General Corporate — Commentary — Articles — English — Vern Krishna —, 2014-06-026 -- Return on Investment (Vern Krishna)

2014-06-05

Search Details

Search Query: Table of Contents

Delivery Details

Date: January 8, 2019 at 3:15 p.m.
Delivered By: VERN KRISHNA
Client File: GAAR

Corporate Tax Centre - Vern Krishna discusses an investor's rate on equity (RoE) by breaking down four factors: gross return on investment, costs of investment, inflation, and taxes.

Return on Investment (Vern Krishna)
Date: June 5, 2014

By Vern Krishna

The objective of investing is to maximize net rate on equity (ROE) and contain risk within one's risk tolerance. Investors must make their decisions within their particular risk tolerance levels and considerations of age and the need for current income. However, they must keep sharp about others who will want a slice of any investment returns. An investor's ROE is a function of four factors: gross return on investment, costs of investment, inflation, and taxes.

The gross return on investment in stocks has two components: the portion attributable to the stocks sensitivity to general market movements, which is measured by its "beta." A beta of 1, for example, means that the particular stock will move exactly in relation with the market's general movements. The second element is the portion of the stock's performance that reflects the stock picker's luck or skill, also known as the "alpha" component. Thus, the total performance is the sum of its beta and alpha movements.

There are essentially two direct costs that one needs to watch for in evaluating fund or stock returns: management fees, and trading fees. In stock market investments one should consider how much one is willing to pay for the beta and alpha returns on stocks. Since beta is a function of the market and not the stock picker, one should not pay substantial trading fees to earn a beta return. Stock index funds and exchange traded funds, which essentially track the market, no more and no less, typically have low management fees, although the range can vary considerably—anywhere from 0.08 to 0.80 percent. Of course, one must expect to pay management fees in order to earn the alpha return that depends upon the stock manager's skill. The only question here is: how much is too much?

Inflation costs are a drag on stock market returns that substantially erode value over the long run. For example, $1 in 1914 would be equal to $21 in 2014, which reflects and average annual rate of inflation of 3.08 percent over the past 100 years. We may think we are making money, but our purchasing power erodes each year and, hence, our real ROE on investments. However, as individuals, we have little control over inflation, which results from macro economic policies. In a limited sense, we can control inflation by choosing the currency in which we wish to invest, but that is best left to professionals, and there are very few, who understand currency markets.

When coupled with trading costs and inflation, taxes also drag down the real net ROE investments, but here we actually have choices between high and low returns. Canadian tax law does not treat all investments equally.

The first consideration is whether we make our investment in a tax-sheltered vehicle, such as a registered retirement savings plan (RRSP) or a tax-free savings account (TFSA). Although there are differences between these two types of plans, they

 © 2019 Thomson Reuters Canada Limited.

both allow one to defer taxes, which can add up to real savings in the long run. $100 of tax deferral in an RRSP over 25 years at a rate of 5 percent, for example, will grow to a tax saving of about $350, which will be taxable upon withdrawal of the funds. Compounding is the single most powerful force of growth in the long run.

Taxes play an even more important role outside of tax sheltered investment vehicles because they have an immediate impact upon ROE. Canadian tax law has separate and distinct rules for each type of investment, which affect their net returns. There are at least four major categories of investments: interest income (bonds), dividends (Canadian eligible stocks), and capital gains (taxable and exempt).

We tax interest income and foreign dividends at the highest rate. In Ontario, for example, the top marginal rate on interest income is about 50 percent. We tax Canadian source dividends at about 34 percent at the top end, and capital gains at 25 percent. There are various policy and structural reasons for these differences that economists debate at length, but for the average investor the crucial element is the net tax cost of each investment is different and should be taken into consideration in investing.
The following table illustrates the effect of taxes on net ROE. Assuming an average rate of gross return of 7 percent, fees and costs (hidden and explicit) of 2 percent, and inflation of 2 percent, the net ROE on interest, dividends, and capital gains is as follows:

	Interest	**Dividends**	**Capital gains**
Gross return	7.0	7.0	7.0
Fees and costs	2.0	2.0	2.0
Taxes	2.5	1.7	1.3
Net after taxes	2.5	3.3	3.7
Inflation	2.0	2.0	2.0
Net ROE	0.5	1.3	1.7

Thus, the investor’s net return improves considerably as we move from interest income towards dividends, and even more so to capital gains. To be sure, the investor must make these decisions within their particular risk tolerance levels and the need for income. However, one must keep an eye on how much the government will take as its share from the investor’s returns.

Vern Krishna, CM, QC, Tax Counsel, and Professor of Law, University of Ottawa.

vern.krishna@taxchambers.ca

Reproduced with permission.

End of Document © 2019 Thomson Reuters Canada Limited.