NEWSLETTER Q1

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What Drives Us

Winter 2024

As we march into 2024, the Brazier Dupuis Wealth Management team wishes you and your families health and happiness for the year ahead!

Think back to January 2023 and you might recall the fatigue from coming out of a challenging year (2022) for returns across almost every asset class. Negative investor sentiment, rising interest rates, inflation still surging and a recession seemingly imminent (not to mention regional bank failures and escalating global conflicts) compounded to create understandable trepidation amongst investors. Although there was significant volatility this past year too, many with a balanced and diversified portfolio of high-quality financial assets were rewarded, often with returns well in excess of inflation.

The past 12 months reinforced our continued belief that the discipline of owning high-quality companies over a long period of time is the best way to weather difficult markets.

In this edition, we explore the difference between real and nominal returns. We also pay tribute to Charlie Munger, the former vice-chair of Berkshire Hathaway, who recently passed and would have celebrated his 100th birthday on January 1. Charlie was an inspiration to us and so many investors across the world.

Stay well,
Brad Brazier

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FP Answers: What's the difference between nominal and real returns and why does it matter?

by Rachel Zhang

Q: What is the difference between nominal and real return for an investment portfolio and why does it matter?

A: Inflation in Canada has come down considerably from the highs in 2022 when it peaked at 8.1 per cent in June, but it remains higher than the long-term target of 2 per cent. The Bank of Canada projects it will hover around 3 per cent before coming back down to the 2 per cent target by mid-2025. Though the numbers may seem small, even mild inflation can make a big difference to investors and consumers. Consider that the same basket of goods that cost $100 in 2000 would cost $165.00 in 2023, and this during a 23-year period of tepid inflation averaging 2.2 annually. Investors need to understand the difference between nominal and real returns to gauge how well their investments are truly performing in protecting their buying power.

Simply put, a nominal return is the total rate of return on an investment before deducting inflation, taxes, trading costs, and investment fees. What remains after these deductions is the real return on the investment which represents actual purchasing power. Except in such circumstances as deflation (negative inflation), or zero inflation, the nominal return will always be higher than the real return. Using nominal returns is a convenient method for comparing the returns of various investments, without having to adjust for different levels of taxation or fees.

In the developed world, inflationary forces include changing demographics, shrinking working-age population, higher wages and healthcare costs, geopolitical strife increasing spending on defense, the onshoring of manufacturing, and higher charges related to reducing greenhouse gas emissions. For investors, protecting buying power from the corrosive effects of inflation is an important goal.

Historically, bonds are the most sensitive to rising inflation and interest rates as both the value of the principal and the fixed interest payments are eroded when the bond is held to maturity. In addition, because bond prices move inversely to bond yields, with longer-dated maturities being more sensitive to changes in yields than shorter-dated maturities, higher yields cause bond prices to fall. (However, bonds with higher yields will provide higher interest payments which may compensate investors somewhat for the drop in price.) Inflation-linked government bonds (called TIPS in the US, real return bonds in Canada) that track real inflation rates benefit investors in a rising rate environment but have not performed well because real rates have repriced by about 200-250bp for RRBs which is not far from the increase in nominal yields.

Equities are less affected by high inflation because their value is primarily derived from business earnings which may increase if prices are rising due to inflation. Over a very long period, from 1900-2022, they have posted positive real returns of 5 per cent. However, while corporate earnings benefit from inflation, there is significant room for multiples to compress over time as equity risk premiums are historically low. Starting points matter, if you had bought the S&P 500 in March 2000, a decade later your return would have been negative in nominal terms.

During 2022, the S&P 500 Index fell 18 per cent in nominal terms but to recoup the loss in real terms, it would need to rise more than 30 per cent. The global aggregate bond index dropped 16 per cent. It was a tough year for investors who had a typical balanced fund of 60/40, equities/bonds. Given stretched valuations going into the year, it could be a long time before investors recoup their losses in either real or nominal terms.

Where can investors reliably expect to find real returns? Historically real assets like real estate, timber and infrastructure served as an inflation hedge. However, historical relationships might not be the best guide to forward returns as private market valuations are anchored to exceptionally low discount rates and have been slow to adjust to the new reality of higher rates. Comparisons to the 1970s are challenged by a different demographic set up this time. Baby Boomers entering their peak consumption years supported high multiple stocks growing into their valuations in the most recent episode of higher inflation.

Another option is to consider active asset management. The bull market of the past 20 years rewarded passive investors, however, in this new cycle of greater volatility, uncertainty, and higher-than-average inflation, active management and alternative strategies may become an important source of generating meaningful, positive real returns. For example, the Pender Alternative Absolute Return Fund which I generate research for is a low-risk alternative credit strategy that aims to produce absolute positive returns at all stages of the economic cycle. It has a low correlation to both traditional equity and fixed-income investments. These are the types of flexible strategies investor may wish to add to their portfolios with the goal of providing diversification and the opportunity to earn real returns in unpredictable markets.

Thank you to PenderFund Capital Management Ltd for this article: bit.ly/4aZBOGS

Thanks, Charlie

Brad Simpson, Chief Wealth Strategist | TD Wealth

Within the investment community, Charlie Munger was our Saint Nick. Every year, the vice-chair of Berkshire Hathaway and his legendary investment partner, Warren Buffett, would travel down to Omaha, Nebraska, for the company's annual conference, and bestow the gift of wisdom and common sense upon shareholders and other attendees. Over five decades, even as markets grew increasingly volatile — disrupted by technology and globalization and the 24-hour news cycle — Munger was a port in the storm, putting us at ease with his good humour, his razor wit and his impregnable pragmatism. He gave us so many gifts over the years. Below you'll find some of my favourites.

Here's his take on:

...the importance of reading:

"In my whole life, I have known no wise people (over a broad subject matter area) who didn't read all the time — none, zero. You'd be amazed at how much Warren reads — and at how much I read. My children laugh at me. They think I'm a book with a couple of legs sticking out."

...self-pity, a subject he would be well aware of, having lost his nine-year-old son to leukemia:

"Life will have terrible blows, horrible blows, unfair blows, it doesn't matter. Some people recover and others don't. ... [Epictetus] thought that every mischance in life ... was an opportunity to learn something, and that your duty was not to be immersed in self-pity but to utilize the terrible blow in a constructive fashion."

...the difference between knowing something and just knowing something by name:

"I frequently tell the apocryphal story about how Max Planck, after he won the Nobel Prize, went around Germany giving the same standard lecture on the new quantum mechanics.

Over time, his chauffeur memorized the lecture and said, 'Would you mind, Professor Planck, because it's so boring to stay in our routine, [what if] I gave the lecture in Munich and you just sat in front wearing my chauffeur's hat?' Planck said, 'Why not?' And the chauffeur got up and gave this long lecture on quantum mechanics. After which a physics professor stood up and asked a perfectly ghastly question. The speaker said, 'Well I'm surprised that in an advanced city like Munich I get such an elementary question. I'm going to ask my chauffeur to reply.'"

... trying to replicate someone else's path to success:

"If you want to get rich the way I did, by learning a little bit about a hell of a lot, I [wouldn't] recommend it. ... If I want a proctologist, I do not want a proctologist who knows Schopenhauer or astrophysics, you know? I want a man who's specialized. That's where the market is. And you should never forget that. On the other hand, I don't think you'd have much of a life if all you did was proctology.

... the difference between wanting something and deserving it:

"The safest way to get what you want is to try and deserve what you want. Spend each day trying to be a little wiser than you were when you woke up. Discharge your duties faithfully and well. Systematically, you get ahead, but not necessarily in fast spurts. Nevertheless, you build discipline by preparing for fast spurts. Slug it out one inch at a time, day by day. At the end of the day — if you live long enough — most people get what they deserve."

....settling for what you can get:

"I think life is a whole series of opportunity costs. You know, you've got to marry the best person who is convenient to find who will have you. Investment is much the same sort of a process."

.... living a successful life:

"You don't have a lot of envy, you don't have a lot of resentment, you don't overspend your income, you stay cheerful in spite of your troubles, you deal with reliable people, and you do what you're supposed to do — all these simple rules work so well to make your life better."

...the importance of keeping it simple:

"It is remarkable how much long-term advantage people like us have gotten by trying to be consistently not stupid, instead of trying to be very intelligent."

....the importance of operating within your own competence:

"I don't play in a game where the other people are wise and I'm stupid. I look for a place where I'm wise and they're stupid. You have to know the edge of your own competency. I'm very good at knowing when I can't handle something."

To view the entire digital version of this TD Wealth Monthly Perspectives Newsletter, please follow this link: bit.ly/3ROBZvH

BDWM IN THE COMMUNITY

Windsor International Film Festival & get-togethers with people that inspire us

BDWM was a proud sponsor of the Windsor International Film Festival. L to R: Victor Lukassen (TD Sr. Private Banker), Vincent Georgie (WIFF Executive Director and Chief Programmer), PJ Dupuis and Brian Porter.

At a Franklin Templeton advisor event. L to R: PJ Dupuis and Dennis Tew (President and CEO Franklin Templeton Canada).

Timely Reminders

RRSP – Registered Retirement Savings Plan

The deadline for 2023 RRSP contributions is February 29, 2024. The contribution limit for 2023 is $30,780, and the new limit for 2024 is $32,490. Your personal contribution room can be found on your Notice of Assessment or the CRA website.

TFSA – Tax-Free Savings Account

The annual contribution limit has been increased for 2024 to $7,000, bringing the total lifetime contribution room to $95,000.

RESP – Registered Education Savings Plan

If you have a RESP set up for your children, contact us to ensure that you make annual contributions that maximize the available government grants.

FHSA – First Home Savings Account

Please reach out if you would like to learn more about the First Home Savings Account and if it can be helpful to you or a family member.