



## **What the \$1 Million Investor Should Know**

The following article will be discussing four important issues that the \$1 million investor should know about. Naturally, it stands to reason that there are far more than four important issues. However; the topics discussed here are four that are rarely mentioned in the press or in mainstream financial publications, and often times are not even mentioned by the average financial advisor.

The intention of this article is simply to inform and educate affluent individuals about issues that may pertain specifically to their demographic and may not be heard about elsewhere. These issues include having the ability to gain access to investment options reserved exclusively for wealthy clients, minimizing tax obligations on investments, efficiently transferring wealth to chosen heirs and tying it all together in a comprehensive financial plan.

### **Exclusive Options for Affluent Investors**

As your wealth grows, so too do your available options for investment management. It's important to be aware of your options as they can have a significant impact on the type of investment management you receive, the fees you pay and the number of restrictions on your money.

Growing quickly in popularity, what remains as one of the lesser known options, although one of the most effective is the private "investment counsel" firm. Investment counselors (ICs) work almost exclusively with affluent Canadians. We say *almost* exclusively because in addition to working with wealthy clients, IC firms may also manage private trusts and endowment funds.

For very wealthy Canadians, usually with a minimum of \$3 million to invest, an investment counsel firm will create a customized portfolio of securities in a segregated account and provide direct hands on service. This means meeting personally with the firm or even the portfolio managers themselves. Some IC firms will work with lower minimums, particularly outside the major cities in Canada, but this author would argue that \$3 million is the minimum amount needed in order to create a properly diversified portfolio that encompasses fixed income, Canadian equities, U.S. equities and foreign equities, in addition to other specialty securities such as royalty trusts or REITs. Many investment counselors agree, which is why they will also offer their service in the form of a 'pooled fund' for lower minimum investments. A pooled fund's minimum investment is usually \$500,000 although some will be as low as \$250,000. The pooled fund approach is an efficient means of accessing the management abilities of the investment

counselor while still building up to the larger minimums and efficiencies required for a personal segregated account.

The investment counsel firm differs from a stock broker in many ways. The investment counselors are all professional portfolio managers, mostly with Chartered Financial Analyst (CFA) designations. Managing the investment portfolio is their primary role. Further, IC firms don't underwrite new issues of securities and they don't charge transaction fees on buying and selling securities. However; unlike stock brokers, your investment counselor may not be local. Although you can meet personally with the IC firm it is usually at a scheduled frequency and your investment counselor is unlikely to call you on a regular basis to discuss the holdings in your account.

The investment counsel firm is also different from a mutual fund company in that they may offer a personal segregated account to very wealthy clients. When the IC uses the pooled fund approach it is still different from a mutual fund company in that typically the investment management fees are lower than a traditional 'loaded' mutual fund. One of the reasons why they often have lower management fees is that they spend very little money on marketing and publicity, as opposed to some mutual fund firms that employ very aggressive and expensive marketing campaigns. Many investment counsel firms will also provide pooled fund clients very clear statements that show assets invested, what securities are being held, what fees are being paid and a personal rate of return.

Many wealthy investors have expressed a desire to stay away from mutual funds, often because they have had a prior negative experience relating to fees, perceived average performance or being "locked in" to a particular fund or fund family. For the \$1 million investor, investment counsel firms are something to be aware of, particularly the pooled fund offering, which provides access to the IC firm and its money management strengths. However, this does NOT mean that we should rule out mutual funds for wealthy investors, but rather pay particular attention to the *type* and *class* of mutual fund being offered. Most mutual fund companies offer a class of funds designed exclusively for the affluent client that address the issues causing concern.

The concept of a mutual fund is arguably the best option for investing under \$3 million and is fundamentally the same concept as the pooled fund offered by the investment counsel firms. A fund (mutual, pooled, or other type) is an efficient way to build a diversified portfolio of both domestic and foreign investments while accessing professional investment management. Some mutual fund companies even hire investment counsel firms to manage their funds in a 'sub-advisory' relationship. It's important to know that most mutual fund companies offer a class of funds designed exclusively for affluent clients, although like investment counsel firms, they are not as widely publicized as their traditional 'retail' mutual funds. While different mutual fund companies use varying nomenclature, the most common classes of funds designed for the affluent are known as "F-class" and "I-class." These classes of funds differ from traditional "loaded" funds (back-end load, front-end load and low-load) in that they are completely "unloaded." This means that you don't pay a fee when making the initial investment and you won't pay any fees if you withdraw your money before the load

period expires. Further, the investment management fees are typically lower, as there are economies of scale in managing only large accounts, and the fee you pay the mutual fund company and the fee that gets paid to your financial advisor is separated. This way you have clarity as to how much you pay for investment management and how much your advisor is paid for providing you financial advice.

Important for non-registered money, some mutual fund companies will offer F-class and I-class funds that can be accessed on a 'corporate class' platform. Corporate class funds are designed to provide more opportunities for tax-efficiency over typical mutual fund trusts, but are nearly identical investment vehicles in terms of underlying investment mandates and access to professional management with liquidity, flexibility, and simplicity. Mutual fund corporations are discussed in more detail in the next section on tax-efficiency.

While some affluent investors may have expressed a negative feeling about mutual funds, it's usually because they have only been exposed to traditional loaded mutual funds and have never experienced their lesser known big brothers. An investor with \$1 million in an F or I corporate class fund has access to a professionally managed portfolio (possibly even by an IC), low fees, clarity on what they pay in fees and tax-efficiency on the non-registered assets.

### **Minimizing Tax Implications on Non-Registered Investments**

Given the relatively low maximum RRSP contribution amount more and more successful affluent individuals hold their wealth in non-registered accounts. While RRSPs are tax-deferred, the growth in a non-registered investment is taxed every year, and the level of taxation differs depending on the type of growth the investment earns. Interest income, which comes from more conservative vehicles such as Guaranteed Investment Certificates (GICs), bonds and T-bills, is taxed at the highest rate –the same as employment income. Dividends and capital gains are both taxed more favourably, relative to interest income, and come primarily from equity-based securities such as stocks.

The impact of taxation on investment earnings, particularly interest income, can take a significant bite out of your net returns. Consider an example of \$1 million invested in a bond portfolio that earns 5% annual interest. That means that there will be \$50,000 of interest income, which is fully taxable. At the top marginal rate in Alberta of 39%, that means just under \$20,000 in taxes owing!

**Tax-efficient strategies are available.** Despite the fact that growth in non-registered investments are taxed every year there are investment programs available to affluent investors that makes non-registered investing extremely tax efficient and in most years the amount of taxes due are mitigated significantly if not deferred completely, and you don't need to change your investment strategy in order to do it.

*Mutual fund corporations* are designed to provide more opportunities for tax-efficiency over typical mutual fund trusts. Mutual fund corporations are nearly identical investment

vehicles in terms of underlying investment mandates and access to professional management with liquidity, flexibility, and simplicity. This means you don't need to change your investment strategy in order to access them. They are however, enhanced in terms of taxation with the following benefits:

- The potential to **reduce or possibly eliminate taxable investment distributions** in any given year through pooling of income with expenses and pooling all investment gains with investment losses. This means lower taxes and therefore, the potential higher after-tax growth.

A typical investment trust must deduct the expenses of operating the pool against the income earned in the pool, which is not as efficient in an equity pool as it earns dividends and capital gains. The mutual fund corporation provides the ability to deduct the expenses of operating an equity fund (more tax efficient) against the earnings generated in a cash or fixed-income pool (less tax efficient income) and then dividends and capital gains earned in the equity pools. This way, if there are any taxable earnings left to distribute, they are dividends or capital gains and never interest.

- The potential to **receive capital gains or dividend income only** –even from the fixed income and cash management classes, which normally attract interest income. This means lower taxes and therefore, potentially higher after-tax growth.

The corporation will use the pooling mechanism mentioned above to eliminate all interest earnings, and/or use a derivative mechanism to replicate the earnings in the fund. The use of this mechanism will generate a nearly identical return to the underlying basket of securities but generates capital gains on the turnover.

- The ability to **defer paying capital gains** generated from switching between pools of the same corporation (taxes are paid when exiting the corporation). This can be of great benefit when rebalancing a portfolio.

The Income Tax Act allows individuals to exchange different classes of shares of the same corporation, with a change to the Adjusted Cost Base, but deferring the triggering of capital gains or losses until disposition of the corporation's shares. The different pools in a mutual fund corporation (such as Canadian Equity or Bonds) are different classes of shares of the same overall corporation.

The traditional advantage to the RRSP is that the contribution is tax deductible and the growth is tax deferred. The potential downside to the RRSP is that you are mandated by the government to begin withdrawing retirement income at age 71 and the withdrawals are taxed entirely as income. With the use of a non-registered mutual fund corporation, while you do not receive a tax deduction for the contribution you can achieve significant tax efficiency on the growth. Withdrawals are made whenever you want, for the amount

that you want, and they are taxed as capital gains rather than as income, which again is more preferred from a taxation standpoint.

### **The Effective Transfer of Wealth**

For many wealthy individuals an effective and comprehensive financial plan will show that they have enough wealth to provide the income they require well beyond their life expectancy, even after factoring in some potentially ‘unexpected’ variables such as additional travel expenses, healthcare costs, or helping out children and grandchildren later in life.

Despite having an “excess” amount of wealth, people typically continue to manage their assets cohesively and often times conservatively. Usually, there’s no need to take any unnecessary risks in the portfolio as income is being generated and relied on and the excess wealth is destined for chosen beneficiaries such as children, grandchildren or charitable causes. With non-registered money the challenges are that any growth in the investment is taxed each year, and when the last surviving spouse passes away the assets are brought into the estate, the estate gains are taxed, the estate may be probated and whatever remains is dispersed according to the will (not having a will should be unthinkable!). While the use of a corporate class investment may be employed to help mitigate the annual taxation on any growth, there will still be taxes owing on any gains of the investment upon the death of the last surviving spouse and the proceeds are paid into the estate, which may then be probated.

Having excess wealth is indeed a great problem to have. Fortunately there’s also an insurance strategy to turn this problem into a great opportunity, known as the “personal asset transfer” or the “insured asset transfer.” This is a financial security planning strategy that is designed for people who have achieved a strong measure of financial success, are experiencing tax obligations from growth on their investments, have a desire to reduce taxes on income and assets and want to increase the value of their estate and pass that value efficiently to their chosen heirs.

When most people think of life insurance they think of traditional uses such as replacing the income of a deceased spouse, providing for burial costs or covering final tax liabilities. What many people don’t know about, or don’t think about, is that permanent life insurance policies, such as universal life or participating whole life, contain provisions for the accumulation of money in a tax-advantaged policy, within certain legislative limits, without paying tax on the growth. By transferring existing wealth into a tax-advantaged insurance policy you are able to retain control of your capital in a tax-advantaged policy, and depending on the type of policy implemented, the investment component of the policy may very closely resemble the type of investment strategy they may be using currently. Universal life has investment options utilizing market indices or options modeled on mutual funds and segregated funds. Once the assets are inside the policy (which also carries an acquired death benefit), any withdrawals of are subject to taxation based on rates and rules in effect at the time of withdrawal, however; the death benefit, as well as the cash value remaining in the policy (less any withdrawals), are paid out to your beneficiary tax free.

Ultimately, what this means is that if you have wealth invested that will likely be passed on to the next generation, you are subject to tax on any growth each year and upon the death of the last surviving spouse, a tax will be due on the estate gains, the estate may be probated and what's left will be dispersed. By implementing the personal asset transfer strategy you have a chance to transfer your excess assets into a tax-exempt life insurance policy (with an investment component that may be similar to your current investment strategy) where you will not be subject to the tax on any growth unless funds are withdrawn. Upon the death of the last surviving spouse, the value of your accumulated cash surrender value (the investment component) plus the death benefit of the policy, is paid out directly to your named beneficiaries completely tax free and by-passing the estate. You have now saved tax annually on any growth of your money giving you the potential to provide an even larger estate to your named beneficiaries tax-free, all with wealth that was considered "excess" and already destined to land with the next generation, and you have maintained complete control of your assets.

### **Bringing it all Together in a Comprehensive Financial Plan**

As is hopefully outlined already, it's important for wealthy individuals to be aware that they have effective options and strategies available to them, such as investment counselors, F and I corporate class funds and the personal asset transfer strategy. However, caution is advised when attempting to implement complex planning strategies in isolation. In order to determine if any planning strategy will be suitable and effective a full comprehensive financial security plan should be completed. After all, how would you know that you have "excess" wealth if you don't have a complete financial plan?

A discussion on a financial plan often brings out the key question on this topic: just what is meant by a comprehensive financial plan? What is often shown as a financial plan is often little more than an investment plan, with an outline on what to invest in and how your money is projected to grow. While an investment plan is vitally important, it is really only a sub-set of a complete financial plan. The objective of the financial plan is to provide a clear path of achieving financial security. It should outline where you are today, where you would like to be and how you are going to get there. It should also outline potential risks and how to protect yourself and your plan against those risks. Components of the plan should include a retirement strategy, a risk management strategy and often times an estate plan.

It's vital that a financial plan be comprehensive in that, not only will it contain the above segments plus your income and assets, but it will also account for inflation, include government benefits, integrate pensions, reflect a sale of business or an executive retirement compensation arrangement and include insurance policies for life, disability and critical illness. Ideally, this plan will also be able to accommodate contingency planning to deal with concerns such as increased retirement spending, variable growth rates and the potential of living well beyond life expectancy.

Ultimately, the financial plan is what ties everything together. The investment plan or insurance strategies are really methods of implementing a financial plan. They are tools

used to help the plan come to fruition. For someone with \$1 million considering retirement, the discussion with a financial advisor should centre first on what level of income can be expected in retirement, where it will come from and how it will be protected. Once that has been determined then a discussion can follow on how assets should specifically be invested in order to help achieve the income plan, or specifics on an insurance recommendation in order to help protect the plan. Too often, discussions with financial advisors focus first on investments and returns, without discussion on what's really important about money, which is *what it can do for you*.

## **Summary**

As previously discussed, there certainly are more than four important issues with respect to wealth management for the \$1 million investor. However, the intention of this report is to outline four important issues that are rarely publicized and often rarely discussed, that affluent investors should be aware of. The intention here is NOT to suggest that everyone with \$1 million should go out and make sure they are using an investment counselor or investing in F or I corporate class funds, or implementing a personal asset transfer. What this report will hopefully do is prompt wealthy investors to engage in a discussion with their professional financial advisor about ensuring that they have a comprehensive financial plan and that they are taking into consideration investment strategies reserved for affluent clients, tax-efficiency and estate planning.

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Mike Robinson is an investment representative of Quadrus Investment Services Lt.

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