*The Smith Group

SUMMER 2006

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Coping With Volatility

Volatility in today's markets seems more pronounced than ever. In some emerging markets which have been beacons of growth in recent years, abrupt declines of 15 percent or more were recorded in a matter of a few days in May. North American markets also suffered declines, but not as sharp. From a global perspective, Canada is seen as a resource-based economy and we have been the focus of investors' attention worldwide as oil and other resource prices have ratcheted upward.

Indeed, about three-quarters of the S&P/TSX index now reflect resource and financial issues. No doubt a high level of speculative (vs. long-term investment) content has been a driving force. Another reason for increased volatility is near-instant communications. Any shortfall in expected earnings estimates, for example, is met with immediate and severe retribution that often overshoots the mark of what might be reasonable.

Broader participation in market activity today is yet another cause. Relatively new, but influential, entities such as hedge funds and private equity funds often have the shortest of investment time horizons and will turn over substantial portfolios almost instantaneously for any perceived advantage.

Let Diversification Help You.
Fundamental factors suggest that our resource boom may yet have a long way to go. But prudent investors will take a detached view to protect portfolio values. As always, the keys to success will include a commitment to a longer holding period and an emphasis on quality, value, and diversification.

In positive markets, as our favourite stock continues to climb, we can lose sight of the fact that our portfolios may become seriously overweighted in one name. While we may be reluctant to sell down because we will need to pay capital gains taxes, we must keep perspective and ensure our risk exposure is in keeping with our own objectives.

Volatility is a reminder that portfolio growth does not occur at a steady rate. But don't be discouraged by the headlines or the periodic dips in markets that we are bound to see. If your personal investment plan is a sound one, stick to it, manage your portfolio wisely, an let time in the markets be your key to success.

First Conservative Budget

The Federal Budget and Investors

The spring budget of the new minority government was greeted with widespread approval by Canadians, though economists expressed some reservations. Most eye-catching, of course, was the 1 percent reduction in GST, but even this was the source of some grumbling, as experts argued that consumption taxes should not have been the target of cuts.

Apart from this, there were adjustments to many tax items that ensured almost every taxpayer would see at least some benefits. Here are some of the major items that individuals and investors should note:

Dividend Tax Cuts Confirmed — The cut in the tax rate for dividends introduced in November by the former Liberal government was formally confirmed. To refresh your memory, the tax on dividends was to be slashed, in part to make dividend income more competitive with trust income on an after-tax basis.

Dividend income (generally from Canadian corporations paying taxes at normal corporate rates, not the small business rate), will enjoy an enhanced gross-up of 45 percent and a dividend tax credit (DTC) of approximately 19 percent. The exact tax level depends on the provinces to follow suit with matching legislation. Quebec has acted independently, Manitoba and BC have already committed to align their rates with the federal initiative, and other provinces were awaiting formalization of the Ottawa position.

Capital Gains Taxes Removed on Charitable Donations — Where donations are made via appreciated securities to registered charities, capital gains taxes will no longer be payable on disposal of the assets. Previously, the donation was subject to such tax at half normal rates.

The government has estimated the cost of this measure at about $50 million, but judging by media reaction recently, the impact could very well be much higher.

Flow-Through Shares — The mineral exploration tax credit, an incentive available to individual investors through flow-through shares, has been extended until March 2007. (It had previously expired at the end of 2005.) The cost of this measure is estimated at $90 million in fiscal 2006-07.

Corporate Tax Cuts — The budget sets out a plan to reduce the taxes on corporations, thereby improving competitiveness and, hopefully, eventual corporate valuations in the case of large companies. Among these:

- Reduce general federal corporate tax rates to 19 percent from 21 percent by 2010.
- Eliminate federal corporate surtaxes in 2008.
- Eliminate federal corporate capital taxes immediately.
- Extend the small business tax rate of 12 percent to the first $400,000 of income in 2007 (up from the current limit of $300,000), and lower the 12 percent rate to 11 percent by 2009.

Personal Tax Cuts — Several measures were introduced that will have broad impact, but whose effect will depend on personal circumstances:

- The basic income exemption level, below which no federal tax is payable, will increase to $10,000 by January 2009.
- Families receive a new Universal Child Care Benefit of $100 per month for each child under six years of age.
- Scholarship income becomes largely tax-free in most cases.

A number of other measures will have more modest impact since they are based on tax credits. Examples:

- A doubled pension income credit based on $2,000 of eligible pension income (up from $1,000),
- A new textbook credit for secondary school students,
- Transit rider credits, and
- A Canada Employment Credit for employees based on up to $250 of work-related expenses in 2006, and up to $1,000 for 2007.

All actual credits will be calculated based on the lowest personal income tax rate in effect for the year.

Not Mentioned in Dispatches — The first budget of a minority government could not be expected to be all-encompassing. For example, general income tax rates were not reduced at the higher bracket levels, as the previous government had intended, and as this government was apparently considering. There was nothing on deferring capital gains tax where the proceeds are reinvested, a flashy promise late in the election campaign by the Conservatives. Nor was there any mention of tax-prepaid savings plans, favoured by many MPs of all parties.

Perhaps in a future budget.

Please note that comments included throughout this publication are not intended to be a definitive analysis of tax law. The comments contained herein are general in nature and professional advice regarding an individual's particular tax position should be obtained in respect of any person's specific circumstances.

Not Gone – Nor Forgotten

Inflation – Hiding in the Bushes?

One does not need to be a senior citizen to remember the inflation problems of the 1970s — high interest rates (do you recall 19.5 percent CSBs, but also unaffordable mortgages?), out-of-control prices and wage demands, languishing equity markets and more. Also recall draconian measures such as wage and price controls and the National Energy Policy that ensued.

Since that time, central banks such as the Bank of Canada and the U.S. Federal Reserve have set the fight against inflation as one of their primary policy objectives.

Today, it appears inflation remains well contained with Statistics Canada saying the core rate is somewhere north of 2 percent. This "core rate," however, does not include some of the more volatile elements of our goods and services. The most notable example is the high gasoline price, which is not directly reflected in the base inflation number but which is a fact of life for all of us.

It is also curious that economic growth is nominally quite high and employment statistics indicate essentially full employment. In some areas like Alberta, a booming construction industry is putting real pressure on wages in all industrial sectors, as well as on house prices, and more. These can be expected to be reflected sooner or later in higher inflation.

Inflation is a silent killer. If left unchecked, it can destroy the buying power of a currency or retirement income stream and wreak havoc on the incomes and well-being of individuals, corporations, and countries.

Let's hope it remains relatively benign, but investors should be aware that inflation may become of increasing concern as we progress through the market cycle.

Performance Numbers

Understanding Rates of Return

When investors purchase an investment, generally speaking they want to see good performance—over time, a rising stock price and perhaps rising dividends as well, or in the case of a mutual fund, a rising unit value.

A rate of return calculated over time will allow us to compare the performance of competing investments. A return calculated over exactly one year will be an annual return, usually, but not necessarily, for a calendar year.

Over periods of more than a calendar year, the custom is to calculate an annualized return. Thus, we are accustomed to seeing performance quoted as annualized returns over one, three, five, ten and since inception, calculated backwards from say, May 31, 2006. Annualized returns may be easily calculated for periods of less than a year as well, but are not allowed for fund marketing purposes. These numbers can then be used to compare performance among different investments over time.

Volatility is Important

Annualized returns are not the whole story, however. For example, an investment that provides an annual return each year for three years of 7 percent will have an annualized return of 7 percent as well.
But another investment which provides annual returns of 10, -10, and 24 percent per year over the same three years will also have an annualized return of 7 percent.

That is, both investments will arrive at the same final value, but will have taken markedly different routes to get there. Annualized returns, therefore, do not provide any information about the potential volatility of a possible investment. Investors who are concerned with stability will want to look at both numbers when investing. For most clients, a combination of reasonable annualized returns and lower volatility may be preferable. Like the fable of the tortoise and the hare, don't assume that a high-flyer will necessarily be the best long-term performer.

Not Necessarily Simple

Calculating the numbers may not be a simple matter. One of the reasons is that the book value, or adjusted cost base, of an investment can change over time. With mutual funds, most investors choose to reinvest any distributions in additional units. In non-registered accounts, these distributions will be added to the original cost to arrive at a current adjusted cost base. This may result in a capital gain or loss when the investment is eventually sold. The current cost base may be significantly different than the original cost.

Charitable Giving – Post-Budget Comments

The recent federal budget has made it easier than ever to support your favourite registered charity.

The federal government has now determined that donations of appreciated securities to registered charities will not be subject to capital gains tax. This move is likely to spur additional interest in making gifts of securities (rather than cash) to charitable organizations.

If an appreciated asset is donated to charity, a charitable donation credit is generated for the market value of the asset. The federal credit for the first $200 of all donations claimed in the year is set at the lowest marginal rate in effect (i.e. 15.25 percent for 2006). Any excess enjoys a federal credit calculated at the highest marginal rate of 29 percent, regardless of the individual's own top tax rate. Combined with provincial tax, this means an overall effective credit can be almost 46.4 percent in Ontario, as an example.

The net effect is demonstrated in the table below. Clearly, the move is expected to stimulate additional giving through appreciated securities.

Other Tactics

Tax observers have noted several additional possibilities. It is not necessary to dispose of an investment position to benefit. Under existing rules, it appears one could donate any appreciated holding, benefit from the donation credit, and then immediately repurchase the investment on the open market, without tax penalty but resetting the cost base at a higher level.

Flow-Through Shares — Flow-throughs offer a significant immediate tax deduction when purchased. It would appear that these entities will continue to be encouraged as a result of a separate budget announcement.

Typically, a resource flow-through may offer first-year tax write-offs of 90 percent of the amount invested. They must be held for a number of years, after which they are usually converted to a mutual fund along with a substantial capital gains liability. Some tax experts now suggest that those who were intending to make a charitable donation anyway can give any shares they currently own to their charity as above, thus eliminating the capital gains tax liability. Donors benefit from the original write-offs and the donation receipt. Depending on the underlying investments, this could be a profitable manoeuvre.

Community Foundations — These as well as other pooled arrangements will also benefit by encouraging the donation of appreciated assets. A substantial donation today can go on benefiting a number of organizations for many years.

As always, seek professional advice from a tax professional where major expenditures are contemplated or if there is any uncertainty as to the best course of action.

The New Math of Donations

Donating $5,000 in Various Ways

	Selling Securities First Then Giving Cash	Giving Securities Before Budget New Rules	
Pre-tax Gift	$5,000	$5,000	$5,000
Capital Gains Tax*	$928	$464	$0
Donation Credit	$2,275	$2,275	$2,275
Net Donation Cost	$3,653	$3,189	$2,725

* For illustrative purposes, assumes a capital gain of $4,000 and a taxpayer in the top bracket. Assumes a combined federal/provincial tax rate of 46.4%.

Commissions, trailing commissions, management fees and expenses all may be associated with mutual fund investments. Please read the prospectus before investing. Mutual funds are not guaranteed, their values change frequently and past performance may not be repeated.

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