ODLUM BROWN REPORT

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ODLUM BROWN
Investing for Generations®

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Odlum Brown Limited
Suite 1100 - 250 Howe Street
Vancouver BC V6C 3S9

Main 604 669 1600
Toll Free 1 888 886 3586

Kelowna 250 861 5700
Victoria 250 952 7777
Chilliwack 604 858 2455
Courtenay 250 703 0637
Langley 604 607 7500

Email information@odlumbrown.com

Odlum Brown Limited
Odlum Brown Community
@Odlum_Brown
OdlumBrown

Dealing With Volatility: Treat Your Stocks Like You Treat Your Home

Stocks are struggling this year. As of writing, the major equity benchmarks are down meaningfully, and many individual stocks are down considerably more. Shares of businesses like Zoom, Peloton and Netflix, which did very well in the early stages of the pandemic, have fallen dramatically and are below pre-pandemic levels. More recently, the biggest and most popular technology stocks, including Apple, Amazon, Alphabet and Microsoft, have come under pressure.

The primary reason for the disappointing stock market performance is inflation. It's currently high and out of control because central banks made money too cheap and too easy for too long. To correct that mistake, central banks are on a path of raising interest rates aggressively. Equity valuations are under pressure as investors worry this tighter monetary policy will trigger an economic slowdown and possibly a recession. The war in Ukraine, COVID-19 lockdowns in China, and ongoing supply shortages and logistical challenges caused by the pandemic are also contributing to investor pessimism regarding the outlook.

While it's quite possible that equity markets will correct further in the near term, we are increasingly optimistic regarding the medium and long-term prospects for the stocks we own and recommend.

Central banks are committed to bringing inflation under control. That's a good thing. Although it will cause some economic pain and contribute to unsettled markets in the near term, it will create a much stronger economic foundation for the future. Overly accommodative monetary policies have fueled inequality and asset bubbles in recent decades, and we believe central banks will learn important lessons from the current battle against inflation. Importantly, we believe central banks will be more disciplined and mindful of inflation risks and other unintended consequences of their easy money policies in the future.

A significant amount of speculative froth has been expunged from the market over the past year, and that has rendered investor sentiment extremely negative. That is positive from a contrarian perspective, as markets are known to climb a proverbial wall of worry. The odds of generating attractive returns over a three to five-year horizon are always better when sentiment is negative and valuations are depressed than when investors are optimistic and stock prices are near their highs.

Successful long-term investors understand that enduring periodic episodes of heightened volatility is the price one must pay to achieve the superior longer-term rewards that stocks offer. Those who try to time the market invariably do worse than those who don't. It's time in the market that counts, not timing the market. For many, their home is their most valuable asset. That's usually because they live in it and own it for a long period of time. Homeowners don't typically consider selling and renting when risks of a recession are in the headlines, or when house prices decline. Portfolios would be better off if people treated their stocks the same way.

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> **“For many, their home is their most valuable asset. That’s usually because they live in it and own it for a long period of time. Homeowners don’t typically consider selling and renting when risks of a recession are in the headlines, or when house prices decline. Portfolios would be better off if people treated their stocks the same way.”**

As human beings, we are not emotionally wired to do well in assets that can be easily bought and sold. We typically want to buy more shares when the outlook is bright and prices are high. Similarly, we are inclined to sell when the outlook deteriorates and prices fall. Letting those emotions dictate our behaviours is a formula for disappointment over time.

Still, it’s tempting to think one can trade in and out of investments at the highs and lows in anticipation of economic and market cycles. To time the market well, one has to get two things right: when to sell and when to buy back in, and that exercise is fraught with risk. A mistake isn’t just costly at the time that it is made; it compounds over time. For instance, money sitting on the sidelines doesn’t earn interest, dividends and capital gains each and every year for the rest of your life. Investors sometimes forget that, which is why those who don’t try to time the market tend to do better than those who do.

Another thing that weighs on investors’ emotions during turbulent times is individual stock mistakes, those stocks that get absolutely pummeled. There hasn’t been a period in Odlum Brown’s history where we haven’t made such mistakes, and this cycle is no different. Mistakes are inevitable, and they are part of the reality of investing in equities. Even the legendary Warren Buffett has a track record of mistakes. One of the keys to being a successful investor is to appreciate that the world doesn’t always unfold as expected. It’s important to move on when an investment thesis is broken and reallocate funds to more promising opportunities. At the end of the day, it’s the batting average that matters. The goal is for the gains on the winners to more than adequately offset losses from the stocks that disappoint. The Odlum Brown Model Portfolio[1] had its best year ever in 2000 with a return of 44%. That same year, nearly a third of our investments experienced a decline in value. While we always strive for perfection, it’s simply not realistic to participate in the upside stocks offer without being exposed to downside risk and occasional mistakes.

We own and recommend a collection of high-quality businesses that are well positioned to survive tougher economic times and thrive in the long term. Valuations have retreated to the point where we believe the odds are excellent that we will achieve favourable returns in both absolute and relative terms over a three to five-year horizon. Our advice is to sit tight and treat your stocks like you do your home.

MURRAY LEITH, CFA
Executive Vice President and Director, Investment Research
@murrayleith

[1] 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.

Odlum Brown Model Portfolio

COMPOUND ANNUAL RETURNS* (Including reinvested dividends, as of May 15, 2022)

	YTD	1 YEAR	3 YEAR	5 YEAR	10 YEAR	20 YEAR	INCEPTION**
Odlum Brown Model Portfolio	-5.2%	12.3%	11.6%	8.9%	13.5%	11.1%	14.2%
S&P/TSX Total Return Index	-4.4%	6.6%	10.4%	8.4%	9.1%	7.8%	8.6%
S&P 500 Total Return Index ($CDN)	-13.2%	4.3%	12.6%	11.7%	16.8%	7.9%	10.1%

* Except for YTD period. ** December 15, 1994.

The drawdown in global equities this year has impacted the Odlum Brown Model Portfolio, although we are thus far weathering the storm relatively well. As of mid-May, the Model was down 5.2% year to date versus losses of 4.4% and 13.2% for the respective Canadian and U.S. equity benchmarks. Over the last 12 months, the Model’s gain of 12.3% compares quite favourably to the 6.6% return from the S&P/TSX Total Return Index and the 4.3% advance in the S&P 500 Total Return Index ($CDN).

While we have experienced stomach-turning losses on several stocks, including Netflix, LendingTree and Vertiv Holdings, our general focus on quality businesses trading at reasonable prices has kept us out of some of the hardest-hit areas of the market. Diversification in the cyclical Energy and Materials sectors and defensive

Utilities, Consumer Staples, Communication Services and Health Care sectors has also helped buoy results. Over the last year, Canadian Natural Resources, Tourmaline Oil Corporation and Cenovus Energy have produced total returns, including dividends, of 97%, 162% and 169%, respectively. Those impressive results came after a devastating multi-year bear market for traditional energy businesses and highlight the benefit of both diversification and patience.

The U.S. market has performed worse than the Canadian market, largely because it is geared more to growth-type stocks, which are proving to be the most sensitive to the increase in inflation and interest rates. Not only does the Model have considerably less exposure to those types of stocks than the S&P 500 Index, but our overall U.S. exposure has declined to 43% from 50% at the beginning of the year.

Given the heightened level of uncertainty and wide range of possible economic outcomes, we believe diversification is essential. As such, we own many high-quality businesses operating in a broad cross-section of industries and geographies. They likely won't all move up and down in unison, and that is by design. Our goal, as always, is to do better than our benchmarks in the long run by losing less during the tough times.

MURRAY LEITH, CFA
Executive Vice President and Director, Investment Research
@murrayleith

The Principal Residence Exemption

The Principal Residence Exemption (PRE) can be the most valuable tax exemption available to Canadian residents, given the dramatic recent increase in property values.

What are the criteria?

For a principal residence (PR) to be eligible for the PRE, the following must be met:

- The taxpayer must have been a resident of Canada for tax purposes during the years the PRE is being claimed;
- The taxpayer, or specific types of trusts where the taxpayer is a beneficiary, owns the property;
- The property is a house, apartment/condo, cottage, trailer or houseboat;
- The property was ***ordinarily inhabited*** in the year by the taxpayer, their spouse or their children.

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Thunderbird Show Park Langley, BC

Odlum Brown is thrilled to return as the Investment Management Partner of Thunderbird Show Park for the 2022 show season. Thunderbird Show Park is one of North America's top horse show facilities.

We are proud to be the Title Sponsor of the Odlum Brown BC Open week of competition, which includes the prestigious Longines FEI Jumping Nations Cup™ on June 5.

On July 10, we look forward to being back at this incredible venue for the $20,000 Odlum Brown Grand Prix.

For more information, visit tbird.ca.

Ordinarily inhabited is not defined by tax law, but the courts have allowed relatively short periods of time to qualify, so long as there is some regularity to it. Furthermore, the property does not have to be located in Canada to qualify, and you may treat a rented-out property as your principal residence if you live in it before or after it is rented and meet other criteria.

Since 1982, the PRE is limited to one property at a time per family unit, while taxpayers could designate different properties to each claim a PRE before 1982. The PRE is calculated as: **[(1 + # of years as a PR) ÷ # of years owned] x The capital gain.** In essence, the calculation ensures that a single property's gain can be fully exempt from tax where the required criteria have been met. The '1+' in the calculation also allows a property to be covered for one extra year when there is overlap with another eligible property. Note that the 1+ is not available if the taxpayer was a non-resident of Canada in the year of purchase.

What is reported to the CRA?

Previously, where the capital gain was entirely covered by the PRE, taxpayers were not required to report the sale on a tax return. However, for dispositions after 2016, taxpayers are now required to report the sale on Schedule 3 of their T1 personal tax return, and to designate the property as a PR on form T2091.

What if I own two eligible properties?

A taxpayer can only claim one exemption for any given year, but can choose which property to claim for each year. For example, let's assume a taxpayer owned two properties, one in Vancouver and one in Whistler. The Vancouver property has been owned for 10 years with an unrealized gain of $1,500,000, while the Whistler property has been owned for 15 years with an unrealized gain of $750,000. The taxpayer dies (with no spouse) while holding both properties, and, under our income tax rules, is deemed to have disposed of the assets at fair market value at the date of death, in this case giving rise to capital gains. Their will leaves both properties to their adult children and empowers their executor to decide how to claim the PRE.

The executor will generally want to first select the property with the highest average gain per year. The average gain per year is $150,000 on the Vancouver property and $50,000 per year on Whistler. To maximize the value of the PRE, the executor should designate the Vancouver property for nine years (claiming a PRE for 10 years, due to the 1+ in the formula) and Whistler for six years (claiming a PRE for seven years due to the 1+). This would fully exempt the Vancouver property gain and would exempt $350,000 of the Whistler property gain. Assuming that 50% of the remaining $400,000 capital gain on the Whistler property is taxable at a marginal tax rate of 53.5% (BC's highest rate, as of writing), the resulting taxes payable would be approximately $107,000.

Where one property is sold in advance of another, the taxpayer will need to determine whether it is more beneficial to claim the PRE on the property recently sold, or to retain the exemption, in part or in full, for the future disposition (deemed or otherwise) of the second property. The impact that immediate taxation may have on their financial wellbeing and long-term family plans for the remaining property should be considered.

Planning ahead, for a large tax bill

If you will owe taxes on a property that will be sold before or upon your death, these can generally be covered from the sale proceeds. However, if your estate will owe taxes, it may not have sufficient liquidity to pay these when due, despite best intentions to sell the property or keep it in the family. In next month's *Odlum Brown Report,* we will discuss planning strategies for transferring property, such as recreational homes, to the next generation.

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

RICHARD MYERS CPA, CA, CFP®
Tax and Estate Planner
Odlum Brown Financial Services Limited

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