

Tax Free Savings Accounts

February 5, 2009

Portfolio Strategies for 2009

In the 2008 Budget, the Federal Government introduced a new Tax-Free Savings Account (TFSA). Contributions are not deductible for income tax purposes, but investment income, including capital gains, earned in a TFSA will not be taxed, even when withdrawn. Funds can be withdrawn at any time, and the amount withdrawn can be put back in the TFSA at a later date without reducing your contribution room. Furthermore, neither income earned in a TFSA nor withdrawals will affect your eligibility for federal income-tested benefits and credits.

Starting this year, Canadians aged 18 and older can save up to \$5,000 every year in a TFSA, and unused contribution room can be carried forward to future years.

Investment Principals for Tax-Free Savings Accounts

Now that the money has been transferred into the Tax-Free Savings Account, investment decisions have to be made. The Portfolio Advisory Group proposes investors use the following four investment principals for their Tax-Free Savings Accounts:

1. Maximize the tax-free savings benefit
2. Take a holistic approach
3. Recognize limitations of smaller investments
4. Focus on Liquidity

Maximize the tax-free savings benefit

The ability to grow your investments free of annual income tax is substantial. The Portfolio Advisory Group recommends investors maximize this advantage by selecting investments that produce returns that are normally taxed at the highest rate – those that produce interest income. Income producing securities belong in every balanced portfolio, and we believe therefore the most appropriate place to position them is in the Tax-Free Savings Account, as this immediately maximizes the tax savings for the investor.

Take a holistic approach

The Tax-Free Savings Account will likely not represent the sole savings vehicle of the investor. Therefore, when selecting investments for the TFSA, it is important to consider the combination of investments also held in Retirement Savings Accounts, Retirement Income Funds, Cash and Margin Accounts, bank savings, and all other assets and investments. Investments in the TFSA should complement and enhance the ability to reach the client's investment objectives, while recognizing risk tolerance and investment constraints, in portfolio construction. The TFSA can and should be used to further diversify and help round out asset allocation.

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Recognize the limitations of smaller investments

The maximum investment contribution to the Tax-Free Savings Account in 2009 is \$5,000. This may prevent buying full board lots of certain shares, and can create reinvestment difficulty from the resulting smaller levels of dividend or interest payments. Therefore, mutual funds with low subsequent investment amounts, and compound interest securities, are both ideal.

Focus on Liquidity

The Tax-Free Savings Account can be an ideal source of emergency funds, as sales of securities will trigger no immediate tax implications. Hence, investments should focus on those with a high level of liquidity – investments that are easily sold and converted to cash without impacting market value. This naturally leads to a bias towards more conservative investments within the TFSA.

Investment Ideas for Tax Free Savings Accounts for 2009

Under these four guiding principals, for 2009 the Portfolio Advisory Group recommends investors consider the following investment ideas for their Tax-Free Savings Accounts.

Putting Cash to Work – Money Market Alternatives

For investors looking to the TFSA as a source of emergency funds, or, alternatively, as a complement to their allocation towards cash/money market securities in their Asset Allocation, we recommend investors consider both Investment Savings Accounts and Cashable GICs.

Investment Savings Accounts, represent deposits at Canadian chartered banks, and carry CDIC insurance, essentially giving them the backing of a federal government guarantee for investments up to \$100,000. These are attractive as they offer relatively high rates of interest, and also offer a high degree of liquidity, with access to cash next day at no risk to principal.

Cashable GICs also offer the guarantee of the issuing entity, and also carry CDIC insurance. Although rates are below those currently offered on many investment savings accounts, they do lock in a guaranteed rate of return for one year, which is an important feature in the current environment where short term rates are expected to fall further. They are also highly liquid, as they can be cashed or “redeemed” for the next day, with interest paid provided they are held at least 30 days.

Income Producing Securities – GICs, Corporate Bonds, and Strip Coupons

For investors looking to the TFSA as either a shelter for interest income, or as a place to invest to complement to their allocation towards fixed income securities, we recommend focusing on **Guaranteed Investment Certificates (GICs), Corporate Bonds, and Strip Coupons.**

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GICs are currently offering their most attractive rates of interest in over a decade. GICs typically offer yields below that of Government of Canada securities of similar term. However, the ongoing market turmoil we are currently experiencing has seen banks look to GICs as an important source of funding, and hence yields have remained relatively attractive even as yields on government debt securities have fallen significantly. GICs carry CDIC insurance for up to \$100,000 per issuer. They are also available in compound interest format, further enhancing the ability to grow investments within the TFSA, and maximize the tax advantage (in a taxable account, compound interest GICs create a tax liability annually, even though they do not provide an annual cash flow).

Corporate bonds are also currently offering very attractive yields, with the yield pick-up over government bonds at historically unprecedented high levels. In the current environment, investors can achieve high single digit yields by investing in the debt obligations of many very high quality companies, such as the Canadian banks, insurance companies, utilities, and infrastructure issuers. The \$5,000 available to invest in the TFSA is the typical minimum investment amount to buy fixed income securities directly, meaning there are hundreds of securities available to choose from. For a list of ideas, refer to the ScotiaMcLeod Fixed Income Offering Sheet, or call the Portfolio Advisory Group for alternatives.

Finally, **strip coupons** allow investors the ability to fully invest the \$5,000 in their TFSA to the exact dollar, and see that investment compound over time (tax free!) until maturity. This enables investors to put every investment dollar to work, while also planning for future spending or retirement needs. There is a diverse selection of government and corporate strip coupons available, with yields commensurate with interest rate and credit risk – refer to the FIT system for availability, or call the Portfolio Advisory Group for ideas and alternatives.

Equity Investments – Diversify Globally

Most Canadians have a home country bias not only for their coffee and their sporting teams, but also for their investments. In fact, although Canada represents less than 5% of global market capitalization, most investors hold well over 50% of their equity investments in Canadian securities.

This tendency foregoes a multitude of international alternatives. Therefore, investors looking to the TFSA as a place to invest as a complement to their allocation towards equity investing, we recommend going global.

There are numerous options available to invest globally, but in consideration of the limited funds available in the TFSA, the Portfolio Advisory Group recommends looking to either open end **mutual funds** or **exchange traded funds (ETFs)** for alternatives.

There are several **international equity ETFs** available from Barclays Canada that trade in Canadian dollars on the TSX, and whose returns are hedged to Canadian dollars. They include the Barclays iShares MSCI EAFE (ticker symbol XIN), and S&P 500 (XSP) index funds.

The ScotiaMcLeod Mutual Fund Research team also has a select list of recommendations for investors who prefer the flexibility of open end mutual funds for smaller investment amounts. Several funds worth highlighting include the AGF, Global High Yield Bond Fund, the Dynamic Power American Growth Fund, and the IA Clarington Global Small Cap Fund. For more information and ideas, contact the Mutual Fund Research team.

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Alternative Investments – Focus on Real Returns

Asset Allocation does not stop at cash, bonds, and equities. In fact, most investors have room to allocate a greater portion of their portfolio to both real and absolute return strategies.

The alternative investment universe, however, is not very conducive to small investors, as most hedge funds and private equity funds have substantial minimums that exceed the funds that will be available in the TFSA in 2009, and many of these investments are also ineligible for the TFSA.

However, investors looking to the TFSA as a place to invest to complement to their allocation towards alternative investing, we recommend looking towards **real return bonds** and **real estate**.

Real Return Bonds are primarily government guaranteed bonds which bear interest that consists of both an inflation compensation component (based on the Consumer Price Index) and a cash entitlement. Real Return bonds are taxable on both the cash compensation and the inflation accrual on an annual basis, making the TFSA an ideal home for these securities. With their perfect inflation protection and low correlation to equities and traditional fixed income instruments, they also provide a significant level of diversification to balance portfolios.

Real estate is also an asset class which historically has provided high long term returns, driven by both income and price appreciation. Real Estate has also historically had a low correlation to equities and fixed income securities. For investors looking to add exposure to this asset class, we highlight that **Real Estate Investment Trusts (REITS)** are eligible investments in the TFSA.

For the TFSA, the Portfolio Advisory Group also recommends looking to **ETFs** and **mutual funds** as the preferred investment vehicles for investing in either Real Return Bonds or REITS. For more information and recommendations, please contact us or contact the Mutual Fund Research team.

Joey Mack, CFA

Portfolio Advisory Group

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*The author(s) of the report own(s) securities of the following companies.
None.*

*The supervisors of the Portfolio Advisory Group own securities of the following companies.
None.*

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