ODLUM BROWN REPORT

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ODLUM BROWN
Investing for Generations®

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Envy, Interest Rates and the Magnificent Seven

For the year through to August 15, 2023, the Odlum Brown Model Portfolio* appreciated 6.8%. While that was better than the 4.8% gain in the Canadian S&P/TSX Total Return Index, it was considerably less than the 16.4% advance in the S&P 500 Total Return Index. Understandably, investors are envious and wish we had more exposure to the American market.

U.S. stocks have performed exceptionally well this year, yet it is important to appreciate that the impressive showing followed a very poor result in 2022, when that market was down 12.4%. Since the end of 2021, U.S. stocks are up 1.9%. Over the same period, Canadian stocks declined 1.3% and our Model rose 2.0%.

OB MODEL PORTFOLIO – A SMOOTHER RIDE

Total Returns ($CDN)	2022	YTD 2023[1]	Since 2021[1]
OB Model Portfolio	-4.6%	6.8%	2.0%
S&P/TSX Index	-5.8%	4.8%	-1.3%
S&P 500 Index	-12.4%	16.4%	1.9%
Magnificent Seven Average	-42.3%	88.4%	3.0%
Nvidia	-46.8%	199.8%	59.5%
Apple	-21.3%	36.7%	7.6%
Microsoft	-23.0%	34.4%	3.5%
Alphabet	-34.4%	46.3%	-4.0%
Meta	-61.7%	150.1%	-4.3%
Amazon	-46.1%	63.3%	-12.0%
Tesla	-62.6%	88.5%	-29.5%

[1] As at August 15, 2023

This year's surge in the S&P 500 has been driven by a relatively small group of very large stocks popularly referred to as the "Magnificent Seven": Nvidia, Apple, Microsoft, Alphabet, Meta, Amazon and Tesla. Collectively, these seven companies account for roughly 30% of the index, and on average they produced a

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total return (in Canadian dollars) of 88% for the year through to mid-August. While that's remarkable, the same stocks were among the heaviest burdens on the benchmark last year, losing an average of 42%. Since the end of 2021, the Magnificent Seven have generated an average Canadian dollar total return of just 3%.

The foregoing figure might seem incorrect given that the percentage recovery in 2023 is so much bigger than the percentage loss in 2022, but that's the way the math works: it takes a 100% gain to recover from a 50% loss.

What's noteworthy about the Magnificent Seven's impressive rally is that it happened despite central banks tightening monetary policy more than expected and bond yields rising further than feared. Higher interest rates typically put downward pressure on stock multiples because investors use higher discount rates in their valuation models. Moreover, high-growth businesses like the Magnificent Seven are theoretically more sensitive to changes in interest rates because they are expected to produce greater earnings further into the future than slower-growth firms. Theory and reality have clearly diverged in 2023.

It's never a simple story, and there are plenty of plot twists to consider. Lots of other factors influence stock prices. Things like the economic outlook, technological developments and investor sentiment also play a role.

Despite widespread fears of recession, the dreaded economic slowdown has not transpired. The global and North American economies have remained resilient despite the bite from higher interest rates, and inflation has moderated meaningfully. That's a "Goldilocks" scenario, and shareholders have celebrated accordingly. With a more constructive outlook for the economy and corporate profits, it's understandable that investors have bid stock prices higher.

The impressive developments in Artificial Intelligence (AI) have no doubt added to the optimism, too. Most pundits believe the Magnificent Seven will benefit from the exciting technology, and we agree.

We took a closer look at the evolution of consensus 2024 earnings per share (EPS) estimates for the Magnificent Seven to see if the optimism toward the economy and AI had translated into brighter forecasts. While there was significant improvement in the outlook for Nvidia and Meta this year, estimates are generally down from where they were at the end of 2021. On average, they fell 13% in 2022 and rose 18% in 2023, which nets out to a 4% decline over both periods. Exclude the extraordinary 63% increase in the 2024 EPS expectation for Nvidia over the full period, and the average decline is 15%, with estimates for Amazon, Meta, Alphabet and Microsoft, in particular, down significantly.

As is often the case, valuation multiples contracted and expanded in sync with the trends in earnings estimates, magnifying the losses in 2022 and augmenting the gains in 2023. Today, four of the seven are more expensive from a price-to-earnings (P/E) perspective than they were at the start of 2022. Nvidia and Tesla had the highest multiples, and those metrics have declined modestly, while Apple's valuation is roughly the same.

Improved investor sentiment has clearly been an important tailwind for the Magnificent Seven, but we don't consider it a case of hype trumping substance. The popular moniker is not hollow; the seven companies are truly magnificent businesses with deep competitive advantages, tremendous profitability and ample growth potential. Most of the time, great businesses are great stocks. The caveat is that too high a price can render even a fantastic business a poor investment. That was the case with technology stocks around the turn of the century. From its peak in 2000 to its low in 2002, the S&P 500 Information Technology subindex dropped more than 80% and didn't recover until 2017.

In 2000, we had strong conviction that the euphoria toward technology stocks was misplaced. Valuations were sky high and untethered from business fundamentals. That's not the case today.

On balance, the valuations of the Magnificent Seven seem reasonable relative to their profitability and growth prospects. One way to support this view is to consider the PEG ratio, a valuation metric for determining the trade-off between the stock price, EPS and the company's expected growth rate. For each company, we calculated the P/E based on consensus EPS estimates for the next fiscal year, the expected two-year compound annual growth in EPS, and the ratio between the two figures (PEG = P/E divided by growth rate).

With an average P/E of 29x and growth rate of 23%, the group's PEG ratio is 1.3x. That is reasonable relative to other growth stocks and is far from the levels technology stocks reached in the late 1990s and early 2000s. It doesn't guarantee pleasant returns, as changes in interest rates, the economic outlook, earnings expectations and investor sentiment could undermine performance, but it does moderate the downside risk.

We own four of the Magnificent Seven in the Model: Apple, Microsoft, Alphabet and Amazon, and we are glad we do. Owning them has contributed to this year's gains. But because our weightings in these gems are less than the benchmark, our Model has not kept pace with the U.S. market this year. For the same reason, our results didn't suffer nearly as much last year. Being more diversified than the benchmark has helped reduce the volatility of our portfolio. We also believe the posture will help us achieve market-beating performance over the long term and cushion the downside during the inevitable market drawdowns.

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* The Odlum Brown Model Portfolio was established on December 15, 1994, with a hypothetical investment of $250,000. The Model provides a basis with which to measure the quality of our advice. It also facilitates an understanding of how we believe individual security recommendations could be used within the context of a client portfolio. 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.

Easter Seals Drop Zone
September 2023
Various locations

We are proud to continue our support of Easter Seals BC/Yukon as the Presenting Sponsor of their Vancouver Drop Zone event and a Sponsor of the Surrey and Victoria Drop Zones. This year, brave Odlum Brown team members in these three locations will come together and rappel down skyscrapers in support of two essential services provided by Easter Seals BC/Yukon: Easter Seals House and Easter Seals Camp.

Easter Seals House in Vancouver provides a home away from home for adults and families travelling to Vancouver for medical appointments. Easter Seals camps range from virtual to week-long overnight camps, available in three locations, for all children and adults with disabilities aged 6-49 years old.

For event details, visit **dropzonebc.ca.** For more on Easter Seals BC/Yukon, visit **eastersealsbcy.ca.**

The Perils of Joint Ownership

Often cited reasons for registering property[1] in joint names include wanting to avoid probate,[2] expediting asset distribution following death and easing account administration. Unfortunately, many "do-it-yourself" estate plans fail to achieve these objectives and may introduce additional pitfalls, particularly when owning property jointly with someone other than a spouse or common-law partner.

Forms of joint ownership

There are two typical forms of joint ownership: joint tenants with right of survivorship (JTWROS) and tenants in common (TIC). [3] Unless stated otherwise, all references to joint ownership in this article refer to JTWROS.

Risks of joint ownership

1) Loss of control

The new joint owner of a bank or non-registered investment account could withdraw funds without the original owner's consent. On the other hand, decisions regarding jointly held real estate must be made jointly, requiring the cooperation of all owners.

2) Exposure to creditors

Jointly held property is exposed to current and future personal and business creditors of all joint owners.

3) Exposure upon relationship breakdown

Jointly held property with an adult child may be exposed to claims by the child's partner in the event of a relationship breakdown.

4) Family conflict

When only one of multiple children becomes a joint owner with a parent, there is potential for conflict and dispute among siblings over the parent's intentions following their death. Did the parent intend to gift the property to one child to the exclusion of the others, or was the one child meant to simply hold the property in trust for their siblings? What happens if the surviving joint owner does not honour a promise to distribute the asset in accordance with their parent's wishes? What if they die or become incapacitated before the distribution?

5) Accelerated tax consequences

The Income Tax Act allows property to be rolled over to a spouse on a tax-free basis (at cost). However, gifts and transfers of beneficial ownership[4] to a person other than a spouse are deemed to be at fair market value, triggering any unrealized capital gains to be taxable at that time.

6) Potential ineffectiveness in avoiding probate

There is a risk that some "do-it-yourself" estate plans that rely on joint ownership with an adult child to avoid probate not only expose jointly owned assets to the risks identified above but may not even avoid probate. This may arise from the inherent contradiction in having the parent retain the full rights and benefits of ownership without reporting capital gains at the time of transfer to joint ownership, while contending that a change in beneficial ownership[4] took place for the purpose of excluding the asset from probate.

Consult professionals and document intentions

At the heart of many family disputes and litigation is the issue of whether adding a joint owner presumes (1) an immediate gift with a right to control plus a right of survivorship, (2) a temporary trust arrangement without right of survivorship or beneficial interest, or (3) a gift of the right of survivorship with no other rights.

Before transferring assets into joint name, carefully consider your intentions – what are you trying to accomplish? Reducing or eliminating probate is a legitimate objective, and holding assets jointly may accomplish this. But as with any planning, consider the costs (risks) and benefits (savings) of this strategy and whether any alternative strategies may better meet your needs.

The Supreme Court of Canada has ruled in differing ways based on the facts and evidence specific to each situation. When registering an asset jointly (particularly with someone other than a spouse), it is essential to clearly document your intention, which may, for example, be formalized with a "deed of gift" or "bare trust agreement." As such, legal and tax advice should be sought prior to transferring an asset into joint ownership.

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Consider new trust reporting rules

For taxation years ending on or after December 31, 2023, a far wider range of trusts, including **bare trusts,** will be required to file a tax return and report additional information about their stakeholders to the Canada Revenue Agency (CRA). The deadline for filing a trust return is 90 days after the taxation year-end. For more information, ask for our article, "New Trust Reporting Requirements."

Weigh alternative strategies

Given the many risks of holding property as JTWROS with someone other than a spouse, it is useful to start by critically considering your main objectives and then deciding which tools or strategies best meet your needs. Below is a summary of five commonly used strategies to not only avoid or reduce probate fees, but also address other estate planning objectives.

Strategy / Objective	1 Give gifts during your lifetime	2 Name beneficiaries	3 Use two wills	4 Use a power of attorney	5 Use a trust
Avoid probate fees	✓	✓	✓		✓
Keep assets and affairs private – out of public record	✓	✓	✓		✓
Plan for lack of capacity				✓	✓
Support children from a previous marriage	✓	✓			✓
Exclude potential beneficiaries from your estate	✓	✓			✓
Control distribution of assets from "beyond the grave"					✓

Conclusion

Holding property jointly with a spouse is often a very practical strategy with respect to continuous access by both spouses and in avoiding probate fees upon the death of the first spouse. Introducing an adult child as a joint owner invites additional risk and may accelerate capital gains tax. Legal and tax advice should be sought prior to transferring an asset into joint ownership.

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[1] The term "property" includes personal property such as a bank or investment account as well as real property (real estate). The terms "property" and "asset" are used synonymously throughout this article.

[2] Probate is an estate-settlement process for which fees are charged. It involves having a provincial probate court: confirm that a will is the deceased's final and valid will; confirm who will function as executor(s); and acknowledge what assets are passing through the estate. Executors must swear an affidavit that they have reported all the deceased's assets in the probate application. While probate isn't necessary to settle every estate, often third parties such as financial institutions and land title offices require proof of a grant of probate before they will allow money or property to be transferred out of the deceased's name. To provide probate services, courts charge fees. BC's probate fees are based on the gross value of all estate property and are on average 1.4% of the probatable estate's value. However, not all assets owned by the deceased are subject to probate: for example, accounts and life insurance policies with valid beneficiary designations could pass without being included in the probated estate.

[3] Under Joint Tenancy with Right of Survivorship (JTWROS), each owner has an undivided interest in the property with identical interests and equal rights to the whole property. Depending on the original owner's intent and relationship with the new owner, the deceased co-owner's share may pass directly to the surviving co-owners, bypassing the deceased's estate and without reference to their will. With Tenants in Common, co-owners have a divided interest in the property and may hold different shares. There is no right of survivorship, and each co-owner's share forms part of their estate and is distributed per their respective wills (or provincial intestacy rules where the deceased has no valid will).

[4] Legal and beneficial ownership may be the same but can also be held separately. **Legal ownership:** The legal owner may have property registered in their name (title) but held in trust for a different true owner. Legal ownership on its own has no real value or rights. **Beneficial ownership:** The beneficial owner is the real owner of the property and is the one who can ultimately exercise the rights of ownership on the property. If **legal title** to an asset is transferred into joint names from "A" to "A and B" but **beneficial ownership** stays with A, and on A's death probate is required, the value of the jointly registered asset must be disclosed on the probate application. The distinction between legal and beneficial ownership is also relevant in determining income tax implications, as it is a change in beneficial ownership (not merely legal title) between parties other than spouses that gives rise to a deemed disposition and may result in capital gains or losses.