The Rational Reminder Podcast episode 50 : Tax Tales: Considering The Tax Implications Of Asset Allocation ETFs

[INTRODUCTION]

[0:00:05.8] Benjamin Felix: This is the Rational Reminder Podcast, a weekly reality check on sensible investing and financial decision-making for Canadians. We are hosted by me, Benjamin Felix and Cameron Passmore.

[0:00:15.2] Cameron Passmore: Episode 50. Two more to our one-year anniversary.

[0:00:19.2] BF: Wow, yeah. Wow. I didn't even realize that it's been going that long. That's neat.

[0:00:24.8] CP: Yeah. Some very interesting topics this week, perhaps a little more technical than usual, but still, I think they're high-value discussions.

[0:00:32.7] BF: I don't know if I'd say more technical than usual. We get pretty technical a lot of the time.

[0:00:36.7] CP: I keep trying to make us less technical and you keep making the case. We should be more technical, so be it. I thought there were great topics, interesting. Talked about disability insurance as well, in addition to our portfolio topics.

[0:00:48.9] BF: Yup, that's it. It was a fun episode. Good conversation. We hope that you enjoy it. I know I always say this; I hope you won't get tired of it; we keep getting more and more new listeners. Every new episode has more first-day downloads than the previous record for first-day downloads, which I think is an indicator of more people listening to the podcast.

[0:01:10.7] CP: Lining up great guests, which is getting easier with better numbers, so –

[0:01:14.3] BF: That is true too.

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[0:01:14.7] CP: - we're getting great people coming on, some great guests lined up right through Labor Day. Love getting listener questions.

[0:01:22.2] BF: Yup. Keep interacting. Thanks.

[EPISODE]

[0:01:31.2] BF: Welcome to episode 50 of The Rational Reminder Podcast. Just Cameron and I today, as usual every other episode.

[0:01:38.8] CP: We do have some great guests coming up.

[0:01:40.6] BF: Yeah. We do have some really interesting guests coming up. We're actually going to New York to speak with a handful of people that we think they're going to make for some really good conversations for the podcast.

[0:01:50.3] CP: Yeah. This week you had a question, listener question this week on a topic that is very near and dear to your heart.

[0:01:57.2] BF: Yeah. We did get a listener question. I know that Justin's been getting questions about it too, because he just wrote a blog post about the same question, so it seems like it's coming up a lot. We figured it's worth discussing it on the podcast again. It's really just about the tax efficiency of VGRO, or I mean, any of the asset allocation ETFs from Vanguard and iShares.

[0:02:17.6] CP: Yes. These are the one-decision ETFs. VGRO the AD stock 20 bond, right?

[0:02:21.5] BF: Yup. You buy the one ETF and it gives you the whole portfolio.

[0:02:24.4] CP: 22 basis points of expense automatically balancing.

[0:02:27.0] BF: It's a nice product.

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[0:02:27.9] CP: It's very compelling. The question that's been coming up is on the tax efficiency of those in certain types of accounts. If you're holding for example, VGRO in your taxable account, withholding tax is not going to be so much of an issue, but you start running into this issue of premium bonds, which is something that Justin and Dan have written about for years. What a premium bond means is if you think about a bond, think about a bond that's issued today. Say market yields, or say they're 2%. Bonds are issued with a yield to maturity of 2%. If interest rates fall and market yields are now 1%, the price of our bond that's paying a 2% coupon is going to go up.

[0:03:11.5] BF: It has to. This is key to understand the rest at the point of this segment. Interest rates have a huge impact in the value of those bonds.

[0:03:18.8] CP: On bond prices, right.

[0:03:20.8] BF: The change in the price of the bond is going to be such that the yield to maturity on that higher coupon bond is now going to be the same as market yields. In our example of this 2% coupon bond and the 1% market yields, the price of that bond is going to increase, such that at maturity, because bonds always mature at par. If a bond is issued at $100, it will mature at $100. If you buy a bond for $100, no matter what the price is over the time that you own it, I mean, I think people are generally aware of this. At the end of the term the bond, you get your principal back.

[0:03:57.7] CP: I get my $100 back, but I may have paid $110 for that bond. Meaning, at maturity I have a $10 capital loss.

[0:04:03.9] BF: Here's the thing, if you don't buy the bond at issue, if you don't buy it when it's issued at par, then you're going to usually be buying it at a premium, or a discount, so like you just said. I didn't do the calculation to figure out for my 1%, 2% example, what the price change would have to be. Say it is a $110.

[0:04:19.6] CP: That's suffice to say we've gone through an era of falling interest rates, so there's a ton of premium bonds out there. This is an issue that's widespread right now.

[0:04:28.3] BF: Globally.

[0:04:29.5] CP: Certainly, in the Canadian marketplace, which is –

[0:04:32.0] BF: It’s worst globally. I was looking at the numbers early.

[0:04:33.7] CP: Really?

[0:04:34.5] BF: Yeah. We'll talk about the numbers in a sec. You end up with these expensive bonds that are paying a really high coupon. You're getting a lot of interest income, which maybe seems like a good thing. In a taxable account, it's not so good. Because you've got all this interest and then you've got a capital loss, so that before taxes, your yield to maturity is the same as every other bond.

[0:04:53.9] CP: Has to be.

[0:04:54.7] BF: After taxes, because you're getting all this interest income, you're paying more tax in the interest and then you're getting this capital loss, which could offset capital gains, which helps a bit, but only half of it can offset capital gains. You're not going to net out after-tax with the same return. The way that you can summarize all this is premium bonds are relatively tax-inefficient, compared to –

[0:05:19.4] CP: In a trading account. Again, in an RRSP or TFSA, it's not relevant.

[0:05:23.3] BF: Right, in a taxable account. Anyway, that's been the core of the questions that we've been getting on, should I be holding VGRO in my taxable account because of the premium bond issue? Now VGRO gets its bond exposure from three different ETFs, VB, GV, AB and BBU.

[0:05:44.3] CP: It works well on the podcast.

[0:05:46.2] BF: Why is it funny?

[0:05:47.3] CP: I just find spitting out the acronyms, or the trade symbol is funny.

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[0:05:51.5] BF: Okay. Well, it gets exposure from – bond exposures through three different ETFs.

[0:05:55.2] CP: These are highly diversified.

[0:05:56.8] BF: Very, very diversified, which we'll talk more about in a bit. Between the three ETFs that they're using, you're getting global bond market exposure hedged to Canadian dollars; Canada-US international truly global bond market exposure. You're also getting premium bonds.

Now, the way that you can identify a bond fund that is holding premium bonds is you just look on the website. I checked before we recorded, you go on the Vanguard website and for VBG, sorry to repeat the ticker, you can find the yield to maturity and you can find the coupon.

[0:06:27.3] CP: Right. Yield to maturity is, give me an example of a rate.

[0:06:30.1] BF: The yield to maturity for VBG right now is 0.9%, which is really low.

[0:06:34.7] CP: That's how much yield you buy that – that's the average yield to maturity of the bonds in that portfolio.

[0:06:39.8] BF: Correct.

[0:06:40.8] CP: Made up of interest, as well as any capital gains and loss.

[0:06:46.0] BF: Yeah. Then the average coupon for that same fund is 2.1%.

[0:06:49.6] CP: Wow.

[0:06:50.1] BF: Anytime that you have that – like we're talking about before, any time that you have coupons higher than your yield to maturity, that means that you're holding premium bonds.

[0:06:58.6] CP: I have those coupon payments hit your tax return, because that shows up as income, as interest income, free tax return.

[0:07:05.4] BF: Yup. I mean, funds, they – well, they can't distribute losses, right?

[0:07:10.7] CP: No, they have to use them. I guess, we maybe need to look at the fund level to see how much on capital losses are they carrying forward for future gains, might make them very valuable going forward. We need to look at the balance sheet of the funds, actually.

[0:07:23.0] BF: Then I looked at VAB as well, which is just Canadian Aggregate Bonds. It's got a yield to maturity of 2.3%, average coupon 3.3%.

[0:07:32.0] CP: You have enough capital loss to pull out 3.3 down to the expected return.

[0:07:35.3] BF: Yup, to the yield to maturity. Exactly.

[0:07:37.0] CP: I think people get that.

[0:07:38.4] BF: That's fine and it is what it is, but there are alternatives, which is why the question of tax efficiency comes up. Obviously, everything is tax-efficient, or not relative to something else. One of the things that you can do is instead of buying VGRO, which has these three fixed income ETFs that hold premium bonds, you could just buy some other equity ETFs, maybe the EQT, the All-Equity Asset Allocation ETF, or maybe some other equity ETFs, whatever you decide to do. Combine that with some other form of fixed income. Those other forms of fixed income might be ZDB, which is the BMO Discount Bond ETF, which the name suggests, instead of holding –

[0:08:17.3] CP: That must be hard to find well.

[0:08:18.8] BF: Well, yeah. You can tell by looking at ZDB, it is hard to find. The way that you can tell that is the fact that it's actually at a premium right now, which I found interesting. The average coupons 2.18 and the yield to maturity is 2.05, so it's much tighter, much, much tighter, but still a bit of a premium.

[0:08:36.3] CP: Still on a discount bond.

[0:08:37.7] BF: Yeah, but way closer than the others. Then the other thing that you notice is that it's got much less holdings. It's got 152 holdings. When you compare that to VAB for example, which is now we're comparing ZDB Canadian bonds to VAB Canadian bonds, but discount bonds versus aggregate bonds, VAB has got 949 holdings. If we're comparing ZDB to VGRO, which has those three different ETFs in there, you've got VAB with 949 holdings, VBG with 7,661.

[0:09:10.4] CP: It's crazy.

[0:09:10.8] BF: VBU with 5,789 holdings.

[0:09:14.1] CP: 14, 15,000 holdings.

[0:09:16.2] BF: It's no comparison, in terms of diversification. I think that the really important figure to understand when we're talking about should you use VGRO, or should you cobble together the asset allocation that you want using a different form of fixed income and equities, I think that the really important data point is the actual amount of relative tax efficiency that you're getting. I looked at VAB and just made up a bond fund that's at par, but has the same yield to maturity as VAB, and just compare what is the after-tax return of the two. You're getting a difference of a little bit more than 20 basis points after tax.

[0:09:54.4] CP: That's the tax drag.

[0:09:55.9] BF: That's the tax drag from the premium bonds, a little bit over 20 basis points. Now we're talking about VGRO, 20% of the portfolio is in fixed income. The tax drag on your portfolio is 4 or 5 basis points on VRO. That's what you're trading off, and we just talked with the diversification.

[0:10:11.9] CP: The auto-rebalancing.

[0:10:13.8] BF: Auto-rebalancing. It goes even deeper than that. I think one of the big things – now to be fair, the premium bond thing has been going on for a long time, but one of the big things that people need to understand with premium bonds is that the bonds can't be premium

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bonds forever. The bond market cannot be at a premium forever. If interest rates stay the same –

[0:10:32.4] CP: Then we have big problems. It can be a perpetual problem.

[0:10:36.6] BF: Well, yeah, sure. If interest rates keep falling, then we're getting to – I mean, I think Germany went into negative interest rate territory at one point. Even if interest rates did the same, premium bonds eventually go away.

[0:10:48.2] CP: It's also the rate of change of interest rates too, right? The change slows, if they get tighter just as bonds mature.

[0:10:56.7] BF: Yup. If rates go up, then bond prices fall; premium bonds stop paying premium bonds. This is a temporary issue. Even if it's going to go on for a while and I don't know how long it will go on for, but it is a temporary issue. Making big changes to a portfolio such as choosing VEQT and ZDB, instead of using VGRO, that's a big decision because you're giving up on auto-rebalancing. For temporary issue, is a – well, it's a decision. I think understanding those decision points is important in that decision.

Then the other interesting points on this, just talking about that trade-offs, we're talking about this 20 basis points spread. Whenever you have a more concentrated portfolio, even if ZDB is still an index, it's still tracking an approximation of the Canadian bond market. Whenever you decrease your holdings, you increase the dispersion of your outcomes.

[0:11:45.3] CP: Chance of the turn being a lot different than what you expected.

[0:11:47.8] BF: Right.

[0:11:48.1] CP: Lower or higher?

[0:11:49.3] BF: It's probably still going to be fine. ZDB has been very close to ZAG.

[0:11:53.1] CP: It is still 152 holdings, which is way more diversified than picking your own bonds, which is what we used to see a lot of.

[0:11:58.9] BF: Right. You would expect some dispersion. Obviously, if the dispersion ends up being – it could be negative or positive. If it does end up being negative, it could out-weigh any tax benefits, but who knows what's going to happen. The fact is you're increasing – you're adding a little bit more uncertainty by decreasing your diversification.

Then the other big one, specifically when we're comparing to VGRO, although XGRO is similar too, because they've got some US fixed income exposure. Vanguard and actually Dimensional too, have done some really good research on currency-hedged global fixed income.

[0:12:29.6] CP: This is so interesting, how you get exposure to different credit markets. When you take the currency out of the equation, you end up with their yield curve being the same as your yield curve.

[0:12:39.6] BF: Where you end up with their yield curve in your currency terms. You end up with a different – a yield curve that's different from yours.

[0:12:46.3] CP: It has the same starting point is what I mean, right?

[0:12:48.7] BF: Correct.

[0:12:49.0] CP: You're able to get exposure, even though let's say interest rates in the other country are much lower, it doesn't matter. It's the yield curve that you're after.

[0:12:55.2] BF: That's right.

[0:12:55.6] CP: Their yield curve without taking on the currency.

[0:12:57.7] BF: Vanguard did a paper that we can link in our notes, titled Going Global With Bonds, The Benefits of a More Global Fixed Income Allocation. It’s actually fascinating. In the paper, they had four charts that showed for US, Canada, UK, euro region of Australia and they showed the sector exposure, in terms of what is the fixed income market made up of, government, corporate securitized. Then they showed within corporate, the different sector exposure within the corporate bonds, then they showed the maturity structure of each bond

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market and the credit qualities of each bond market. They're vastly different, each bond market, which is just fascinating. Because if you just have Canada obviously, you're getting the Canadian bond market and its structure and its sensitivity to interest rates and Canadian inflation and all that stuff.

As soon as you have more bond markets, just like with stocks are adding more diversification. Vanguard made pretty compelling arguments in that paper, in terms of increasing the volatility reduction benefit of bonds. They made some pretty compelling arguments too adding global fixed income, which by definition, you're losing if you just go ZDB. You're gaining tax efficiency, losing diversification.

[0:14:01.3] CP: That's pretty intuitive, right? You want more diversification, more countries, more economies.

[0:14:06.1] BF: The other thing that a lot of people do is instead of using ZDB, they might use GICs in place of fixed income, which can be fine, but it's got also portfolio structure implications. Obviously, the same diversification arguments apply, we're talking about GICs versus VGRO. Now I guess, it's important to point out, GICs are always at par for tax purposes. You can't have a tax inefficient premium GIC.

[0:14:28.9] CP: You do give up some liquidity.

[0:14:30.7] BF: You give up liquidity. I think one of the things that people to understand about GIC is that you still have risk. You don't have principal at risk, but you still have an economic risk. If interest rates go up, your bond fund is immediately buying new bonds issue that are now higher rates. The GIC, you've got to wait until it matures before you can reinvest. There is an economic cost to holding GICs if rates rise, even though you don't see it in your account.

I think the biggest one with GICs, when we're talking about GICs again versus the Vanguard fixed income, is your max getting five-year term exposure. Term is a risk, but it's a price risk, so you would expect a benefit from holding longer maturity bonds over the long-term. Moving toward five-year GICs, or even the latter, which is less, weighted average less in five years, you're ending up with –

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[0:15:19.2] CP: They're also harder to rebalance too, right? Because you can't sell your GIC to rebalance back to equities.

[0:15:23.7] BF: True, but I think a lot of people would do a mix of GICs and bonds.

[0:15:27.5] CP: Yeah, bond funds.

[0:15:29.0] BF: The point is there are these obvious trade-offs between tax efficiency, which you can increase with GICs and ZDB and portfolio structure, which you give up, I think. You're giving up something by using those holding. It's not an obvious – well, if you save tax, you're going to be better off, because you've got a factor in the other trade-offs that are involved in that decision. That was a long digression. It wasn't a digression, it's just a long discussion. My main takeaway is that I'm not worried about the tax efficiency of the fixed income in VGRO.

[0:15:57.2] CP: We once did a survey a long time ago, past clients in the survey what they thought about the tax efficiency of our portfolios. One of the feedback comments was, "I find doing my tax is very quick. I have no issue with the efficiency of getting my tax slips," that we're talking 20 years ago. She or he didn't understand what we're talking about with tax efficiency. A little later joke. Clearly didn't go over well. On a next topic.

[0:16:19.5] BF: It just took me a second to get it. That is funny.

[0:16:21.6] CP: Did the next one come from a listener question? I know it's come up in a few meetings lately.

[0:16:25.6] BF: Not a specific listener question, but it comes up often enough that I thought it was worth talking about.

[0:16:31.7] CP: The question was, can you over diversify? A lot of people when they look at index funds and say, "I'm owning everything. I'm owning the good and the bad. I'd rather take out the bad," as one example. It goes back to what you said in the past discussion around dispersion of outcomes. The more concentrated your portfolio is, the more dispersion you will have for sure, good or bad.

[0:16:52.0] BF: Yeah, the more dispersion you would expect, for sure.

[0:16:55.8] CP: Right. You dug up some papers on this?

[0:16:57.3] BF: Yeah. There are a couple of pretty good papers that they don't exactly address dispersion. That wasn't the purpose of the papers, but they're definitely papers that lend to the discussion. The first one is from Vanguard and it talks about active share. Active share is a metric that came out, I think was 2003 or 2004 when the first paper came out, but it's a measure for how active is a fund. A fund with high-active share would be very different from the index.

[0:17:22.0] CP: Or high conviction fund.

[0:17:24.1] BF: Right. A high-conviction fund would be high-active share, or a high concentration, I guess. When someone says index funds are too diversified, another way of saying what they're saying is you should have more active share in your portfolio. There was one paper that introduced active share as a metric, another paper that suggested it was a good way to find active funds that outperform, and that research, that paper that came out saying active share identifies good active funds, that got smoked by academic and practitioner literature after it came out. That didn't last long.

[0:17:58.5] CP: There's also marketing buzz too around few fund companies in Canada with active share funds.

[0:18:03.2] BF: Right. Yeah, dynamic pumps their high-active share.

[0:18:06.0] CP: Yeah, because of course, you want someone with high conviction in the stocks.

[0:18:08.6] BF: You know what? It's true. Vanguard in their paper, they do point this out. If you're going to go active, you should want high-active share. If you're going to pay the fees for active, you should want someone very different from the index. You don't expect necessarily a better outcome.

[0:18:22.2] CP: You don't want to pay active management fees for an index portfolio for sure.

[0:18:27.1] BF: Right. In Vanguard's paper, they looked at active share as a metric. They used it to identify – well, they measured active share and then compared the returns of high-active share versus low-active share funds. All they found, which is what you'd expect is as active share increases, the dispersion of outcomes increases. Funds with high-active share were more likely to have extremely high, or extremely low returns and low-active share, or well, index funds wouldn't have any.

[0:18:53.6] CP: Which can cause bad behavior.

[0:18:55.6] BF: Well, it can cause bad behavior, but it's also why are you taking on that extra risk of dispersion. If you've got such a wide range of outcomes – if you're investing in order to achieve a goal, you don't want a wider range of outcomes. You want a tighter range around your expected outcome.

[0:19:08.9] CP: Why do you think people find these things so appealing? So many people are looking for alternatives like this.

[0:19:15.7] BF: I think there's an element of what would you call it? The same reason people play lottery? I can't remember what the term is.

[0:19:21.9] CP: Hope?

[0:19:23.6] BF: I'm not sure you could call it that. People want to win big. People don't want to settle to be average. There's probably a lack of familiarity with the data. If people understand the data, then you don't want this because it doesn't have an expected benefit. That's one of the things I took away from the Vanguard paper is that when you increase your concentration, you're increasing your dispersion, but you're not increasing your expected returns. You're probably actually decreasing your expected returns after costs. You've got this higher dispersion of outcomes without any actual expected benefit on average, which I mean, that doesn't help you achieve a goal. You want a tighter dispersion of outcomes.

There's another really good paper from Dimensional. Again, not directly addressing dispersion, but it came at it from a different angle. They looked at a model portfolio that they built, that was tilted towards size, value and profitability. They compared it to an index. MSCI, all country World

Index, I think. They built this global index with a tilt toward size, value and profitability, compared it to a market cap weighted global index.

They found over the period that they were examining, which was 1994 through 2017, they found that the tilted index beat the market. There you go; small cap and value outperformed over that time period. No surprise, we already know that. What they did that was really interesting is they took the 2,637 stocks that were in this tilted index and then they sampled from that to reconstruct sub-portfolios of the securities in that index that had the same risk and return characteristics of the index as a whole. Now you've got this broad index, then you've got a portfolio made out of 50 stocks that has the same risk and expected return as the overall index.

[0:21:02.9] CP: So interesting.

[0:21:03.9] BF: A portfolio of 100 stocks, portfolio of I think they did 50, 200, 500 and 1000 stocks. Each of those portfolios is constructed with different numbers of securities, but constructed with perfect hindsight to have the same risk and return as the index as a whole.

[0:21:18.2] CP: What did they find?

[0:21:19.1] BF: Well, exactly what you'd expect based on where our conversation is going. Each of the sub-portfolios, every time that you decrease the number of securities, you decrease the probability of outperforming the index over the period. Even though they've got the same risk and expected return characteristics, each decrease in the number of securities decrease the probability of getting the expected outcome.

[0:21:42.4] CP: Of capturing that excess premium. Right. The point is you need lots of securities to capture that premium more reliably.

[0:21:49.3] BF: Yeah. They may had mentioned in the paper of the fact that we just don't know where expected returns are going to come from. We don't know which securities the expected returns are going to come from. There's no way to know that. We know there's massive skewness in stock returns.

[0:22:02.5] CP: That's what you'd expect in an efficient market.

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[0:22:05.4] BF: Anyway, I think that that on its own is interesting. Can you over diversify? I think that the answer is if your goal is achieving reliable outcome, like for example saving for retirement, I think you want a reliable outcome for that purpose. If that's your goal, you cannot over diversify. If your goal is to knock it out of the park, or if you want to take that risk of a higher dispersion of outcomes, then yeah, diversification is not a good thing. You're not increasing your expected return by increasing your dispersion. I guess, the reality is in one person's lifetime, increasing dispersion could have a positive or negative outcome. Some people have a positive outcome, they tell everyone about it.

[0:22:44.3] CP: Right. Or they become a mutual fund manager and –

[0:22:46.8] BF: Right.

[0:22:47.7] CP: Okay, planning topic. Disability insurance. This is an article I came across this week. I was actually quite taken by the data. You have disability insurance?

[0:22:57.0] BF: I have our group policy, but then I also have a top-up.

[0:23:00.4] CP: Which is what I have; personal policy, as well as our group plan here. The survey from RBC Insurance found that half of Canadians have no disability insurance coverage, neither through the workplace, nor their own private policy, which I find just staggering. Way more people have group disability that individual plans, that I do not find surprising. It's quite often we meet people, they have no person disability coverage at all. Maybe people just think that well, the system will provide me with some income. That's not necessarily true.

Individual plans, if you get one through insurance company directly that follows you no matter where you work, you can carry it with you. It never is cancelled, unless you cancel it, but it's often more expensive than a group plan.

[0:23:41.4] BF: Oh, it's for sure more expensive and it's harder to get. With a group policy, you sign up and you're in. With an individual plan, it's no joke going through underwriting for disability. They'll exclude any pre-existing conditions. If you hurt your back five years ago, they'll

exclude back injuries for sure. If you have had any hint of mental illness, any depression or anything like that, high probability they won't accept you.

[0:24:09.2] CP: Once they've accepted you, you've got the company on the hook. If you do a claim and often, it's for your own occupation past two years, it could be a lot of money for a long time. If you're paying the premiums, the benefits are tax-free.

Here's some more stats from that. 62% of Canadians have been exposed to someone who has had to take time off due to disability. 43% have had immediate family take time off due to disability. One in seven Canadians are disabled at any given time. They have little survey on their website. I did it. It said that I have a 12% chance of becoming disabled for 90 days or more. The average length of my disability will be 80 months.

[0:24:48.4] BF: Wow.

[0:24:49.3] CP: The question is, have that happened to you, are you able to make ends meet while you're disabled?

[0:24:54.6] BF: Without having, yeah, any disability insurance.

[0:24:57.0] CP: Correct.

[0:24:57.7] BF: I found another stat that a typical 30-year-old has a four times greater chance of becoming disabled than they do of dying before age of 65. Most people are all fired up about getting term life insurance, especially if they have houses and kids and things like that. People don't worry as much about disability. I think when you're looking at disability coverage, because most people do, most people. A lot of people do have group disability. I think that's –

[0:25:22.2] CP: More than half.

[0:25:23.9] BF: Right. That's the reason that I was – yeah, surveyed 1,600 people, I think. However, many people have group disability, that will cause them not to go and get an individual policy, because I think our group disability is done. Even life insurance. I talk to a lot of

people who have a group plan for life insurance and they, “Nah. I've got through work.” Yeah, but –

[0:25:43.7] CP: What if you change your work? The average person now changes their employers, what? More than five times on average, I believe. Every time you change, that insurance goes away.

[0:25:53.2] BF: It’s also not usually sufficient coverage. It might have a few a few $100,000 through work.

[0:25:59.3] CP: You’re young and in typical health. Life insurance is really cheap. This what gets me about disability insurance, which is much more expensive, people will say, “I can't afford that.” Let's think about that statement for a minute. The more you can't afford it, the more you can't not afford to get it.

[0:26:14.4] BF: Yeah, the more you need it.

[0:26:15.4] CP: Because if you go in disability, you're basically cooked.

[0:26:18.2] BF: Yeah. I thought of and dug up a few different things that people should look for. If you have a group plan, these are things that you can be thinking about. You've got to know what percentage of your income is covered. I find, especially that people who have relatively high incomes, a group plan will cap out.

[0:26:33.4] CP: Yeah, unless you've applied for the –

[0:26:35.4] BF: Even then, even then there’s a –

[0:26:36.4] CP: - the added coverage.

[0:26:37.5] BF: Even then, there's a cap in most cases. It's definitely important to know, like you said, Cameron. If there is a way to increase, have you applied for that, which usually cost – well, it will cost more. Even with that, does that cover your expenses? If someone has a young family and high expenses, maybe even with that top-up, it's not going to be enough coverage. In that

case, you would maybe do what I've done and get an individual plan that sits on top of your group plan. Then it's also really important to know who pays the premiums, because if your employer is paying them for you, the benefit that you receive is taxable. If you pay the premiums yourself, the benefit is tax-free. For our group plan at PWL, we pay the premiums ourselves.

Definitely important to know what the waiting period is. Whenever you've got a disability policy, it will – you become disabled and it won't start paying until the end of the waiting period, which is X amount of time [inaudible 0:27:30.4].

[0:27:30.9] CP: The bottom thing is like 90 to 120 days where the price drops a fair amount.

[0:27:36.0] BF: That also means that you as the insured have to have enough savings.

[0:27:39.1] CP: Have to cover off that four-month period.

[0:27:40.5] BF: You got to know what is my waiting period, so that you've got enough savings to cover yourself.

[0:27:44.6] CP: Payments I believe start 30 days after your waiting period is over.

[0:27:47.1] BF: Oh, really?

[0:27:48.0] CP: It's another month on top. If you got a 90-day waiting, you could be repaid at day 120.

[0:27:53.2] BF: Exclusions for pre-existing conditions. I don't think that applies for a group policy, but definitely for individual policies. You would know, when you go through the application process if you have any exclusions, that would be very explicit in the underwriting process. Definitely important to know how long the benefits last.

[0:28:08.8] CP: Personal policies go to age 65.

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[0:28:10.7] BF: A group might be five years, two years till 65? It's something that will vary from plan to plan. I think, probably one of the big ones is how long is the own occ period, the own occupation period.

[0:28:22.3] CP: It's employment that you're reasonably educated and trained for, versus any occupation. Many group plans go to any occupation after two years, regardless of your training. Just to be aware of what coverage you have.

[0:28:33.3] BF: That means you explain what that means to someone who becomes disabled.

[0:28:36.8] CP: We'll take you if you become disabled, and you only have an any occupation policy. After two years, if you can go and get any job, whether you have that job or not, it could be working in retail, or fast food, or something different than what you're trained for. Doesn't matter. It's the end of the coverage. It happens.

[0:28:53.8] BF: It’s almost like it becomes increasingly important, the more specialized your human capital gets, the more technical your career is, the more specialized your work is, the more important it is to have that longer period of own occupation. One of the big ones that I found online, which when I was researching this topic, which I hadn't thought too much about, but it's really interesting is that group plans don't generally pay for partial disability, but an individual plan will. That means if I become partially disabled and I can only work half time, my disability plan would cover the difference in my earnings.

[0:29:25.7] CP: That means the personal plan is incentivizing you to get back to work.

[0:29:29.4] BF: The group plan just wouldn't pay for partial disability, in most cases. That's what I found in my research. Then one of the big ones is that individual plans offer the future purchase option.

[0:29:39.1] CP: Without medical underwriting. Income underwriting.

[0:29:42.0] BF: I did that when I bought my disability policy, I purchased that rider, which means every year I get the option to increase my coverage without medical.

[0:29:50.0] CP: Just have to prove that your income is reflective of the new coverage.

[0:29:53.0] BF: Right, which is super valuable, because if something happened to me, or if I got sick or injured or whatever, I might not be able to qualify for a new disability policy with higher coverage. As long as I keep following along, I'll be able to increase my coverage each year.

[0:30:05.6] CP: I've come across a lot of people in the past few years that have had refund a premium on their disability policies. It's an additional rider; you pay a premium on top of your basic premium, but if you don't make a claim in, I think it's 15 or 25 years, you get all your premiums back.

[0:30:20.4] BF: Yeah. I signed up for that. I think it's every 10 maybe? I can't remember the details.

[0:30:24.9] CP: I've seen some people get back some very significant checks for all their premiums back. Now you're paying for it.

[0:30:29.6] BF: You get half your premiums back; I think for disability.

[0:30:32.1] CP: Was it? I've seen, so maybe it's with critical illness take it all back.

[0:30:34.9] BF: Critical illness will often be a full refund. Anyway, yeah. I think to summarize that planning topic, disability insurance is probably, statistically way more important than life insurance. At least from what we see, most people are probably underinsured. The reason is probably because it's expensive and it's also hard to get, but it's something that's worth considering, even if you have a group plan. Even if you don't consider getting an individual policy, it's probably worth looking into the details of your group plan.

[0:31:02.2] CP: Dig it up and we'll be in a table showing you what percentage of income is covered up to a certain level, and if there's a cap or not. Definitely worth reviewing. Worst advice from last week? Where did you hear this one?

[0:31:11.2] BF: I found it on, I think it was on Motley Fool through Yahoo Finance. I mean, just whatever. Plain little article. Nothing special. It was two big mistakes that people make in their

TFSA. They weren't wrong, but the insight – the information wasn't wrong, but the insights were not something that I agreed with at all. Bad enough that I would call it the worst advice that I heard last week. These are always hard to find. There's not that much terrible advice out there.

[0:31:36.6] CP: I thought it would be easy when we come up with us idea, but it's actually not that easy to do.

[0:31:40.1] BF: Yeah, maybe it's because we're following content that's generally good advice. We need to subscribe to some investment newsletters or something.

[0:31:46.4] CP: The first point they made was that some people are being way too conservative with their TFSAs.

[0:31:51.2] BF: Which isn't wrong.

[0:31:52.5] CP: For many people, that's the last asset you'll ever touch. Arguably, you can make that the most aggressive account you have.

[0:31:57.7] BF: You know what? This is a little bit of a digression. I won't take too long here, but [inaudible 0:32:00.3] would've disagree with this. He would say that your bond should go in your tax-free account. The reason is in your taxable account, you only own part of the volatility. If you're targeting – you shouldn't target a mix between stocks and bonds. That doesn't make any sense. You should target a risk-adjusted return, how much risk you want to take. You should optimize the amount of expected return for that amount of risk.

Based on that framework, putting your equities in your taxable account, you're getting more expected return for less risk, because the government's sharing the risk with you, due to capital losses. Wrap your mind around that one. I'm not there in terms of implementing that or anything, because I don't think that you can treat losses as offsetting volatility, because that assumes perfect replacement for the portfolio when you sell something at a loss.

Anyway, so I we generally do say higher expected returning assets in the TFSA. That part of the article I agreed with. Where it went was you should hold aggressive equities, yeah, I agree, but I

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would say in ETF. The article said – they suggested some high-yielding financial stock, put this in your TFSA. What's the problem when you have individual stocks near TFSA?

[0:33:11.1] CP: Dispersion.

[0:33:12.0] BF: Well dispersion, but also the potential for permanent loss. If you put $63,500 in your TFSA and maxed it out and then buy whatever this financial stock was, I can't remember, and it cuts in half and never comes back, which can happen and does happen, or goes to zero, you've now used up all of your TFSA room and you've got nothing in it.

[0:33:29.3] CP: No loss to take advantage of it.

[0:33:31.0] BF: That's the other side of it. No capital loss.

[0:33:32.6] CP: You can pick the ones that go up a lot, of course you want it in your TFSA.

[0:33:35.3] BF: If you can pick them, for sure. We know what the skewness looks like in stock returns. You're way more likely to lose, way more likely to lose than you are to pick a winner. Anyway, sure take risk in your TFSA, I don't disagree with that, but diversification is important, so you don't give up the TFSA room.

Plus, if you're going to take – we've talked about this before. If you're going to take risk with individual stocks, do it in your taxable account where you get the capital loss and you're not risking your registered account room. That stuff is precious.

[0:34:00.7] CP: You turn the worst advice of the week into a good piece of advice for the week.

[0:34:03.8] BF: Yeah. That's good.

[0:34:04.8] CP: Anything else?

[0:34:05.8] BF: No, that's good for me.

[0:34:06.5] CP: That's a wrap.

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[END]

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