer;
4. Transferred the **cash proceeds** from the sale to the Mustard Seed.

All that was required from our client was confirmation to proceed and a signed letter of direction. The process was seamless, the Mustard Seed received the donation promptly, and our client saved a considerable amount of taxes. Following the transfer, we then repurchased shares of John Deere in the client's account (rebalancing) to resume the client's diversification objectives. In this case, there were no timing limitations on such a rebalancing transaction, as seen elsewhere with the superficial loss rules.

I hope that every one of our clients looking to donate to charity in 2021 will first contact us to seek the most tax-efficient path. Sometimes you have to give a little to get a little, but in a situation like this, you can get a lot more back than you might have previously thought. And then give some more if you're so inclined.

[1]https://theseed.ca - The Mustard Seed is a safe and supportive place where individuals experiencing barriers associated with poverty and homelessness can have their physical needs met in the short term. In the long term, the process to heal and grow mentally, emotionally, and spiritually for a better life down the road can begin.
[2]Donation receipt based on price of security when sold by CanadaHelps. It typically takes 3–5 business days to sell and settle a trade from the date that CanadaHelps receives the shares transferred from our custodian (NBIN).

Ford vs Ferrari: RRSPs vs TFSAs

By Mark Pekar, MBA &
Ian Quigley, MBA

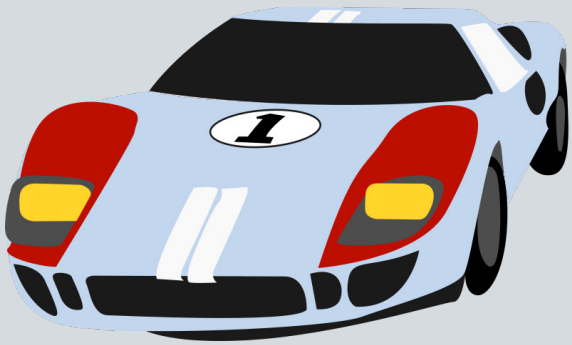
A Unique Comparison

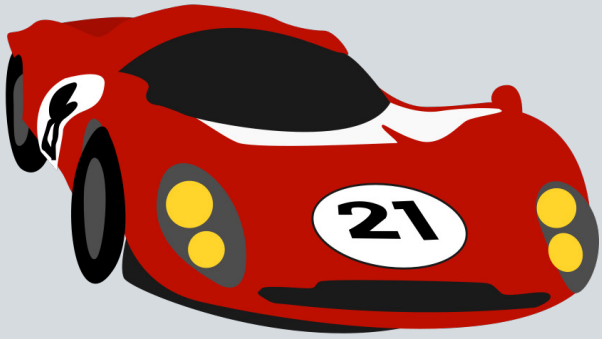
The 2019 film "Ford vs. Ferrari" is a worthy watch - a multi-layered tale, starring Matt Damon and Christian Bale, retelling the epic story of the Ford GT40 and its showdown against the unbeatable Ferrari at the 1966 Le Mans race in France.

At the core of the narrative is the reinvention of the American business culture and a race for America's soul. The film also provides an opportunity for those who love classic cars to immerse themselves in two hours of car glory. The raw madness of American muscle cars, juxtaposed with the refinement and craftsmanship of Italian machines. Like us, you may have also noticed the film provides an analogous comparison between RRSP and TFSA accounts! It would be exciting to own both cars, however, most of us do not have that luxury.

Assuming you cannot purchase both, how does one decide between a Ford and a Ferrari or an RRSP and TFSA? Allow us the opportunity to immerse you in a few minutes in retirement savings glory!

Both an RRSP and TFSA help you save tax, which we assume is an opportunity all Canadians would jump on. However, only 30% of Canadians contributed to a *Tax-Free Savings Account* (TFSA)[1], and only 25% to a *Registered Retirement Savings Plan* (RRSP)[2] in 2017. As financial advisors, parents, and grandparents, it is our responsibility to educate and advise the next generation on financial literacy. Improving financial literacy helps build a strong financial foundation, and reducing confusion over RRSPs and TFSAs is an essential first step. Each has unique benefits and opportunities, depending on the situation or circumstance.





[1]https://www.canada.ca/en/revenue-agency/programs/about-canada-revenue-agency-cra/income-statistics-gst-hst-statistics/tax-free-savings-account-statistics.html
[2]Statistics Canada. Table 11-10-0044-01. Selected characteristics of tax filers with Registered Retirement.

Registered Retirement Savings Plans (RRSPs):

Allow you to place pre-tax money into a savings account to grow tax-free until withdrawn and taxed at your marginal tax rate, reducing your tax bill today. The 2021 contribution limit is the lower of 18% of your previous year's income or $27,780, plus any unused contribution room from previous years.

Tax-Free Savings Accounts (TFSAs):

Allows deposit of after-tax money, which then grows and can be withdrawn tax-free. The 2021 contribution limit is $6,000 plus any unused contribution room from previous years.

Six Concepts to Pass On

#1 Fuel Efficiency

There is no doubt that both TFSAs and RRSPs are great. Both offer tax-free growth on investments, compounding the value year-after-year. This benefit is akin to having an incredibly fuel-efficient car available for your retirement journey (supposedly, neither the Ford nor the Ferrari was very good on gas).

#2 Resale Value

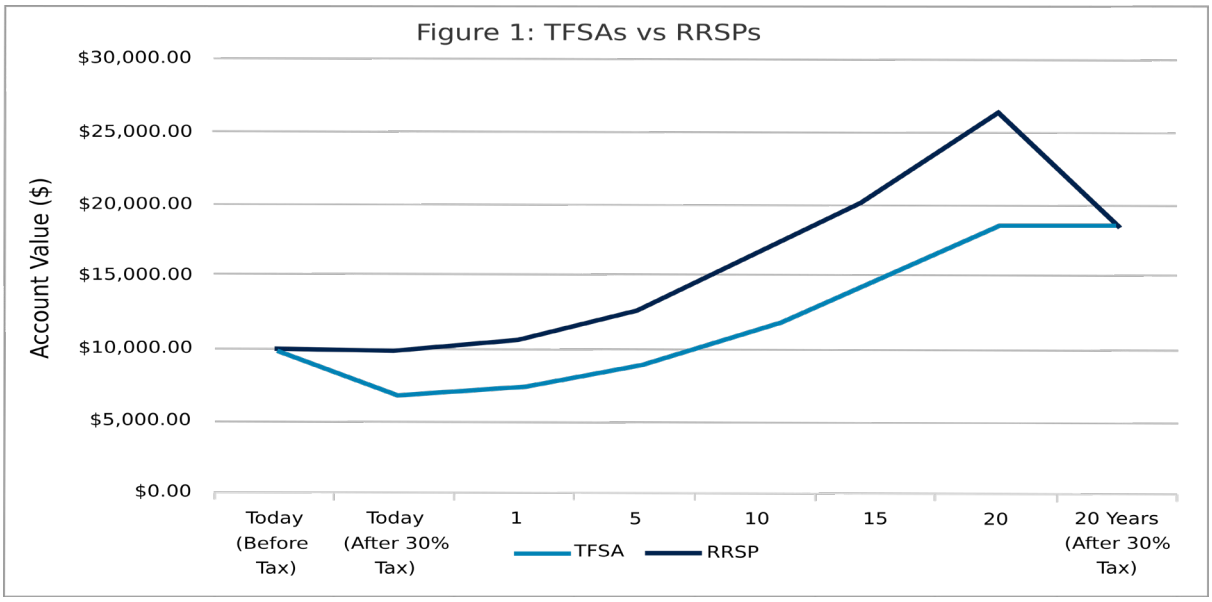
Deposits made to TFSAs account are "after-tax." Suppose you are earning $60,000/yr. and decide to invest $1,000 of it for retirement. In a TFSA, you would take the $1,000 of employment income, pay $310 of tax, and then invest the $690 remaining—bad news. When you decide to withdraw funds from the TFSA later, the withdrawal is tax-free - good news. Compare this action to spending more today on a better brand (e.g., Toyota), knowing the resale should be pretty decent.

Alternatively, an RRSP deposit creates a tax credit that can wipe out the tax when making the deposit. In other words, one can fully invest $1,000 of employment income in an RRSP account compared to the TFSA's $610 —good news. When you withdraw the RRSP funds, the amount is taxable, and taxes will be due - bad news. In other words, depending on your tax bracket in retirement, the "resale value" can fluctuate.

Suppose you were to hold the investment time frame, the return on investment (ROI) and the tax rate would remain constant. TFSAs and RRSPs will grow to the same after-tax value. While this may be a surprise, **Figure 1** illustrates the scenario. By depositing into the TFSA after-tax, the depositor has less to start with and less to grow tax-free. Overall, RRSPs appear to outgrow TFSAs. However, upon withdrawal, taxes will reduce the RRSP balance.

NOTE: No Change in Taxes = No Difference

With no change in tax rates, TFSA's and RRSP's produce the exact same result for retirement. However, as many Canadians (but not all) see tax rates fall in retirement, RRSP accounts generally are the winning choice.



* Assumptions: 5% ROI every year on both TFSAs and RRSPs

#3 New Drivers

A couple of potential challenges with RRSP accounts may influence some investors to prefer the TFSA:

1. Flexibility.

When you withdraw money from an RRSP, you cannot replace it at a later date. The contribution room is lost forever. Further, RRSP accounts only allow deposits until age 71 and have contribution room dependent on eligible earned income.

Alternatively, TFSA accounts will enable you to replace amounts withdrawn in a subsequent year and make deposits at any age independent of income.

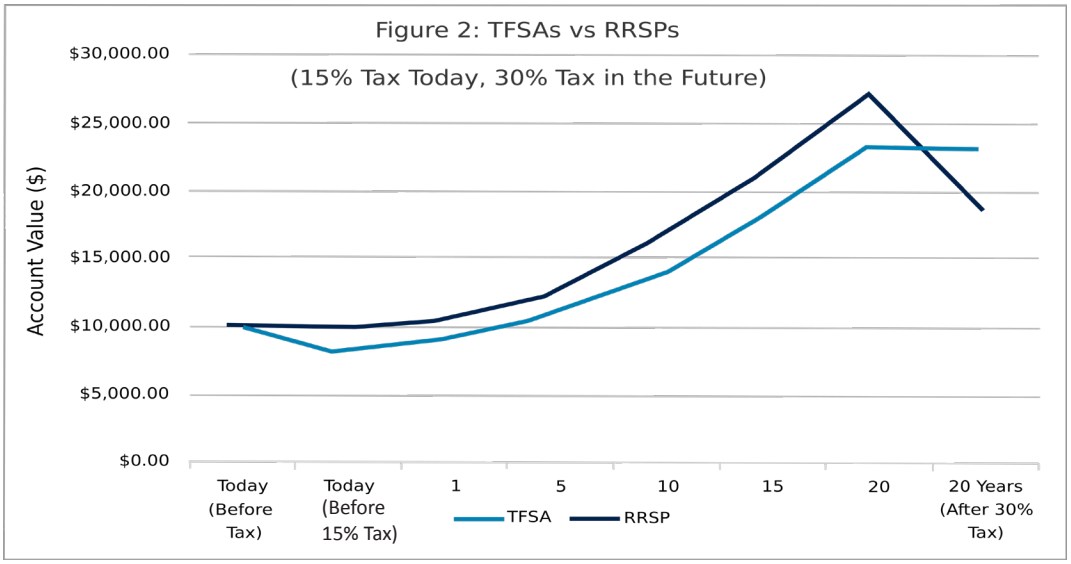
This issue of RRSP flexibility is partially addressed by two government programs: The First Time Home Buyer Plan (HBP) and the Life-Long Learning Plan (LLP). Each provides an account holder access to the investments as an interest and tax-free loan, that you repay in the years that follow. The HBP aids users in purchasing a first home, and the LLP helps with returning to school.

For example, a grandparent offers cash towards the down payment of a first home but first puts funds in the grandchild's RRSP account. Grandchildren can then use the HBP for a down payment while also setting a clear priority that retirement is also important. The child can then repay the RRSP account in the following years.

Another example we saw is a parent helping an adult child return to school using the LLP program. Parents can place the funds needed for school in the RRSP and use the LLP to fund the education. The retirement account is then later repaid by the child, thanks to a better job obtained from the skill upgrade.

2. Tax Damage.

With the RRSP account, there is potential for more taxes to be paid than deferred. We could consider this a "tax collision." If a person sees their tax rate increase at the time of withdrawal, greater taxes would be paid than deferred initially. In this case, the TFSA would be the better option.



You can see in **Figure 2** that the RRSP, in this case, left the investor worse off than if they had used the TFSA account. Going in, the tax rate was 15% and then on exit it had increased to 30%.

#4 Comprehensive Insurance

RRSPs and TFSAs both have the same purpose: to encourage savings. To ensure they accomplish their intended purpose, we recommend some basic strategies.

First, many should consider delaying RRSP contributions when starting a career. Income will likely increase in years to come, driving tax rates higher. Instead, if you were to use the TFSA earlier, you could save the RRSP room for when tax brackets are higher. Further, you could also consider transferring TFSA balances over to the RRSP when the time is right and the contribution room is available.

Second, a real potential problem with TFSAs is their flexibility, which can potentially create a "moral hazard." With increased access to the investments, one can threaten their retirement funds with shorter-term needs and desires. For retirement savings, one should hold TFSA's at the same institution as the RRSP account to reduce this "moral hazard". Finally, COVID has taught us to expect the unexpected. In a year of financial hardship, where income temporarily drops off, one could pause RRSP deposits and save the contribution room. It might also be an excellent time to consider the Lifelong Learning Plan (LLP) and return to school to increase job skills and prospects.

#5 A Roadmap

How Much Should We Be Saving?

A study done by Keith Horner in 2009 factored in other sources of income such as the Old Age Security (OAS), the Canadian Pension Plan (CPP), and bulging Canadian real estate values. Horner proposed that a 30-year-old earning $80,000 per year needs only to save 10% of their paycheck to have a decent retirement[3][4]. Considering many employers offer what are called "6% plans," the 10% challenge is achievable if one starts at a young age and considers monthly RRSP top-up amounts.

Nonetheless, unlike prior generations, the responsibility to fund a retirement rests on the employee, not the employer. It's never too early to get started. By providing sound advice to your kids or grandkids on the benefits of RRSPs and TFSAs, we can ultimately help set them up for success as they progress through their careers. Achieving financial independence needs a coherent plan, and Qube is always happy to assist. Whether a Ford, Ferrari, or even a Hyundai, it doesn't ultimately matter how one travels toward retirement as long as they arrive at the destination!

[3]Horner, K. Canadian Tax Journal, 2009. Volume 57, 3. Pages 419 – 59.
[4]2% inflation. 3% wage growth. ROI on inflation plus 3.5%.

We are Launching a New Product!

Qube is also excited to announce the launch of QubePD! A professional development platform where we create content that is relevant for our clients interested in financial literacy. Also, to inform and update accountants and other advisors (who refer us business) about creative financial planning concepts and strategies. These seminars are intended to be informative and interesting should you wish to expand your financial literacy. Several are in production, and more details will be available soon as we hope to go live with seminars like **'TSFA vs. RRSP: The Financial Tug-of-War'** in the first quarter of 2021.

Lemmings with Lifejackets

By Michael Baker, MBA &
Ian Quigley, MBA

Lemmings Are Real!

In reality, Lemmings are small, wild arctic rodents, but in the 1600s, people thought they were mythical creatures that could spontaneously explode in an angry rage when provoked. Other myths depicted Lemmings frantically launching themselves off cliffs in dramatic fits of mass mania.

The 1958 Disney film, White Wilderness, shows Lemmings jumping off cliffs, but the footage is historically fake. Disney allegedly tossed the Lemmings off the cliffs for dramatic effect. We can assure you that, with this knowledge, re-watching this on youTube can really kill your buzz.

Market Mania

The myth of Lemmings surprisingly relates to investing in the stock market. The metaphor is used repeatedly for market corrections, with investors watching their account balances falling like Lemmings in the arctic (at least on a Disney film).

At Qube, we have a different worldview. Moments of market mania illustrate for us a dual perspective. On the one side, we see those who invest using a philosophy called "pricing" or "momentum" and, on the other, those using a philosophy called "intrinsic valuation" or "economic value." Spoiler alert, Qube is in the valuation camp.

The valuation perspective seeks a stock's price based on the economic fundamentals of the underlying investment. For example, the dividends a company pays, its profit, competitive position and/or surplus reinvestment strategy. Rather than chasing the mood of other investors, we believe that price will eventually converge on value, even if a mania event is in play. That doesn't mean that Qube is immune from market corrections or price volatility, but an economic perspective should minimize the size of our cliffs and/or the implications of our landings.

People forget that Lemmings can swim! Having confidence that our positions have rational underpinnings allows us to stay calm and tread water during times when it may be required.

Murky Waters

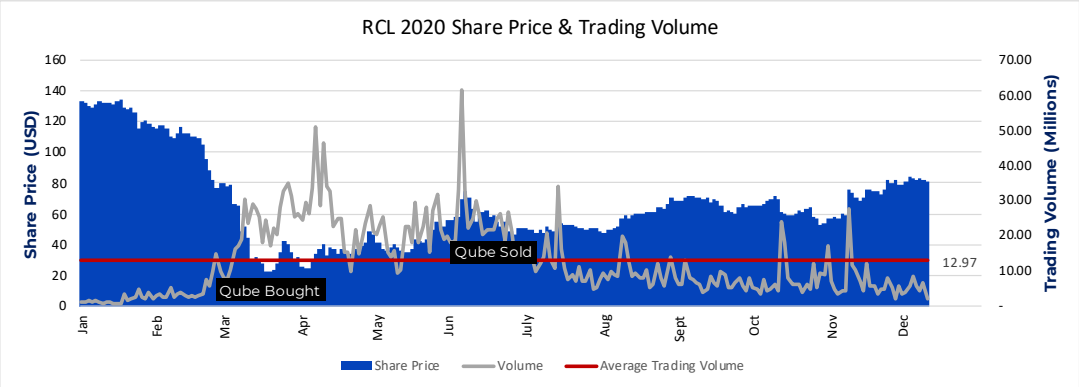
2020 was a clear example of extreme market price fluctuation. In February, the S&P500 reached an all-time high before prices dropped a third, bottoming out in March. Then in December, prices rose to exceed the all-time highs from last February. The hysteria around some companies caused their share prices to swing by amounts rarely ever seen before. One such company was Royal Caribbean Cruise Lines (RCL), a stock we valued in the summer of 2019 before the pandemic.

In our last commentary, Patrick discussed why Qube bought and then ultimately, a few months later, sold RCL for a total gain of 85%. In this article, we don't want to use RCL to promote Qube's healthy returns (check for those on page three) but instead hope to contrast a valuation perspective and its advantage over a momentum/pricing perspective.

Prior to COVID, we were confident in our valuation of RCL, but as it was a cyclical company trading at full value (in the $120-135/share range), we had decided to hold back on taking a position. When COVID mania hit in Feb 2020, and the shares plummeted to $27 US, we were confident a position then made sense. **We had our life jackets.** After looking at the new economic reality for RCL and its ability to sustain the storm without bankruptcy, we calculated a severe mismatch between the then manic share price and our revised valuation.

RCL was justified at $39 or better, so we had at least a $12 buffer, which gave us plenty of time to tread water and wait. We had rational faith that price would eventually converge on economic value. Our position proved choppy from a pricing perspective, as RCL's market price fluctuated wildly. There were many waves, and we were thankful for our lifejackets as we remained confident that, as the pandemic passed, RCL operations would resume at a glorious level. RCL's price continued to fall, and the momentum stayed negative for some time. Putting the momentum into context, at the start of 2020, the average daily trading volume for RCL was 1-3 million shares. The water was relatively calm. Then from March 19th to June 24th, when Qube held RCL, the daily average trading volume was 24.5 million shares, a 1500% increase!

It was such a curious time for our team. How could other investors justify such immense irrationality in the pricing game?



Consider for a moment a large purchase such as a house or a new car. Most of us wouldn't make these purchases without extensive research, but when it comes to investing, it seems emotions and momentum drive many decisions. Asawath Damodaran, a professor from NYU, believes that 80% of investors today use a pricing perspective with a vigor fed by bias, media hype, and online trading platforms. If this were true, it is no wonder the market waters often become frustratingly choppy and frothy.

Thankfully, this is also where we make money for our investors. We aspire to be Homo Economicus or the rational investor. We use economic valuation to arbitrage emotional rollercoasters and periods of pricing momentum or even mania. We try to suppress our emotions and bias before researching a company and focus on the essential characteristics that drive economic value. We then build a quantitative valuation model for each company and, if justified, extend our analysis to integrate its competitive position and business plan back into the model. Finally, under various scenarios, we determine the company's value and become confident in our position taken. This approach assumes a different kind of faith. Faith that rational pricing will return when mania resolves.

After we sold RCL, the share price climbed a bit more and hovered around the $70-$80 US/Share. Did we 'lose' out on a few additional dollars per share? Maybe, however, continuing to hold RCL as value investors would have been attempting to ride the wave rather than act as Homo Economicus. Academic research continually shows that chasing share prices and guessing the top or bottom rarely works and certainly does not build long-term value. No one will ever tell you that they retired on a single trade. Instead, growing your portfolio is the culmination of many investment positions, taken with a rational perspective that aids in the decision to enter and when to exit.

Today, we believe the media is like Disney in 1958, pushing investors into emotional, short-sighted decisions, with copious amounts of hype to inspire hysterical conditions. Resisting these temptations is key to a successful investment strategy, and we want to assure you that our approach in 2021 will not change. We will boldly remain active in this wild world called investing, making our decisions rationally, and being mindful of the steep edges!

The Other Shoe to Drop: Increase to Capital Gains Rate in 2021?

By Noah Clarke, MA

Late one night, a weary guest checked into an inn.

Before being given his room key, the concierge warned him to be quiet as their downstairs neighbour was a notoriously light sleeper. As the protagonist of our story undressed for bed, he inadvertently let one shoe fall loudly to the ground, which, sure enough, unbeknownst to him, awakened the other guest. He managed to get the other shoe off in silence, got into bed, and fell asleep. An hour later, he woke to a pounding on his door and a shout: "When are you going to drop the other shoe?"

In the current context, I find the downstairs' neighbour's plight relatable. There is no question that substantial fiscal stimulus was required in 2020. Through various government programs, businesses were aided, households suffering from a loss of income were offered support, and employment levels were propped up. The vast majority of these actions helped boost confidence and prevent what would inevitably become a severe economic downturn from developing into an absolute economic catastrophe.

But now, before the worst of the pandemic has passed, we find ourselves staring at the ceiling, waiting anxiously for the second shoe to drop.

In our story, it will take the form of tax increases. After all, direct government intervention has a price tag.

Turning to Tax Revenue

Based on federal projections, the deficit in 2020 could hit $389 billion (10 times the 2019 deficit), and repayment of this debt will necessarily be funded through increased government revenues (i.e., taxes).

There are many prospective methods available for increasing tax revenue, for example, an increase in the sales tax, a luxury goods tax, a wealth tax, an increase in income taxes, and/or the adoption of a digital services tax (planned for 2021).

But all eyes seem to be on one model of shoe in particular, whose forthcoming drop is opined by many to be a foregone conclusion: an increase in capital gains taxation via the "inclusion rate."

As tax policy is a subject matter that I, and presumably everyone else, finds to be incredibly interesting, I wanted to spend some time reviewing this potentiality.

For decades, an increase in the capital gains tax has been among the top-five predictions made before the federal budget is released.

Some financial commentators who've made an annual business of encouraging people to crystallize unrealized gains before the predicted increase are no better than Harold Camping, a radio preacher notorious for issuing a succession of failed predictions for the end times. Thankfully, Mr. Camping and the tax speculators are batting 0% so far, but maybe this time will be different?

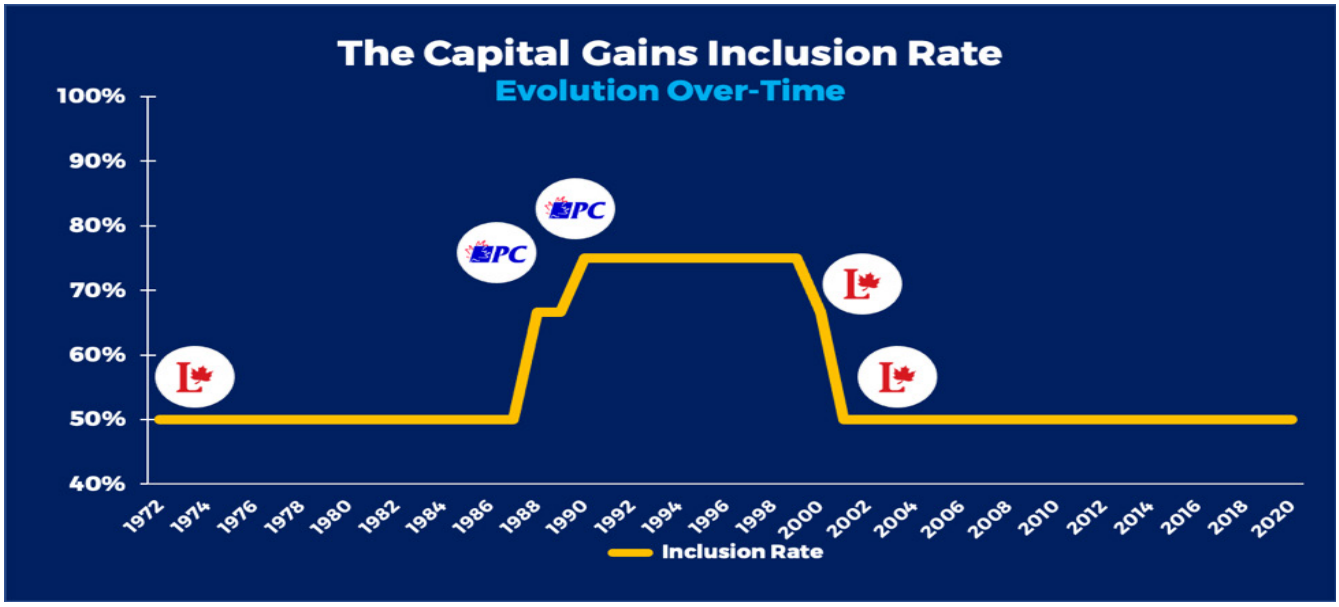
A Refresher

- Capital gains tax is, very broadly, a tax on the difference between an asset's value when acquired and its value at disposal (less any allowable expenses).
- If an investor purchases stock for $100 in a non-registered account and then sells the stock for $200, they will have realized a taxable capital gain of $100.
- Until the point when the stock sells, the capital gain is unrealized and, therefore, untaxed.
- Once realized, though, investors must pay capital gains tax on 50% of the capital gain amount (referred to as the "inclusion rate").

If an invester is in the highest individual tax bracket in, say, Alberta (48%), they will pay $24 in taxes on the $100 gain. The fact that only 50% of the capital gain is taxable (called the inclusion rate) makes capital gains a favorable income source compared to other income sources such as interest and dividends, which are at least 100% taxable at marginal tax rates. This preferential treatment of capital gains has been in place since they were first taxed in the 1970s, but the level of advantage has fluctuated over-time.

In 1962, Canada undertook an extensive review of its tax system upon establishing the Royal Commission on Taxation – commonly referred to as the Carter Commission in recognition of its chair Kenneth Carter. On the Royal Commission's recommendation, Canada introduced a capital gains tax in 1972. Since then, capital gains have been taxed as ordinary income. Underlying this treatment was the belief that, as Carter put it, "A buck is a buck is a buck," whether it came in the form of wages, salary, or gains on the stock exchange or through real estate transactions. Originally only one-half of capital gains were included as income (the inclusion rate). That rate then increased to 67% in 1988, reaching 75% in the 1990s, before dropping to 50% in 2000 under the Chretien Liberals.

When speculating on where we might be going with capital gains taxation, and please keep in mind that this is just that – speculation, it makes sense to review what led to the most recent drop in the inclusion rate. Tax policy plays a powerful redistributive role (one objective). Still, at all times, policymakers need to consider how taxation also affects the economic behavior of individuals by changing incentives – potentially to the detriment of our economic wellbeing.



In May 2000, The Standing Senate Committee on Banking, Trade, and Commerce, tasked to examine and report on Capital Gains' present state taxation, emphasized the latter concern. They submitted that the then-current system was a "serious impediment to the creation of new economic capacity" and "lead to under-investment in new businesses." Five months following this committee report, the inclusion rate dropped to 50%, where it's remained.[1]

The Lock-In Effect – Net Mediocrity

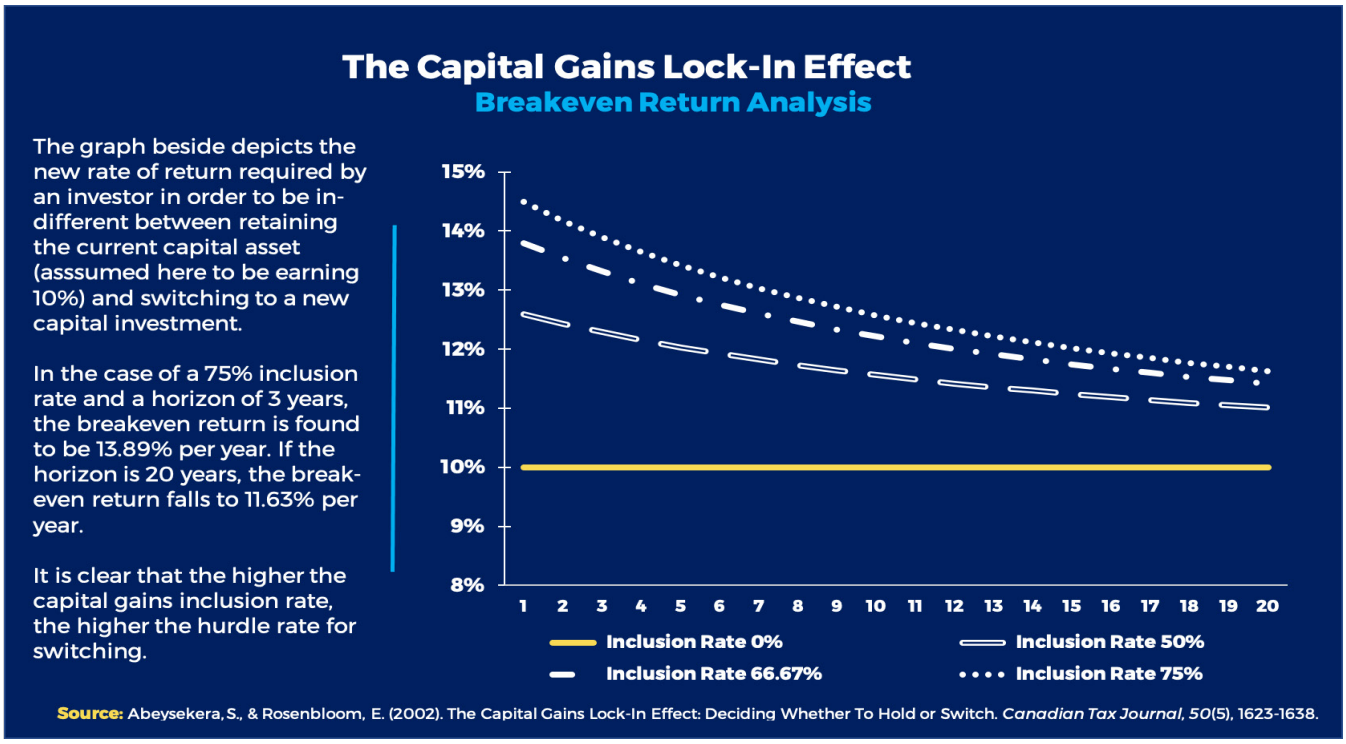
How might you ask, was the then-current method of capital gains taxation an impediment to economic growth? One of the main justifications for this argument was a distortion of investment behavior referred to as the "lock-in effect." Since capital gains are taxed on a realization basis, an investor can continue to defer taxes by retaining their current investments and thereby generate additional returns on the taxable portion of the gain. If this leads an investor to forego more profitable or productive opportunities, the lock-in effect can hinder gross economic output.

Consider an investor/entrepreneur who holds capital with significant unrealized gains but mediocre future expected returns. When presented with a new investment opportunity expected to yield higher returns, the investor should be incentivized to sell their old capital asset and use the proceeds to invest in the new opportunity. This incentive would increase capital market efficiency. However, unless the new investment provides a return rate high enough to recoup the funds paid in taxes plus an additional premium, the investor is not incentivized to make changes.

[1]The argument against a more significant reduction in the capital gains tax was based primarily on the grounds that the direct effect of a decrease from 75% to 50% would disproportionately appear to benefit higher-income taxpayers. Hence, it would go against the former objective. Ultimately, they struck a balance. Nonetheless, the committee report noted that "given the lumpy nature of asset dispositions, statistics on the incomes of those with capital gains tend to overstate their wealth." I.e., capital gains aren't just realized by individuals who are consistently in the top tax bracket. Large capital gains realized through the sale of, for example, depreciated real estate assets or a medium sized business may themselves push usually middle-income households into a higher tax-bracket in a given year.

They will be content with net mediocrity. Such complacency is a problem - the aim is to promote greatness!

The below graph depicts the investor's hurdle rate required on a new investment to break even. In this analysis, we have assumed that their current investment has appreciated by 100%, the risk-free rate of return is 3%, the dividend yield is 2% (for either investment), and the investor is in the top marginal tax bracket (Alberta).



In the case of blue-chip stock portfolios, reluctance to sell one company's share in lieu of another wasn't the concern for policymakers. In an efficient market, buyers and sellers will respond to market signals and ensure a stock's price reflects the collective best assessment of a given company's prospects, regardless of one's tax planning strategy. But the "lock-in effect" was seen as relevant for entrepreneurial activity, venture capital, and new business enterprises (distinctly less efficient markets).

By triggering market responses such as the "lock-in effect," capital gains taxes were percieved to make the capital gathering more complicated and create more obstacles for such investment activities. Therefore, enhancing market efficiencies for these investment activities, viewed as engines of productivity, employment, and wealth creation, was a worthy policy initiative both in 2000 and today.

What has Changed?

If the rationale still holds for why the capital gains inclusion rate was dropped to 50% and held there until the present day, what has changed? We previously touched on one glaring difference - the current deficit. From 1997 to 2006, the Canadian government generated fiscal surpluses. This budgetary position made tax cuts more tenable.

Nonetheless, the reduction of the inclusion rate was not exceptionally expensive. In 1997, revenue from the taxation of estimated capital gains totaled $904 million, less than 1% of the total tax revenue generated from profits, income, and capital gains in that year.

Between 2000 and 2019, this relationship has largely held. In truth, capital gains taxation isn't the cash cow it's made out to be. Assuming that all capital gains in Canada were realized by either corporations or the top 1% of income earners, an increase in the inclusion rate would (based on my rough calculations) increase tax revenues of only $3B. For reference, increasing GST by 1% has been estimated to be worth approximately $7 billion in revenue.

Given that the potential benefits are diminutive - all things being relative, the downside risks of this tax change should be paid more attention. Beyond the "locking in effect" are other potential detractors that could materially impact capital market efficiency and, subsequently, economic growth.

Increasing the capital gains inclusion rate is often presented as a method for reducing wealth inequality. This premise makes sense as the 'rich' are more likely to own appreciated stock and other capital assets. But the presented weapon could very well miss the intended target unless more comprehensive changes are enacted. For one, the rich have an advantage in that they may not need to sell stocks to fund their expenses. As such, they would be inclined to continue sitting on these assets, growing them tax-deferred. More importantly, though, the rich are far better situated to avoid paying capital gains taxes at a higher future inclusion rate.

One basic strategy that is often cost-prohibitive is to sell appreciated securities to a Canadian holding company. This move allows actors to realize a capital gain at the current inclusion rate if rates do end up changing while using the "section 85" rollover to reverse the realization (and taxes) if rates don't change. In this case, one can hedge the tax risk for a good tax lawyer's price and added accounting fees, which the rich can afford. Unless well designed and planned, middle-income households could pay more than their fair share.

The last major tax reform rolled out in the fall of 2017 was intended to eliminate loopholes that allowed some wealthy Canadians to accumulate savings at a lower rate. After fierce opposition, however, implementation was clumsy at best.

In this instance, a push for fairness quickly devolved into an attack on entrepreneurs and family businesses. One could be forgiven for presuming that there was a lesson learned about due-care and the potential for unintended victims in this instance.

What to do?

Many writers have compiled papers and books on capital gains taxation, and I certainly won't pretend politics is my forte. There is always the potential for a raise in the inclusion rate, possibly next year or the year after. This shoe could drop. In which case, what to do about it now?

The easy answer is to sell your appreciated assets now and lock-in your capital gains tax bill at the current 50% inclusion rate. But this conclusion is flawed. First, we must always refrain from letting "the tax tail wag the investment dog."

If you had no intent to sell the asset beforehand, it doesn't make sense to sell now due to fears about future taxes. Second, according to our calculations and provided that your expected holding period for any current appreciated capital is 5-6 years, you are better off continuing to hold the current asset and paying a higher tax rate down the road. As each situation is case-specific, Qube remains ready to assist clients with such tax modeling.

In this case, there is no point lying awake at night, losing out on sleep, waiting for the second shoe to drop. If and when it does drop, the world will have changed, and the most productive thing to do will be to return to what you were doing originally – dreaming of a new day.

Qube Insights: Kaleo Holdings

By Patrick Choi

VEREIT

Kaleo A, Full

Vereit (VER): We recently bought Vereit in our Kaleo portfolios on November 27, 2020, at a price of $7.33. Since then, the company has produced a total, cumulative return on investment of approximately 4.5%, including dividends, on a constant currency basis.

Vereit is a Real Estate Investment Trust (REIT) with one of the largest and most diversified, single-tenant real estate portfolios in the United States. Their assets consist of about 88.9 million square feet of real estate across 3,800 properties and diversified across multiple sectors, geographies (states), and tenants. Most of their leases are structured as a long-term, net-lease structure (some or all expenses paid by the tenant), further providing stable and predictable rent stream payments.

There are three primary reasons for our recent investment in this company. The first is due to Vereit's real estate portfolio's quality, which was recently put through the wringer when COVID-19 measures locked down the US economy. Despite these tough conditions, VER still managed to collect 87% of the rent due in Q2 and 94% of the rent due in Q3. So far in Q4, rent collection has further improved to 97%. Not surprisingly, restaurants, which comprise about 20% of VER's portfolio, were the primary reason for the decline and subsequent improvement in its rent collection. The rest of the 80% is spread between retail (45%), office (17%), and industrial (18%).

The second reason is due to the company's improved governance. Vereit used to be known as American Realty Capital Properties (ARCP), and in October 2014, admitted to an "accounting error" in their financial statements. This led to a class-action lawsuit, which was finally settled back in Q4 of 2019. As a consequence of the scandal, the CEO, CFO, COO, Chairman, and two other directors were all replaced. Since their tenure, we believe these individuals have done all the right things to lead a REIT of this size and restore investor confidence.

The last reason is our current macro environment, and more specifically, a vaccine for COVID-19 amidst continued low-interest rates. We believe that both developments have a biased benefit towards real estate companies like VER - companies with leverage, whose share price and financial performance struggled during the pandemic. The recent approval of a COVID-19 vaccine in the US made this an opportune moment to invest in Vereit.

From an Adjusted Funds from Operations (AFFO) standpoint, we believe that VER's intrinsic value is $21.25 if COVID-19 never happened. This value represents a potential 190% gain from our initial purchase price. We will continue to update our valuations and monitor the company's current share price for an appropriate time to sell.

facebook

Kaleo A, Full

Facebook (FB): We first bought Facebook in our Kaleo portfolios on August 8, 2019, at a price of $189.40. Since then, the company produced a total cumulative return on investment of 45.9% on a constant currency basis. Despite the strong return on our relatively short investment so far, we believe that Facebook can still provide outsized performance going forward due to the continued monetization of its many products and services beyond its namesake platform.

Facebook's products and services include Facebook (the social media platform), Facebook Messenger, Facebook Watch, Facebook Portal, Instagram, WhatsApp, Oculus VR, and Giphy. Additionally, they own a 9.9% stake in Jio Platforms, one of the largest Indian companies by market capitalization with multiple assets and subsidiaries in telecommunications, payments, and software development.

We believe Facebook's main revenue growth driver in the future will be in the value created by the combination of advertising and payments. In advertising, Facebook is already a large player at 23% market share in digital advertising (according to eMarketer). In payments, the company has recently introduced multiple services to reduce friction and increase commerce within the Facebook family: Facebook Pay, Checkout on Instragram, Shops on Facebook, and WhatsApp Pay. These services build upon one another by increasing conversions from an ad seen on Facebook or Instagram to a sale through Facebook's payments platform. This positive feedback loop should help drive higher revenues through increased transaction fees and more advertising dollars spent on Facebook's platforms.

Based strictly on the company's free cash flows, we calculate the company's intrinsic value to be $343.07 (the current price is $276.42). We believe Facebook is currently undervalued due to the debate (and lawsuits) against the company on consumer privacy, antitrust issues, and political manipulation. On December 9, 2020, the FTC and multiple US states filed antitrust suits against the company, with their end goal being the eventual divestment of Instagram, WhatsApp, and potentially other assets.

Ironically, a breakup of the company might increase the value of Facebook's valuation. As seen with TikTok, social media platforms can command high valuations due to their potential for attracting highly profitable advertisement revenues. A breakup of Facebook would help "clear the air" against the many criticisms facing the company while still retaining enough scale to compete against competitors.

As always, we will continue to monitor Facebook's current share price relative to our calculations (with or without a breakup) for an opportune time to sell.

Equity Research Traffic Lights

Company	Sector	Current Status
TFI International	Industrials	
Thomson Reuters Corp.	Industrials	
CNH CORPORATION	Industrials	
ROCKWELL AUTOMAT	Industrials	
TREX CO INC	Industrials	
OLD DOMINION FRT	Industrials	
ALLISON TRANSMIS	Industrials	
CATERPILLAR INC.	Industrials	
BOEING CO	Industrials	
ROBERT HALF INTERNATIONAL	Industrials	

Qube Insights: Equity Research Snapshots

Balancing traditional research techniques with modern portfolio science allows our team to find companies that demonstrate and maintain solid investing fundamentals. We look for less volatile and proven earnings combined with long-standing stable dividend policies. Share prices need to be justified on a combination of current earnings and reasonable earnings growth possibilities. Quality financial statements, coherent management and an operational business plan need to be in place before we rank a company "green."

Company	Sector	Current Status
PENTAIR PLC	Industrials	
COPART INC	Industrials	
OSHKOSH CORP	Industrials	
Curtiss-Wright	Industrials	
Generac Holdings	Industrials	
InterActive Corp.	Communication Services	
Match Group	Communication Services	
Activison Blizzard	Communication Services	
ViacomCBS Inc.	Communication Services	
Aptargroup	Consumer Discretionary	
Domino's Pizza	Consumer Discretionary	
Yum! Brands	Consumer Discretionary	
Choice Hotels Int'l	Consumer Discretionary	
The Wendy's Company	Consumer Discretionary	

Qube Insights: Equity Research Snapshots

Company	Sector	Current Status
Service Corporation Int'l	Consumer Discretionary	
The Home Depot	Consumer Discretionary	
Ralph Lauren Corp.	Consumer Discretionary	
Kohl's Corp.	Consumer Discretionary	
AutoZone	Consumer Discretionary	
NVR, Inc.	Consumer Discretionary	
The Gap	Consumer Discretionary	
Tiffany & Co	Consumer Discretionary	
D.R. Horton	Consumer Discretionary	
Pool Corp.	Consumer Discretionary	
The Hershey Company	Consumer Staples	
Constellation Brands	Consumer Staples	
Kellogg Company	Consumer Staples	
Kimberly-Clark Corp.	Consumer Staples	
The Clorox Company	Consumer Staples	

Qube Insights: Equity Research Snapshots

Company	Sector	Current Status
Lamb Weston Holdings	Consumer Staples	
McDonald's	Consumer Staples	
CME Group Inc.	Financials	
Intercontinental Exchange	Financials	
S&P Global	Financials	
BlackRock	Financials	
The Carlyle Group	Financials	
Franklin Resources	Financials	
RenaissanceRe Holdings	Financials	
Raymond James Financial	Financials	
Ameriprise Financial	Financials	
Erie Indemnity Company	Financials	
FactSet Research Systems	Financials	
BANK OF NOVA SCOTIA	Financials	
AMERICAN INSURANCE GROUP	Financials	
LPL Financial Holding	Financials	

Qube Insights: Equity Research Snapshots

Company	Sector	Current Status
OneMain Holdings	Financials	
Principal Financial	Financials	
MSCI Inc.	Financials	
Radian Group	Financials	
Baxter International	Health Care	
IDEXX LABS	Health Care	
PFIZER INC	Health Care	
MOLINA HEALTHCAR	Health Care	
Becton, Dickinson & Co.	Health Care	
WATERS CORP	Health Care	
HCA HEALTHCARE I	Health Care	
METTLER-TOLEDO	Health Care	
MEDTRONIC PLC	Health Care	
Merck & Co.	Health Care	
Chemed Corp.	Health Care	

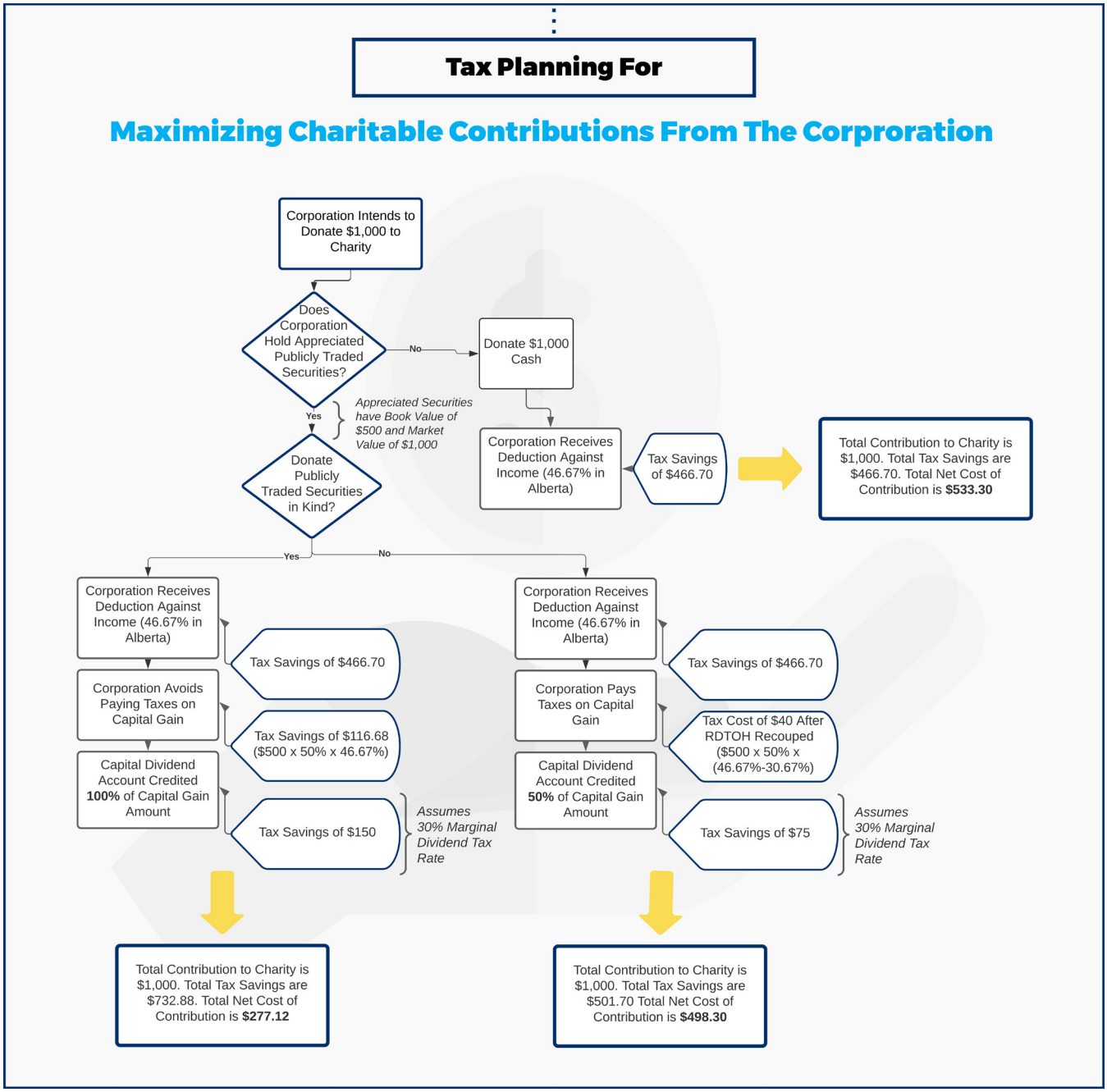
Qube Insights: Equity Research Snapshots

Company	Sector	Current Status
Cognizant Technologies	Information Technology	
Amphenol	Information Technology	
Ansys	Information Technology	
NVIDIA Corporation	Information Technology	
NETAPP INC	Information Technology	
INTEL CORP	Information Technology	
MASTERCARD INC-A	Information Technology	
ALLIANCE DATA	Information Technology	
TEXAS INSTRUMENT	Information Technology	
SEAGATE TECHNOLO	Information Technology	
CADENCE DESIGN	Information Technology	
NXP SEMICONDUCTO	Information Technology	
UBIQUITI INC	Information Technology	
PAYCHEX INC	Information Technology	
XEROX HOLDINGS C	Information Technology	
BROADCOM INC	Information Technology	
CHECK POINT SOFT	Information Technology	
CONSTELLATION SO	Information Technology	

Qube Insights: Equity Research Snapshots

Company	Sector	Current Status
SYNOPSYS	Information Technology	
DXC TECHNOLOGY	Information Technology	
CDW CORPORATION	Information Technology	
KLA CORPORATION	Information Technology	
HOST HOTELS & RE	Real Estate	
BRIXMOR PROPERTY	Real Estate	
HEALTHPEAK PROPE	Real Estate	
WEYERHAEUSER CO	Real Estate	
SIMON PROPERTY	Real Estate	
PPL CORP	Utilities	
AES CORP	Utilities	
BROOKFIELD RENEW	Utilities	
NORTHLAND POWER	Utilities	
Innergex Renewable Energy	Utilities	

Appendix


Tax Planning For
Maximizing Charitable Contributions From The Corporation
Corporation Intends to Donate $1,000 to Charity
Does Corporation Hold Appreciated Publicly Traded Securities?
No
Donate $1,000 Cash
Yes
Appreciated Securities have Book Value of $500 and Market Value of $1,000
Donate Publicly Traded Securities in Kind?
Corporation Receives Deduction Against Income (46.67% in Alberta)
Tax Savings of $466.70
Total Contribution to Charity is $1,000. Total Tax Savings are $466.70. Total Net Cost of Contribution is $533.30
Yes
No
Corporation Receives Deduction Against Income (46.67% in Alberta)
Tax Savings of $466.70
Corporation Avoids Paying Taxes on Capital Gain
Tax Savings of $116.68 ($500 x 50% x 46.67%)
Capital Dividend Account Credited 100% of Capital Gain Amount
Tax Savings of $150
Assumes 30% Marginal Dividend Tax Rate
Total Contribution to Charity is $1,000. Total Tax Savings are $732.88. Total Net Cost of Contribution is $277.12
Corporation Receives Deduction Against Income (46.67% in Alberta)
Tax Savings of $466.70
Corporation Pays Taxes on Capital Gain
Tax Cost of $40 After RDTOH Recouped ($500 x 50% x (46.67%-30.67%)
Capital Dividend Account Credited 50% of Capital Gain Amount
Tax Savings of $75
Assumes 30% Marginal Dividend Tax Rate
Total Contribution to Charity is $1,000. Total Tax Savings are $501.70 Total Net Cost of Contribution is $498.30

DISCLAIMER: This is an internal report intended only for clients of Qube Investment Management Inc. The ideas presented within it form part of an overall portfolio management position and are not to be acted upon without coordination from your advisor.

The content of this report is for general information purposes only and not intended to provide specific personalized advice, including, without limitation, investment, financial, accounting or tax advice. Please contact Qube Investment Management Inc. to discuss your particular circumstances.

Commissions, management fees and expenses may be associated with investment accounts. Please read the simplified prospectus (if applicable), or investment management agreement before investing. Many investments are not guaranteed and are not covered by the Canada Deposit Insurance Corporation or by any other government issuer. There can be no assurances that an investment will be able to maintain its net asset value or that the full amount of the investment will be returned to you. Values change frequently and past performance may not be repeated.

Qube Investment Management Inc. is a registered portfolio management firm in the Provinces of Alberta and British Columbia and was registered as a portfolio management firm on June 25, 2012. Any return period cited before this date was prior to QIM being registered as a portfolio management firm. Inception was Jan 1, 2011 and all returns are for a modeled portfolio initiated at $500,000. Your actual returns may vary according to your individual portfolio. The modeled returns are calculated inclusive of dividends, adjusted to the Canadian currency, and are determined via the IRR (Internal Rate of Return) method. The gain/loss shown are simple (non-compounded) returns for periods up to one year. If the time since inception date is more than one year, then the return shown is an annualized return. For comparison purposes, the Kaleo model(s) are reported as gross returns before investment management fees. Individual investor level returns will differ as the fees agreed to in your Investment Management Agreement (IMA) are subtracted from the gross return.

At any one point in time, the composition of the Kaleo model may change. Currently, the focus for our models (Kaleo A and Full) is to invest in a globally diversified portfolio of liquid stocks with a minimum market capitalization of $1 billion. Our diversification strategy is to have similar industry weightings between our Kaleo models A and Full, which in turn will have similar weightings to the S&P 500. Our investment mandate is to not have any one industry sector or sub-group exceed 2.0 times the percentage weighting assigned to that group by the MSCI Index unless the sector or sub-group composes less than 5% of the total index. Please refer to your Investment Policy Statement (IPS) for more details.

Index comparisons are based on the total return index provided by Standard & Poor's for both the S&P/TSX and the MSCI Global Index. All index returns are inclusive of dividends, adjusted to the Canadian currency, and, similar to the modeled portfolio, determined via the IRR method. Please note that, as total return indices are not actual portfolios, these returns do not include the cost of management and/or trading fees.

Past performance is not indicative of future results and there is no assurance that our model portfolio will achieve its objectives or avoid significant losses.

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