ODLUM BROWN REPORT

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ODLUM BROWN
Investing for Generations®

INSIDE THIS ISSUE

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Don't Get Caught Swimming Naked

Stocks have recovered impressively following the downdraft in the wake of the recent U.S. bank failures. As of mid-April, the Canadian and U.S. equity benchmarks were both up 7.2%, year to date. The Odlum Brown Model Portfolio gained 4.3% over the same period.

COMPOUND ANNUAL RETURNS[1] (Including reinvested dividends, as of April 15, 2023)

	YTD	1 YEAR	3 YEAR	5 YEAR	10 YEAR	20 YEAR	INCEPTION[2]
Odlum Brown Model Portfolio*	4.3%	-0.3%	14.2%	9.9%	12.0%	12.3%	13.9%
S&P/TSX Total Return Index	7.2%	-2.7%	17.3%	9.5%	8.8%	8.9%	8.5%
S&P 500 Total Return Index ($CDN)	7.2%	1.6%	14.0%	12.6%	15.5%	9.7%	10.0%

[1] Except for YTD period. [2] December 15, 1994.

While we are always disappointed when we don't keep pace with the general market, it's not unusual for our Model to underperform in a fast-rising market. In fact, we have outperformed the benchmarks over the long term by modestly underperforming in rising markets and losing meaningfully less during the inevitable corrections. By preserving capital in the tough times, we have more money to compound during the good times.

Last year, our Model was down 4.5 percentage points less than the average decline in the Canadian and U.S. benchmarks. This year, we have given back 2.9 percentage points of that advantage.

Our job is to both protect and grow wealth, and we are currently focused on the protection aspect of that equation. The Model is purposely positioned defensively relative to the general market, and we believe that posture will ultimately produce market-beating results.

The accompanying attribution table highlights our sector weights and year-to-date returns and compares them to a blended 50/50 Canada-U.S. benchmark. Our comparatively weak performance this year is a consequence of being underweight the best-performing sectors and overweight those that haven't performed as well. Our stock-picking batting average has been reasonably good, with better-than-benchmark performance in seven of the 11 sectors.

ATTRIBUTION ANALYSIS – OB MODEL PORTFOLIO* VS. BLENDED 50/50 CANADA-U.S. BENCHMARK

Portfolio Diversification	OB Model Portfolio Weight	Blended Benchmark[1] Weight	Over/Under Weight	OB Model Portfolio YTD Return[2]	Blended Benchmark[1] YTD Return	Over/Under Performance
Technology	9.0%	16.1%	-7.1%	23.3%	22.5%	0.8%
Communication Services	4.3%	6.2%	-2.0%	16.7%	15.4%	1.2%
Materials	5.0%	7.8%	-2.8%	2.9%	8.9%	-6.1%
Consumer Discretionary	7.1%	6.9%	0.2%	7.7%	8.8%	-1.1%
Consumer Staples	7.9%	5.7%	2.2%	2.7%	4.6%	-1.9%
Industrials	6.6%	11.2%	-4.6%	8.5%	4.0%	4.5%
Utilities	8.2%	3.7%	4.5%	7.0%	3.5%	3.6%
Real Estate	2.5%	2.5%	0.0%	11.9%	2.2%	9.7%
Energy	13.0%	11.0%	2.0%	-1.1%	1.3%	-2.4%
Financials	22.6%	21.5%	1.1%	-0.2%	-0.6%	0.4%
Health Care	10.3%	7.4%	2.9%	-2.4%	-3.5%	1.1%

[1] Blended Benchmark: 50% S&P/TSX Total Return Index and 50% S&P 500 Total Return Index ($Cdn)
[2] As of April 15, 2023

The table is sorted by the year-to-date sector returns for the blended benchmark. Notably, we have less exposure to the three best-performing sectors: Technology, Communication Services and Materials. The first two have performed particularly well, with gains of 22.5% and 15.4%, respectively, because they contain a lot of growth stocks that investors believe will do well if the economy slows and central banks lower interest rates. We are not convinced that will hold true, as growth stock earnings may suffer more than expected if we have a recession. The strong performance in the Materials sector has been fueled by sizable gains in gold company stocks.

Continued on next page

In support of

BC Children's Hospital™ Foundation

BC Children's Hospital Foundation – Jean Up
May 2023
Throughout BC

Odlum Brown has proudly supported the BC Children's Hospital Foundation for almost 30 years and has sponsored Jean Up for over a decade. Jean Up is an annual online initiative held throughout the month of May for British Columbians to come together and wear jeans to help sick and injured kids get out of their hospital gowns and back into their jeans.

Odlum Brown is proud to be the School Match Sponsor of Jean Up, matching donations made through schools' fundraising pages up to $30,000 throughout the month of May. Support for this initiative will fund everything from innovative research and equipment to specialized care that's tailored to the unique needs of kids.

For more information, visit jeanup.ca.

We own high-quality businesses, and we have greater-than-market exposure to defensive sectors like Health Care, Utilities and Consumer Staples. Most of those businesses are less economically sensitive, and many have above-average dividend yields. We believe investors will value these attributes more dearly as the economy slows. The authorities handled the bank failures well, and fears of a systemic banking crisis have appropriately passed. Still, the sudden demise of a few banks is a reminder that there are negative consequences of a long period of cheap and easy money.

As we discussed at our Annual Address earlier this year, ultra-low interest rates encourage excessive risk taking and debt leverage. While the drama and details surrounding the failure of Silicon Valley Bank and others may have been shocking, it's not surprising that there were some poorly managed banks that made bad investments and loans. As Warren Buffett said in a recent CNBC interview, "It gets back to that old story,… when the tide goes out you learn who's been swimming naked." It's what usually happens after central banks take away the proverbial punch bowl following a long period of stimulative monetary policy.

Taming inflation requires extinguishing the excesses that fueled higher prices. Bank failures and business and consumer bankruptcies are necessary and inevitable parts of the process.

U.S. bank-lending standards had already tightened meaningfully prior to the bank failures, and we have little doubt that they will tighten further. The U.S. regional banks, in particular, will need to dial back lending to enhance their financial strength, which will take a toll on consumers and businesses. Canadian banks are similarly becoming more conservative. The least credit-worthy borrowers will be unable to refinance loans. There will be more casualties, as that's what happens when credit conditions tighten.

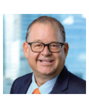
While the process is unpleasant, and the possibility of recession is real, unfortunately it's necessary to arrest inflationary pressures, put the economy on a healthier footing and set the stage for the next expansion.

There are reasons to believe that an economic setback, if indeed one arrives, will be relatively mild. The overall banking system, in North America and globally, is considerably better capitalized than it was prior to the 2008 financial crisis. Back then, it was low-quality, sub-prime mortgages that caused the crisis. Today, it's high-quality government bonds and agency mortgage-backed securities that are the problem. The former fell in value as the 2008 crisis unfolded, fueling a vicious self-feeding cycle. The latter securities have risen in price this time around, as longer-term interest rates have trended down on the expectation that the U.S. Federal Reserve will lower administered, short-term interest rates later this year in reaction to a weaker economy.

The U.S. is the most important consumer cohort in the world, and, as a group, they are in much better financial shape than they were prior to the 2008 crisis. They have learnt important lessons from that era and have reduced their collective debt leverage considerably in the ensuing years. Moreover, they've developed a strong preference for fixed-rate 30-year mortgages after getting burned by variable-rate mortgages the last time the central bank raised interest rates meaningfully. That, together with savings accumulated during the pandemic and a strong job market, makes U.S. consumers better positioned to weather higher interest rates and economic turbulence.

The possibility of a recession has been widely telegraphed by the media and investment pundits, and, because of that, we believe much of the risk is already discounted in stock prices. That doesn't mean we don't expect volatility – we do – but it also implies that we are constructive regarding the prospects for pleasing returns over the next few years.

We own businesses that have strong competitive advantages and the financial wherewithal to survive. In other words, they aren't "swimming naked" and at risk of being exposed as the tide goes out. On the contrary, they have the strength to invest in the face of adversity, gain market share and ultimately thrive. Their share prices may fluctuate as we navigate these uncertain times. But, like Warren Buffett's attitude towards Berkshire Hathaway, we will be more enthusiastic if share prices temporarily go on sale.



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* The Odlum Brown Model Portfolio is an all-equity portfolio that was established by the Odlum Brown Equity Research Department on December 15, 1994, with a hypothetical investment of $250,000. It showcases how we believe individual security recommendations may be used within the context of a client portfolio. The Model also provides a basis with which to measure the quality of our advice and the effectiveness of our disciplined investment strategy. Trades are made using the closing price on the day a change is announced. Performance figures do not include any allowance for fees. Past performance is not indicative of future performance.

2023 Federal Budget Highlights

On March 28, 2023, Canadian Deputy Prime Minister and Minister of Finance Chrystia Freeland delivered the government's 2023 federal budget, anticipating a deficit of $43 billion for 2022-23[1] and forecasting deficits of $40.1 billion for 2023-24 and $35 billion for 2024-25. Here is a brief overview of some notable proposals affecting individuals and business owners.

No changes are proposed to personal or corporate tax rates nor to the capital gains inclusion rate or principal residence exemption. However, the budget proposes to make changes to the Alternative Minimum Tax (AMT) calculation to further focus on high-income taxpayers.

Individuals

Registered Accounts

Tax-Free First Home Savings Account (FHSA) Budget 2022 introduced the First Home Savings Account (FHSA), a registered plan that allows individuals to make tax-deductible contributions, earn investment income tax-free and make withdrawals tax-free for the purchase of a first home.[2] Eligible individuals can contribute up to $8,000 annually, and up to $40,000 over their lifetime.

Budget 2023 confirmed the legislation's effective date of April 1, 2023. Most financial institutions are working toward launching the FHSA in late 2023.

Registered Education Savings Plan (RESP) When a child withdraws funds for post-secondary education, the return of contributions is tax-free, whereas CESGs and investment income and growth withdrawn are taxable to the child. This taxable income is known as an Educational Assistance Payment (EAP).

To address the increasing cost of education, the budget proposes that, effective March 28, 2023, EAP withdrawals during the first 13-week period of post-secondary education be increased to:

- $8,000 (up from $5,000) for beneficiaries enrolled in full-time programs, and
- $4,000 (up from $2,500) for beneficiaries enrolled in part-time programs.

Effective immediately, the budget proposes to allow divorced or separated parents to open joint RESPs for one or more of their children, or to transfer an existing joint RESP to another financial institution.

Registered Disability Savings Plan (RDSP) A Registered Disability Savings Plan (RDSP) is a savings plan designed to help family members prepare for the long-term financial security of a person with a severe and prolonged mental or physical impairment. A lifetime maximum of $200,000 can be contributed to an RDSP.

Temporary rules, set to expire December 31, 2023, allow a "qualifying family member" (QFM) to open an RDSP and be the holder if no qualifying person is authorized to act on behalf of an adult beneficiary and the opinion of the RDSP issuer is that the beneficiary's contractual competency is in doubt. A QFM includes the individual's parent and spouse or common-law partner (unless living apart due to a breakdown in their marriage or partnership).

Budget 2023 proposes to broaden the definition of QFM to include a sibling of the beneficiary who is 18 years of age or older. The proposed expansion of the QFM definition will apply as of royal assent of the legislation and be in effect until December 31, 2026. A sibling who becomes a QFM and plan holder before the end of 2026 can remain the plan holder after 2026.

Other

Alternative Minimum Tax (AMT) The Alternative Minimum Tax (AMT) is a parallel tax calculation that establishes a minimum level of tax for taxpayers who would otherwise pay little or no tax by claiming certain tax deductions and credits. The AMT is based on an "adjusted taxable income" calculation that allows fewer deductions, exemptions and credits than under the regular income tax calculation. Taxpayers pay the AMT or their regular tax liability, whichever is highest. Additional tax paid as a result of the AMT can generally be carried forward for seven years and credited against future personal tax liabilities to the extent it exceeds AMT in those years.

The current AMT calculation applies a flat 15% tax rate (A) to adjusted taxable income (B) that exceeds a $40,000 exemption (C). The AMT is then reduced by a number of allowable non-refundable tax credits (D).[3]

AMT = A* (B – C) – D

A Tax rate
B Adjusted taxable income
C Exemption
D Allowable non-refundable tax credits

To better target the AMT to high-income individuals, Budget 2023 proposes several changes to its calculation, including broadening the AMT base by further limiting tax preferences (i.e., exemptions, deductions and credits), increasing the AMT exemption and raising the AMT tax rate.

Broadening the AMT Base

Capital Gains and Stock Options Under the regular tax calculation, 50% of capital gains are taxable. The government has not proposed any changes to the regular capital gains inclusion rate. Under the AMT calculation, the capital gains inclusion rate is 80%. The budget proposes an increase to the AMT capital gains rate to 100% while keeping capital loss carry-forwards and allowable business investment losses to be deductible at 50% in the AMT calculation. The budget also proposes that 100% of the benefit associated with employee stock options be included in the AMT base.

Lifetime Capital Gains Exemption Under current rules, 30% of capital gains eligible for the lifetime capital gains exemption are included in the AMT base. The government proposes to maintain this treatment.

Donations of Publicly Listed Securities In addition to receiving a tax receipt for the value of the donation, capital gains that would otherwise be taxable on disposing of securities can be eliminated when donating publicly listed securities in kind. For AMT purposes, the government proposes to include 30% of capital gains on donations of publicly listed securities in the AMT base, mirroring the AMT treatment of capital gains eligible for the lifetime capital gains exemption.

Deductions and Expenses Under the proposed rules, the AMT base would be broadened by limiting a number of deductions by 50%, including employment expenses (other than those to earn commission income), moving expenses, childcare expenses, interest and carrying charges incurred to earn income from property, deduction for limited partnership losses of other years, and non-capital loss carryovers.

Non-Refundable Credits Currently, most non-refundable tax credits can be credited against the AMT. The government proposes that only 50% of non-refundable tax credits would be allowed to reduce the AMT, subject to a few exceptions.

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The proposed AMT would continue to use the cash (not grossed-up) value of Canadian dividends and fully disallow the dividend tax credit.

Raising the AMT Exemption

The government proposes to increase the exemption from $40,000 to the start of the fourth federal tax bracket. Based on expected indexation for the 2024 taxation year, this would be increased to approximately $173,000. The exemption amount would be indexed annually to inflation.

Increasing the AMT Rate

The government proposes to increase the AMT rate to 20.5% (from 15%), corresponding to the rates applicable to the second federal income tax bracket.

The proposed changes would come into effect beginning in 2024. Additional details will be released later this year.

The Grocery Rebate To address the increasing cost of living, the budget proposes to enhance the existing GST credit by offering Canadians with low-to-modest incomes a one-time grocery rebate of up to $225 for seniors, $153 per adult and $81 per child. Single adults may be eligible to receive an additional $81 supplement.

Automatic Tax Filing To ensure more low-income Canadians can quickly and easily auto-file their tax returns, Budget 2023 announces the government's plan to increase the number of eligible Canadians for File My Return to two million by 2025.

Corporations

Intergenerational Share Transfers

Budget 2023 proposes to close certain loopholes in Bill C-208 relating to corporate surplus stripping transactions. A surplus strip generally involves disposing of the shares of a corporation to a non-arm's-length (NAL) corporation, resulting in a capital gain rather than the shareholder extracting the value of the first corporation as a dividend. Where the lifetime capital gains exemption can be claimed on the disposition, the shareholder can further reduce or eliminate the tax arising from the transaction.

In 1985, the government instituted an anti-avoidance provision known as Section 84.1 which, where specific criteria are met, recharacterizes the capital gain as a deemed dividend.

The Budget 2023 proposals will require that the purchasing family member (or other NAL entity) continues to be actively engaged on a regular and continuous basis in the business, and that they retain legal control over the corporation for a period not less than 36 months. Additional criteria have been outlined in the budget.

These measures would apply to transactions occurring on or after January 1, 2024.

Budget 2023 can be viewed online in its entirety on the Department of Finance Canada's website[4] and is subject to parliamentary approval.

For more information, please contact your Odlum Brown Investment Advisor or Portfolio Manager.

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[1] Ending March 31, 2023.
[2] For the purpose of opening an FHSA, you will be considered a first-time home buyer if, at any time in the calendar year before the account is opened or at any time in the preceding four calendar years, you did not live in a qualifying home as your principal residence that either you owned, or your spouse or common-law partner owned.
[3] For the full AMT calculation, see CRA Form T691.
[4] https://www.budget.canada.ca/2023/home-accueil-en.html